RELEVANT FOR JUNE, 2020 SESSION ONWARDS

STUDY MATERIAL

PROFESSIONAL PROGRAMME

BANKING – LAW & PRACTICE

MODULE 3
ELECTIVE PAPER 9.1

THE INSTITUTE OF
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Phones
011-45341000

Fax
011-24626727

Website
www.icsi.edu

E-mail
info@icsi.edu

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PROFESSIONAL PROGRAMME
BANKING – LAW & PRACTICE

In the contemporary perspective, Indian economy is considered as the one of the fastest growing and emerging economies in the world. Contributing to its high growth are many critical sectors including Agriculture, Banking Industry, Capital Market, Money Market, Financial Services and many more. Among all, 'Banking Sector' has unarguably been one of the most distinguished sectors of Indian economy.

Indeed, the development of any country depends on the economic growth, the country achieves over a period of time. This confirms the very fact that the role of financial sector in shaping fortunes for Indian economy has been even more critical, as India since independence has been equally focussed on other channels of growth too along with resilient industrial sector and the domestic savings in the government instruments. This prompted India to majorly depend on sectors for its dynamic progression.

Considering the fact that banking sector plays a significant role in the economic empowerment and global growth of the country, a balanced and vigil regulation on Banking Sector has been always mandated to ensure the transparent run of this sector while avoiding any tantamount of fraud and malpractices injurious to the interest of investors, stakeholders and country as a whole.

Therefore a robust regulatory regime has been established in India along with the presence of Reserve Bank of India to regulate the conduct and day to day affairs of banking sector.

In the phase, where plethora of Laws, Regulations and Rules are the guiding the conduct of Banking Industry towards good governance, the role of Company Secretaries become much vivacious to meet the challenges of a more dynamic business and regulatory environment on one side and to ensure timely compliance on other side.

Considering the role of Company Secretaries in the Banking Sector as well as supporting the idea of all-rounded development of our professional brigade, this subject under the title of Banking Laws and Practice serve a one spot resource of understanding basic features of Banking and Banking Industry along with providing a detailed account of laws and regulation governing the banking industry in the country.

With this objective in mind, a number of procedures have also been included at relevant places.

Besides, as per the Company Secretaries Regulations, 1982, students are expected to conversant with the amendments to the law made up to six months preceding the date of examination.

The legislative changes made upto December, 2019 have been incorporated in the study material. However, on one hand, where the subject of Banking Laws and Practice is inherently fundamental to understand the basics and advanced principles related to Banking Industry and on the similar end it is subject to the refinement of Legislation, Rules and Regulations. Henceforth, it becomes necessary for every student to constantly update with legislative changes made as well as judicial pronouncements rendered from time to time by referring to the Institute's monthly journal 'Chartered Secretary', E-Bulletin 'Student Company Secretary' as well as other legal and professional journals along with the aid of reference books related to the subject.

In the event of any doubt, students may write to the Directorate of Professional Development, Perspective Planning and Studies of the Institute for clarification.

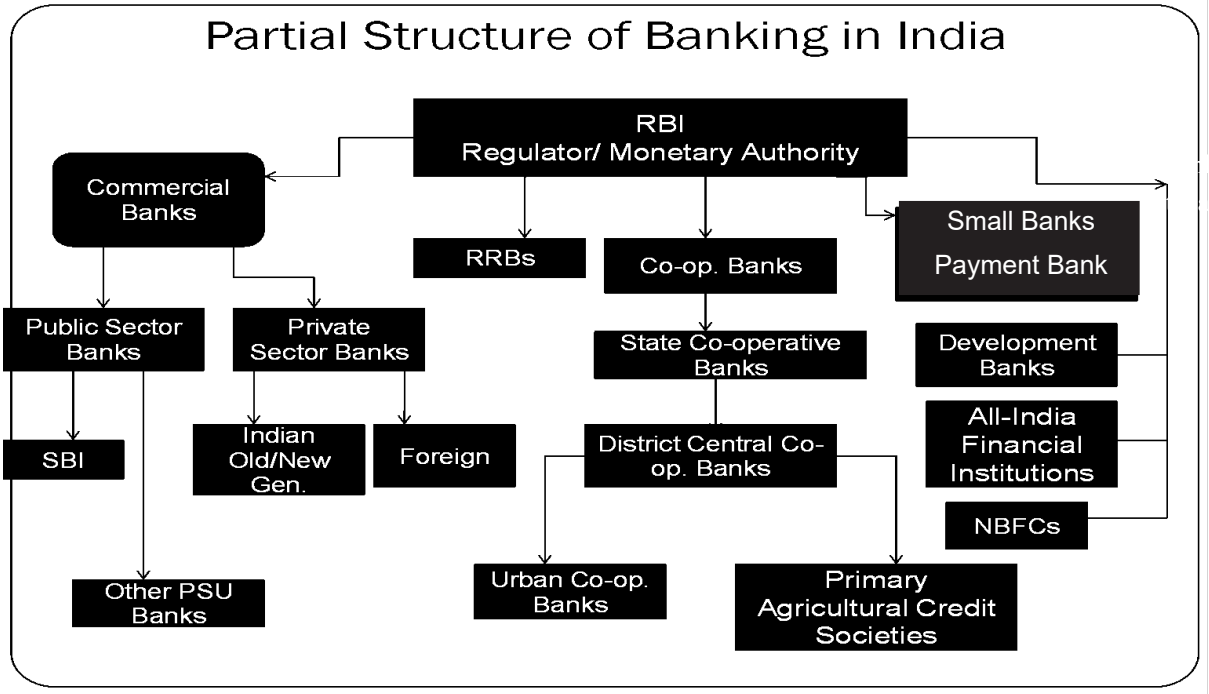
Although due care has been taken in publishing this study material, the possibility of errors, omissions and /or discrepancies cannot be rules out. This publication is released with an understanding that the Institute shall not be responsible for any errors, omissions and /or discrepancies or any action taken in that behalf.

Should there be any discrepancies, errors or omissions noted in the study material, the Institute shall be obliged, if the same is brought to its notice for issue of corrigendum in the e-Bulletin 'Student Company Secretary'.

PROFESSIONAL PROGRAMME – BANKING – LAW & PRACTICE

Banking sector plays a vital role in the development of the economy of a country and day by day the importance of bank is increasing in everybody's daily life. There are various risks like Credit Risk, market risk, operational risk, business risk etc. faced by the Banks. A banking professional working in a bank or providing any service related to the banking sector can reduce the risks associated with bank by gaining appropriate knowledge of banking. A career in banking and finance is one of the most lucrative career options one can choose these days. Changes in the banking environment make it necessary for banking staff to equip themselves with the banking skills and knowledge in the financial sector.

Banks are a subset of the financial services industry. It is a financial institution that provides banking and other financial services to their customers. A bank is generally understood as an institution which provides fundamental banking services such as accepting deposits and providing loans. The banks safeguards the money and valuables and provide loans, credit, and payment services, such as checking accounts, money orders, and cashier's cheques and some banks also offer investment and insurance products. Due to their critical status within the financial system and the economy, banks are subject to stringent regulations.

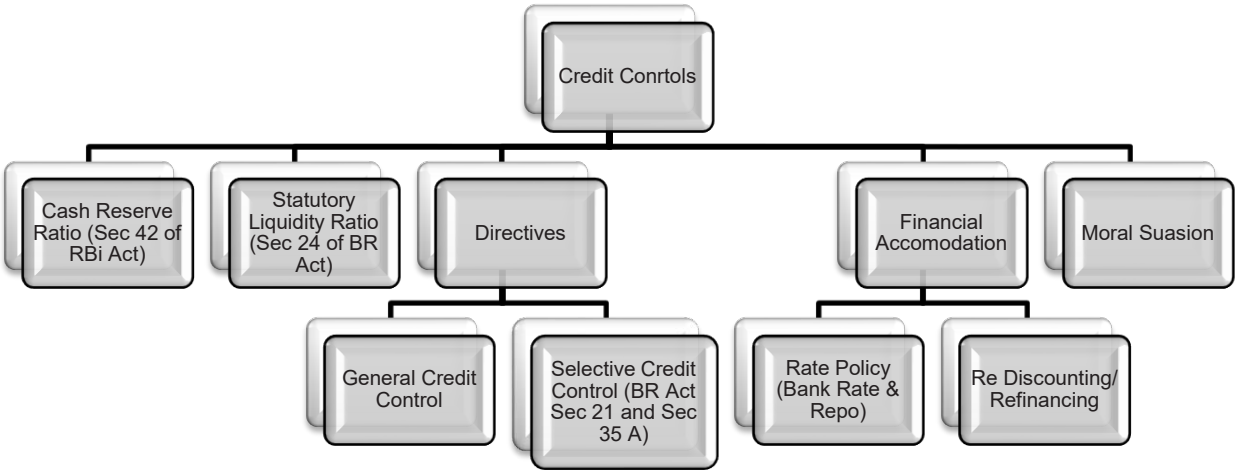


Reserve Bank of India Act, 1934

The RBI Act was enacted with an objective of constituting Reserve Bank of India to regulate issue of bank notes, to keep reserves to ensure monetary stability, to operate currency and credit system.

This Act is the basis for constitution, powers, and functions of RBI. This act does not regulate banking directly though section 18 and 42 of RBI Act are used in regulating credit. In broad sense, RBI Act deals with Incorporation, Capital, Management, Business of RBI itself, Central Banking Functions, Collection and furnishing of information, Regulating Non-Banking Institution receiving deposits and financial institutions, Prohibition of Acceptance of deposits by unincorporated bodies, Regulation of transactions in derivatives, money market instruments, securities etc., Joint mechanism, Monetary Policy, General Provisions, Penalties along with Schedule I and II.

The RBI Act was amended several times in the past to expand the powers of RBI. The last amendment to RBI Act was done in February, 2016 to provide for a Monetary Policy Committee ('MPC'), to maintain price stability under an overall objective of growth. The task of the MPC would be fixing the benchmark policy rate (repo rate) to control and contain inflation within the specified target level. The Committee-based structure is expected to bring in value addition and transparency in this area of policy decisions. MPC will hold meetings at least four times a year and publish the decisions after each such meeting.



Diverse Role of A Company Secretary : The role of Company Secretary in the banking company derives from the nature of assignments performed by him/her in that organization. While it is a statutory requirement to engage/employ on whole-time basis a Company Secretary for the banking company set up under the Companies Act 2013 and having a Banking Licence to carry on banking business under the Banking Regulation Act 1949, the other banking companies irrespective of their nature of corporate entities such as commercial banks, Regional Rural Banks, Non Banking Finance Companies, Development Finance Institutions will be better placed where professionally qualified Company Secretaries are employed in view of their diversified knowledge in legal and related fields.

It is indeed an arduous task for the Board of Directors to see that not only the shareholders, but also the other stakeholders, viz. the customers, suppliers, investors, employees and the society at large, are benefited by the result of excellent management practices, so as to justify the survival and sustenance of the organization. The role of a Company Secretary, being a Principal Officer of the organization, in the banking sector, is crucial, since he acts as a facilitator in the entire corporate management process, to ensure that the corporate entity is run on sound management principles and practices.

The role of the Company Secretary in different management hierarchy, varies from the positions held in the organization and the functions looked after by him/her. Company Secretary's functions encompass a wide spectrum of duties and responsibilities, which, if laid down, would be a never ending list. However, for the sake of brevity and to be precise, some of the important tasks, generally entrusted to a Company Secretary and satisfactorily discharged by him/her in the banking organizations, are enumerated below.

Adherence to Regulatory Guidelines

Company Secretaries in the Banking Companies formed either under the Companies Act 1956 or any other legislation(s) and having Banking Licence from RBI under the Banking Regulation Act 1949, have to discharge onerous responsibility not only to ensure compliance with the various statutory provisions as a Principal Officer, but also to ensure fulfilment of the requirements of various allied Statutes, Rules, Regulations issued by statutory authorities/Govt. agencies including RBI, SEBI, Ministry of Finance/Ministry of Company Affairs, Govt. of India on issues related to the banking sector.

Company Secretaries are in a better position to discharge this responsibility with greater confidence. Company Secretaries also play an important role in the process of conforming to the different statutory/regulatory requirements as prescribed by RBI such as maintaining Statutory Liquidity Ratio, Cash Reserve Ratio, Capital Adequacy etc. Banks are also required to ensure compliance with the lending norms in different sectors/ categories as specified by RBI from time to time. In view of strict banking governance norms, especially to achieve Basel I/II compliance targets, professional services rendered by Company Secretaries, in this regard, deserve due recognition.

Formulation of Corporate Management Policies

Company Secretaries generally take part in the formulation of various corporate policies for approval by the Board of Directors. Threadbare discussions are held by the Corporate Management Team including the Company Secretary, before any policy is firmed up. His/her views on any corporate matters are held in high esteem in the banking sector, in view of diverse knowledge/expertise acquired as a qualified Company Secretary.

Conducting Corporate Meetings

Smooth and systematic conduct of Board/Directors' Committees/shareholders' meetings in conformity with the provisions of the Companies Act, Banking Regulations Act etc. and to comply with all related statutory functions are the inherent functions performed by the Company Secretary. His administrative acumen is reflected in the manner in which all such Corporate Meetings are conducted right from convening such Meetings till their completion.

Active Contributory to Corporate Governance

Practices Company Secretary generally involves himself/herself in the establishment of various corporate governance practices in the organization. In the banking sector also, such role is played by the Company Secretary, who acts as Secretary to the different Directors' Committees constituted to look after various matters, either under the Listing Agreement (Clause 49), or for better management practices. Some of the Committees of Directors in banking organization, where he/she acts as Secretary, are –

- Audit Committee of the Board
- Shareholders'/Investors'/Customers' Grievance Redressal Committee
- Remuneration Committee.
- Shares/Securities Transfer Committee
- Management Committee
- Risk Management Committee
- Fraud Monitoring Committee

Liaison in the Audit Process

Company Secretary also keeps a close liaison with the different departments in the organization to enable the Statutory Auditors to complete the audit process in time, till the Accounts are considered/recommended/approved by the Audit Committee/Board and finally adopted by the shareholders at the Annual General Meeting. He/she also ensures compliance with statutory/regulatory requirements including reporting to the Stock Exchanges (in case of listed banking organization), finalization and submission of quarterly/half-yearly accounts, which are subjected to review by Statutory Auditors.

During the course of such Supplementary Audit by CAG, close co-ordination is required amongst the Corporate Accounts Department, Incharge of Internal Audit Department, Statutory Auditors and the CAG audit team, till

the Supplementary Audit Report is received. Reply to any observation (adverse or otherwise) is to be prepared/ finalized, recommended by the Audit Committee and approved by the Board of Directors and finally adopted by the shareholders at the Annual General Meeting.

Advice to the Board of Directors

To render proper and timely advice to the Board of Directors and other top executives in adhering to the various prudent corporate governance practices, not only as a pre-requisite for the Listing Agreement but also as a systematic development of core ethical standards is within the domain of the Company Secretary's functions. Being assigned with the task of Secretary to the various Directors' Committees in the banking organization, he/she ensures compliance with the various statutory obligations/requirements, which include formulation of Code of Conduct for the Directors and Senior Management Personnel, adherence to the proper internal control systems, etc. In the matter of servicing shareholders' for payment of dividend (including interim dividend), redemption of preference shares, wherever applicable, further issue of shares etc. Company Secretary's advice is generally sought by the Board of Directors/top management to ensure that the relevant laws, rules, regulations, guidelines, if any, are complied with.

Risk Management Functions

In view of the complex nature of the guidelines issued by RBI from time to time in the matter of assessment of various risks involved such as credit risk, interest risk, market risk etc., the professional knowledge of the Company Secretary facilitates evolving appropriate strategy in such matters without jeopardizing the interest of the Banks. Different criteria/systems are developed by the individual banks to assess the nature of risks involved in the bank's dealings on credit management, investment/disinvestment strategy, determining bank's prime lending rates etc. Now-a-days the professional knowledge of the Company Secretaries is also utilized by the Banks in various decision making process.

Formulation of Recovery Policy Another important area where Company Secretary generally renders effective and fruitful services, is to participate in the formulation of appropriate recovery policy for approval by the Board. The functions of Banks including Non-Banking Finance Companies and Development Finance Institutions include lending activities to various sectors/industries and categories of customers, such as individuals, firms, corporate bodies etc. Hence, their recovery policy varies depending upon the category of loan/investment portfolio and quantum of assistance at stake. As is common in banking parlance, Standard/ Performing Assets and Stressed/Non-performing Assets (NPAs) are to be dealt with based on separate strategies/principles and degree of importance. Such strategy differs from Standard to NPAs. Attention/ focus on recovery from Standard Assets is generally drawn/thrust not only to ensure maintenance of quality of assets, but also to arrest slippage of Standard Assets to NPA category. On the other hand, intensive endeavour is made by bank management to initiate appropriate timely recovery steps depending upon the nature of NPA such as substandard, doubtful and loss assets, classified as per the guidelines issued by Reserve Bank of India from time to time.

Recovery policy of the banks also envisages, inter-alia, One Time Settlement for recovery of dues from NPAs through protracted negotiations in the recovery settlements by applying prudent negotiating skills to realize best possible deal for the organization. Company Secretary, when assigned with such tasks of recovery process, along with other assignments, offers suggestions in consultation with the legal executives in the banks for timely action for recovery under the Securitization & Reconstruction of Financial Assets & Enforcement of Security Interest Act, 2002, which has proved to be an effective tool for the bank management to realize dues from Non-performing Assets with greater promptness.

Merger/Acquisition Process

Company Secretary also plays an important role in the process of merger and amalgamation in the Banking sector and/or for any takeover, acquisition of any target/weak bank either as a strategic decision to bail out

any weak bank, as may be advised/permitted by Reserve Bank of India, or as a policy decision to expand the bank's business domain. Armed with adequate professional knowledge/expertise in this field, the role played by the Company Secretary in such tasks, to ensure compliance with the various statutory requirements under the Companies Act, Banking Regulations Act and other allied legislations/Regulations, is quite significant.

In the prevailing global economic scenario, the issues arising out of overseas acquisition/take over etc. in the banking sector, can be effectively dealt with by the Company Secretary. His/her professional skills with legal background and far sightedness in dealing with such matters, helps the top management not only to ensure compliance with different regulatory requirements in the countries involved, but also to strike a better deal for the organization for takeover/merger of any banking company.

Resource Mobilization

Strategy For mobilization of resources by way of shares/Bonds etc., the role played by Company Secretary is of paramount importance. Right from deciding on the nature of resources such as Share Capital, Subordinate Capital/Bonds etc. as per Reserve Bank of India norms upto the actual raising of such capital and during the course of servicing thereof, professional services rendered by the Company Secretary is crucial and widely appreciated/relied upon by the top management.

Compliance Officer

The Company Secretary in the Banking organization, also acts as a Compliance Officer under the Listing Agreement, where the shares/securities of the Banking organization are listed with any Stock Exchange. He/she also advises on various compliance requirements, applicable to the concerned Banking organization and periodically certifies to the appropriate authority(ies).

In the present era of globalization, "survival of the fittest" is the rule of the game and there is an impending danger of weeding out the weak entities unless the organization is run by the management based on sound principles. In this respect, Company Secretary's role in the Banking organization, need not be over emphasized. He/she is the person who generally participates in the key decision making process at various stages besides attending Meetings of the Board of Directors/various Directors' Committees, Corporate Management Team and other various crucial Committees in the top management hierarchy, so as to ensure highest standard of excellence in various activities/functions. Enforcement of corporate governance practices by rules or legislative measures only may not yield a desired result unless there is a key man behind the scene in achieving this task, which is best performed by the Company Secretary. The expertise of the Company Secretary in the banking industry can be best utilized by the top management with a view to ensure enhancement of the value of the company to the stakeholders viz. customers, borrowers, lenders, suppliers, Government and public at large, which is ultimately reflected in the Annual Report, generally drafted by the Company Secretary, in association with other key executives in the organization and ultimately approved by the Board of Directors and adopted by the shareholders. It is expected that a time will come when there may be legal necessity to have a professional Company Secretary in place for all such banking organizations, with a view to ensure satisfying standard of governance.

PROFESSIONAL PROGRAMME
MODULE 3
ELECTIVE PAPER 9.1
BANKING – LAW & PRACTICE (MAX MARKS 100)

Objective

To develop a robust knowledge base pertaining to significant facets of Banking Sector among those students who wish to pursue a career in Banking Sector.

SYLLABUS

1. **Overview of Indian Banking System** : Indian Banking System – Evolution; RBI and its role; Structure of Banks in India; Commercial Banks; Co-operative Banking System; Development Banks; NBFCs.
2. **Regulatory Framework of Banks** : Constitution, Objectives, Functions & powers of RBI; Tools of Monetary Control; Regulatory Restrictions on Lending; Business of Banking; Constitution of Banks; RBI Act, 1934; Banking Regulation Act, 1949; Role of RBI; Govt. as a Regulator of Banks; Control over Co-operative Banks; Regulation by other Authorities.
3. **Control over Organization of Banks** : Licensing of Banking Companies; Branch Licensing; Paid up Capital and Reserves; Shareholding in Banking Companies; Subsidiaries of Banking Companies; Board of Directors; Chairman of Banking Company; Appointment of Additional Directors; Restrictions on Employment; Control over Management; Directors and Corporate Governance.
4. **Regulation of Banking Business** : Power of RBI to Issue Directions; Acceptance of Deposits; Nomination; Loans and Advances; Regulation of Interest Rate; Regulation of Payment Systems; Internet Banking Guidelines; Regulation of Money Market Instruments; Reserve Funds; Maintenance of CRR, SLR; Assets in India.
5. **Banking operations** : Preparation of Vouchers, cash receipt and payment entries, clearing inward and outward entries, transfer debit and credit entries, what is KYC and what are the different documents to satisfy KYC, verify KYC and authenticity of documents, operational aspects in regard to opening of all types of accounts, scrutiny of loan applications / documents, allowing drawals and accounting entries involved at various stages, operational aspects of CBS environment etc., Back office operations in banks, handling of unreconciled entries in banks.
6. **IT in Banking** : Overview of Banking services and IT related risk and controls, components and architecture of CBS, Core Business processes Flow and relevant risks and controls Reporting System and MIS, data analytics and business intelligence.
7. **Payment and Collection of Cheques and Other Negotiable Instruments** : NI Act; Role & Duties of Paying & Collecting Banks; Endorsements; Forged Instruments; Bouncing of Cheques; Its Implications; Return of Cheques; Cheque Truncation System.
8. **Case Laws on Responsibility of Paying Bank** : Negotiable Instruments Act and Paying Banks;

Liability of Paying Banker; Payment in due course; Payment in Good Faith; Whether Payment under Mistake Recoverable.

9. **Case Laws on Responsibility of Collecting Bank** : Statutory protection to Collecting Bank; Duties of Collecting Bank.

10. **Various Government Schemes** : Pradhan Mantri Jan DhanYojana (PMJDY); SukhanyaSamridi Account; MUDRA Bank Yojana; Pradhan Mantri Jeevan Jyoti BeemaYojana (PMJJBY); Pradhan Mantri Suraksha BimaYojana (PMSBY); Atal Pension Scheme.

11. **Consumer Protection** : Operational Aspects of Consumer Protection Act & Banking Ombudsman Scheme.

12. **Loans and Advances** : Different Types of Borrowers; Types of Credit Facilities- Cash Credit, Overdraft, Demand Loans, Term Loans, Bill Finance.

13. **Securities for Banker's Loans** : Types of Securities; Assignment; Lien; Set-off; Hypothecation; Pledge; Mortgage; Indemnities and Guarantees; Factoring; Bill discounting; Letter of Credit; Commercial Papers; Bank Guarantees; Book debts; Corporate Securities; Charges.

14. **Documentation** : Types of Documents; Procedure; Stamping; Securitisation.

15. **Calculation of Interest and Annuities** : Calculation of Simple Interest & Compound Interest; Calculation of Equated Monthly Instalments; Fixed and Floating Interest Rates; Calculation of Annuities; Interest Calculation using Products / Balances; Amortisation of a Debt; Sinking Funds.

16. **Calculation of YTM** : Debt- Definition, Meaning & Salient Features; Loans; Introduction to Bonds; Terms associated with Bonds; Cost of Debt Capital; Bond value with semi-annual Interest; Current Yield on Bond; Calculation of Yield-to- Maturity of Bond; Theorems for Bond Value; Duration of Bond; Properties of Duration; Bond Price Volatility.

17. **Foreign Exchange Arithmetic** : Fundamentals of Foreign Exchange; Forex Markets; Direct and Indirect Quote; Some Basic Exchange Rate Arithmetic – Cross Rate, Chain Rule, Value date, etc.; Forward Exchange Rates – Forward Points; Arbitrage; Calculating Forward Points; Premium / discount; etc.

18. **Non Performing Assets** : Definition; Income Recognition; Asset Classification; Provisioning Norms; CDR Financial Inclusion BC; BF; Role of ICT in Financial Inclusion, Mobile based transactions, R SETI.

19. **Final Accounts of Banking Companies** : Definition and Functions of a Bank; Requirements of Banking Companies as to Accounts and Audit; Significant Features of Accounting Systems of Banks; Principal Books of Accounts; Preparation and Presentation of Financial Statements of Banks; CMA Format; Accounting Treatment of Specific Items; Preparation of Profit and Loss Account; Comments on Profit and Loss Account; Important Items of Balance Sheet; Disclosure Requirements of Banks; Additional Disclosures prescribed by RBI; Disclosures required under BASEL norms.

20. **Risk Management in Banks and Basel Accords** : Introduction to Risk Management; Credit Risk Management; Liquidity and Market Risk Management; Operational Risk Management; Risk Management Organisation; Reporting of Banking Risk; Risk Adjusted Performance Evaluation; Basel-I, II & III Accords.

LESSON WISE SUMMARY
BANKING – LAW & PRACTICE

1. Overview of Indian Banking System

Banks are one of the important pillars that support the edifice of economy of every country and so too in India. Banking system in its modernized form in India has evolved over the last two hundred and forty two years and it continues to do so even to the present day. India has a complex banking structure with Reserve Bank of India ('RBI') playing the pivotal role of Central bank of this country. Apart from its statutory functions (as enshrined in The RBI Act 1934) the RBI regulates Commercial banks, Cooperative banks, Payment Banks and Small Finance Banks, Regional Rural Banks, Local Area Banks, Development Banks/All-India Financial Institutions. In view of emerging global and local regulatory compulsions such as capital adequacy and other related developments, the Government of India has effected a major consolidation of PSU Banks recently. Also to encourage and expand the reach of financial inclusion among the public at large, setting up of Small Finance Banks and Payment Banks are being actively encouraged.. Apart from banks RBI is also given powers to regulate NBFCs. To have a better regulation based on activity over NBFCs, the RBI has harmonized the classification of NBFCs

2. Regulatory Framework of Banks

RBI regulates banks in terms of powers it derives from The RBI Act, 1934 and The Banking Regulation Act, 1949 ('BR Act'). The RBI Act confers power to RBI in the matter of managing itself as well as discharging its supervisory duties vis-à-vis other banks as well as powers to function as Monetary Policy/Control Authority. The BR Act confers vast powers to RBI vis-à-vis banks such as issuing directions to banks in the area of Deposit Accounts, interest rates, advances, foreign exchange, CRR/SLR etc. To increase the effectiveness of regulation over NBFCs, the RBI Act has also been amended recently, to confer more powers than ever before, in tune with emerging economic/financial scenario.

It also regulates credit in India as per the clauses of the BR Act. Recently RBI has also been empowered to direct banks to initiate insolvency resolution process of borrowers under Insolvency and Bankruptcy Code 2016. Apart from RBI, banks are also regulated by other regulators in a limited way such as Securities and Exchange Board of India, Insurance Regulatory and Development Authority of India, Registrar of Companies, Central / State Registrar of Co-operatives etc. wherever applicable.

3. Control over Organization of Banks

RBI exercises control over banks through the power conferred on it by the Banking Regulation Act 1949. The control measures include Licensing of various categories of banks including branches/banking outlets of banks including RRBs, Small Finance Banks and Payment Banks, prescribing Capital & Reserves, Shareholding, Setting up of banking subsidiaries, composition of Board of Directors, Duties and functions of Chairman, Directors, fit and proper criteria for election of a person as a Director, other officials as well as various Corporate governance aspects of banks in India.

4. Regulation of Banking Business

The extensive regulatory powers conferred on RBI enables it to regulate the following aspects of banking viz. advances, guarantees, rate of interest, deposit portfolio, affairs of Board of Directors/Directors/Other officials, electronic/internet banking, payment and settlement systems of banks. In order to make payment & settlement system more customer friendly, RBI has announced Harmonisation of Turn Around Time (TAT) and customer compensation for failed transactions using authorised Payment Systems. RBI also issues directions in the

interest of banking policy to banks and guidelines, on resolving stressed assets. It also maintains Depositor Education and Awareness Fund in respect of specified inoperative deposit accounts and other sundry liability items of banks, provide guidance to banks on Nomination in deposit accounts, safe deposit lockers and safe custody accounts. As a part of its monetary control measures RBI controls issue of various money market instruments. It also guides and monitors the maintenance of reserve fund, Cash Reserve Ratio and Statutory Liquidity Ratios of banks.

5. Banking Operations

As public financial entities, banks offer various products and services. Doing so, involves accounting, passing of vouchers, opening accounts for different types of customers across different asset and liability products through cash, clearing and transfer modes. As all routine operations are done practically through computerized packages involving sophisticated software and hardware, it requires proper follow-up, monitoring and reconciliation in the light of directions and guidelines of RBI. In the light of national and global developments in the state of economy, prevention of Money Laundering and other regulatory developments, RBI periodically revises it's directions to banks which need careful implementation and follow-up.. Also banks use extensive centralized back office operations for several services such as opening accounts, KYC verification, cheque book issue, servicing third party products, dematerialized accounts, other investments as well reconciliation of entries.

6. IT in Banking

Banking has been transformed in to an information technology ('IT') intensive operation which has introduced efficient customer service, better housekeeping and improved internal controls, productivity and decision making. On the flip side, IT based products and services have their inherent risks which need to be managed through preventive, detective and corrective controls. Also banks implement various other control measures to protect interests of customers and themselves. Majority of commercial banks offer CORE banking based services to customers across various geographical locations with the help of Central Data Centers. CORE banking operations also carry risks which are being managed through various controls. CORE banking has enabled banks to generate various Management Information System reports for decision making, as well as for analysis with a view to improve various products and services offered to customers.

7. Payment and Collection of Cheques and Other Negotiable Instruments

As a part of banking operations banks handle many types of Negotiable Instruments such as Cheques, Bills of Exchange, Demand Drafts etc. on behalf of their customers. Negotiable Instruments Act, 1881 (NI Act) which governs various aspects of Negotiable Instruments, deals with duties and responsibilities of a paying bank as well as a collecting bank of such Negotiable Instruments. To get legal protection under NI Act banks have to adhere to various provisions as enumerated in the said Act. For making payment and collection of NIs such as cheques and DDs, Banks use the process of clearing. Cheque Truncation System (CTS) has been adopted in India in clearing of cheques to speed up customer service, reduce reconciliation problems, eliminate logistic problems and minimize frauds. CTS is subject to detailed rules and procedures prescribed by RBI in this regard.

8. Case Laws on Responsibility of Paying Bank

Negotiable Instruments Act offers protection to a paying bank in terms of Section 85 & 85 A in respect of Cheques and DDs provided these instruments are paid in due course. When banks act with negligence while paying a NI, disregarding the provisions of the NI Act, they stand to lose the protection of the Act and are liable to the parties concerned thereof as borne out in various judgments of courts. A paying banker is also affected by the provisions of Consumer Protection Act in addition to that of NI Act.

9. Case Laws on Responsibility of Collecting Bank

Banks when they act as Collecting Banks are governed by Section 131& 131A of NI Act which also governs the framework of their role and responsibilities. There have been numerous judgments pertaining to legal cases which have been handed down by various courts in India when banks have acted negligently while acting as collecting banks.

10. Various Government Schemes

To address some of the major issues that affect our economic growth such as unemployment, poor agricultural and industrial growth, non-availability of credit at reasonable interest, social inequities etc., Government of India has been coming up with various bank linked credit delivery schemes from time to time for promoting - agriculture, micro, small and medium industries, employment opportunities (including self-employment) as well making , available credit at affordable rates of interest, nil/marginal security etc. Additionally the Government has introduced socio- welfare schemes for the citizens of the country through banks. Some of the schemes have been state specific and in some cases a collaborative effort between the Centre and the states. The government has started the 'Make In India' initiative to encourage more SMEs to become a part of India's growth journey.

11. Consumer Protection

Banking being a service industry dealing with a variety of customers who need to be protected against deficiencies in services extended to them. Bank customers are also covered under the definition of "Consumer" and can take recourse through Consumer Protection Act 1986. A customer can file a case within a period of 2 years from the date cause of action has arisen with Consumer redressal councils according to the monetary jurisdiction applicable. Supreme Court has the ultimate appellate jurisdiction in the matter. Similarly customers' complaints against banks can also be resolved through Banking Ombudsman Scheme in an inexpensive way. The scheme came in to force from 2006. Under this scheme, a bank customer has one year time to complain to Banking Ombudsman after he/she has complained to the bank concerned. However the monetary limit for awarding compensation by a Banking Ombudsman is restricted up to a maximum of Rs. 20 lacs. Decisions of the Banking Ombudsman can be appealed against with the Appellate authority by either the complainant or the bank, subject to rules in this regard.

12. Loans and Advances

Lending is one of the generic functions of banks. When banks extend loans and advances, they follow certain basic principles such as safety, liquidity, profitability, security, purpose and spread to minimize risks involved. As banks lend to different types of customers they adopt appropriate legal procedures in consonance with the constitution of such customers. While lending, banks are required to adhere to various directives of RBI issued from time to time. While lending, banks obtain security to safe guard themselves against the risk of default by borrowers. Based on type of advance and the nature of security, banks create appropriate charges against such securities so as to legally enforce their rights in the event of default by borrowers. As a part of lending, banks also provide certain non-fund based facilities such as Letters of Credit and Guarantees. Banks also finance, receivables of a borrower through the facility of 'factoring'. Banks extend sales finance in the form of Purchase/ Discounting of bills to eligible borrowers. Also banks extend finance against Corporate Securities such as Shares/Debentures/Bonds.

13. Securities for Banker's Loans

Security is something of value given to a lender by a borrower to support his or her intention to repay. Securities given by a borrower comes to the rescue of banks in cases where borrower defaults. To legally enforce their rights, Banks create different types of 'charge' over securities offered by borrowers such as Assignment, Lien,

Pledge, Hypothecation, and Mortgage. Apart from securities, banks also obtain Guarantees (both personal and corporate) and Indemnities from borrowers to safe guard themselves against defaults in certain cases..

14. Documentation

Documentation is an integral part of bank credit portfolio that enables a bank to identify the borrower, his capacity, security, type of charge created, and also serves as evidence in a court of law in recovery proceedings. Properly executed documents (including registration and stamping wherever necessary) by different types of borrowers are essential to determine limitation period. Further properly executed documents enable banks to enforce their rights without the intervention of courts as provided under SARFAESI Act, 2002 as well as commence recovery action through Debt Recovery Tribunals.

15. Calculation of Interest and Annuities

For deposits held by customers banks pay interest on simple and compounded basis. They also charge interest on loans and advances, which forms their main source of income, as per their credit policy. Where loans are repayable over a term, banks provide an option of Equated Monthly Instalment (EMI). As a part of financial innovation banks offer fixed or floating interest rates on certain products based on specific terms and conditions. The concept of annuities is used by banks while calculating interest. Banks also collect interest upfront in certain credit facilities like Discounting of bills and also charge interest on daily product basis on facilities like Cash credit etc. Estimation of annuity values are derived by banks based on the Sinking fund concept.

16. Calculation of YTM

As a part of one of their core functions, banks make investments and trade in various securities such as Bonds, Debentures and Money Market instruments. Through this process banks meet their statutory obligation of SLR investment and also earn revenue from such instruments. Banks are also involved in extending wealth management services for their clients which involves investment in various securities. Therefore to maximize revenue, banks take in to account the calculations of various aspects of bonds such as Yield, current yield, yield to maturity, duration as well as bond volatility, carrying amount, underlying value etc .

17. Introduction to Foreign Exchange

Banks offer a variety of Foreign Exchange products and services, (as RBI licensed ‘Authorised Dealers’) to customers as a part of their routine business. These products and services can be classified as Current/Capital Account transactions and are subject to rules and regulations of Foreign Exchange Management Act, RBI’s directions, Trade control regulations, FEDAI Rules, International Commercial Rules, Uniform Customs and Practices for Documentary Credits, Uniform Rules for Collection, International Standard Banking Practices etc. As a part of the foreign exchange business, banks buy from customers as well as sell to customers, foreign currencies by following exchange arithmetic rules such as chain rule, cross rate, forward points etc., for arriving at the correct exchange rate by following applicable FEDAI/Internal guidelines. Banks also make profits by doing arbitrage transactions in various forex markets across the globe.

18. Non Performing Assets

As a part of Prudential guidelines, Banks follow the RBI norms of Asset classification, Income recognition, Provisioning for bad advances and maintain stipulated risk weighted Capital. While making asset classification, banks segregate their assets in to performing and Non-performing, based on the record of repayment of principal and interest by borrowers. Banks also undertake debt restructuring exercise for corporates for the benefit of all stake holders.

What is Restructuring and the prudential norms. When and how the one-time settlement (OTS) is done. BIFR

and Asset Reconstruction Companies (ARCs). Functioning of Debt Recovery Tribunals (DRTs). SARFEASI Act and conditions for sale of assets.

19. Final Accounts of Banking Companies

What are major financial statements and the objective of financial statement analysis. Who are the users of the financial statements and the tools used for the analysis of financial statements, Important ratios for evaluation of performance of the banks. The accounting system followed by banks in India, differs from the general accounting system followed by companies and other business entities. Nevertheless, they are required to prepare and present their Annual Financial Statements as per specified formats in compliance with provisions of B R Act, The Companies Act, RBI directions and ICAI Accounting Standards. While doing so, Banking companies are required provide a summary of Accounting policies followed by them in preparing these financial statements as well as comply with Disclosure/Additional disclosure requirements as advised by RBI, from time to time. Some terms used in Analysis of Bank performance.

20. Risk Management in Banks and Basel Accords

Every business organization is exposed to many risks while doing business. Banks too face several financial and non- financial risks such as Credit risk, Market risk, Operational risk, Strategic risk, Funding risk, Political and Legal risks. Based guidelines issued by RBI, banks assess the magnitude of risks faced by them and adopt proper strategies to manage the same. In the light of banks adopting BASEL I, II and III norms, RBI has sensitized them in sound risk management practices, as under the present norms a Bank's capital is linked to various risks faced by it. RBI also monitors compliance of risk management practices of banks through its on-site and off-site surveillance so as to prevent crisis in the banking sector. Prompt Corrective Action -2017, the existing framework was revised by RBI and made effective from March 2017.

21. Audit in Banks

Banks play an significant role in any financial system by virtue of the important role they play in spurring economic growth by undertaking maturity revolution and supporting the critical payment systems. An audit is a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the concern.

LIST OF RECOMMENDED BOOKS

BANKING – LAW & PRACTICE

BOOKS FOR READINGS

1.	M.L. Tannan revised by	:	Banking Law and Practice, Wadhwa & Company, Nagpur C.R. Datta & S.K. Kataria
2.	A.B. Srivastava and K. Elumalai	:	Seth's Banking Law, Law Publisher's India (P) Limited
3.	R.K. Gupta	:	Banking Law and Practice, Modern Law Publications.
4.	Prof. Clifford Gomez	:	Banking and Finance - Theory, Law and Practice, PHI Learning Private Limited
5.	J.M. Holden	:	The Law and Practice of Banking, Universal Law Publishing.

ARRANGEMENT OF STUDY LESSON

Module-3 Elective Paper-9.1

BANKING – LAW & PRACTICE

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LEARNING OBJECTIVES

India has one of the largest and a complex Banking system in the world which forms the backbone of its economy, where the old and the new banks co-exist in the service of the nation, having evolved over a period of more than two centuries.

This chapter will enable a reader

- To learn about the Indian Banking system and its evolution over the last two centuries.
- To learn about the role and functions of Reserve Bank of India.

To learn about the structure of Banks in India including Commercial banks, Co-operative banks, Development banks, All-India Financial Institutions and NBFCs.

INTRODUCTION

Banks form the back bone of a country's financial system. Modern Banking system in India is more than two centuries old. The Indian banking system consists of various constituent banks which mobilize savings from several sources for lending to productive activities. These banks are regulated by Reserve Bank of India (RBI) which came in to existence in 1935. RBI controls credit, issues currencies and regulates banks and other non-banking financial companies. Besides these, the services offered by banks also have expanded over the years in the light of various national and international developments. Keeping in mind all these the chapter covers evolution of banking system in India, role of RBI and structure of banks which are a must for any student of Banking. The topic and contents are of Level 1 orientation and will expose students about evolution of banking in India, RBI and about structures of banks in India.

INDIAN BANKING SYSTEM – AN EVOLUTION

The Evolution of Indian Banking System encompasses Agency House Banks, Presidency Banks, Imperial Bank of India, Reserve Bank of India, Private/Joint Stock Banks (Old generation private sector banks), State Bank of India, Associate Banks, Nationalized Banks, Old and New Generation Private Sector Banks, Foreign Banks, Co-operative Banks, Regional Rural Banks, Small Banks and Payment Banks and Financial Institutions known as Development Banks and Non-Banking Financial Companies.

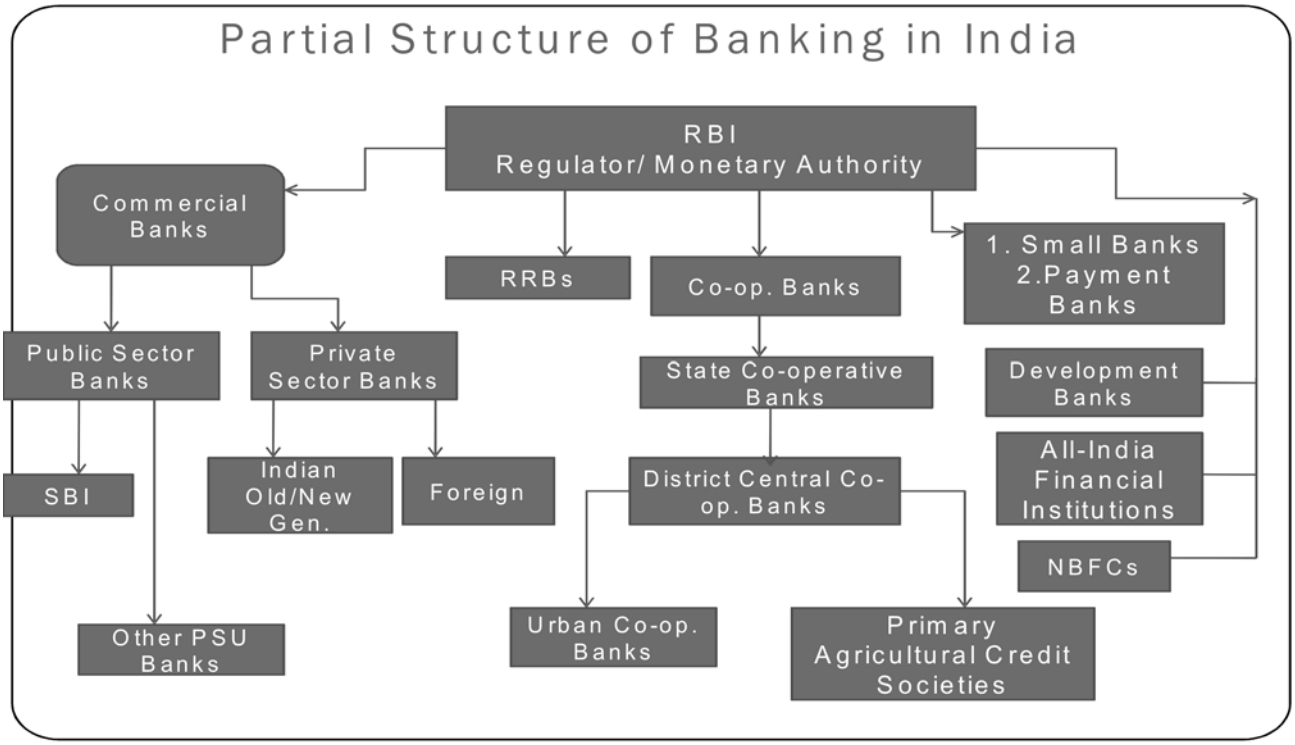
From the beginning till early 20th century

Agency House Banks/Presidency Banks/Imperial Bank of India

Though money lending and trade credits were known in India since Vedic period and subsequent times, seeds of modern Banking system was sown in India in the year 1776, when Bank of Hindustan at Kolkata (the then capital of British in India) was established by the British agency house of Alexander and Company for catering to the needs of British merchants operating in India. This bank can easily said to be the first commercial bank in India. This was followed by General Bank of India in 1786. However liquidation proceedings were started in the year 1829 for winding up Bank of Hindustan and finally it was liquidated in 1832. The General Bank of India survived only for five years and in the year 1791 it failed.

Thereafter, Bengal Presidency (equal to present day State Government) established a Bank called Bank of Calcutta in the year 1806 which was later rechristened as Bank of Bengal in 1809. The Bank was funded by the Presidency of Bengal. This was later followed by two more Presidency Banks namely Bank of Bombay in the year 1840 and Bank of Madras in 1843. All three Presidency banks were incorporated as joint stock companies. Under Royal charter "these three banks received the exclusive right to issue paper currency till 1861 when, with the Paper Currency Act, the right was taken over by the Government of India". Later these three Presidency banks were merged to form Imperial Bank of India in 1921, which in 1955 was renamed as State Bank of India. Until the birth of Reserve Bank of India in 1935, the Presidency Banks and later Imperial Bank of India were acting as a sort of bankers to the government, by holding Government of India's balances", a function which was later taken over by RBI upon its commencement.

During the period, British merchants established the Union Bank of Calcutta in 1829, first as a private joint stock association, then converting in to a partnership. Union Bank was incorporated in 1845 but failed in 1848, as it became insolvent. Bank of Upper India, which was established in 1863 and survived until 1913.



BRIEF OVER VIEW OF THE START OF RESERVE BANK OF INDIA (RBI)

In1927,the British government appointed a commission under Hilton-Young (known as the Royal Commission on Indian Currency and Finance) with the main objective to separate the control of currency and credit from the government, as well as spread the banking network across the country. The commission recommended setting up a central bank in India known as Reserve Bank. However, initially the proposal was not accepted. Later, with a few modifications it was reintroduced and finally it was accepted in 1934. As a consequence, Reserve Bank of India ('RBI') was established on 1935 as a banker to the central government. It was initially head quartered in Kolkata and commenced its operations from April1, 1935. Later in the year 1937 it was shifted to Mumbai.

At the beginning of its operation, RBI was started as a privately owned entity with a share capital of Rs. 5 crores; almost fully subscribed by private shareholders excepting a token shareholding (2.2 per cent) of the Central Government. In 1948, the Central Government took over the institution through an Act named Reserve Bank (Transfer to Public Ownership) Act. All private shareholders were paid compensation. The complete government take over took place in 1949 as RBI started in statutory role from January 1, 1949.

Private /Joint Stock Banks

There were many commercial banks that were started as Private/Joint stock banks in India. The Allahabad Bank in 1865 was one of the earliest joint stock banks started in India. Subsequently it was nationalized in 1969 and continues its existence. On 30 August 2019, the Ministry of Finance announced that Allahabad Bank would be merged with Indian Bank, another nationalized Bank. The proposed merger would create the seventh largest public sector bank in the country with assets of Rs.8 lakh crore..

Oudh commercial Bank was the first joint stock bank conducting its operations from 1881 to till it failed in 1958. In 1894 The Punjab National Bank was established at Lahore, is now one of the largest public sector banks in India.

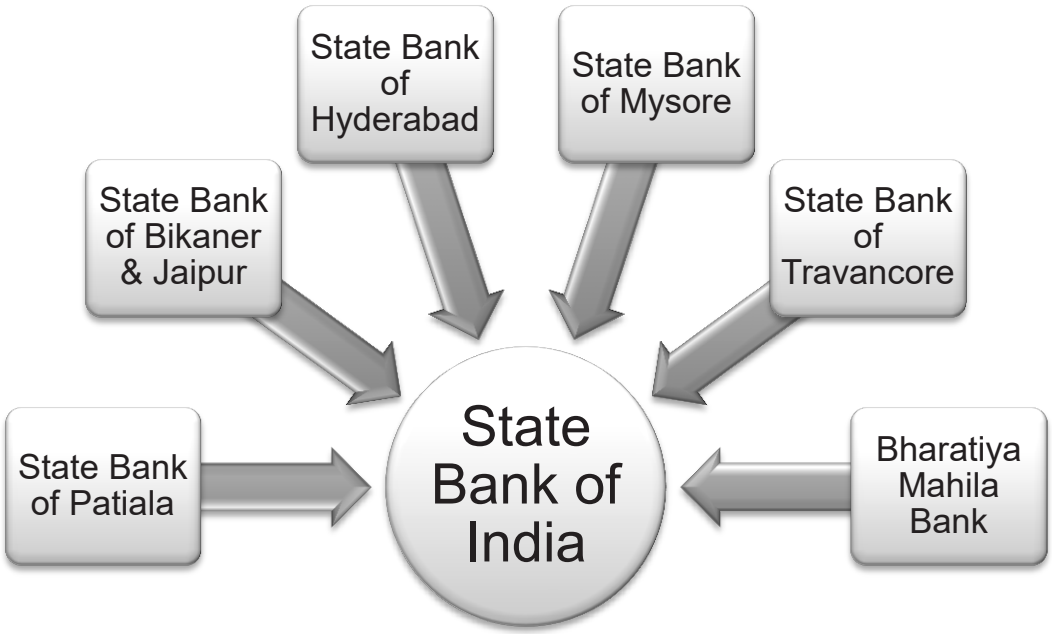
The period between 1906 and 1920 saw the establishment of banks inspired by the 'Swadeshi' movement. Inspired by the movement, native Indians founded banks to serve the Indian community at large. A number of banks established as joint-stock banks then, have survived to the present day such as Bank of Baroda, Central Bank of India, Catholic Syrian Bank, The South Indian Bank, Bank of India, Corporation Bank, Indian Bank, Indian Overseas Bank. The Swadeshi movement also had its impact in South Kanara district of present day Karnataka State in which Syndicate Bank, Corporation Bank, Canara Bank, Vijaya Bank and Vysya Bank were founded.

Consequent upon nationalization of banks in 1969 and 1980, as well as economic liberalization ushered in 1991-92, there was a profound impact of expansion of bank/branch network of banks in India.

Establishment of State Bank of India/Associate Banks

As indicated in the beginning, State Bank of India as we know today originated from the three Presidency banks namely Bank of Bengal, Bank of Bombay and Bank of Madras and the successor to these Presidency banks viz. Imperial Bank of India. These banks were basically created by European masters and served mostly to the common needs of local European commerce in India. Though Imperial Bank of India was recognized for its services and integrity, its contribution was mainly confined to urban populace of India. And it was "not equipped to respond to the emergent needs of economic regeneration of rural areas." As this was an area of concern for the Government of India, the All-India Rural Credit Survey Committee recommended creation of a Government-partnered and sponsored bank by taking over the Imperial Bank of India along with those princely-states owned banks. Through State Bank of India Act, in 1955 the Government of India constituted State Bank of India that had a 25% share of Indian banking resources at that time.

Subsequently through another enactment viz. State Bank of India (Subsidiary Banks) Act in 1959, all the princely state banks were taken over by State Bank of India. Thus the focus of State Bank of India was concentrated towards social purpose. It had a network of 480 offices, sub-offices, Local Head Offices to service the planned economic development of the country to start with. Thus State Bank of India was destined to be the prime mover of national development in the banking sphere.



The eight princely-State Banks that became associate banks of State Bank of India were State Bank of Patiala,

State Bank of Bikaner, State Bank of Jaipur, State Bank of Hyderabad, State Bank of Saurashtra, State Bank of Indore, State Bank of Mysore and State Bank of Travancore. In 1963 State Bank of Bikaner and State Bank of Jaipur were merged to form State Bank of Bikaner and Jaipur. Subsequently on 13 August 2008 State Bank of Indore and State Bank of Saurashtra were merged with State Bank of India as a part of Government of India's plan for creating a "mega bank" by merging all associate banks with State Bank of India. On 15 February 2017, the Union Cabinet approved the merger of five associate banks with SBI. Pursuant to this, from 1st April 2017 the remaining associate banks were merged with State Bank of India. Also along with its former Associate Banks, the erstwhile Bharatiya Mahila Bank, an all-women bank established by the Government of India in 2013 for "empowering women and instilling confidence among them to avail bank financing" was also merged Bharatiya Mahila Bank was set up to provide credit exclusively to women. Apart from India only two countries viz, Pakisthan and Tanzania have a bank especially for women. Immediately before the merger, Bharatiya Mahila Bank had 103 branches and business volume was Rs. 1600 crores. The merger of Bharatiya Mahila Bank was made considering the large outreach of SBI and its record of establishing all-women branches and providing loan to women borrowers.

Over the years due to various regulatory developments and relaxations made available in permitted activities by the banking regulator and the Government of India, State Bank of India has created the following non-banking subsidiaries:

- SBI Capital Markets Ltd.
- SBI Funds Management Pvt. Ltd
- SBI Factors & Commercial Services Pvt. Ltd
- SBI Cards & Payments Services Pvt. Ltd. (SBICPSL)
- SBI DFHI Ltd.
- SBI Life Insurance Company Limited
- SBI General Insurance Company Limited.

Apart from the above, SBI has 190 overseas offices spread over 32 countries having the largest presence in foreign markets among Indian banks.

Nationalization of Banks

Until 1968 excepting State Bank of India, all other joint-stock banks were under private ownership. As these banks were catering to the banking needs of urban India, a large number of them did not involve themselves in the economic upliftment of rural areas, though they mobilized deposits from public at large. Looking at this state of affairs, the Government of India brought in Social Control of Banks in 1967with a view to make these banks contribute to the economic regeneration of rural and semi-urban areas of the country. The Banks which were operating under private ownership then were also given targets to be achieved in extending loans to the rural segment. However, dissatisfied with the performance of private banks, the Government nationalized 14 banks in July 1969 through Banking Companies (Acquisition and Transfer of Undertakings) Ordinance which was later made in to a law in 1970.

Major reasons for nationalization can be summarized as under:

1. To curtail monopoly practices by the industrialists who were having close connections with owners of these banks such that new entrants would not pose a threat by way of competition to established units. Therefore, through nationalization this monopoly practice was sought to be curtailed.

2. Private banks did not participate effectively in social welfare measures of the Government. Some of the banks were lukewarm in their approach and did not follow regulations given under social control. This failure of social welfare front forced the Government to nationalize banks.

3**.** To prevent the misuse of resources mobilized from public: Banks collected deposits in the form of savings deposits, term deposits etc. from the public at large. Since the controls over these funds were with private hands, they neglected to apply these for specified sectors like agriculture, small-industries which were treated as 'Priority' by the Government. Thus, through nationalisation of banks, the Government could access to these funds so that they could be channeled for national development.

4. *Greater spread of branch network***:** Privately owned banks confined their operations in select geographical areas that were convenient to them thus neglecting rural areas which also had business potential. Nationalization was resorted to mobilize resources in the form of deposits through expansion of branch network.

5. Financing of Agriculture was grossly neglected by privately owned banks. India's economy primarily depends upon agriculture in many ways. Private banks were reluctant to extend finance to agriculture sector in which 70% of the population was involved. Thus, for providing increased finance to agriculture, banks were nationalized.

6. *For balanced development all regions***:** In our country due to various reasons, many areas remained backward for lack of financial resources and credit. Private banks neglected these areas due to lack of business potential and profitability. With a view to provide bank finance and resources for achieving balanced growth and to remove regional disparities, nationalization was ushered in.

7. *For implementing greater credit control and discipline*: As credit was scarce in India**,** bank credit need to be monitored and strict control has to be exercised by the regulator and government. If the ownership of banks is under the control of the Government it would be smooth to exercise such control. Hence, nationalization was brought in.

8. *To provide greater Stability of banking structure*. Due to historical reasons, the fear of failure of banks under private ownership was perceived greater in comparison to banks under Government control. India cannot afford such failures when it was in a crucial take off stage of economic revival. Therefore to provide confidence to customers about the safety of their savings and funds, nationalization was resorted to.

Taking into account all the factors listed above,14 banks (as listed below), which had a demand and time liabilities base of Rs. 50 crores and above were nationalized in the first phase of nationalization in 1969.

List of nationalized banks (First Phase):

1. Allahabad Bank
2. Bank of Baroda
3. Bank of India
4. Bank of Maharashtra
5. Canara Bank
6. Central Bank of India
7. Dena Bank
8. Indian Bank
9. Indian Overseas Bank

10. Punjab National Bank
11. Syndicate Bank
12. Union Bank of India
13. United Bank of India and
14. United Commercial Bank.

A similar exercise was also carried out in1980 and the Government took over the control of the following six banks which had demand and time liabilities base of Rs. 200 Crores and above.

They were:

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

Till the start of liberalization period Government of India held 100% of the equity capital of banks. Post-liberalization the Government had diluted its stake in several of these PSU Banks in such a way that it has just majority stake in these institutions.

Consolidation of PSU Banks

In view of stringent capital adequacy norms as well as mounting NPAs, especially among the Public Sector Banks and also to arrest sliding performance in their contribution to the economic development of the country, the Government of India took a decision in late 2018 to consolidate the PSU Banks. In pursuance of this objective in April of 2019, Vijaya Bank and Dena Bank were amalgamated with Bank of Baroda. In effect, the operations of Vijaya Bank and Dena Bank have been combined with Bank of Baroda. Ultimately the merged banks will be functioning under the umbrella of Bank of Baroda brand. Their consolidated operations have already commenced from 1st April 2019.

In addition to the above, in August 2019, the Union Finance Minister announced a second dose of consolidation of PSU Banks to strengthen banking system for a robust performance. The details are as follows:-

Details of merging PSU Banks

Merging Banks	To be merged with (Merger to be effective from 1.4.2020)
1. Oriental Bank of Commerce	Punjab National Bank
2. United Bank of India	
3. Syndicate Bank	Canara Bank

4. Andhra Bank	Union Bank of India
5. Corporation Bank	
6. Allahabad Bank	Indian Bank

With this process of consolidation, the total number of PSU Banks will stand reduced to 12 as indicated below:

They are as follows: 1. Bank of Baroda 2. Bank of India 3. Bank of Maharashtra 4. Central Bank of India 5. Indian Overseas Bank 6. Punjab & Sind Bank 7. State Bank of India 8. United Commercial Bank 9.Canara Bank 10. Indian Bank 11. Punjab National Bank 12. Union Bank of India.

New Generation Private Sector Banks

The private sector banks which were operating in India prior to the liberalization year of 1991 are known as Old generation private Sector banks. The banks that came into existence subsequent to Narasimham Committee Report I and revised RBI guidelines in 1993 are known as new generation private sector banks. The Narasimham Committee-I, recommended to allow private and foreign banks into the industry as a part of economic liberalization policy of Government of India. In deference to the recommendations of the committee, the RBI formulated guidelines for the establishment of the private sector banks on January 1993. These guidelines prescribed that the private banks should be established as public limited companies under the then Indian Companies Act 1956. The paid-up capital shall not be less than Rs. 100 Crore. The new guidelines issued in 2001 raised the minimum paid-up capital to Rs. 200 Crore, which should be enhanced to Rs. 300 Crore within three years after the commencement of business. The promoters' share shall not be less than 40 per cent and the voting right of a shareholder shall not exceed 10 per cent.

Housing Development Finance Corporation Limited ("HDFC") was the first private bank in India to receive license from RBI, to set up a bank in the private-sector in India. Accordingly, nine banks were set-up in private sector including some by development financial institutions. Prominent among them are ICICI Bank, Global Trust Bank, HDFC and IDBI bank. Another interesting development was the merger of some banks. Bareily Corporation Ltd. merged with Bank of Baroda in 1999, Times Bank merged with HDFC Bank in 1996, Bank of Madura Ltd. merged with ICICI bank in 2001 and Nedungadi Bank Ltd. merged with Punjab National Bank in 2003.

Presently the following new generation private Banks operate in India:

S. No.	Name of the Bank	Year of establishment
1	Axis Bank	1993
2	Development Credit Bank	1995 (See note 2 below)
3	HDFC Bank	1994
4	ICICI Bank	1990
5	Indus-Ind Bank	1994
6	Yes Bank	2004
7	Kotak Mahindra Bank	2001
8	IDFC First Bank**	2015
9	Bandhan Bank	2015

Note*: 1. The new generation banks namely Times Bank, Centurion Bank, Global Trust Bank, Bank of Punjab have merged with other banks and hence cease to exist.*

2 .Erstwhile Development Cooperative Bank renamed into Development Credit Bank in 1995 after it got Schedule Bank License. Again it is changed its name into DCB in 2014.

** Consequent upon merging a NBFC named Capital First with itself in December 2018, IDFC Bank has changed its name to IDFC First Bank.

As the name itself implies the majority of the equity is held by private promoters including permitted foreign entities and other investing public in these institutions.

Foreign Banks

Foreign banks too started setting up their branches in India during late 19th century. The Chartered Bank of India which later became Standard Chartered Bank, opened an office in Calcutta in 1858 after getting a Royal Charter from the Queen of England. In Kolkata, Grindlays Bank commenced its operations by opening its first branch in 1864.The arrival of the Hong Kong and Shanghai Banking Corporation (HSBC) was in 1859 after it acquired a bank known as Mercantile Bank in India. The Comptoird' Escompte de Paris, started operations in Kolkata in 1860 which later was one of the constituent of BNP Paris which represented the French. American banking companies entered India in 1902 through Citibank's predecessor, The National City Bank of New York and JP Morgan, a noted name in American banking entered India in 1922 through its affiliation with Andrew Yule and Co. Ltd of Kolkata. The post-liberalization era saw several foreign banks enter India for business opportunities.

Co-Operative Banks

The beginnings of Indian Co-operative credit institutions can be traced back to the great Bengal famine of 1840s. Problems of rural poverty and indebtedness and matters associated with such conditions of rural farmers forced the then British government to set up a commission to suggest a holistic remedial measures. The Woodhead Commission which enquired in to the famine, suggested many remedial measures to the British Government. One such remedial measure suggested was to make available credit at low rate of interest to the needy people (more so to farmers).The farmers found this proposition very attractive as their experience with private money lenders not to their liking in view of exorbitant interest rates. Subsequently, the Rayat Commission which was set up to look in to the matters including credit availability, suggested creation of Co-operatives as an organizational means to extend credit to farmers in the year 1872. As a sequel to these developments, the first Co-operative Land Mortgage Bank was started.

In order to strengthen the credit availability to agriculturists, in the year 1904 the Co-operative credit societies Act was passed enabling establishment of co-operative credit societies for making available agricultural credit through such societies. Further in 1912 a comprehensive Cooperative Societies Act was passed to facilitate starting of non-credit related societies too, since the 1904 Act was oriented only towards "Credit" to the exclusion of other activities.

With the passing of 1904 and 1912 Acts "a large number of Cooperative Credit societies, Central banks. Provincial Cooperative Banks came into existence." The reforms Act of 1919 made 'Co-operation' a provincial (a State) subject. The Bombay Co-operative Societies Act, 1925 brought in the concept of one-man- one-vote. In the year 1929 Land Mortgage Banks were also started for providing long term loans to agriculturists.

Since the subject of 'Co-operation' came under the purview of provinces, several thousand co-operative banks had been set up in various provinces. In 1942, the British Government enacted the Multi-Unit Cooperative

Societies Act, 1942 with an object to cover societies whose operations extended to more than one state. After independence in 1966 Co-operative Banks were brought under the supervision of RBI through The Banking Regulation (Co-operative Societies) Rules, 1966. The co-operative banks were also brought under the provision of Banking Regulation Act, 1949. From the year 2012 (through a Banking Law Amendment Act, 2012) a primary Cooperative Society can carry on the business of banking only after obtaining a license from RBI. These banks thus face duel control from State Governments/Central Government (in the case of multi-state co-operative societies) and RBI which exercises control over their banking operations. Co-operative banks are owned by members who subscribe to their shares.

Regional Rural Banks

Close on the heels after Nationalization of Private banks, Regional Rural Banks (RRBs) were established in 1975 under the provisions of an ordinance promulgated on September 26, 1975 which was followed by Regional Rural Banks Act, 1976. This was done due to a perceived feeling "that even after nationalization, there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers."

The main objective for establishing these banks were "to develop the rural economy and to create a supplementary channel to the 'Cooperative Credit Structure'" so as to expand the scope of institutional credit for rural and agriculture sector. The share capital of these banks were contributed in the proportion of 50%,15% and 35% respectively by Government of India, the concerned State Government and the Sponsoring bank, of a RRB. RRBs were permitted to engage in all permitted Banking activities with their area of operation restricted to a few notified districts in a State. RRBs came in to existence in 1975 and as on date only 56 exist out of 196 established at different points in time from 1975.

Small Finance Banks and Payment Banks

To deepen and to develop a comprehensive monitoring frame work to track the financial inclusion, a Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (commonly known as the Nachiket Mor Committee) was appointed in September 2013 by RBI. The committee submitted its final report on 7 January 2014. One of the recommendations made by the committee was to establish Small Banks and Payment banks – a new class of banks with an exclusive focus on small businesses and low income households. The licensing conditions of Small Finance Bank and Payment Bank is elaborated in Lesson-3.

Payment Banks

In July 2014, the RBI released the draft guidelines for payment banks, seeking comments from interested entities and public at large. After taking in to account suggestions from respondents in November 2014, RBI released the final guidelines for payment banks and invited applications for opening such banks from interested parties, subject to the guidelines enunciated.

There were 41 applications from various applicants including some corporate houses. After a due process of vetting these applications through an External Advisory Committee headed by Mr. Nachiket Mor, in August 2015, the RBI accorded 'in-principle' licences to the following eleven entities to launch payment**s** banks within a period of 18 months.

1. Aditya Birla Nuvo Limited
2. Airtel M Commerce Services Limited
3. Cholamandalam Distribution Services Limited

4. India Post Limited.
5. FinoPayTech Limited.
6. National Securities Depository Limited.
7. Reliance Industries Limited.
8. Vodafone M-Pesa Limited.
9. Paytm Limited.
10. Tech Mahindra Limited.
11. Sun Pharmaceuticals Limited.

Within this period of 18 months, these entities were to comply with requirements regarding capital funds of Rs. 100 crores. The "in-principle" license was valid for 18 months within which the entities must fulfill the requirements and they were not allowed to engage in banking activities within the period. The RBI will grant full licenses under Section 22 of the Banking Regulation Act, 1949 after it is satisfied that requirements/conditions have been fulfilled.

The other terms and conditions are as follows:

- To be registered as a public limited company under the Companies Act, 2013.
- Payment Banks cannot form subsidiaries.
- For the first five years, the promoters stake to remain at 40% at minimum.
- Foreign shareholding will be allowed in these banks as per extant FDI norms.
- The voting rights will be regulated as per provisions of The Banking Regulation Act 1949. [Voting rights are restricted at 10% for any one share holder. RBI has the discretion to raise this to 26% on merits.].
- If there is any acquisition of more than 5% shares this will require prior RBI approval.
- The majority of the bank's board of directors should consist of independent directors, appointed according to RBI guidelines.
- The bank should be fully networked from the beginning.
- Initially, the deposits will be capped at Rs. 1,00,000 per customer, but later it may be raised on the basis of performance of the bank.
- No lending activity is permitted. Bank can accept utility bills.
- A quarter of its branches should be in unbanked rural areas.

The list of Payment Banks operating in India are -

1. The Airtel Payments Bank Limited.
2. Paytm Payments Bank Limited.
3. India Post Payments Bank Limited.
4. Fino Payments Bank Limited.
5. Aditya Birla Idea Payments Bank Limited *

6. Jio Payments Bank Limited.
7. NSDL Payments Bank Limited.

*****Note:*** As of November 2019, Aditya Birla Idea Payments Bank Limited is put under liquidation.

Small Finance Banks

These banks also have been established with an aim of financial inclusion "to sections of the economy not being served by other banks, such as small business units, small and marginal farmers, micro and small industries and unorganied sector entities." These banks were expected to provide an institutional mechanism for promoting rural and semi urban savings and extending credit for viable economic activities in the local areas.

In July 2014,draft guidelines for small finance banks, seeking comments from interested entities and the general public was released by RBI. After receiving comments and submissions from public, the final guidelines were released in November 2014 with the instructions that interested parties were to submit applications before 16 January 2015.

Thereafter, in February 2015, RBI released the list of 72 entities which had applied for a small finance bank license. After a due screening of these applications by an External Advisory Committee headed by Mrs. Usha Thorat, in September 2015, RBI had issued 10 provisional licences to entities, which were required to convert themselves in Small Finance Banks within one year.

Small Finance Banks are -

1. Ujjivan Small Finance Bank Limited.
2. Jana Small Finance Bank Limited.
3. Equitas Small Finance Bank Limited.
4. AU Small Finance Bank Limited.
5. Capital Small Finance Bank Limited.
6. Fincare Small Finance Bank Limited.
7. ESAF Small Finance Bank Limited.
8. North East Small Finance Bank Limited.
9. Suryoday Small Finance Bank Limited.
10 . Utkarsh Small Finance Bank Limited.

Salient Regulatory features of Small Finance Banks

- These banks can be promoted by individuals, corporate houses, trusts or societies.
- Promoters should have 10 years' experience in banking and finance and they should have a capital stake of 40% of equity which must be brought down to 26% over a period of 12 years.
- Joint ventures are not permitted. Foreign shareholding will be allowed in these banks as per the Foreign Direct Investment rules in private banks in India.
- Existing Non-banking Financial Companies (NBFCs), Micro Finance Institutions (MFI) and Local Area Banks (LAB) may convert themselves to become small finance banks by making applications to RBI.

- These Small Finance Banks need to be registered as Public Limited Companies under The Companies Act, 2013 and Reserve Bank of India Act, 1934, Banking Regulation Act, 1949 and other relevant statutes, are applicable to them.
- The banks will not be restricted to any region. 75% of its Net Credit should be lent to Priority Sector and 50% of its loans should be in the range of up to Rs. 25 lakhs.
- The Small Payment Banks should have capital of at least Rs. 100 crore.
- At net worth of Rs. 500 crore, listing will be mandatory within three years.
- Those Small finance banks having net worth of below Rs.500 crore could also get their shares listed voluntarily.

The scope of business of a small finance bank, include "basic banking activities of acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganised sector entities". With prior approval of RBI it can undertake risk less activities such as distribution of mutual fund units, insurance products, pension products, etc. after complying with the requirements of the sectoral regulator for such products. The small finance bank can also become a Category II Authorised Dealer in foreign exchange business for its clients' requirements. It cannot set up subsidiaries to undertake non-banking financial services activities.

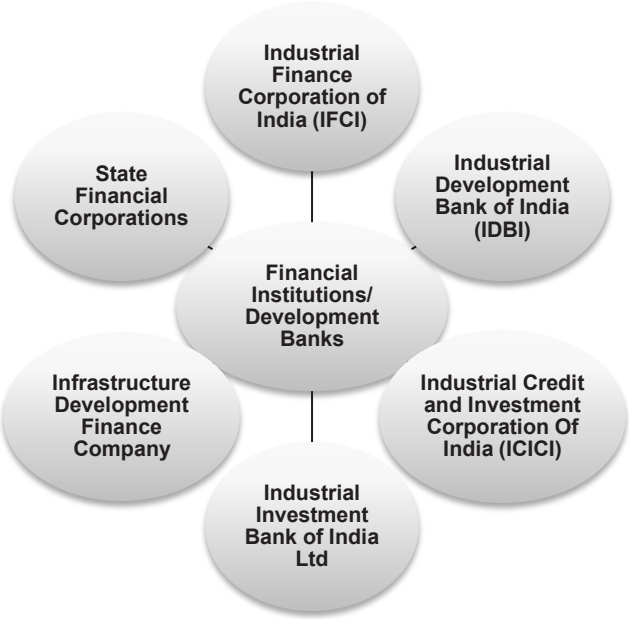
Initially the RBI had issued detailed guidelines for Licensing of "Small Finance Banks" in the Private Sector on November 27, 2014. The process resulted in licensing and granting in-principle approval to ten applicants and they have since then successfully established the banks. It was also notified by RBI that result of gaining experience in dealing with these banks, RBI will consider 'on tap' licensing of these banks. After a review of the performance of the existing small finance banks and to encourage competition, it was announced in the Second Bi-monthly Monetary Policy Statement, 2019-20 dated June 06, 2019 that the Reserve Bank would put out draft guidelines for 'on tap' licensing of such banks. Accordingly, the RBI has circulated guidelines for licensing of small finance banks in the private sector have been formulated for continuous authorization (i.e. "On Tap licensing"). These guidelines consist of the following:

1. Registration, licensing and regulations 2. Objectives 3. Eligible promoters 4. Scope of activities 5. Capital requirement 6. Promoters' contribution 7. Foreign shareholding 8. Voting rights and transfer / acquisition of shares 9. Prudential norms 10. Additional conditions for NBFCs/MFIs/LABs converting into a bank 11. Business plan 12. Corporate governance 13. Other conditions 14. Transition path 15. Procedure for application 16. Procedure for RBI decisions

Development Banks

The emerging economies of post-colonial era, assumed responsibilities of national economic development activities such as industrial, financial, infrastructure, agricultural, exports etc. themselves. Financial institutions which were created to address these issues of economic importance are called Developmental Financial Institutions ('DFI').The basic emphasis of a DFI is to offer cheaper long-term financial assistance "for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear."

In India soon after independence RBI was entrusted with the responsibility of establishing appropriate institutions in the preferred sectors as per plans of the Government. The need of the hour was to establish institutions to cater to the demand for long-term finance by the industrial sector. This was followed by the formation of Industrial Finance Corporation of India (IFCI) in the year 1948.



The following represents a list in chronological order Development Banks set up in India over the years.

1. **Industrial Finance Corporation of India (IFCI) 1948**: IFCI was established for catering to the long term finance needs of the industrial sector. It was provided access to low-cost funds through the RBI's Statutory Liquidity Ratio (SLR) which in turn enabled it to provide loans and advances to corporate borrowers at concessional rates. This arrangement lasted till 1990s. Later it was decided to access capital markets for its funds needs. For this purpose its constitution was changed to a company under The Companies Act 1956. IFCI's main focus was project finance, financial services and corporate advisory service. It continued to play its pioneering role. IFCI has been revamped over the years.

IFCI is also a Systemically Important Non-Deposit taking Non-Banking Finance Company (NBFC-ND-SI), registered with the Reserve Bank of India. The primary business of IFCI is to provide medium to long term financial assistance to the manufacturing, services and infrastructure sectors. Through its subsidiaries and associate organizations, IFCI has diversified into a range of other businesses including broking, venture capital, financial advisory, depository services, factoring etc. As part of its development mandate, IFCI was one of the promoters of National Stock Exchange (NSE), Stock Holding Corporation of India Ltd (SHCIL), Technical Consultancy Organizations (TCOs) and social sector institutions like Rashtriya Gramin Vikas Nidhi (RGVN), Management Development Institute (MDI) and Institute of Leadership Development (ILD).

The Government of India, as per the Budget for FY 2014-15 has mandated IFCI for setting up of a Venture Capital Fund under Social Sector initiatives with an aim to promote entrepreneurship among the Scheduled Castes (SC) and to provide concessional finance to them. IFCI, since its inception, has cumulatively sanctioned Rs.1,06,714.22 Crore to 5,239 projects and disbursed Rs.91,558.39 Crore.

2. **Industrial Credit and Investment Corporation of India (ICICI) 1956**.: For providing foreign currency financing over medium term and long term for importing of capital goods for industries, ICICI was formed at the initiative of the World Bank, the Government of India and Indian industry. From 1990s onwards, ICICI focused on Project Finance. However due to liberalization of economic policies of the Government of India, during the period1991- 2000, ICICI transformed itself as a diversified financial services group, including commercial banking services through its subsidiary ICICI Bank. Later in the year 2002 through the merger route, ICICI Ltd.

along with two of its subsidiaries merged with ICICI Bank Ltd. to form a single entity. Today, ICICI along with its subsidiaries, has moved close to being an Universal Bank and is functioning under umbrella brand of ICICI Bank.

3. **Industrial Development Bank of India (IDBI) 1964**: Government of India through an Act of parliament established IDBI in the year 1964. IDBI has played a pioneering role in promoting industrial growth through financing of medium and long-term projects from various sectors for the development of Indian economy. IDBI has played a significant role, particularly in the pre-reform era period of 1964-1991. Right from the beginning IDBI focused its objectives on long term financing of industries. Unlike IFCI which focused on a few industries, IDBI had a broad based approach of a gamut of industries including core sector. The basket of services provided included financial assistance in rupee and foreign currencies, for green-field projects as also for expansion, modernization and diversification purposes.

In the wake of financial sector reforms unveiled by the Government since 1992, IDBI evolved an array of fund and fee-based services for providing an integrated solution to meet the entire demand of financial and corporate advisory requirements of its clients. IDBI also provided indirect financial assistance by refinancing loans extended by State-level financial institutions and banks, and by rediscounting bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

In response to the felt need and on commercial prudence, IDBI was advised to transform itself in to a Bank. Since IDBI was constituted through an Act of Government of India in 1964 as a Development bank, to facilitate it's conversion in to a Bank, the , Industrial Development Bank (transfer of undertaking and Repeal) Act, 2003 [Repeal Act] was passed repealing the Industrial Development Bank of India Act, 1964.

"In terms of the provisions of the Repeal Act, a new company under the name of Industrial Development Bank of India Limited (IDBI Ltd.) was incorporated as a Govt. Company under the Companies Act, 1956 on September 27, 2004. Thereafter, the undertaking of IDBI was transferred to and vested in IDBI Ltd. From the effective date of October 01, 2004. In terms of the provisions of the Repeal Act, IDBI Ltd. has been functioning as a Bank in addition to its earlier role of a Financial Institution. In view of changes in the economic and corporate environment due to reforms, Government of India later decided to transform IDBI into a commercial bank without sacrificing its development finance role and obligations. The new structural change enables IDBI to have access to low-cost current, savings bank deposits, would support the development finance obligations as also simultaneously enable it to expand its client/ asset base." Subsequently United Western Bank Ltd. a private sector bank which was under moratorium was amalgamated with IDBI on October 3, 2006.

To truly reflect it's the multifarious functions it performed, the name of the Bank was changed to IDBI Bank Limited effective from May 07, 2008. In 2011 two of IDBI's wholly owned subsidiaries viz. IDBI Home Finance Ltd. and IDBI Gilts Ltd. were amalgamated with IDBI Bank. After merger IDBI Bank has been able to offer a comprehensive services to various clientele right from an individual to a giant corporate.

On account of NPAs from the year 2016-17 onwards, there was mounting losses recorded by IDBI Bank. Due to this, the RBI placed IDBI Bank under Prompt Corrective Action ('PCA') restricting its credit disbursal. Taking cognizance of the developments, in August 2018, the Union Cabinet "approved the acquisition of controlling stake by Life Insurance Corporation (LIC) as a promoter" in IDBI Bank through "a combination of preferential allotment and open offer of equity". Accordingly LIC applied to Insurance and Regulatory and Development Authority (IRDA), for permission as LIC's primary business was that of Insurance. IRDA gave a technical go ahead for acquisition of 51% of the stake of the IDBI Bank by LIC. The acquisition of 51% stake in IDBI Bank was completed on January 2019 making it a majority stake holder of the bank. Later on March 21, 2019 by way of Press Notification, the RBI has informed the public as under :

"IDBI Bank Limited has been categorized as a 'Private Sector Bank' for regulatory purposes by Reserve Bank of India with effect from January 21, 2019 consequent upon Life Insurance Corporation of India acquiring 51% of the total paid-up equity share capital of the bank."

4. **Industrial Investment Bank of India Ltd. :** The Industrial Investment Bank of India, earlier known as Industrial Reconstruction Bank of India is one of oldest banks in India. It was earlier known as The Industrial Reconstruction Corporation of India Ltd., (IRBI) which was set up in 1971 for rehabilitation of sick industrial companies. It was reconstituted as in 1985 under the IRBI Act, 1984.. With a view to convert the institution into a full-fledged development financial institution, IRBI was incorporated under the Companies Act, 1956, as Industrial Investment Bank of India Ltd. (IIBI)in 1997. IIBI offered a wide range of products and services, including term loan assistance for project finance, short duration non-project asset-backed financing, working capital/ other short-term loans to companies, equity subscription, asset credit, equipment finance as also investments in capital market and money market instruments However, due to plethora of problems faced by this institution on account of impaired assets, IIBI was ordered to be wound up in the year 2012.

5. **Infrastructure Development Finance Company (1997) :** IDFC was founded in 1997 in terms of recommendations of an expert group on commercialization of Infrastructure projects under the Chairmanship of Dr. Rakesh Mohan. Later in the year 1998 it applied for a Non-Banking Finance Company registration with RBI. In the year 1999 it was declared as a Public Financial Institution. In 2000 it registers as a Merchant Banker and also as a debenture trustee in 2001. In subsequent years IDFC has forayed in to overseas fund raising for private equity and through infrastructure bonds, investment banking, asset management etc. In 2013 IDFC had applied for a Banking licence to RBI under new licencing policy. In April 2014 RBI had granted an in-principle approval to IDFC for setting up a bank. After 18 months IDFC got a banking licence to commence Banking operations. It started operating Banking services from October 2015. Now, IDFC operates its banking operation through a separate entity called IDFC Bank.

Over the years IDFC had been building up its competence in various areas of financial services like providing assistance by way of debt and equity support, mezzanine financing and advisory services. It encouraged banks to participate in financing of infrastructure projects through 'takeout' financing for a specific term and at a preferred risk profile, with IDFC taking out the obligation after a specific period. Also through its guarantee structure, had helped to promote raising of resources from international markets. IDFC was ~~s~~ actively involved in the process of policy formulation of Government of India, relating to infrastructure sector development. However due to changes in Macro environmental factors globally as well as locally. With a range of expertise under its belt IDFC can be said to be well settled to play a role of an Universal Bank.

IDFC Bank and a NBFC called Capital First had announced completion of their merger on December 2018, creating a combined loan asset book of Rs 1.03 lakh crore for the merged entity and renamed itself as IDFC First Bank Limited. Their aim was stated to become a "Universal Bank" in providing banking services to the public.

6. **State Financial Corporations :** The State Financial Corporation Bill passed by both houses of parliament, received the concurrence of the Hon'ble President on 31st October,1951. It came on the statute book as "The State Financial Corporation Act, 1951." This Act empowered ~~the~~ each state and union territory to establish a state financial corporation with a view to provide financial assistance to house hold, small and medium scale industries. The area of operation of each State Financial Corporation (SFC) falls within the state, in which it has been established, but in some exceptional cases the activities may be extended to neighbouring states or union territory, if there are no state financial corporations in the concerned states. For example, Maharashtra State Financial Corporation's activities extended to Goa, Daman & Diu. Similarly, Delhi Financial Corporation, on reorganization of erstwhile Punjab Financial Corporation (PFC) which was divided into four SFCs in 1967

was established and since then the DFC has been catering the financial needs of the industries in UT of Delhi and Chandigarh. In terms of Section 13(1)(1) of SIDBI Act,1989 SIDBI provides refinance to State Financial Corporations and other banks. Under the scheme, SIDBI sanctions refinance against term loans sanctioned by the SFCs to industrial concerns in Micro, Small and Medium Enterprises (MSMEs) sector for setting up of industrial projects and also for their expansion, modernization and diversification. Based on the annual Business Plan and Resources Forecast (BPRF), refinance limits are sanctioned to SFCs annually.

The services of State Financial Corporations (SFCs), mainly aims at lending money for creation, technology up-gradation, modernization, expansion and overall development of Micro, Small and Medium Enterprises (MSME), including commercial vehicles. SFCs are also providing financial assistance to manufacturing and service industries of their respective states. To diversify its activities, the SFCs are also contemplating to offer their services through Non-Banking Financial Companies(NBFC).By the year 1955-56, only 12 SFCs were set up and 1967-68, all the 18 SFCs came into existence and now are fully in operation. SFCs set up in various states as regional institutions represent an attempt to diversify structure of development banking in India so as to be able to cope up with requirements of wider sections of industrial enterprises.

NON-BANKING FINANCIAL COMPANIES (NBFC)

Financing of business by unorganized sector had been a long time practice in India. It dates back to 1930s till 1965. In 1965 need was felt to bring in separate regulatory mechanism. As a consequence Chapter III-B was inserted in the RBI Act. This was basically brought in to regulate the fiercely competitive car segment. Thus began the regulation of the unorganized players in the financial market. In 1975 the RBI accepted the recommendations of James Raj committee which went in to the working and regulation of finance companies in the market. Certain recommendations made relating to the quantum of accepting deposits from public and also regarding net-owned funds. In spite of this, there was quantum jump in the establishment of NBFCs in India. The number of NBFCs went up from 7000 in 1980 to 30,000 in 1992. The sudden growth brought in its own set of problems as well as certain unhealthy practices in these finance companies.

To address these issues RBI set up a committee under the Chairmanship of Mr. A.C. Shah, which recommended compulsory registration and prudential norms. Subsequently, regulatory norms were put in place in 1997 incorporating the above norms. In the light of continuous changes in operating environment, further amendments to NBFC regulations were made in subsequent years too on an ongoing basis.

According to RBI, the current definition of NBFC is “a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company called Residuary non-banking company.”

Technically a NBFC has also been defined by RBI as “ ….when a company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfills both these criteria will be registered as NBFC by RBI”.

NBFCs differ from Banks on following grounds:

i. NBFC cannot accept demand deposits; whereas banks can accept the same.

ii. NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself, whereas banks can do so;

iii. Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

iv. An NBFC is not required to maintain Reserve Ratios (CRR, SLR etc.)

v. An NBFC cannot indulge Primarily in Agricultural, Industrial Activity, Sale-Purchase and Construction of Immovable Property.

NBFCs play an important role in the Indian financial system by complementing and competing with banks and by bringing in efficiency and diversity into financial intermediation. The Reserve Bank's regulatory perimeter is applicable to companies conducting non-banking financial activity, such as lending, investment or deposit acceptance as their principal business. The regulatory and supervisory architecture is, however, focused more on systemically important non-deposit taking NBFCs (with asset size Rs. 5 billion and above) and deposit accepting NBFCs with light touch regulation for other non-deposit taking NBFCs.

***Harmonisation of different categories of NBFCs:** With effect from February 22, 2019, the RBI has decided to harmonise three different categories of NBFCs into one, based on the principle of regulation by activity rather than regulation by entity. Accordingly, three categories of NBFCs, that is, asset finance companies (AFCs), loan companies (LCs) and investment companies (ICs) are to be combined into a single category NBFC Investment and Credit Company (NBFC-ICC). Accordingly the categorization of N BFC will stand reduced from 12 to 10.

Classification of NBFCs based on Activity (Feb.2019)

Type of NBFC	Activity
1. Investment and Credit Company (NBFC- ICC) (merged entity of Asset Finance Company (AFC) /. Loan Company, Investment Company)	Financing of physical assets supporting productive / economic activities, including automobiles, tractors and generators.
	Providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an asset finance company.
	Acquiring securities for purpose of selling.
2. NBFC- Infrastructure Finance Company (NBFC-IFC)	Providing infrastructure loans.
3. NBFC-Systemically Important Core Investment Company (CIC-ND-SI)	Acquiring shares and securities for investment mainly in equity market.
4. Infrastructure Debt Fund-NBFC (IDF-NBFC)	For facilitating flow of long-term debt into infrastructure projects.
5. NBFC-Micro Finance Institution (NBFC-MFI)	Extending credit to economically disadvantaged groups.
6. NBFC-Factor	Undertaking the business of acquiring receivables of an assignor or extending loans against the security interest of the receivables at a discount.

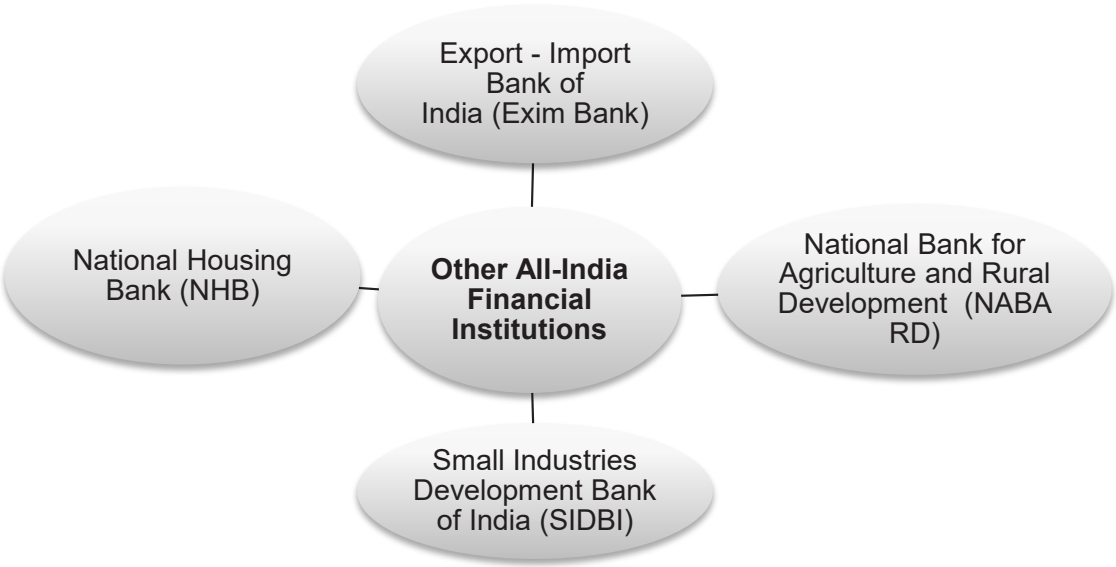
7. NBFC- Non-Operative Financial Holding Company (NOFHC)	For permitting promoters / promoter groups to set up a new bank.
8. Mortgage Guarantee Company (MGC)	Undertaking mortgage guarantee business.
9.. NBFC-Account Aggregator (NBFC-AA)	Collecting and providing information about a customer's financial assets in a consolidated, organized and retrievable manner to the customer or others as specified by the customer.
10. NBFC-Peer to Peer Lending Platform (NBFC-P2P)	Providing an online platform to bring lenders and borrowers together to help mobilize funds.

According to "Progress and Trend of Banking in India" published by RBI, as at the end of September 2018 the total number of NBFC stand as under :-

- The total number of NBFCs - 10,190
  - NBFCs – Deposit taking - 108
  - NBFCs – Non-Deposit taking 10,092
- Out of 10,092 Non-Deposit taking NBFCs, 276 are considered as Systemically Important.

Financial Institutions in India

According to the Economic Survey of 2012-13 the Reserve Bank of India had declared the following institutions as All-India Financial Institutions. They are-



Export- Import Bank of India

Established in 1982 through an Act of Government of India viz. Export –Import Bank of India Act, 1981. It was established to make available financial facilities for exporters and importers. Export-Import Bank of India is the premier export finance institution of the country. Also EXIM Bank was intended to serve as principal financial institution coordinating the functioning of those institutions engaged in financing export and import of goods and services with a view to promote International Trade of our country . Commencing its role as a purveyor of export

credit, similar to some of its foreign counterparts, EXIM Bank over the period had evolved in to a dependable institution for the global operations of various industries including that of Small and Medium enterprises.

EXIM Bank offers a wide range of products for partner industries such as import of technology and export product development, export production, export marketing, pre-shipment and post-shipment and overseas investments.

The flagship schemes of EXIM Bank are as follows:

- Buyer's Credit
- Corporate Banking
- Line of Credit
- Overseas Investment Finance
- Project Exports

In addition to the above, EXIM Bank offers

- **Marketing Advisory:** To help Indian exporting firms in their globalisation efforts by proactively assisting in locating overseas distributors/buyers/partners for their products/services as well as to identify overseas opportunities for setting up plants or projects or for acquisition of overseas companies. In this EXIM Bank plays a promotional role to create and enhance export capabilities and international competitiveness of Indian companies. For this efforts, the Group leverages the Bank's high international standing, in-depth knowledge and understanding of the international markets and well established institutional linkages. Its physical presence supports Indian companies in their overseas marketing initiatives on a success based fee.
- **Research & Analysis:** A team of experienced economists and strategists with in-depth insights on international economics, trade and investment monitors trends in global and domestic economies to analyse their impact on Indian and other developing economies. Besides catering to the constituents within the Bank, the Group also connects with the Government, RBI, exporters/importers, trade & industry associations, external credit agencies, academic institutions and researchers. It also searches avenues to enhance India's international engagement and implements the research under a broad classification of regional, sectoral and policy related studies etc. With an objective to provide up-to-date information to Indian traders and investors, the Group publishes various bulletins regularly with information on export opportunities and highlights developments that have a bearing on Indian exports.
- **Export Advisory:** Under this, EXIM Bank offers a diverse range of information, advisory and support

services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness. Value added information and support services are provided to Indian projects exporters on the projects funded by multilateral agencies.

EXIM Bank undertakes customised research on behalf of interested companies in the areas such as establishing market potential, defining marketing arrangements, and specifying market distribution channels. Developing export market entry plans, facilitating accomplishment of international quality certification and display of products in trade fairs and exhibitions are other services provided.

EXIM Bank provides a wide range of information, advisory and support services, which complement its financing programmes. These services are provided on a fee basis to Indian companies and overseas entities. The scope of services includes market-related information, sector and feasibility studies, technology supplier identification, partner search, investment facilitation and development of joint ventures both in India and abroad.

Thus EXIM Bank has evolved itself as a single window service provider to international trading entities from India.

National Bank for Agriculture and Rural Development (NABARD)

Till late 1970s there was no institutional credit arrangement for Agriculture and Rural credit in India. The needs were looked after by Reserve Bank of India and Agricultural Refinance and Development Corporation ('ARDC'). However, the importance of institutional credit in boosting rural economy has been clear to the Government of India right from its early stages of planning. Therefore, the Reserve Bank of India (RBI) at the insistence of the Government of India, constituted a Committee to Review the Arrangements For Institutional Credit for Agriculture and Rural Development (CRAFICARD) to look into these very critical aspects. The Committee was formed in 30 March 1979, under the Chairmanship of Shri B. Sivaraman, a former member of Planning Commission, Government of India.

The Committee's interim report, submitted in November 1979, outlined the need for a new institutional arrangement for providing attention, direction and focus to credit related issues linked with rural development. It recommended for formation of a unique development financial institution which would address these aspirations and this lead to the formation of National Bank for Agriculture and Rural Development (NABARD) as approved by the Parliament through Act 61 of 1981.

NABARD came into existence in July 1982 by transferring the agricultural credit functions of RBI and refinance functions of the then ARDC. It was dedicated to the service of the nation by the then Prime Minister in November 1982.

Set up with an initial capital of Rs.100 crore. Consequent to the revision in the composition of share capital between Government of India and RBI, NABARD today is fully owned by Government of India. As on March 2019 the entire capital of NABARD which stands at Rs. 12,580 crores is fully held by Government of India. NABARD is involved directly and indirectly in an extensive manner in financing of agriculture, rural development apart from extension activities and supervisory roles. A brief on the same is as follows:

- Direct Finance in the form of Loans for Food Parks and Food Processing Units in Designated Food Parks,
- Loans to Warehouses, Cold Storage and Cold Chain Infrastructure,
- Credit Facilities to Marketing Federations, Rural Infrastructure Development Fund,
- Direct Refinance Assistance to Co-operative Banks,

- Financing and supporting Producer Organisations,
- More Direct Finance in the form of Infrastructure Development Assistance,
- Financing and developing Primary Agricultural Co-operative Societies and Umbrella Programme for Natural Resource Management.
- Short term and long term refinancing of agriculture loans to various banks and other agencies apart from refinancing under off-farm sector.

NABARD in its developmental role, is involved in efficient credit delivery system to service the needs of agriculture and rural development. Since more than 50% of the rural credit is disbursed by the Co-operative Banks and Regional Rural Banks (RRBs) NABARD is responsible for regulating and supervising Co-operative banks and RRBs. In this direction NABARD has been taking various initiatives in association with Government of India and RBI to improve the health of Co-operative banks and Regional Rural Banks. Apart from this, NABARD is also involved in Financial inclusion, Micro credit and Micro credit innovation, Core Banking Solution to Co-operative Banks, Climate change, to name a few.

In its supervisory role as empowered by Section 35(6) of the Banking Regulation Act, 1949, NABARD conducts inspection of State Cooperative Banks, Central Cooperative Banks and RRBs. On its own, on a voluntary basis NABARD conducts periodic inspections of state level cooperative institutions such as State Cooperative Agriculture and Rural Development Banks (SCARDB), Apex Weavers Societies, Marketing Federations etc.

Small Industries Development Bank of India (SIDBI) (1990)

The Small Industries Development Bank of India (SIDBI) came in to existence in 1990 through an Act of Parliament (SIDBI Act, 1989) as a wholly owned subsidiary of IDBI. It was envisaged to be the principal financial institution for promoting, financing the development of industries in the small-scale sector and also carries out coordinating the functions of institutions engaged in similar activities.

SIDBI commenced its operations in April 1990 by taking over the outstanding portfolio and activities of IDBI pertaining to the small-scale sector. By an amendment to the SIDBI Act in 2000, IDBI the majority stake holder, diluted its holdings in SIDBI in favour of a few Public Sector Banks and other Central Government undertakings.

SIDBI's operational domain consist of the entire domain of SSI sector, including the tiny, village and cottage industries as defined under MSME Act, 2008. With appropriate tailor made schemes to meet setting up of new projects, expansion, diversification, modernization and rehabilitation of existing units therein. SIDBI caters the need of SSI sector. SIDBI also offers refinance, bills rediscounting, lines of credit and resource support mechanisms to route assistance to SSI sector through a network of banks and State level financial institutions. SIDBI also offers direct finance for meeting specific requirements of SSI sector. The Government also extends line of credit to SIDBI to enable it to extend loans at more affordable rates to its traditional clientele. Over the years SIDBI has carved for itself a 'niche' in financing of SSI and associated sectors.

National Housing Bank (NHB)

In India there was no institutional arrangement for long term financing of individuals' housing, for a long time. This short coming was identified by the Sub-Group on Housing Finance for the Seventh Five Year Plan (1985-90) as a stumbling block, hindering the progress of the housing sector and recommended setting up of a nodal, national level institution.

The Government of India, accepted the recommendation of the sub-group of the planning commission and a High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor of RBI, was set-up

to examine the proposal. The high level group recommended the setting up of National Housing Bank ('NHB') as an autonomous housing finance institution which as accepted by the Government .

While presenting the union budget in 1987-88 the Hon'ble Prime Minister of India, on February 28, 1987 announced the decision to establish the NHB as an apex level institution for housing finance.

Following that, the legislative process for passing an Act was in progress and NHB bill was passed in the winter session of 1987 and in December, 1987, became an Act of Parliament. The National Housing Policy, formulated in 1988 envisaged the setting up of NHB as the Apex level institution for housing. All these steps resulted in setting up of NHB on July 9, 1988 under the NHB Act, 1987.NHB is wholly owned by Reserve Bank of India, which contributed the entire paid-up capital. However the RBI has divested its entire stake in NHB amounting to Rs. 1450 crore on March 19, 2019 in favour of Government of India. With this, the Government of India now holds 100% stake in NHB. This was done on the basis of the recommendation of Narasimham Committee II Report and the Discussion Paper prepared by RBI on Harmonizing the Role and Operations of Development Financials Institutions and Banks. Based on the recommendation, RBI announced the proposal to transfer ownership of its shares in SBI, NHB and NABARD to the Central Government in the Monetary and Credit Policy for the year 2001-02.

The Preamble of the National Housing Bank Act, 1987 describes the basic functions of the NHB as –"… to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto."

According to Section 14 of NHB Act, some of the important businesses which NHB is permitted to transact, are the following:

"(a) promoting, establishing, supporting or aiding in the promotion, establishment and support of housing finance institutions.

(b) making of loans and advances or rendering any other form of financial assistance whatsoever to housing finance institutions and scheduled banks, [or to any authority established by or under any Central, State or Provincial Act and engaged in slum clearance].

(d) guaranteeing the financial obligations of housing finance institutions and underwriting the issue of stocks, shares, bonds debentures and securities of every other description of housing finance institutions.

(h) formulating one or more schemes, for the purpose of mobilisation of resources and extension of credit for housing.

(i) formulating one or more schemes for the economically weaker sections of society which may be subsidised by the Central Government or any State Government or any other source etc."

The operations of NHB include the following :

- Raising resources from various sources including from general public.
- Refinancing various Primary Lending Institutions.
- Extending Project Finance in terms of Section 14 (ba) of the NHB Act, 1987 to various public agencies like State Housing Boards, State Slum Clearance Development Municipal Corporations, Urban Local Bodies, etc.
- The power to Register, Regulate and Supervise Housing Finance Companies (HFC) of NHB has been now taken over by RBI on account of the following:

On August 19, 2019 RBI had issued the following notification – "The Finance (No.2) Act, 2019 (23 of 2019) has amended the National Housing Bank Act, 1987 conferring certain powers for regulation of Housing Finance Companies (HFCs) with Reserve Bank of India. HFCs will henceforth be treated as one of the categories of Non-Banking Financial Companies (NBFCs) for regulatory purposes. Reserve Bank will carry out a review of the extant regulatory framework applicable to the HFCs and come out with revised regulations in due course. In the meantime, HFCs shall continue to comply with the directions and instructions issued by the National Housing Bank (NHB) till the Reserve Bank issues a revised framework. NHB will continue to carry out supervision of HFCs and HFCs will continue to submit various returns to NHB as hitherto. The grievance redressal mechanism with regard to HFCs will also continue to be with the NHB." This effectively implies that RBI will exercise its authority for registering, regulating and supervising HFCs from a date to be notified in future.

- Provides Equity Participation to various HFC.
- Participation in Government Schemes as a Nodal agency for the following schemes.
    - NHB introduce 1% interest subvention scheme on 1.10.2009

NHB is one of the two nodal agencies for the Urban Poor (ISHUP) and heating and solar lighting systems in renamed it as Rajiv Rinn Yojana (RRY)

NHB has been designated as an agency for administering and monitoring Capital Subsidy Scheme for Installation of Solar Water Heating and Solar Lighting Systems in Homes

LESSON ROUND UP

- Under the British government, Agency banks gave rise to Presidency banks. Presidency Banks later lead to the formation of Imperial Bank of India, which was succeeded by State Bank of India after independence.
- Reserve Bank of India which was formed in 1935 started playing the roles of central bank and monetary authority which until then were performed by Imperial Bank of India. Post-independence Reserve Bank was nationalized and also is armed with Regulatory powers.
- According to the felt needs of the government, State Bank of India was established for taking over the functions of Imperial Bank of India. Later banks of all princely States were amalgamated with State Bank of India as its Associates.
- These Associates were again amalgamated in to State Bank of India and presently State Bank of India is a single entity and its Associates having merged in SBI.
- Private Joint stock banks were being established from 1894 onwards in India; some of them continue to function even today. Out of these 20 of them were nationalized in 1969 and 1980 respectively and they became a formidable force in Indian banking, which is highly regulated by Government /RBI.
- Post-independence era saw the establishment of Development Banks at national level and at States levels spanning across Industrial Development including Small Industries, Agriculture, Housing, Export-Import etc., and some of them have converted themselves as commercial banks.
- Economic liberalization coupled with banking reforms saw the birth of New generation private sector banks which have become a force to reckon with in Indian banking.

- Cooperative Institutions have emerged from a simple setup to one of the largest segments that finance agriculture over the period of time.
- Private financing companies which were in existence from 1930s have been brought under a regulatory frame work and today they function as NBFCs.
- To deepen Financial inclusion as well as financing of small businesses and also to track the same, new categories of banks viz. Small Finance Banks and Payment banks were established from 2015/2016 onwards.

GLOSSARY

- **Indian banking System** - Indian Banking System encompasses Agency House Banks, Presidency Banks, Imperial Bank of India, Reserve Bank of India, Private/Joint Stock Banks (Old generation private sector banks), State Bank of India, Associate Banks, Old Nationalized Banks, New Generation Private Sector Banks, Foreign Banks, Co-operative Banks, Regional Rural Banks, Local Area Banks, Small Finance Banks and Payments Banks and Financial Institutions known as Development Banks and Non-Banking Financial Companies.
- **Reserve Bank of India** - It was established on 1935 as a banker to the central government.
- **Scheduled Bank** - A scheduled bank is one which is included in the Second Schedule of RBI Act and enjoins it to have a minimum capital of Rs. 5 lacs and maintain reserves as per the directions of RBI.
- **Non-Scheduled Bank** - Non-scheduled banks are those which are not listed in the Second schedule of the RBI Act, 1934 having a reserve capital of less than 5 lakh rupees.
- **Private Sector Banks** - As the name implies the ownership of these banks rests with private individuals and corporates including foreign entities.
- **State Bank of India** - State Bank of India originated from the three Presidency banks namely Bank of Bengal, Bank of Bombay and Bank of Madras and the successor to these Presidency banks viz. Imperial Bank of India.
- **Old Generation Private Bank** - The private sector banks which were operating in India prior to the liberalization year of 1991 are known as Old generation private Sector banks.
- **New Generation Private Bank** - The banks that came into existence subsequent to Narasimham Committee Report I and revised RBI guidelines in 1993 are known as new generation private sector banks.
- **Co-operative Banks** - Cooperative Banks are registered under the Cooperative Societies Act, 1912. And regulated by the Reserve Bank of India under the Banking Regulation Act, 1949 and Banking Laws (Application to Cooperative Societies) Act, 1965.
- **Regional Rural Bank (RRBs)** - RRBs are scheduled banks (Government banks) operating at regional level in different States of India. Regional Rural Banks (RRBs) were established in 1975 under the provisions of the Ordinance promulgated on September 26, 1975 and followed by Regional Rural Banks Act, 1976.
- **Small Finance Banks** - These banks promote financial inclusion to sections of the economy not being served by other banks, such as small business units, small and marginal farmers, micro and small industries and unorganised sector entities.

- **Payment Bank** - A payments bank aims to further financial inclusion, especially through savings accounts and payments services. Accordingly, a payments bank is not allowed to give any form of loan or issue a credit card.
- **Development Finance Institutions (DFIs)** - Financial institutions which were created to is offer cheaper long-term financial assistance "for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear." are called Developmental Financial Institutions ('DFIs').
- **State Financial Corporations** - The services of State Financial Corporations (SFCs), mainly aims at lending money for creation, technology up-gradation, modernization, expansion and overall development of Micro, Small and Medium Enterprises (MSME), including commercial vehicles. SFCs are also providing financial assistance to manufacturing and service industries of their respective states.
- **Non Banking Finance Corporations(NBFCs)** - NBFC is "a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/ debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.
- **Export Import Bank of India** - Export-Import Bank of India is the premier export finance institution of the country. Established in 1982 through an Act of Government of India viz. Export –Import Bank of India Act, 1981.
- **National Bank for Agriculture and Rural Development (NABARD)** - NABARD came into existence in July 1982 by transferring the agricultural credit functions of RBI and refinance functions of the then ARDC
- **Small Industries Development Bank of India (SIDBI)** - Small Industries Development Bank of India (SIDBI) was established in April 1990 and it acts as the Principal Financial Institution for Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector as well as for co-ordination of functions of institutions engaged in similar activities.
- **National Housing Bank(NHB)** - NHB is an apex financial institution for housing. NHB has been established with an objective to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions and for matters connected therewith.

SELF TEST QUESTION

1. Fill up the blank
   a. RBI was established in the year _____.
   b. As on date the total number of nationalized banks are _____.
   c. Which among the following does not directly finance Small Scale industries?
2. State whether the following is True of False.
   a. Presidency Banks were amalgamated to form State Bank of India.

b. RBI plays the role of only Monetary Authority.

c. NBFCs come under the jurisdiction of Government of India.

d. Cooperative banks come under the regulatory jurisdiction of RBI only.

e. Payments Banks are allowed to issue credit card.

f. Small Finance Banks finance only entities in the unorganized sector.

3. Write Short note on –

   i. State Bank of India

   ii. Reserve Bank

   iii. AIFI

iv. RRBs

4. Explain the reasons for Nationalization of private banks.

5. Explain the reasons for establishing Small Banks and Payment banks.

For further reading:

1. RBI functions & Other materials – available in www.rbi.org,in
2. Banking Law and Practice – P.N.Varshney , 25th Edition, Sultan Chand & Sons
3. Law and Practice of Banking – M.L. Tannan
4. Commercial Banking – Volume I, II &III – IBA Publication
5. Various articles on History of Banking in India from internet.
6. Evolution of SBI – www.sbi.co.in.

Lesson 2
Regulatory Framework of Banks

LESSON OUTLINE

- Reserve Bank of India Act, 1934 (An overview)
- Banking Regulation Act, 1949 (An overview)
- Constitution of RBI
- Objectives of RBI
- Functions of RBI
- Powers of RBI (An overview)
- Tools of Monetary Control
- Regulatory Restrictions on Lending Business of Banking
- Government as a Regulator of Banks
- Control over Co-operative Banks
- Regulation by other Authorities
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Banking companies are regulated in India through various laws. The principal ones among them are The Reserve Bank of India Act, 1934 and The Banking Regulations Act, 1949.

This chapter will enable a reader to learn about -

- The Reserve Bank of India Act, 1934 and its salient features.
- Powers of The Reserve Bank of India.
- Tools of Monetary policy used by the Reserve Bank of India.
- The Banking Regulation Act, 1949 and its salient features.
- How Co-operative banks are regulated.
- How The Government regulates banks.
- How other Authorities regulate banks.

INTRODUCTION

Banks in India are highly regulated and have to ensure compliance and reporting to RBI and other authorities. The principal regulations applicable to banks originate from the Banking Regulation Act and RBI Act. A detailed knowledge of these are necessary for any student of banking in India. Keeping this in mind, contents this chapter covers constitution and powers of RBI, monetary control measures adopted by banks, constitution & control of banks and other regulatory authorities of banks. These form the broad regulatory frame work of banks in India, the knowledge of which is essential for a any student on banking. The contents are of Level 1 orientation and will be useful for equipping oneself with deeper knowledge about how banks are regulated.

Regulatory Framework of Banks

The principal regulatory frame work of Banks in India involves among others, The Reserve Bank of India Act, 1934 ('RBI Act') and Banking Regulation Act 1949 ('BR Act'). Let us have an over view of the same. Detailed discussion on various provisions of the same are dealt in various topics of this lesson.

RESERVE BANK OF INDIA ACT, 1934 (AN OVERVIEW)

The RBI Act was enacted with an objective of constituting Reserve Bank of India to regulate issue of bank notes, to keep reserves to ensure monetary stability, to operate currency and credit system.

This Act is the basis for constitution, powers, and functions of RBI. This act does not regulate banking directly though section 18 and 42 of RBI Act are used in regulating credit. In broad sense, RBI Act deals with Incorporation, Capital, Management, Business of RBI itself, Central Banking Functions, Collection and furnishing of information, Regulating Non-Banking Institutions receiving deposits and financial institutions, Prohibition of Acceptance of deposits by unincorporated bodies, Regulation of transactions in derivatives, money market instruments, securities etc., Joint mechanism, Monetary Policy, General Provisions, Penalties along with Schedule I and II.

The RBI Act was amended several times in the past to expand the powers of RBI. The last amendment to RBI Act was done in February, 2016 to provide for a Monetary Policy Committee ('MPC'), to maintain price stability under an overall objective of growth. The task of the MPC would be fixing the benchmark policy rate (repo rate) to control and contain inflation within the specified target level. The Committee-based structure is expected to bring in value addition and transparency in this area of policy decisions. MPC will hold meetings at least four times a year and publish the decisions after each such meeting.

Amendments to RBI Act (August 2019)

While presenting the Finance Bill of in August 2019, The Finance Minister proposed the following amendments/ Insertions of Sections to RBI Act 1934 : -

45 IA – Amendment. Increasing the quantum of Net owned funds of a NBFC, 45-ID – (Insertion) Power of RBI to remove directors of an NBFC from office, 45 IE – (Insertion) Supersession of Board of directors of NBFC (other than Government Company)., 45MAA - Power to take action against auditors, '45MBA - Resolution of non-banking financial company, 45NAA – Power in respect of group companies, 58B – (Amendment) Increase in Penalties for Non-compliance and 58G – (Amendment) Increase in Penalties for Non-compliance by NBFCs. Implications of these amendments are as under:-

- RBI has been given more Powers to regulate NBFCs than before including seeking additional financial and business information including activities of group/group companies.

- Empowering RBI to remove directors and Superseding board of directors of delinquent NBFCs.
- Empowering RBI for a Resolution of problematic NBFCs by way of framing of schemes of amalgamation, reconstruction or spilitting in to separate companies, of NBFCs.
- Empowering RBI to forceably interefere in legitimate business of NBFCs in case of emergencies.
- Arming RBI with power of removal/ debaring of Auditors for a period of three years, at a time from auditing any RBI regulated entities.

THE BANKING REGULATION ACT, 1949 (AN OVERVIEW)

The Banking Regulation Act, 1949 applies to the whole of India including Jammu and Kashmir. The Act was initially brought in to force as the Banking Companies Act, 1949, and later renamed as Banking Regulations Act, 1949 w.e.f. 01.03.1966. The Banking Regulation Act does not apply to primary agricultural credit societies, non-agricultural primary credit societies and cooperative land mortgage banks as per section 3. Till 1965 the coverage of this Act was limited to Banking Companies and later in 1966 Co-operative banks were also brought under its jurisdiction. The Banking Regulation Act is applicable along other statutory laws applicable, unless specifically exempted. Therefore provisions of Companies Act are also applicable unless there is an express special provision in the Banking Regulation Act.

Broadly speaking, the Act regulates the entire activities of banking right from licensing, restrictions on share holding, directors, voting rights etc. In addition to these, by an amendment in August 2017, RBI has also been empowered to issue directions to banks to initiate insolvency resolution to recover bad loans.

The Banking Regulation Act further specifies restriction on loans and advances, interest rates to be charged, maintenance of SLR reserves, Audit, inspection, submission of balance sheet and accounts. There are also provisions regarding control over managements, apart from liquidation and winding up as well as penalties. Thus, the Banking Regulation Act tries to regulate the entire gamut of banking business.

CONSTITUTION OF RESERVE BANK OF INDIA

The Genesis

Till the establishment of Reserve Bank of India (RBI), there was dual control of currency issuance and credit control by the then Central government (under British rule) and the Imperial Bank of India respectively. Due to certain developments in the economy, there was a strong view that currency issuance should be delinked from the Government. The Hilton-Young Commission, which was appointed to go in to this issue among others, recommended constituting a central bank to be named as – Reserve Bank of India — which would regulate note issuance and to operate credit system throughout the country. This is evident in the Preamble to The RBI Act, 1934 which reads as " to constitute a Reserve Bank for India to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency any credit system of the country to its advantage". Hence, the Reserve Bank of India was constituted with these primary objects.

Constitution of RBI & Management

The main purpose for which RBI was constituted has been stated in Chapter II Section 3 (1) and (2) of the RBI Act as under -

> "(1) A bank to be called the Reserve Bank of India shall be constituted for the purposes of taking over the management of the currency from the Central Government and of carrying on the business of banking in

accordance with the provisions of this Act.

(2) The Bank shall be a body corporate by the name of the Reserve Bank of India, having perpetual succession and a common seal, and shall by the said name sue and be sued."

RBI has been constituted as a body corporate (under the then prevailing Companies Act) in 1935 and continues in the same manner as it was envisaged, with a capital of Rs. 5 crores, which is wholly owned by the Government of India from January 1, 1949. Prior to 1949 RBI was Private entity owned by public shareholders.

In terms of sections 7(2) and section 8 of the RBI Act, the general superintendence and direction of the affairs and business of RBI is vested in Central Board of Directors, consisting of a Governor, 4 Deputy Governors, and 16 Directors (4 from each local boards, 10 nominated directly by Central Government, 2 Government officials) appointed in terms of the Provisions of RBI Act.

Section 7(1) of RBI Act empowers the Central Government to give directions to the Governor in the public interest after due consultations. The Governor and Deputy Governors hold office for a period of five years, the independent director's tenure is for four years and that of government officials is at the pleasure of the government. All the board officials are eligible for re-appointment. However, independent directors' appointment is restricted to two terms of 4 years each (continuously or intermittently spread over 8 years). A Deputy Governor and Government officials nominated as Director may attend any meeting of the Central Board and take part in its deliberations but shall not be entitled to vote.

However, in the absence of the Governor, and if permitted by Governor in writing, a Deputy Governor may vote in the meetings of Central Board.

In terms of section 9 of the RBI Act, Four local boards have been constituted for each of four areas namely Delhi, Mumbai, Kolkata and Chennai. Local board consists of 5 members each appointed by Central Government to represent, "as far as possible, territorial and economic interests and the interests of co-operative and indigenous banks."

RBI Act confers powers to disqualify Directors and members of Local Boards, remove and vacate them from their office under section 10 & section 11. The Governor has to convene meeting of Central Board at least six times in a year and at least once in a quarter. If any four Directors request the Governor to convene the meeting of Central Board, the Governor has to convene a meeting forthwith.

For the day-to-day conduct of the bank's business the Central Board, in terms of the powers vested in it under section 58 of the RBI Act can make such regulations as it may consider necessary. The regulations so made will be effective only with the prior sanction of the Central Government. The powers of the Board to make regulations .are fairly wide in that the Board can make regulations to cover all matters for which provision is necessary or convenient for the purpose of giving effect to the provisions of the Act including that of internal functioning of RBI.

In particular, the Board is authorised to make regulations in regard to the following matters:

- Conduct of the business of the Central Board/Local Boards and the procedure that may be followed at meetings;
- Delegation of powers and functions to Central Board to Deputy Governors, Directors, or Officers of the Bank, Local Boards;
- Formation of committees of the Central Board and delegation of functions and powers to such committees;

- Constitution and management of staff and superannuation funds
- Execution of contracts binding on RBI, Use of the common seal of the Bank;
- Maintenance of accounts and preparation of balance sheets of RBI;
- Remuneration of Directors;
- The relationship of the scheduled banks with the RBI;
- The returns submitted by the scheduled banks to the RBI;
- Conduct and management of clearing houses for scheduled banks;
- Refund of currency notes of the Government of India or bank notes which are lost, stolen, mutilated or imperfect;
- Any other matter for the efficient conduct of the business of the RBI.

OBJECTIVES OF RBI

The original objectives for which RBI was established were:

- To regulate the issue of Bank notes.
- To keep reserves with a view to securing monetary stability in India.
- To operate the currency and credit system of the country to its advantage.
- addition to the above, due to an amendment in 2016, the following objective was also added viz.
- To operate the monetary policy for maintaining price stability while keeping in mind objective of growth.

FUNCTIONS OF RBI

The functions of the RBI have been enumerated in Chapter III of the RBI Act. The following are broad functions:

- Issue and Management of Currency and Distribution of coins
- Banker to the Government
- Banker to the Banks
- Lender of Last Resort
- Loans and Advances
- Emergency Advances
- Controller of Credit
- Managing the External Value of Rupee
- Collection and Furnishing of Credit Information

Functions of RBI

(i) Issue and Management of Currency and distribution of coins

The currency of our country consists of One-rupee notes and coins (including lower denominations thereof) as well as Bank notes issued by RBI. Issuance of bank notes (currency) is one of the original central banking

functions for which the RBI was established. In terms of section 22, of the RBI Act, RBI has the sole right to issue bank notes in India. Such bank notes are issued by a department of RBI known as Issue Department, which is a separate and wholly distinct department from the Banking Department which is responsible for banking business of the RBI. However the design, form and material of bank notes are to be approved by the Central Government on the basis of recommendations of Central Board of the RBI. Every bank note shall be a legal tender at any place in India. On recommendation of the Central Board, the Central Government may declare any series of bank notes of any denomination to be not a legal tender. For example on November 8, 2016, the Government of India announced the demonetization of all Rs.500 and Rs.1,000 banknotes of the Mahatma Gandhi Series. It also announced the issuance of new Rs.500 and Rs.2,000 banknotes in exchange for the demonetised banknotes. Also RBI has introduced new Rs. 200 notes.

Under Section 24 of RBI Act, RBI has the power to recommend to Central Government various denominations of bank notes, which shall be two rupees, five rupees, ten rupees, twenty rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees, five thousand rupees and ten thousand rupees or other denominations not exceeding ten thousand rupees. The issue department keeps its assets, which forms the backing for note issuance, distinctly separate from that of the assets of the banking department.

The assets of the Issue Department against which notes are issued to public consist of gold coin, gold bullion, foreign securities, rupee coin and rupee securities to such aggregate amount as is not less than Rs. 200 Crores of rupees out of which the value of Gold coins and bullion are to be not less than Rs. 115 Crores.

Within RBI, the Department of Currency Management ('DCM') has the responsibility of administering the functions of currency management. Currency management basically relates to the issue of notes and coins and retrieval of unfit notes from circulation. As on March 2019, the currency management infrastructure consists of a network of 19 issue offices, 3812 currency chests (including sub-treasury offices and a currency chest of the Reserve Bank at Kochi), and 3519 small coin depots of commercial, cooperative and regional rural banks ('RRB's) spread across the country. In order to improve the currency distribution system by leveraging technology, the RBI adopted a hub-and-spoke model for the distribution of banknotes across the country. Fresh note remittances are sent to larger currency chests, which meet the currency needs of a designated area (such as a district). These chests are identified as hub chests and, in turn, supply notes to smaller currency chests in their vicinity which act like spokes in the distribution model. Fresh notes are distributed to every issue office of the RBI as per an allocation plan.

RBI has established a chain of currency chests with several banks in the country. A currency chest is a place where the RBI keeps all the excess money in the form of cash under the custody of different banks. Currency chests are designated branches of commercial banks authorised by the RBI to hold stock of bank notes, rupee notes and coins. These currency chests have the responsibility for distribution of these notes and coins on behalf of RBI. The currency chests get their supply of printed notes from RBI, which are later delivered to the respective banks. Currency chests can be stated to be a depository frame work of the RBI.

The banks which host the currency chests are required to maintain accounts of the chests independently which is subject to monitoring and scrutiny of RBI. Also through a separate set of policy and rules RBI exchanges mutilated or torn notes surrendered by customers through bank branches and currency chests. The bank notes which are issued and circulated by RBI are bearer promissory notes and they are exempt from payment of stamp duty.

(ii) Banker to the Government

In terms of section 20 of RBI Act, RBI has an obligation to Act as a banker to the central government. Under this obligation RBI has to accept monies for account of the Central Government, to make payments up to the

amount standing to the credit of Central Government, to carry out its exchange, remittance and other banking operations, including the management of the public debt of the Union of India.

Also under section 21 of RBI Act, RBI has a right to transact Government business in India which include money, remittance, exchange and banking transactions in India; and, the Central Government to deposit free of interest all its cash balances with the RBI under mutually agreed terms. The Reserve Bank is also saddled with the responsibility of receiving and paying money on behalf of the various Government departments. For carrying out its duties as banker to the Government of India, it is not paid any remuneration. RBI is entitled for a commission for managing public debt functions. The Government transaction work also includes maintaining currency chests at places specified by the Central Government. Similarly section 21A of the RBI Act enables RBI to enter in to agreements with State Governments to transact their businesses.

Under sections 20 and 21(A)(b) of the RBI Act, RBI manages public debt of both Central and State governments. Float new loans on behalf of Central/State governments, conduct periodical auctions of Treasury Bills, issue of dated Government securities as well buying and selling the same are some of the additional work done by RBI in its capacity as a Banker to the Government.

Under the mandate signed with Central Government and State governments RBI extends Ways and Means Advances up to 90 days at an interest rate 2% over the Repo rate. This is basically to manage the temporary mismatches in their short term receipts and payments. RBI also provides investment services by deploying temporary surplus cash balances in Government accounts. RBI also advises the Government on monetary and banking issues when requested to do so. Also manages Consolidated Fund of India, contingency fund and public accounts as these accounts are maintained by RBI.

(iii) Banker to the Banks

This is a special relationship that is created due to statutory requirements under the RBI Act. Once the name of a bank is included in the Second Schedule, that Bank is eligible to be called as a Scheduled Bank. Among other conditions, it is bound to maintain the stipulated Cash reserves under section 42 in an account with RBI. The Scheduled Bank status to any bank also confers privileges such as availing financial accommodation from RBI under specified conditions.

Reserve Bank also provides means of transfer and settlement of funds between banks on account of clearing, remittances, lending and borrowing through such accounts. Thus RBI provides a platform for inter-bank financial transactions. Such accounts of banks are maintained by Deposit Accounts Department of RBI. Intra-bank funds transfers also takes place through an RBI portal known as e-Kuber.

(iv) Lender of last resort

When banks exhaust all other means for raising funds for their operations, they fall back on RBI as a source for finance as provided under the RBI Act. Hence RBI is known as Lender of last resort. RBI grants financial accommodation to banks in terms of section 17(2), (3) and 3 (A) “sale, purchase and rediscount of eligible bills” as well as loans and to advances banks under section 17(4) of RBI Act.

Rediscount of bills with RBI by banks are confined to the following categories :

(a) **Bonafide Commercial bills** forming part of commercial or trade transactions drawn on and payable in India and maturing within 90 days from the date of discount by banks. In case of export bills relating to export from India the maturity may be 180 days. The other pre-requisite is that such bills should have two signatures with one among them that of a scheduled bank.

(b) **Bills related to financing agriculture operations or marketing of crops**: Such bills which are to

mature within 15 months from the date of purchase or discount by banks.

(c) **Bills that are associated with Cottage and Small Scale Industries:** Such bills that are associated with production or marketing aspects of these industries maturing within 12 months of its discount or purchase by banks, drawn and payable within India and having two signatures one of which that of a State Co-operative Bank or a State Financial Corporation supported by a guarantee from State Government concerned on repayment of Principal and interest on these bills.

(d) **Bills representing holding or trading in Government Securities:** Such bills drawn and payable within India, bearing the signature of a Scheduled Bank and maturing within 90 days from the date of purchase or re-discount.

(e) **A foreign bill:** Bills arising out of bonafide export transactions maturing with 180 days drawn in or on any country outside India, such country being a member of International Monetary Fund. For other than export bill, the maturity is not to exceed 90 days.

(v) Loans and Advances

Section 17(4) of the RBI Act empowers Reserve Bank to grant loans among others to, Scheduled Banks, State Co-operative Banks, and State Financial Corporations loans and advances, repayable on demand or on the expiry of fixed periods not exceeding ninety days.

Such loans and advances are granted against the securities of

- stocks, funds and other (than immovable property) securities, in which there is an authorization to a trustee to invest monies
- Gold or silver or documents of title to these
- Promissory Notes or Bills of Exchange eligible for purchase or rediscount by RBI or guaranteed by State Government regarding repayment of principal and interest due on them
- Promissory notes of any scheduled bank or State Co-operative Bank which are supported by documents of title to goods (which have been already transferred, assigned or pledged to any other bank as a security for any advance or loan made of bonafide commercial or trade transactions or those in respect of financing agricultural operations or marketing of crops).

Further by means of Section 17(3-A) of the RBI Act, RBI grants financial accommodation at concessional rates on export oriented bills, repayable on demand or a fixed period which mature in not exceeding 180 days based on declarations from banks. For financing under these schemes RBI had introduced Bill Market Schemes in 1951 and subsequently modified the same in 1970 as New Bill Market Scheme.

(vi) Emergency Advances

Also RBI, grants emergency advances to specified banks on special occasions as envisaged in Section 18 of the said Act in the interest of regulating credit to trade, commerce, agriculture and industries. This special provision is available despite any restrictions stated under Section 17 and Section 18 to RBI and extend such financial accommodation to banks on such bills which are not financeable by RBI, otherwise. Further under Section 18 RBI can make an advance to a State Cooperative Bank or to a cooperative society based on the recommendations of a State Cooperative Bank. Such advance is repayable on demand, or on the expiry of fixed period generally not exceeding 90 days under the terms and conditions specified by RBI.

(vii) Controller of Credit

As Bank credit extended by various banks has its own impact on the economy, one of the key functions for which RBI was constituted was to manage the credit for the advantage of the country. RBI exercises control over the credit extended by banks through specific instruments on account of wide powers granted to it by RBI Act as well as Banking Regulation Act, 1949.

The frame work of credit control are implemented through the following instruments at the command of RBI. They are-

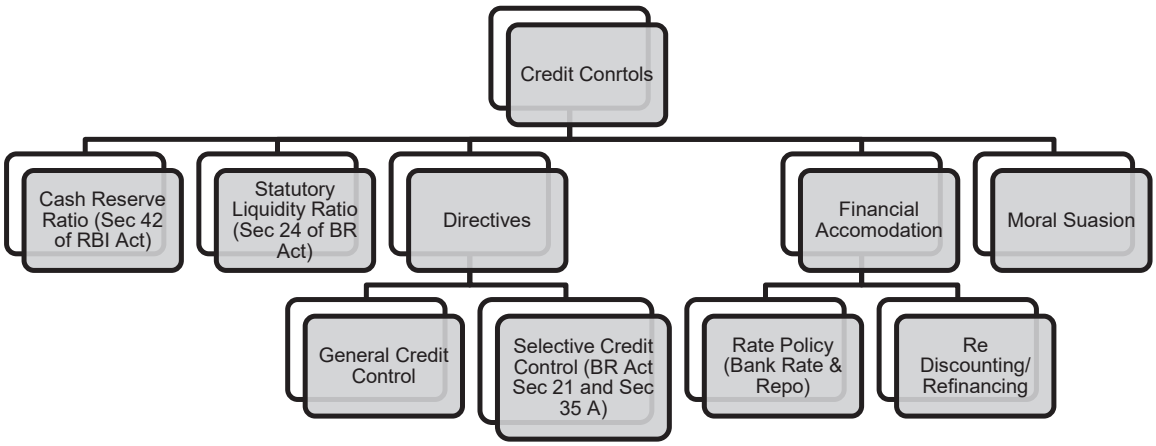
a. Cash Reserve Ratio

b. Statutory Liquidity Ratio

c. Directives under BR Act

d. Refinancing of loans

e. Moral suasion



a. Cash Reserve Ratio (CRR)

In terms of Section 42 of the RBI Act every scheduled bank in India is required to maintain an average daily balance the amount of Cash Reserves with RBI as a percentage of Total Net Demand and Time Liabilities in India. Reserve Bank notifies the percentage of CRR to be maintained by banks at regular intervals through gazette notifications.

Cash Reserve Ratio (CRR) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. according to the

The main purpose of maintaining CRR by the banks is to secure the monetary stability of the country. By increasing the CRR or decreasing the CRR the lendable resources of a bank can be reduced or

increased. This would lead to scarcity of availability of funds or increase in availability of funds in the economy resulting in a deflationary or inflationary effect.

When the RBI Act was introduced, the minimum and maximum floor rates of this ratio to be maintained by banks was specified between 3% to 20% .This was amended 2006 and floor rates were abolished, to give RBI the flexibility to decide and announce the percentage of CRR to be maintained by banks from time to time keeping in view the monetary situation prevailing in the country. By varying CRR, RBI can expand or contract the credit extended by a bank, thus affecting the quantum of credit a bank can extend.

All scheduled banks and Non-scheduled banks have to maintain CRR as per Sec 18 of the RBI Act. Banks have to calculate the CRR on the basis of their respective demand and time liabilities as on the Friday of second preceding fortnight. Reserve Bank of India has prescribed statutory returns i.e. Form A Return (for CRR) under section 42(2) of the RBI Act, and Form VIII Return (for SLR) under section 24 of the Banking Regulation Act, 1949. In addition to the above an incremental CRR in terms of section 42(1A) also need to be maintained as advised by RBI from time to time. At present no incremental CRR need to be maintained. Provisional return of Form A to be submitted by banks within 7 days and final Form A to be submitted within 20 days from expiry of the relevant fortnight.

As per the latest directions after calculations, each bank has to maintain at least minimum CRR balances up to 90 per cent with effect from the fortnight beginning April 16, 2016.

According to RBI, the following are liabilities for the purpose of computation of CRR:

a. Liabilities to the banking system computer under Section 42 (1) of the RBI Act.

b. Credit balances on Asian Currency Union (US Dollar) Account.

c. Demand and Time liabilities of the respective banks off-shore units.

With effect from March 31, 2007 RBI has discontinued paying interest on CRR balances maintained by banks with RBI.

Since June 24, 2006 if a bank defaults in maintaining CRR on daily basis RBI has powers to recover penal interest at the rate of 3% p.a. over Bank Rate on the amount which falls short of the balances on that day. If the short fall continues subsequently on succeeding days, the penal rate will be recovered at a rate of 5% p.a. over Bank Rate.

Presently banks have to maintain 4% of their Net Demand and Time liabilities as CRR.

b. Statutory Liquidity Ratio

In terms of section 24 (2A) of Banking Regulation Act, another tool for controlling credit in the country is available to RBI in the form of Statutory Liquidity Ratio under which, Liquid assets (in the form of prescribed securities by RBI) have to be maintained by all scheduled banks in India.

Statutory Liquidity Ratio (SLR) is the Indian government term for the reserve requirement that the commercial banks in India are required to maintain in the form of cash, gold reserves, government approved securities before providing credit to the customers.

The value of such assets will be specified by RBI from time to time and “such assets shall be maintained,

in such form and manner, as may be specified in such notification."

SLR has to be maintained by both Scheduled and Non-Scheduled banks in India. Scheduled banks have to maintain SLR in addition to the CRR to be maintained by them under Section 42 of the RBI Act and as far as Non-Scheduled banks are concerned SLR would be in addition to balances to be maintained under section 18 of the Banking Regulation Act.

Liquid assets are those assets which can be converted into cash within a shortest time. The main aim of this statutory obligation for a bank to maintain SLR is to safeguard the interests of the depositors but it has also been used as an effective credit control instrument in the hands of RBI. The category of assets to be maintained by banks need to be specified by RBI, though it was earlier formed part of Banking Regulation Act itself.

The Securities that banks can invest under SLR are as follows:

a) Cash

b) Gold Valued at the current market price

c) Unencumbered securities as under:

   i. Dated Securities of Government of India under market borrowing programme or Market Stabilization Scheme; or

   ii. Treasury Bill of Government of India; or

   iii. State Development Loan securities under their market borrowing programme

d) Deposit and unencumbered approved securities under Section 11 of the Banking Regulation Act, 1949 to be made with the Reserve Bank by a banking company incorporated outside India;e) Balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained under CRR.

f) Any other securities notified by RBI from time to time.

The procedure for computation of net demand and time liabilities for the purpose of SLR under section 24 of the Banking Regulation Act 1949 is broadly similar to the procedure followed for CRR purpose. On the recommendations of Narasimham Committee, RBI has reduced the SLR from its peak level of 38.5% in 1991 to 27%in 1997 and to 25% in October 1997. By amending Section 24 of the BR Act, RBI has done away with the minimum level of SLR to be maintained by banks that is 25% but has retained the upper cap level of 40%. And in subsequent years the SLR level to be maintained by banks has been gradually scaled down. RBI in its fifth bi-monthly monetary policy review, took a decision that it will reduce the SLR by 25 basis points (0.25 per cent) every calender quarter until the SLR reaches 18 per cent of the net demand and time liabilities (NDTL) as part of aligning it with the liquidity coverage ratio (LCR). As of now in December 2019 the SLR stands reduced to 18.5%. If a bank defaults in maintaining SLR,RBI will levy a penalty for that day at the rate of three per cent per annum above the Bank Rate on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate of five per cent per annum above the Bank Rate for the concerned days of default on the shortfall.

The effect of increasing SLR would result in leaving lesser amount of lendable funds at the hands of a Bank. Therefore this automatically reduces the supply of funds in the economy resulting in deflationary

effect. The same effect can also be created by increasing the interest rates of lendable funds. On the other hand reducing the SLR would have the opposite effect of increasing the availability of lendable funds which may lead to inflationary effect.

c. Directives

Though one of the core businesses of banking is lending, it has to done by the banking system in a judicial manner so that all sectors of the economy are benefitted. One of the key objectives of RBI is to control the credit through which RBI ensures that credit distribution is in line with national priorities. This casts responsibility on it to ensure adequate credit to industry, priority sector (that includes agriculture and others), housing, infrastructure and other consumers. Therefore RBI has put in special mechanisms for credit controls which are carried out through General Credit Control and Selective Credit Control.

Under General Credit Control RBI uses monetary policy instruments such as Repo rate, Bank rate, Open market operations, and moral suasion and under Selective credit control RBI restricts quantum of credit, margins, maximum amount, etc. relating to sensitive commodities and sectors.

d. Rediscounting /Refinance

Reserve Bank as a lender of last resort provides liquidity support though on a temporary basis through rediscounting/refinance of various schemes, the details of which has already been covered under "Lender of last resort". By increasing or reducing the quantum, rates of interest and period up to which refinance can be availed RBI can curtail or expand the credit availability in the market.

e. Moral Suasion

Moral suasion is a persuasion of banks by Reserve Bank to adhere to the directives and guidelines issued by it. Through advisories the RBI tries influence the banks to follow a desired practice. This is used a soft tool in controlling credit in the economy.

(viii) Managing the external value of Rupee (i.e. Managing Foreign Exchange)

Under section 40 of the RBI Act, there is an obligation on the part of RBI to buy or sell foreign exchange from or to an Authorised Person based on the exchange rate as well as other conditions as the Central Government may determine. The Authorised Persons are those who are licensed to buy or sell foreign exchange under Foreign Exchange Management Act, 1999 (FEMA). In addition, RBI is charged with maintaining the foreign exchange reserves of the country and plays a significant role as controller/regulator of foreign exchange transactions in terms of wide powers it derives from FEMA.

Under the Foreign Exchange Regulation Act regime from 1973, RBI had a very highly centralized role in the area of foreign exchange and it had delegated only limited powers to the Authorised Dealers. All foreign currency inflows were to be surrendered by banks to RBI and it was the only agency which can supply foreign currency at the rates it had determined. Therefore it had a pivotal role in determining and administering rupee exchange rate. However gradually over a period from August 1993, due to liberalization and banking reforms RBI started relaxing many controls over foreign exchange transactions. Due to this, surrendering of foreign exchange to RBI is no more obligatory on banks. RBI also had shifted to market determined rates based on demand and supply for exchanging foreign currency.

With the introduction of FEMA in 2000, the RBI's directions are more obligatory on banks. Authorised persons have been delegated considerable powers relating to various foreign exchange transactions including remittances, overseas. Due to India's significant reliance on capital flows, which are often large, bulk demand for oil imports and bunching up of government payments, along with international political and economic developments, the

forex market becomes susceptible to bouts of volatility. Under these circumstances, as a matter of policy RBI intervenes in the market along with monetary and administrative measures to stabilize the exchange rate of Rupee.

The main objective of exchange rate management by RBI is to ensure that exchange rate of Indian rupee reflects the strong economic fundamentals of the country. Additionally, maintenance of external value of Indian Rupee is guided by three major objectives: "first, to reduce excess volatility in exchange rates, while ensuring that the market functions in an orderly fashion; second, to help maintain an adequate level of foreign exchange reserves, and; third, to facilitate the development of a healthy foreign exchange market."

(ix) Collection and furnishing of Credit Information

Section 45(B) of the RBI Act empowers the RBI to collect credit information regarding borrowers from banks and under Section 45(D) to furnish the same to other banks against request in writing and payment of a nominal fee. The term Credit information includes

- **i.** the amounts and the nature of loans or advances and other credit facilities granted,
- **ii.** the nature of security taken from any borrower for credit facilities granted,
- **iii.** the guarantee furnished by a bank for any of its customers,
- **iv.** the means, antecedents, history of financial transactions and the credit worthiness of any borrower,
- **v.** any other information which the Bank may consider to be relevant for the more orderly regulation of credit or credit policy.

The information furnished to or furnished by RBI is to be treated as Confidential.

POWERS OF RBI (OVERVIEW)

Reserve Bank derives extensive powers under RBI Act as well as Banking Regulation Act, to regulate and supervise various banks in India. An over view of important powers of RBI are given as under:

Under Banking Regulation Act the RBI enjoys the following powers:

Section 10 BB - Power of Reserve Bank to appoint Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director of a banking company.

Where the office of the Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director of a banking company is vacant, the Reserve Bank may, if in its opinion that the continuation of such vacancy is likely to adversely affect the interests of the banking company, appoint a person as Chairman of the Board of Directors or a Managing Director of the banking company.

Section 21 - Power of Reserve Bank to control advances by banking companies: Reserve Bank has the powers to determine policies and direct banking companies to follow the same.

Section 22 - Licensing of banking companies: All Banking companies need to get a licence from RBI and it issues licence only after 'tests of entry' are fulfilled.

Section 24A- Power to exempt a Co-operative bank : Without prejudice to the provisions of section 53, the RBI by notification in the Official Gazette, declare that, the whole or any part of the provisions of section 18 or section 24, as may be specified therein, shall not apply to any co-operative bank.

Section 27 - Monthly returns and power to call for other returns and information: At any time, the RBI may direct a banking company to furnish it with such statements and information relating to the business or affairs of

the banking company (including any business or affairs with which such banking company is concerned) as RBI may consider necessary or expedient to obtain for the purposes of this Act, apart from calling for information every half-year regarding the investments of a banking company and the classification of its advances in respect of industry, commerce and agriculture.

Section 29A - Power in respect of associate enterprises : The RBI may direct a banking company to annex to its financial statements or furnish to it separately, within such time or intervals, necessary statements and information relating to the business or affairs of any associate enterprise of the banking company. It can also conduct an inspection of any associate enterprise of a banking company and its books of account jointly by one or more of its officers or employees or other persons along with the Board or authority regulating such associate enterprise.

Section 30 – Power to order Special audit : In the public interest or in the interest of the banking company or its depositors, the RBI may at any time by order direct that a special audit of the banking company's accounts.

Section 35 - Inspection of Banking Companies : Reserve Bank on its own or being directed so to do by the Central Government, inspect any banking company and its books and accounts and supply to the banking company a copy of its report on such inspection.

Section 35A - Power of the Reserve Bank to give directions : In the public interest or in the interest of Banking policy RBI has powers to issue, modify or cancel as it deems fit, and the banking companies or the banking company, are bound to comply with such directions.

The following Sections have been inserted with effect from May 2017

Section 35AA: Power to Central Government: To, authorise RBI to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016

Section 35AB. (1) Power to RBI:, To issue directions to any banking company or banking companies for resolution of stressed assets. (2) Power to RBI to specify one or more authorities or committees with such members as the Reserve Bank may appoint or approve for appointment to advise any banking company or banking companies on resolution of stressed assets.'.

Section 36 - Further powers and functions of Reserve Bank : RBI may caution or prohibit banking companies or any banking company in particular against entering into any particular transaction or class of transactions.

- On a request by the companies concerned and subject to the provision of section 44A, assist, in the amalgamation of such banking companies.
- Give assistance to any banking company by means of a loan or advance in terms of under section 18 of the RBI Act.
- Direct the banking company to
  - call for a meeting of Directors or
  - discuss such matters with Officers of RBI,
  - depute an officer to such meeting, appoint observers to such meetings
  - furnish information of such meetings
  - make changes in management.

In addition to the above the RBI has also been vested with powers to remove managerial and other persons from

office(section 36AA), to appoint additional Directors (section 36AB), to issue directions in respect of stressed assets (Section 35AB), Supersede Board of Directors in certain cases(Section 36ACA),Supersede Board of Directors of a multi-State Co-operative bank (Section 36AAA) and also to impose penalty (Section 47).

In addition to the above, RBI also enjoys certain powers vis-a-vis banks under RBI Act as per the following table-

	Power	Section
1	Power of direct discount.	18
2	Power to require returns from co-operative banks.	44
3	Power to collect credit information.	45B
4	Power to call for returns containing credit information	45C
5	Power to determine policy and issue directions	45JA
6	Power to call for information from financial institutions and to give directions.	45L
7	Power to regulate transactions in derivatives (excluding capital market derivatives), money market instruments	45W.
8	Power of Bank to depute its employees to other institutions	54AA.
9	Power of the (RBI's) Central Board to make regulations.	58.

Note : The following amendments were inserted in the RBI Act in August 2019: 45 IA – Amendment. Increasing the quantum of Net owned funds of a NBFC, 45-ID – (Insertion) Power of RBI to remove directors of an NBFC from office, 45 IE – (Insertion) Supersession of Board of directors of NBFC (other than Government Company)., 45MAA - Power to take action against auditors, '45MBA - Resolution of non-banking financial company, 45NAA – Power in respect of group companies, 58B – (Amendment) Increase in Penalties for Non-compliance and 58G – (Amendment) Increase in Penalties for Non-compliance by NBFCs.

BANKING REGULATION ACT, 1949

Provisions With Respect To Deposit Accounts

Acceptance of deposits

This is a fundamental function of banks. However this is regulated by RBI under the provisions of Section 35 A including the types of deposits that can be accepted, period up to which deposits can be accepted, rates of interest in case of specific deposits such as non-resident deposits , FCNR accounts etc.

RBI has given freedom to banks to decide the interest rates to be offered on deposits based on their Asset Liability Management policies. It has also issued deposit policy to be followed by banks for providing uniform customer service across all banks.

Unclaimed Deposits

Under section 26A of RBI Act (as per announcement made on May 2014), with effect from June 2014, any unclaimed deposits or unclaimed balances remaining with the banks for 10 years and above should be transferred to Depositor Education and Awareness Fund (DEAF) and such accounts becoming due in each calendar month (i.e. proceeds of the inoperative accounts and balances remaining unclaimed for ten years or more) on the last working day of the subsequent month. Subsequently when a claim is made by depositors or legal heirs it should be re-credited with interest applicable for Savings Bank accounts and a claim to be lodged with RBI for retransferring such balances. Prescribed returns are to be submitted by banks at different

periodicities to RBI.

Nomination facility

Under Section 45 ZA the facility of nomination is provided to depositors of banks including Cooperative banks. The nominee is entitled to claim the deposits in the event of death of depositor/s. In case of a minor too this facility is available in favour of a person who is legally entitled to be a guardian. Payment made by banks in terms of the nomination rules, discharges a bank. The rules framed outline the procedure to be followed and forms to be submitted for nomination, cancellation and variation of nomination.

Similar facility of nomination is available to customers who hire Safe deposit lockers, avail Safe custody service from banks as per Section 45 ZC and Section 45 ZE. For detailed information on Nomination please refer to Annexure to Lesson 5.

Regulation of Payment Systems and Internet banking

Till the year 2007, payments system in India was unregulated. Since the introduction of Payment and Settlement Systems Act, 2007 ('PSS Act') as well as the Payment and Settlement System Regulations, 2008 framed thereunder, came into effect from August 12, 2008. In terms of Section 4 of the PSS Act, only the Reserve Bank of India (RBI) can commence or operate a payment system in India unless authorised by RBI. Coupled with powers conferred under Section 58 and PSS Act provisions, RBI has the power to make clearing houses rules for banks as well as post office savings bank. Also to bring in electronic payment within the ambit of RBI regulation, The Information Technology Act of 2000 was amended to provide powers for RBI through insertion Section 58(2) that enables RBI to frame regulations in respect of electronic payment systems of banks and financial institutions.

Reserve Bank has since authorised payment system operators of pre-paid payment instruments, card schemes, cross-border in-bound money transfers, Automated Teller Machine (ATM) networks and centralised clearing arrangements.

In addition to these, RBI has issued detailed internet banking guidelines to all banks in respect of internet banking in the year 2001. All banks are expected to follow these guidelines which concern the (i) security and technology issues (ii) legal issues (iii) regulatory and supervisory issues.

Additionally RBI has issued detailed guidelines regarding issuance of Card products such as Credit Card, Debit Card and Rupee Denominated Co-branded Pre-paid Card operations of Banks and Credit Card issuing NBFCs.

Banks can undertake Credit card business either departmentally or through a subsidiary company set up for the purpose. They can also undertake domestic credit card business by entering into tie-up arrangement with one of the banks already having arrangements for issue of credit cards. No prior approval of the RBI is necessary for banks to issue credit cards independently or in tie-up with other banks. They need their Board of Directors approval. Banks with networth of Rs. 100 crore and above should undertake credit card business, other Banks would require prior approval of the Reserve Bank. Each bank must have a well documented policy and a Fair Practices Code for credit card operations. RBI guidelines *inter alia* provide detailed rules regarding issuance of cards, interest rate or other charges, wrongful billing, issue of unsolicited card, fair practices in debt collection, redressal of grievances etc.

Debit cards were issued by banks since 1999. In the light of Payment and Settlement Systems Act, 2007 RBI also issued instructions on some aspects of debit cards such as security and risk mitigation, transfer of funds between domestic debit, prepaid and credit cards, and merchant discount rates. Debit card issuing banks have to adhere to RBI guidelines on Board approved policy, Compliance with Prevention Money Laundering Act,

2000, Payment of interest on balances, Terms and conditions for issue of cards to customers, Security and other aspects, compliance with RBI directives, etc. Similar set of guidelines have also been issued covering Rupee Denominated Co-branded Pre-paid Cards.

Reserve Bank of India has the right to impose any penalty on a bank/NBFC under the provisions of the BR Act, 1949/the RBI Act, 1934, respectively for violation of any of these guidelines.

Scheme of Banking Ombudsman

In exercise of powers vested with RBI under Section 35A of the Banking Regulation Act, RBI had established an Authority of Banking Ombudsman in 1995 for resolving customer complaints on various grounds against commercial banks excluding RRBs. The scheme was expanded in 2002 covering RRBs too. Additionally the scope, authority and functions of Banking Ombudsman were expanded with a provision of empowering Banking Ombudsman as an Arbitrator. All scheduled banks, RRBs and Co-operative banks are now covered under the revised scheme. The Scheme was further amended in 2006/2007/2009/2017 to encompass deficiencies arising out of sale of insurance/ mutual fund/ other third party investment products by banks misselling of Mobile Banking/ Electronic Banking services in India.

Under the latest amendment in the Banking Ombudsman Scheme the pecuniary jurisdiction of the Banking Ombudsman to pass an Award has been increased from existing rupees one million to rupees two million. Compensation not exceeding Rs.1 lakh also be awarded by the Banking Ombudsman to a complainant for loss of time, expenses incurred as also, harassment and mental anguish suffered by the complainant.

The procedure for complaints settled by agreement under the Scheme has also been revised. Appeal has now been allowed for the complaints closed under Clause 13 (c) of the existing Scheme relating to rejection which was not available earlier. Presently the Banking Ombudsman Scheme 2006 (As amended upto July 1, 2017) is in operation.

On January 31, 2019 RBI has launched the Ombudsman Scheme for Digital Transactions (OSDT) for redressal of complaints against System Participants as defined in the said Scheme. The scheme also includes an appellate mechanism for appeal against decisions of OSDT. Please see Lesson 11 for a detailed coverage on this topic.

TOOLS OF MONETARY CONTROL

There RBI uses various direct and indirect tools (instruments) for implementation of monetary policy.

These are:

- Repo Rate,
- Reverse Repo Rate,
- Liquidity Adjustment Facility (‘LAF’),
- Marginal Standing Facility (‘MSF’),
- Corridor,
- Bank Rate,
- Cash Reserve Ratio (‘CRR’),
- Statutory Liquidity Ratio (‘SLR’) ,
- Open Market Operations, (‘OMO’s) and

- Market Stabilization Scheme (MSS).

Repo Rate: With the introduction of Liquidity Adjustment Facility ('LAF') from the year 2000 onwards RBI has started to provide funds against collateral of government and approved securities for short duration periods to banks against Re-purchase option of such securities by borrowing banks. The interest rate at which the Reserve Bank provides this short duration liquidity to banks is known as 'Repo' rate. Under inflationary conditions RBI increases the Repo rate and this discourages the banks to borrow thereby reducing the money circulation in the economy. This helps to reduce inflation. Repo rate has become a reference rate for interest rate movements in the banking system as of now, a place which was occupied by Bank rate in earlier times.

Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF. The effect of increasing Reverse Repo rate, will lead to decrease in the money supply as commercial banks will get better interest rates to keep their funds with the RBI. Therefore Reverse Repo rate also is used as an instrument of monetary control by RBI.

Liquidity Adjustment Facility: The monetary policy environment in India has been greatly influenced with the launch of Liquidity Adjustment Facility (LAF) by the RBI in June 2000. With the introduction of LAF, the important tool of monetary policy- 'the repo rate' became the prime instrument at the hands of RBI for controlling the monetary policy. LAF is a mechanism for adjusting liquidity in the banking system. It has twin aims of withdrawing funds or increasing the same in the banking system when there are excess or shortages of liquidity in the system. LAF is operated daily by RBI thro Repo / Reverse Repo mechanisms.

Normally the Reverse repo rate is charged at a lower rate than the repo rate. This means whenever the repo rate changes, the reverse repo rate also changes. For example, an increase in repo rate by 50 basis points, the reverse repo rate may also increase by 50 basis points. Therefore LAF forms a component tool for controlling monetary system.

Marginal Standing Facility ('MSF'): From May 9, 2011 RBI had introduced an additional facility for the scheduled commercial banks to borrow funds, up to 1% of their Net Demand and Time Liabilities against their SLR securities. The rate of interest applicable on such advances is fixed at a higher rate than Repo rate. Presently the applicable rate is 6.50% p.a., the same as Bank rate. (As on Dec. 2018 the applicable rate is reduced to 5.40%, the same as Bank rate.) In the event, the banks' SLR holdings fall below the statutory requirement up to one per cent of their NDTL, banks will not have the obligation to seek a specific waiver for default in SLR compliance arising out of use of this facility from RBI in terms of notification issued under sub section (2A) of section 24 of the Banking Regulation Act, 1949. The MSF facility acts as a safety valve against sudden short fall in liquidity for a bank.

Corridor: Also known as interest rate corridor**.** It is a term that denotes arrange with in which a short term interest rate moves around. In the context of monetary policy of RBI, Repo rate can be said to be the policy rate as of now. The interest rates of MSF and Reverse repo determine the corridor for the daily movement in the weighted average call money rate.

Bank Rate, Cash Reserve Ratio ('CRR'), and Statutory Liquidity Ratio ('SLR') are also used by RBI as effective monetary tools by RBI. These have already been discussed in the earlier paragraphs.

The differences between Repo rate and Bank rate can be summarized as under:

Repo Rate	Bank Rate
Interest rate fixed for repurchase of securities sold by banks to RBI.	Interest rate charged by RBI for discounting or extending loans to eligible banks.
Lower than the Bank Rate.	Higher than repo rate.
Repo Rate increases do not directly affect Customers of banks directly.	Increase in Bank rate can hike lending rates.
Securities as a collateral are involved under Repo rate transactions.	Collaterals are not directly involved in the transactions. Mostly based on declarations and statements.
Repo Rate is for short term financial needs.	Bank Rate is for a longer rate duration, some times as long as 180 days for banks.

Open Market Operations ('OMO'): Open market operations are conducted by the RBI either to increase or decrease the liquidity in the market in order to adjust the money supply. This is done by way of sale or purchase of Government Securities popularly known as G-Secs. The RBI sells G-Secs and reduce the liquidity from the financial system or buys back G-Secs to increase liquidity into the system. OMOs are conducted on a daily basis to balance inflationary forces at the same time ensuring banks continue to lend.OMO includes both, outright purchase and sale of government securities, for increasing or decreasing liquidity, respectively.

Market Stabilization Scheme ('MSS'): MSS is an instrument to reduce money supply in the economy. This was used to by RBI to purchase of foreign currencies in the foreign exchange market which flowed in to our economic system due to huge capital inflows on account of foreign investments. This resulted in appreciation of the value of rupee. As this was not in the interests of exports, RBI started buying dollars in exchange for Rupees. This led to an excess liquidity and gave rise to potential for inflation. To avoid this situation, RBI started selling Government bonds to reduce excess Rupees in circulation. This process is called sterilisation. MSS is used as one of the instruments of monetary control since 2004.

The money mobilized under MSS is kept in a separate account at RBI and is not transferred to Government, as per agreement with RBI. Government of India pays interest on these bonds through a special budgetary allocation.

REGULATORY RESTRICTIONS ON LENDING

There are some key **regulatory restrictions** on granting advances by commercial banks so also to regulate credit. These can be summarized as under:

i. As per section 20(1) of the Banking Regulation Act, 1949 no bank can grant any loan or advance against security of its own shares.

ii. Under section 20(1), Banks cannot sanction loans and advances to Directors and firms in which they hold substantial interest with exception of following loans granted to Chief Executive Officers, Whole Time Directors. These are - Loan for a car, personal computer, furniture, construction/acquisition of a house for personal use, festival advance and limits granted under credit card facility.

iii. In all other cases Banks have to approach RBI for prior permission except in case of loans granted to a Director who was an employee before his appointment as a Director.

iv. However with effect from September 16, 2015 RBI has permitted banks to extend loans and advances

to Chief Executive Officer/ Wholetime Director without seeking prior approval under the following circumstances-

a. if granting of such loans forms part of remuneration/compensation policy approved by the Board of Directors of the bank concerned

b. these loans do not attract guidelines of RBI on Base rate on loans; interest rates on these loans cannot be lower than rate of interest applicable for staff members.

v. While extending non-fund based facilities such as guarantees, L/Cs, acceptance on behalf of directors and the companies/firms in which the directors are interested; it should be ensured that: (a) adequate and effective arrangements have been made to the satisfaction of the bank that the commitments would be met by the openers of L/Cs, or acceptors, or guarantors out of their own resources, (b) the bank will not be called upon to grant any loan or advance to meet the liability consequent upon the invocation of guarantee, and (c) no liability would devolve on the bank on account of L/Cs/ acceptances.

vi. A banking company cannot start a subsidiary company except under circumstances provided under section 19 (1) (a),(b) and (c).

vii. A banking company cannot hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

viii. Banks are not to provide loans to companies for buy-back of shares/securities.

ix. Banks to follow regulatory restrictions while granting loans and advances to directors and their relatives and also to senior officers of banks and their relatives.

x. Banks are not to extend finance for setting up of new units consuming/producing the Ozone Depleting Substances (ODS). Similarly no financial assistance should be extended to small/medium scale units engaged in the manufacture of the aerosol units using chlorofluorocarbons (CFC) and no refinance would be extended to any project assisted in this sector.

xi. Banks are to follow the directions given by RBI while extending loans and advances - against Shares, Debentures and Bonds to individuals, to Share and Stock Brokers/ Commodity Brokers**, to** Market Makers, to Individuals against shares to Joint holders or third party beneficiaries, for subscribing to IPOs by individuals, against Mutual Fund units, financing Promoters Contribution, for Margin Trading to brokers, for Housing, for financing Infrastructure, Certificate of Deposits, Discounting/Rediscounting of Bills by Banks, for purchase of Gold and lending against Gold Bullion/Coins/Primary gold etc.

RBI also contains flow of lending to certain sectors through selective credit control (discussed in next section) and through tweaking prudential norms relating to risk weights. Increasing risk weight of an exposure to a particular sector act as disincentive to lenders as such lending reduces CRAR. For example, loans extended against shares carries a risk weight of 125%.

SELECTIVE CREDIT CONTROL (UNDER SECTION 21 AND SECTION 35A OF BANKING REGULATION ACT)

To control speculative holding of essential commodities by traders who hoard the same with the help of advances from banks and thereby stem the price rise, RBI under section 21 and section 35A issues directives to banks containing restrictions in financing against selective commodities. This is known as Selective Credit Control measure. The directives of RBI to banks contain the following:

i. Purpose for which advances can be made.

ii. The margins to be maintained on secured advances.

iii. The maximum amount of Advances that can be extended to any constituent.

iv. The interest rate to be charged, as well as other terms and conditions for extending advances.

In the past advances against price sensitive commodities such as food grains, cotton, kappas, oils seeds(grown indigenously such as ground nut, rapeseed, mustard, cottonseed, linseed and castor seed) and their respective oils, all imported oils, vanaspati, sugar, kandasari and jaggery (gur) and cotton textiles including man-made fibres, yarn and fabric made out of man-made and Cotton fibres were subject to strict guidelines under Selective Credit Control.

Over a period due to Economic liberalization and improvements in economic environment, several of the aforesaid commodities have been taken out of Selective Credit Control mechanism of RBI. Presently the following are under Selective Credit Control coverage:

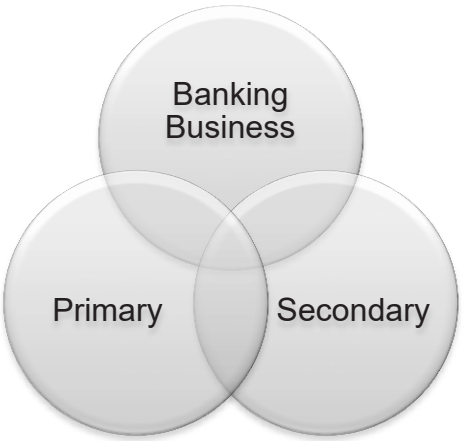
i. Buffer stock of Sugar with Sugar Mills.

ii. Unreleased stocks of sugar with Sugar Mills representing levy sugar as well as free sale sugar.

RBI has specified 0% margin on buffer stocks of sugar and 10% on unreleased sugar with sugar mills representing levy sugar.

Business of Banking

The business of banking is broadly defined by section 5 & 6 section of Banking Regulation Act.



They can be classified as Primary and Secondary functions. These are as follows:

Primary

- Accepting of deposits.
- Lending and investment.

Secondary

The following forms of business in which banking companies may engage are as follows:

i. the borrowing, lending or advancing of money either upon or without security;

ii. the drawing, making, accepting, discounting, buying, selling, collecting and dealing in negotiable instruments and quasi negotiable instruments.

iii. issuing of letters of credit, traveller's cheques and circular notes;

iv. the buying, selling and dealing in bullion and specie;

v. the buying and selling of foreign exchange including foreign bank notes;

vi. the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds;

vii. purchasing and selling of securities and bonds or other forms of securities on behalf of constituents or others, the negotiating of loans and advances;

viii. the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults;

ix. the collecting and transmitting of money and securities;

Agency business

i. acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description excluding the business of a Managing Agent or Secretary and Treasurer of a company;

ii. contracting for public and private loans and negotiating and issuing the same;

iii. indulging in Merchant banking activities and the lending of money for the purpose of any such issue;

iv. carrying on and transacting every kind of guarantee and indemnity business;

v. Managing, selling and realising any property which may come into the possession of the banking company in satisfaction or part satisfaction of any of its claims;

vi. acquiring, holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

vii. undertaking and executing trusts;

viii. undertaking the administration of estates as executor, trustee or otherwise

ix. establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons;

x. granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

xi. the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

xii. selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

xiii. acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub- section;

xiv. doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

xv. any other form of business which the Central Government may, specify for a banking company.

a. In pursuance of the powers available, the Central Government has permitted banking companies to engage either departmentally or through subsidiaries in Mutual Funds, Locker services,

Housing finance, Life and General Insurance (Bancassurance), Credit Card Services, Wealth management, Factoring, Forfaiting, Demat Services etc.

A banking company cannot engage in any form of business other than those referred to in sub-section (1) of Section 6 of the Banking Regulation Act.

In addition to the above, a Banking company cannot appoint managing agents or employ a person who is an adjudicated insolvent or a person convicted by a court of moral turpitude.

Government as a Regulator of Banks

Directly or indirectly under the RBI Act, 1934 as well as The Banking Regulation Act, 1949, the Government of India, enjoys extensive powers in the banking domain in India. This is primarily due to the following:

i. The Government of India is the owner of RBI as it holds the entire share capital of RBI.

ii. Power to appoint Governor and the Board members of the Central Board, as also removing them is vested in the Government.

iii. Wherever necessary Government has powers to issue special directions to banks in consultation with RBI.

iv. The Government also enjoys the status of appellate jurisdiction vis-à-vis RBI in the matters of removal of managerial persons, cancellation of banking licence, refusal of issuance of certificate regarding floating charge on assets.

v. Besides these, the Government has powers to suspend the operation of the BR Act, 1949 or grant exemption from the applicability of the provisions of the same on the basis of recommendations of RBI.

vi. The Government has power to determine the forms of business a banking company can do under Sec. 6(1) of the BR Act.

vii. Powers to make rules under Sec 52 and 45 Y are also reside with the Government.

viii. The Government also enjoys numerous powers for permitting formation of subsidiary for some business activities, notifying banks for maintenance of assets under Section 24, with reference to accounts and balance sheet, direction for inspection of banks, acquire undertakings, appointment of court liquidator, suspension of business, amalgamation of banks etc.

The Government being the majority share holder in case of SBI, Public Sector Banks etc. also enjoys statutory powers granted under such statues.

Control over Co-operative Banks

A Cooperative Bank is by basic constitution is a cooperative society governed by Cooperative Act of either

Central Government or State Government. Due to an amendment in 1965, cooperative banks come under the jurisdiction of RBI in the matters of licensing and regulation of banking business. Therefore cooperative banks face dual control from Central Government (in case of Multi State Cooperative Banks)/State governments and RBI.

Cooperative banks operating in more than one state are known as multi-state cooperative banks. These are regulated by Multi-State Cooperative Societies Act 2002 as far as their cooperative aspects are concerned. The Registrar of Multi-state Cooperative Societies appointed by the central government oversees their functions other than licensing and regulation of banking business are concerned. Their licensing and banking functions come under the jurisdiction of RBI.

On the contrary, banks which operate within a state come under the State Cooperative Societies Act and monitored by Registrar of Cooperative societies of the respective states. Registrar of Cooperatives enjoys vast powers under the Cooperative Societies Act. However their banking functions come under the jurisdiction of RBI as in the case of Multi-State Cooperative Banks.

Regulation by other Authorities

Apart from RBI, **the banking companies come under regulatory jurisdiction of the following Authorities, during the course of business conducted by themselves or through subsidiaries. Major regulators are listed and list is not exhaustive.**

S. No.	Function/Reasons	Regulatory Authorities
1	Incorporation as a corporate body/cooperative body/ entity with Registered office.	Registrar of Companies/Registrar of Cooperatives (State & Central)
2	Profit earning entities through services provided to customers	Income Tax authorities/ GST Authorities
3	Employing large number of personnel.	Labour law authorities/Employment Exchanges.
4	Having a place of business/branch	Local bodies such as Municipal Authorities/ Nagar ‘panchayats’ etc.
5	Offering Equity participation to public/ providing Demat accounts to customers /Merchant banking	Securities Exchange Board of India.
6	Offering bancassurance products	Insurance Regulation and Development Authority.
7	Housing Finance subsidiaries	NHB
8	Overseas subsidiaries	Host country Regulators/ supervisors
9	ADR/GDR issued by Indian banks.	Respective country’s capital market authorities like Security Exchange Commission.

LESSON ROUND UP

- The Reserve Bank of India Act, 1934 was enacted with a view to constitute RBI to regulate issue of bank notes and to control monetary and banking system.
- Banking Regulation Act, 1949 came into the picture which played a very important role in controlling the banking sector & the activities related to it.
- Through the RBI Act, 1934 the role of issuance of notes was allotted to RBI in order to bring in a stability in the economy of India.
- The constitution of RBI started with an initial capital of Rs. 5 crores which is wholly owned by Government of India from 1st Jan 1949, prior to which it was owned by public shareholders.
- Through different quantitative & qualitative measures, the RBI manages monetary stability and plays a critical role to monitor Indian banking system.
- The objectives of RBI are: i) to regulate the issue of Bank notes. ii) To keep reserves with a view to securing monetary stability in India iii) to operate the currency and credit system of the country to its advantage iv) To operate the monetary policy for maintaining price stability while keeping in mind objective of growth.
- Banking Regulation Act, 1949 provides detailed provisions on acceptance of deposits and nomination facilities.
- RBI has come up with different rules regarding issuance of card products.
- In order to settle down customer complaints against different commercial banks, RBI has come up with the Banking Ombudsman Scheme.
- In order to make effective control of the monetary system, RBI uses different tools like Bank rate, SLR, CRR etc.
- RBI uses selective credit controls to channelize the flow of credit to desired sectors and to restrict the flow of credit to sensitive sectors.
- The Government of India through various Acts, Regulations etc. (including Regulations of Self-Regulatory Bodies, e.g. SEBI) regulated different aspect of Banking Business.

GLOSSARY

- **Monetary Policy Committee ('MPC')** -- a committee of the Reserve Bank of India that is responsible for fixing the benchmark interest rate in India.
- **Liquidity Adjustment Facility ('LAF')** -- is a monetary policy tool which allows banks to borrow money through repurchase agreements
- **Marginal Standing Facility ('MSF') -** is the rate at which the banks are able to borrow overnight funds from RBI against the approved government securities.
- **Open Market Operations ('OMO's)** - refer to the buying and selling of government securities in the *open market* in order to expand or contract the amount of money in the banking system.
- **Market Stabilization Scheme (MSS)** – a monetary policy intervention by RBI to withdraw excess liquidity or money supply by selling government securities in the economy

- **Automated Teller Machine (ATM)** - a machine that dispenses cash or performs other banking services when an account holder inserts a bank card
- **Payment and Settlement Systems Act, 2007 ('PSS Act')** - provides for the regulation and supervision of *payment systems* in India and designates the Reserve Bank of India (Reserve Bank) as the authority for that purpose and all related matters.
- **Foreign Exchange Management Act, 1999 (FEMA)** – This is an Act of the Parliament of India "to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India
- **Repo rate** - is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds.
- **Statutory Liquidity Ratio** - is the Indian government term for the reserve requirement that the commercial banks in India are required to maintain in the form of cash, gold reserves, government approved securities before providing credit to the customers.
- **Cash Reserve Ratio (CRR)** - is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as *reserves* either in *cash* or as deposits with the central bank.
- **Department of Currency Management ('DCM')** - has the responsibility of administering the functions of currency management,
- **Regional Rural banks ('RRB's)** - are scheduled banks(Government banks) operating at regional level in different States of India.

SELF TEST QUESTIONS

1. Fill in the blanks
   a. A scheduled bank is one which is included in the _____ Schedule of _____ Act.
   b. Cooperative banks are regulated by _____ and _____ Acts.
   c. Repo rate is a _____ of RBI.
   d. CRR is to be maintained under the provisions of _____ Act and SLR is to be maintained under the provisions of _____ Act.
   e. When a Bank sells an insurance policy it comes under the regulatory jurisdiction of _____ _____.

2. **Answer the following questions**.
   a. Discuss the constitution of RBI.
   b. How does RBI manage Issue of currency and distribution of coins.
   c. What are the various credit control measures of RBI?
   d. Discuss various tools of monetary controls used by RBI.
   e. What are the various powers of RBI under Banking Regulation Act?
   f. How does RBI control Cooperative banks in India?

For further reading

1. The RBI Act – www.rbidocs.org
2. The Banking Regulation Act – www.rbidocs .org
3. Commentaries by various authors available in internet
4. Banking Law and Practice – P.N. Varshney, 25th Edition.
5. Law and Practice of Banking in India – M L Tannan

Lesson 3
Control Over Organization of Banks

LESSON OUTLINE

- Licensing of Banking Companies
- Branch Licensing
- Paid up Capital and Reserves of Banking Companies
- Shareholding in Banking Companies
- Subsidiaries of Banking Companies
- Board of Directors in Banking Companies
- Chairman of Banking Company
- Appointment of Additional Directors
- Restrictions on Employment
- Control over Management Directors
- Corporate Governance.
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

RBI exercises control over Banking companies in different ways. This chapter will enable a reader to learn in detail about:

- Licensing policy of various banks.
- Licensing of policy guidelines of branches of banks.
- Paid Capital and Reserves stipulated for different banks.
- Shareholding in Banking Companies and its restrictions.
- Setting up of Subsidiaries of Banking Companies.
- Board of Directors in Banking Companies – Constitution and set-up.
- Chairman of Banking Company.
- Appointment of Additional Directors.
- Restrictions on Employment by banks.
- Control over Management, Directors and other officials of banks.
- Corporate Governance aspects of banks in India.

INTRODUCTION

RBI exercises control over banks through the power conferred on it by the Banking Regulation Act 1949. The contents of this chapter therefore cover in detail, regulations concerning licensing to corporate governance of banks. The contents will expose a student to a deeper level of understanding of applicability of B R Act provisions on banks. The contents are of Level 1 & 2 mix.

Statutory Background

Before the Banking Regulation Act, 1949 was enacted, the provisions of Part XA of the Indian Companies Act, 1913 (as amended in 1936) were made applicable, as a law relating to banking companies. While company law provisions were enacted to safeguard the interests of shareholders, the protection of interest of depositors was found to be inadequate in that legislation. Therefore a separate legislation as known as Banking Companies Act was introduced through a bill in 1944. This bill was passed in 1949 and was named as the Banking Companies Act, 1949. With the introduction of Banking Laws (Application to Cooperative Societies) Act, 1965, the Banking Companies Act was renamed as The Banking Regulation Act 1949 (B R Act).

Licensing of Banking companies forms part of the Banking Regulation Act. To commence and operate banking business in India, every banking company needs a licence in terms of Section 22 of the Banking Regulation Act. Before issuing a licence, the applicant company needs to satisfy RBI about the fulfillment of following conditions:

(i) The company has adequate financial strength or will have strength to pay its present or future depositors in full as and when their claims arise;

(ii) That the company has adequate capital structure and earning prospects;

(iii) The potential scope for expansion of banks is there in the area;

(iv) That the affairs of the company are not and will not be detrimental to the interests of its present or future depositors;

(v) That the character of the management of the applicant bank will not be prejudicial to the public interest or the interest of its depositors.

At the time of commencement of Banking Regulation Act, existing banks at that juncture were required to apply for a licence within six months. They were allowed to continue till their application was rejected. One of the objectives behind licensing was to discourage banks which were operating not on sound lines and also indiscriminate formation of banks.

ISSUING OF LICENCE

Issuing Licenses to an applicant bank is at the discretion of RBI. Before a licence is issued RBI satisfies itself regarding the ‘Tests of entry’ namely :

Issuing of licence

- Information about back ground, credentials of promoters
- Funding aspects of capital
- Sources of such funds
- Background of key supporting professionals
- Geographical coverage of the proposed bank
- Business and economic activity to be financed,
- Profitability aspects
- Public interest

RBI may also scrutinize the books of accounts of the applicant company and also gather market information to satisfy itself about the advisability of granting a licence.

Section 11(2) & Section 11(3) of Banking Regulation Act,1949 specifies a minimum capital and reserves for a foreign bank, local banks operating in more than one state and in one state. RBI has powers to specify a higher amount of paid up capital for the purpose of licensing.

Refusal of license by RBI

The granting of licence or refusal of RBI, if based on relevant material and germane consideration, cannot be challenged in a court of law. In the matter of *Shivabhai Zaverbhai Patel* Vs. *RBI* AIR 1986 Guj. 19; (1985) 1 GLR 257, Hon'ble High Court of Gujarat upheld the RBI's decision of rejection of application for a banking licence which was based on diligent study and material facts.

LICENSING OF FOREIGN BANKS IN INDIA

Foreign banks wishing to open a branch in India require a licence under the Banking Regulation Act, 1949. India issues a single class of banking licence unlike some other countries. No undue restrictions are placed on them on their operations. In some countries there is a requirement of multiple licences for dealing in local currency and foreign currencies with different categories of clientele. Like domestic banks foreign banks enjoy similar facilities to the payments and settlement systems and they are admitted as full members of clearing houses and payments system.

Procedurally, foreign banks are required to apply to RBI for opening their branches in India. Foreign banks' application for opening their maiden branch is considered under the provisions of Section 22 of the Banking Regulation Act,1949. Before granting any licence under this section, RBI may require to be satisfied that the Government or the law of the country in which it is incorporated does not discriminate in any way against banks from India. Other conditions as enumerated in Banking Regulation Act [Section 2(5)] are also required to be fulfilled.

Unlike the restrictive practices of certain foreign countries, India is liberal in respect of the licensing and operation of the foreign bank branches as illustrated by the following:

- India issues a single class of banking licence to foreign banks and does not place any limitations on

their operations. All banks can carry on both retail and wholesale banking.

- Deposit insurance cover is uniformly available to all foreign banks operating in India at a non-discriminatory rate of premium.
- The norms for capital adequacy, income recognition and asset classification are by and large the same. Other prudential norms such as exposure limits are the same as those applicable to Indian banks.

Licencing of private sector banks in India

Prior to 1993 licensing of Private Sector banks were done in a routine way under Section 22 of the Banking Regulation Act. In the year 1993 the RBI has announced a new set of guidelines as a part of economic liberalization in that year and a few in the subsequent years. In 2001 RBI had revised the guidelines for licensing Private Sector banks in India and two more banks namely Kotak Bank and Yes Bank were issued licences. The policy was known as 'Stop and Go'. In Feb 2013, a need was felt for reviewing of the licensing of banks under 'Stop and Go' in view of emerging scenarios in International banking and Indian banking, and also in the light of recommendations of Raghuram G. Rajan Committee and other points of view, RBI decided to have an explicit policy on banking structure. After due deliberations, existing 'Stop and Go' licensing policy was reviewed and in its place a 'continuous authorization [or on tap]' policy was announced with effect from August 1, 2016,with a view to increase the level of competition and bring new ideas into the system.

The salient features of continuous authorization policy

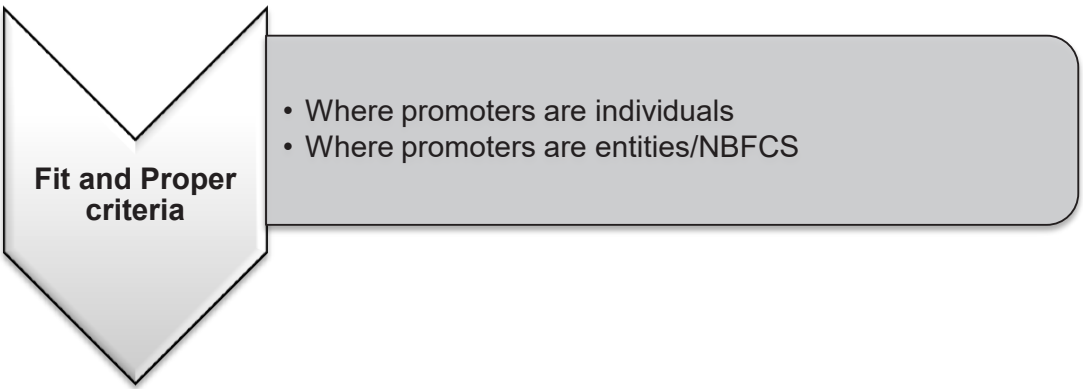
(a) Individuals/professionals who are 'residents' or ('residents' as per FEMA definition) with 10 years of experience in banking and finance at a senior level would be eligible to promote banks, singly or jointly.

(b) Entities/groups in the private sector which are 'owned and controlled by 'residents' [as per FEMA definition],having a successful track record for at least 10 years, with total assets of Rs. 50 billion or more, where in non-financial business of the group does not exceed 40% or more in terms of total assets / in terms of gross income are also eligible to promote banks..

(c) Existing non-banking financial companies (NBFCs), that are 'controlled by residents' [as per FEMA definition], with a successful track record for at least 10 years will be eligible to convert into a bank or promote a new bank.

[*Note*: Any NBFC, which is a part of the group that has total assets of Rs. 50 billion or more and that the non-financial business of the group accounts for 40 per cent or more in terms of total assets / in terms of gross income, is not eligible.]

(d) '**Fit and Proper' criteria**: The RBI assess the promoters under the following parameters to 'decide whether such promoters are 'fit and proper' for promoting banks.



(i) **Where promoters are individuals:** Each of the Promoters should have a minimum 10 years of experience in banking and finance at a senior level. The Promoters should have a past record of sound credentials and integrity. The Promoters should be financially sound and should have a successful track record for at least 10 years.

(ii) **Where promoters are entities / NBFCs:** The promoting entity / promoter group should have a minimum 10 years of experience in running its / their businesses. The promoting entity and the promoter group should have a past record of sound credentials and integrity. The promoting entity and the promoter group should be financially sound and should have a successful track record for at least 10 years. Preference will be given to promoting entities having diversified shareholding.

As an extension of licensing condition the RBI enumerated detailed guidelines in respect of Corporate structure for the applicant that seeks licence as below:

With Non-Operative Financial Holding Company (NOFHC): a) In the case of promoters being individuals or standalone promoting / converting entities who / which do not have other group entities, the requirement of Non-Operative Financial Holding Company (NOFHC) is not mandatory and such promoters would have the option of setting up / converting into a banking company under the Companies Act, 2013. However, in case other group entities are proposed to be established after the bank is incorporated, the bank should move to the NOFHC structure.

b) In case the proposal is for setting up / conversion into a bank, any change in shareholding of 5% or more, within the promoting / converting entity from the date of application to the RBI, of the voting equity capital of the promoting / converting entity, shall be reported to the RBI.

Structure with Non-Operative Financial Holding Company (NOFHC)

In case the individual promoters / promoting entities / converting entities have other group entities, the bank shall be set up only through a NOFHC. In such cases, the following conditions will be applicable:

(a) The NOFHC shall be registered with RBI as a Non-Banking Financial Company (NBFC).

(b) Not less than 51 per cent of the total paid-up equity capital of the NOFHC shall be owned by the Promoter / Promoter Group.

(c) The NOFHC shall hold the bank as well as all the other financial services entities of the Group regulated by RBI or other financial sector regulators. The objective is that the Holding Company should ring fence the regulated financial services entities of the Group, including the bank, from other activities of the Group i.e. commercial, and financial activities not regulated by financial sector regulators and also that the bank should be ring fenced from other regulated financial activities of the Group.

(d) Only those regulated financial sector entities in which the individual Promoter(s) group have significant influence or control will be held under the NOFHC.

(e) The financial services entities whose shares are held by the NOFHC cannot be shareholders of the NOFHC.

(f) Apart from setting up the bank, the NOFHC shall not be permitted to set up any new financial services entity for at least three years from the date of commencement of business of the NOFHC. However, this would not preclude the bank from having a subsidiary or joint venture or associate, where it is legally required or specifically permitted by RBI.

RBI has clarified that:

(i) Specialised activities, such as, insurance, mutual funds, stock broking, infrastructure debt funds, etc. to be conducted through a separate Subsidiary / Joint Venture / Associate structure.

(ii) A bank can conduct activities such as Credit cards, Primary dealers, Leasing, Hire purchase, Factoring, etc., either from within the bank or through a separate outside structure (Subsidiary / Joint Venture / Associate).

Accordingly, the activities at (i) above and activities at (ii) above which are to be / proposed to be carried out outside the bank may be carried out through separate financial entities under the NOFHC.

If Promoters desire to continue existing specialized activities from a separate entity proposed to be held under the NOFHC, prior approval from RBI would be required and it should be ensured that similar activities are not conducted through the bank.

Activities which are not permitted for a bank would also not be permitted to the group i.e. entities under the NOFHC would not be permitted to engage in activities that the bank is not permitted to engage in.

Licensing of Local Area Banks

In the year 1996 the RBI decided to allow Local Area Bank(LABs) to be set up in the private sector for bridging gaps as well enhance credit availability in the rural and semi-urban areas in the country to provide competitive financial intermediation.

Minimum start-up capital of a Local Area Bank was stipulated at Rs.5 crore which should be brought upfront. A family among the promoter group was permitted to hold not more than 40% of the capital. Non-Resident Indians were also allowed to contribute a maximum equity of 40% of the paid-up capital. A lock-in-period of 3 years was fixed for capital contributed by promoters (including their friends and relatives/associates) from the date of licensing of the bank. Promoter's capital is to be locked up for further period of 2 years beyond the initial period of 3 years subject to a review before expiry of five years from the date of licensing of the bank.

LABs can be promoted by individuals, corporate entities and societies; NRI promoters cannot exceed 20% of the total number of promoters. Individual shareholder voting rights are restricted a ceiling of 10% of total voting rights as stipulated under Section 12 (2) of the Banking Regulation Act. The LAB's area operation is restricted up to 3 contiguous districts, geographically. LAB has to focus on local customers in rural and semi-urban areas to reduce credit gaps.

Permitted activities of a LAB include financing agriculture and allied activities, SSI, agro-industrial activities, trading activities and non-farm sector. Forty per cent of their net bank credit should go to priority sector and their lending to weaker section was to be at least 25% of their priority sector lending.

A LAB has to be registered as a public limited company under the Companies Act; get licensed under the Banking Regulation Act, 1949 and would be eligible for inclusion in the Second Schedule of the RBI Act, 1934. As far as liquidity requirements and interest rates are concerned, such banks would be governed by the provisions applicable to the Regional Rural Banks under the Regional Rural Banks Act, 1976. These banks would be subject to prudential norms, capital adequacy, accounting policies and other policies as laid down by RBI from time to time. As per the procedure followed, RBI initially grants an in-principle approval along with terms and conditions for setting up an LAB. Once these terms and conditions are fulfilled a licence is granted.

LICENSING OF DIFFERENTIATED BANKS – SMALL FINANCE BANK AND PAYMENTS BANK

Small Finance Bank (SFB)

Further to the matters covered in Page 10 & 11 of Lesson 1, the following forms part of the licensing aspects of SFBs.

SFBs can be promoted by resident individuals/professionals with 10 years of experience in banking and finance as well as companies and societies owned and controlled by residents. Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), and Local Area Banks (LABs) that are owned and controlled by residents are also permitted to convert themselves in to SFBs. Promoter/promoter groups should have a five year successful record of professional experience or of running their businesses are eligible to promote small finance banks.

The minimum paid-up equity capital for SFB should be Rs. 100 crore. The promoter's minimum initial contribution has to be at least 40% of paid-up equity capital of and gradually brought down to 26 per cent within 12 years from the date of commencement of business of the bank. The foreign shareholding is allowed and would be as per the Foreign Direct Investment (FDI) policy for private sector banks as amended from time to time. SFBs are subject to all prudential norms applicable to existing Commercial banks including CRR, SLR. The small finance banks will be required to extend 75 per cent of its Adjusted Net Bank Credit (ANBC) to the sectors eligible for classification as priority sector lending (PSL) by the Reserve Bank. At least 50 per cent of its loan portfolio should constitute loans and advances of upto Rs. 25 lakh. If a SFB wants to convert in to a universal bank, it would be subject to fulfilling minimum paid-up capital / net worth requirement as applicable to universal banks, its track record of performance as a SFB and the RBI's due diligence exercise.

For granting of licenses an External Advisory Committee (EAC) comprising eminent professionals will evaluate the applications. On the basis of evaluation, RBI will issue an in-principle approval for setting up of a SFB or otherwise. RBI decision will be final. The in-principle approval issued by the Reserve Bank will be valid for eighteen months.

Payment Banks ('PB')

Further to the matters covered in Page 9 & 10 of Lesson 1, the following form part of the licensing part of Payment Banks.

Payment Banks can be promoted by:

(i) Existing non-bank Pre-paid Payment Instrument (PPI) issuers;

(ii) Individuals/professionals;

(iii) NBFCs, Corporate Business Correspondents(BCs);

(iv) Mobile telephone companies;

(v) Super-market chain;

(vi) Companies;

(vii) Real sector cooperatives; that are owned and controlled by residents; and

(viii) Public sector entities.

A promoter/promoter group can have a joint venture with an existing scheduled commercial bank to set up a payments bank. Scheduled commercial banks can take equity stake as permitted under Section 19 (2) of the

Banking Regulation Act,1949. Promoter/promoter groups should be 'fit and proper' with a sound track record of professional experience or running their businesses for at least a period of five years in order to be eligible to promote payments banks.

PBs can accept demand deposits and they will initially be restricted to hold a maximum balance of Rs. 100,000 per individual customer. PBs are also permitted to issue ATM/debit cards (but cannot issue credit cards); offer Payments and remittance services through various channels; function as Business Correspondent of another bank as per RBI guidelines; distribute non-risk sharing products like mutual fund units and insurance products, etc.

PBs cannot undertake lending activities. Apart from maintaining CRR with the RBI, a PB is required to invest minimum 75% of its "demand deposit balances" in SLR securities with maturity up to one year and hold maximum 25% in current and time/fixed deposits with other Scheduled Commercial banks for operational and liquidity management.

A PB should have a minimum paid-up equity capital of Rs. 100 crore with a leverage ratio not less than 3 per cent, i.e., its outside liabilities should not exceed 33.33 times its net worth (paid-up capital and reserves). Minimum initial contribution from the promoter will be 40% of the paid-up equity capital of the PB for the first five years from the commencement of its business. Foreign shareholding is allowed and is subject to prevailing FDI policy applicable for private sector banks.

Right from the beginning a PB should be "fully networked and technology driven" as per the standards generally accepted and norms. Should also have a high powered Customer Grievances Cell to handle customer complaints. Procedure for granting license and its validity is similar to that of SFBs.

Following table depicts salient differences between Payment Banks and Small Finance Banks.

Payment Banks	Small Finance Banks
Payment Banks (PBs) can receive deposits and remittances but can not lend.	Small Finance Banks(SFBs) will lend to unserved and underserved sections including small business unit, micro and small industries and small and marginal farmers.
Deposits from a customer should not exceed Rs. 1 Lakh.	It can provide basic services of excepting deposits and lending.
Cannot give loans and cannot issue credit cards but can issue ATM/Debit Card.	No restriction of area of operation.
Can distribute non-risk financial products such as, Mutual Funds and Insurance Products.	Loan portfolio to the extent of 50% or more should constitute loans and advances of upto Rs. 25 Lakhs.

BRANCH LICENSING

Every company or entity wishing to commence or for carrying on an activity of banking, should obtain a licence under Section 22 of Banking Regulation Act, 1949. In addition to this, in terms of Section 23 (1) (a), (b) of Banking Regulation Act, RBI's permission is also needed for opening a new 'place of business' or changing of location of existing place of business. However if the change of location is within the same city, town or village such prior permission is not needed. Similarly a banking company incorporated in India, needs prior RBI permission to open a new place of business or change a place business (except when the change of place is within the same city, town or village) outside India. Place of business has been defined as "includes any sub-office, pay office, sub pay office and any place of business at which deposits are received, cheques cashed or

moneys lent."

Where an existing place of business is there, a Bank may open a temporary place for business up to one month in an exhibition, mela, conference and similar occassions, no prior permission from RBI is required. The temporary facility has to be within limits of the city or town or village of the existing place of business.

Before granting any permission under this section, the RBI needs to be satisfied through inspection under Section 35 of the Banking Regulation Act, or otherwise, regarding financial condition, history of the company, the general character of its management, the adequacy of its capital structure and earning prospects and that public interest will be served by the opening or, change of location of the place of business.

If a banking company had failed to comply with any of the conditions imposed on it under this Section 23, the Reserve Bank after giving a reasonable opportunity to the bank concerned, may revoke its permission in writing, granted earlier for opening a place of business.

Regional Rural Banks('RRB's) need to route their application for opening a place of business through NABARD, which will put its recommendation on the same and forward to RBI. RRBs also need to send an advance copy to RBI.

Revised Branch Licensing Policy of RBI

In tune with liberalization and banking reforms, RBI has over a period of time relaxed its norms for branch licensing. The latest being during its first Bi-monthly Monetary Policy Statement 2016-17, on April 5, 2016. RBI has issued revised branch licensing policy covering branches and permissible methods of outreach bearing in mind attributes of various banks and the types of services that are dispensed.

General Permission

Domestic scheduled commercial banks (other than RRBs) are permitted to open, by RBI, 'Banking Outlets' in Tier 1 to Tier 6 centres (on the basis of population as per Census 2011), without prior permission in each case otherwise specifically restricted,.

According to RBI, the term 'Banking outlet' for a domestic scheduled commercial bank ('DSCB'), a Small Finance Bank ('SFB') and a Payment Bank ('PB') is" a fixed point service delivery unit, manned by either bank's staff or its Business Correspondent where services of acceptance of deposits, encashment of cheques/ cash withdrawal or lending of money are provided for a minimum of 4 hours per day for at least five days a week."

Such an outlet should carry the usual attributes of a place of business such as signage with name of the bank and authorisation from Head office, contact details of the controlling authorities and complaint escalation mechanism. It should be regularly monitored to ensure proper supervision, 'uninterrupted service' (except temporary interruptions due to telecom connectivity, etc.) and timely addressing of customer grievances. The working hours/days need to be displayed prominently.

Any fixed point service delivery unit of the bank which does not comply with the prescription regarding minimum working hours/days will be considered as a 'Part-time Banking Outlet'.

Extension Counters, Satellite Offices, Part-shifted Branches, Ultra Small Branches and Specialised Branches, subject to their satisfying the definition mentioned above, are eligible to be treated as independent 'Banking Outlets' or 'Part-time Banking Outlets', as the case may be.

ATMs, E- lobbies, Bunch Note Acceptor Machines (BNAM), Cash Deposit Machines (CDM), E- Kiosks and Mobile Branches will not be treated as 'Banking Outlets'.

Point of Sale (PoS) terminals where limited cash withdrawal facility is allowed by banks in terms of existing norms without having an arrangement with the concerned entities as 'business correspondents' will not be considered as 'Banking Outlets'.

An unbanked rural centre (URC) is defined as a rural (Tier 5 and 6) centre that does not have a CBS-enabled 'Banking Outlet' of a Scheduled Commercial Bank, a Payment Bank or a SFB or a Regional Rural Bank nor a branch of a Local Area Bank or licensed Co-operative Bank for carrying out customer based banking transactions

This is however subject to following conditions given below:

At least 25 percent of the total number of 'Banking Outlets' opened during a financial year must be opened in an unbanked rural centres (Tier 5 and Tier 6).

Pro-rata benefit for part-time banking outlet will be given.

- A 'Banking Outlet'/'Part-time Banking Outlet' opened in any Tier 3 to Tier 6 centre of North-Eastern States and Sikkim as well as in any Tier 3 to 6 centre of Left-wing Extremism (LWE) affected districts as notified by the Government of India from time to time, will be considered as equivalent to opening a 'Banking Outlet'/ 'Part-time Banking Outlet', as the case may be, in a URC.
- A full-fledged 'brick and mortar' branch opened in a rural (Tier 5 and 6) centre which is already being served by a fixed point BC outlet by any bank will also be eligible to be treated as equivalent to opening a 'Banking Outlet' in a URC.
- A 'banking outlet' opened in a rural (Tier 5 and 6) centre which is served by only a banking outlet of a Payment Bank will also be eligible to be treated as equivalent to opening a 'banking outlet' in a URC for computing compliance with the 25% norm.
- The time given to a bank for opening an outlet in a URC is one year. If a bank fails to adhere to the requirement of opening 25% banking outlets in a year, RBI will impose penalties including restricting opening of Tier 1 branches.
- To encourage the banks to open more outlets in URCs, they will be allowed to carry forward the benefit of the 'Banking Outlets', opened in excess of the requirement in one year, for a period of next 2 years. No extension to avail the benefit will be allowed.
- State Level Banker Committees (SLBCs) will facilitate banks to choose/indicate the place where they wish to open a 'banking outlet.'
- If a bank fails to open the banking outlet in the prescribed period of 1 year, SLBC convenor bank may indicate the Centre as available for other banks to open a banking outlet. The non-member banks of the SLBC, may also refer to the website and keep the SLBC Convenor banks informed of the centres identified by them.
- If a bank proposes to undertake government business at any of the banking outlets/part-time banking outlets, prior approval of the Government authority concerned as also of RBI's Central Office, DAD should be obtained.

Merger/Closure/ Shifting/Conversion of 'Banking Outlets'

a. Banks having general permission are allowed to shift, merge or close all 'Banking Outlets' (except rural outlets and sole semi-urban outlets) at their discretion.

b. Merger, Closure and shifting of any rural 'Banking Outlet' as well as a sole semi urban 'Banking Outlet'

would require approval of the DCC (District consultative Committee)/DLRC (District Level Review Committee).

c. Conversion of any rural or sole semi-urban banking outlet into a full-fledged brick and mortar branch and vice versa would not require such approval. While merging/closing/shifting/converting a rural or a sole semi urban 'Banking Outlet', banks and DCC/DLRC shall ensure that the banking needs of the centre continue to be met.

d. Banks should ensure that customers of the Banking Outlet, which is being merged/closed/shifted are informed well in time and also continue to fulfill the role entrusted to these 'Banking Outlets' under the Government sponsored programmes and Direct Benefit Transfer Schemes.

e. It may further be ensured that 'Banking Outlets' are shifted within the same or to a lesser population category, i.e., semi urban 'Banking Outlets' to semi urban or rural centres and rural 'Banking Outlets' to other rural centres.

Guidelines for Banks which do not have General Permission

Domestic Scheduled Commercial Banks from whom general permission has been withdrawn, require prior approval of Department of Banking Regulation (DBR), Central Office, RBI for opening all their branches.

Further, in respect of their fixed point BC outlets, they shall also approach RBI for permission except for outlets opened in Tier 5 and 6 Centres.

Small Finance Banks, Payment Banks as well as Local Area Banks (LABs) need to have prior approval of DBR, Central Office, RBI for all categories of banking outlets.

These banks are to submit their Annual Banking Outlet Expansion Plan (ABOEP) with the consolidated details of proposals for opening, closing, shifting, merger and conversion of these banking outlets.

The guidelines are as applicable to banks having general permission. On approval of the consolidated proposal, individual proposals for opening new branches at specific centres, for which prior permission is required from RBI, must be submitted in the prescribed form to RBI.

Proposals required to be submitted to RBI in this regard should have the approval of the Board of Directors of the bank or such other authority to which powers have been delegated by the Board of the bank. Banks shall ensure that an authenticated / certified copy of such approval is invariably submitted along with these proposals.

Support to MFI Structure of the Small Finance Banks

In order to provide an enabling environment to preserve the advantages of the Micro Finance Institutions('MFI')/ Non-Banking Financial Company ('NBFC') structure of SFBs they are allowed a time of 3 years from the date of commencement of business, to comply with branch licensing guideline of RBI. Till such time, they are allowed to continue the existing structure and would be treated as 'Banking Outlets' though not immediately reckoning for the 25 per cent norm.

At the end of three years from the date of their commencement of business, all SFBs should have opened in URCs, at least 25 per cent of their total Banking Outlets failing which penal measures including restrictions on further expansion by such banks will be considered and imposed. This is for ensuring a level playing field for all such entities.

Manning of ATMs/E-kiosks/CDMs/BNAMs/Mobile Branches

Banks are allowed to set up onsite/offsite Automated Teller Machines (ATMs) at centres/places identified by them, including SEZs. Banks are permitted to post suitable staff member(s) to provide guidance to the customers using the services of these outlets. Such ATMs shall not be reckoned as 'banking outlets'. Banks are allowed to open/operate mobile branches in all Centres. These mobile branches will not be considered as Banking Outlets.

Setting up of Administrative Offices, Back Offices (Central Processing Centres/Service Branches) and Call Centres etc.

Banks having general permission can set up Administrative Offices (Head/Regional/Zonal Offices etc.), Training Centres, Back Offices (Central Processing Centres (CPCs)/Service Branches), Treasury Branches and Call Centres, etc. without prior permission from Reserve Bank of India.

The banks should ensure that back offices i.e. CPCs/Service Branches which are set up exclusively to attend to back office functions such as data processing, verification and processing of documents, issuance of cheque books, etc. should not have any direct interface with customers for them to be not considered as banking outlets.

Information as per specified formats regarding opening, merger, conversion, closure etc. of Business outlets are to be communicated to Department of Statistics and Information Management (DSIM) of RBI on a quarterly basis (instead of Annual basis) with effect from April 2017.

Opening of branches in India by Foreign banks

The policy for approving foreign banks applications to open maiden branch and further expand their branch presence has been incorporated in the 'Roadmap for presence of Foreign banks in India' indicated in the Press Release dated February 28, 2005 as well as in the liberalized branch authorisation policy issued on September 8, 2005. The branch authorisation policy for Indian banks has been made applicable to foreign banks subject to the following:

- Foreign banks are required to bring an assigned capital of US $25 million up front at the time of opening the first branch in India.
- Existing foreign banks having only one branch would have to comply with the above requirement before their request for opening of second branch is considered.
- Foreign banks may submit their branch expansion plan on an annual basis.
- In addition to the parameters laid down for Indian banks, the following parameters would also be considered for foreign banks :
    - Foreign bank and its group's track record of compliance and functioning in the global markets would be considered. Reports from home country supervisors will be sought, wherever necessary.
    - Weightage would be given to even distribution of home countries of foreign banks having presence in India.
    - The treatment extended to Indian banks in the home country of the applicant foreign bank would be considered.
    - Due consideration would be given to the bilateral and diplomatic relations between India and the home country.
    - The branch expansion of foreign banks would be considered keeping in view India's commitments

at World Trade Organisation (WTO). Licences issued for off-site ATMs installed by foreign banks are not included in the ceiling of 12 (explained below).

In terms of India's commitment to WTO, as a part of market access, India is committed to permit opening of 12 branches of foreign banks every year. Reserve Bank of India has permitted more number of branches in the past. The Bank follows a liberal policy where the branches are sought to be opened in unbanked/under-banked areas. Off-site ATMs are not counted for the purpose of calculation of limit.

Financially Sound and Well Managed (FSWM) UCBs are those which satisfy following criteria:

(a) Capital to Risk Assets Ratio not less than 10 per cent;

(b) Gross NPA of less than 7% and Net NPAs not more than 3%

(c) Net profit for at least three out of the preceding four years subject to it not having incurred a net loss in the immediate preceding year.

(d) No default in the maintenance of CRR / SLR during the preceding financial year;

(e) Sound internal control system with at least two professional directors on the Board;

(f) Core Banking Solution (CBS) fully implemented; and

(g) the bank should have track record of regulatory compliance and no monetary penalty should have been imposed on violation of any RBI directives / guidelines during the last two financial years.

Branch licensing policy for Regional Rural Banks (RRBs)

- RRBs are required to obtain prior approval of RBI for opening new branches in Tier 1 centres. The applications will be considered on a very selective basis on merits of each case including the overall financial position of the RRB, quality of its management, efficacy of the internal control system, CBS compliance and other relevant factors.
- RRBs are permitted to open branches in Tier 2 to Tier 6 centers (with population of up to 99,999 as per Census 2001) without having the need to take prior permission from RBI in each case, subject to reporting, provided they fulfill the conditions laid down in this regard. RRBs which do not satisfy the said conditions should obtain prior approval from the Regional Office of RBI.
- RRBs which require prior approval for opening branches should submit applications to the concerned Regional Office of the Reserve Bank, through respective Regional Office of NABARD in the prescribed Forms under Banking Companies Rules, 1949 which will give its comments on the merits of the application.
- The RRBs need to submit an advance copy of the application to the concerned Regional Office of the RBI.
- RRBs should open at least 25 percent of the total number of branches proposed to be opened during a year in unbanked rural (Tier 5 and Tier 6) centres.

Recently RBI has issued a separate Branch licensing policy for RRBs. It is as follows:

Opening of Banking Outlets by Regional Rural Banks

Regional Rural Banks are permitted to open banking outlets in Tier 1 to Tier 6 centres subject to the following:

Prior RBI approval is required for opening of banking outlets (excluding BC outlets) in Tier 1 to 4 centres, RRBs have to fulfill the following conditions:

(a) Minimum CRAR of 9% .(b) Net NPA ratio does not exceed five percent. (c) No default in maintenance of CRR and SLR during last two years. (d) Should have registered net profit in the previous financial year. (e) All branches and Head offices of the RRB should be CBS compliant and have in place system generated NPA recognition.

No specific approval is needed from RBI for opening banking outlets in rural centres i.e. Tier 5 and 6 centres) in each case, subject to post facto reporting (within seven days of opening a banking outlet) to Regional Office concerned of RBI. Only after the RRB has achieved the target of opening 25 percent of the total banking outlets in unbanked rural centres, during the previous financial year, permission for opening new branches in tier 1 to 4 centres will be granted in the current year. If they fail to achieve no permission will be granted for opening branches in tier 1 to 4 in the current year. RRBs opening branches in Tier 5 and 6 centres, may approach the Regional Office concerned of RBI for post-facto automatic issue of the licence/s. Such licences should be displayed in branches for the information of customers. Regional Office concerned of RBI, through the Empowered Committee on Regional Rural Banks, will be monitoring opening/ closing/shifting /merger of banking outlets of the RRBs under their jurisdiction.

Directions for opening of 'Banking Outlets' during a financial year will be subject to the following conditions:

At least 25% of the total number of banking outlets opened during a financial year must be opened in unbanked rural centres. A part-time banking outlet, opened in any Centre, will be counted and added to the denominator as well as numerator on pro rata basis for computing the requirement as well as the compliance with the norm of opening 25% banking outlets in unbanked rural centres. Some illustrations on the computation of part-time banking outlet are provided under Annex II to the guidelines.

A banking outlet/part-time banking outlet opened in any Tier 3 to Tier 6 centre of North-Eastern States as well as in any Tier 3 to 6 centre of Left-wing Extremism (LWE) affected districts as notified by the Government of India periodically, will be considered as equivalent to opening a banking outlet/ part-time banking outlet, as the case may be, in a URC. As the overall objective is enabling expansion of banking facilities,each banking outlet opened, irrespective of the banked/unbanked status of the centre, will be reckoned as having been opened in an URC.

The first fixed point BC outlet of a bank as well as the first 'brick and mortar' branch of any bank opened in a URC will be reckoned for computing compliance with the 25% norm.

The time given to a RRB for opening a banking outlet is one year. If a bank fails to adhere to the requirement of opening 25% banking outlets in URC in a year, appropriate penal measures, including restrictions on opening of banking outlets in Tier 1 to 4 centres (except tier 5 and 6) shall be imposed. To encourage the RRBs to open more number of banking outlets in unbanked rural centres, they will be allowed to carry forward the benefit of the banking outlets, if any, opened in excess of the requirement specified in these rules for a period of next 2 years. No further extension to avail the benefit will be allowed.

For identifying an unbanked rural centre, State Level Bankers Committees (SLBCs) will compile and provide an updated list of all unbanked rural centres in the state on their website. This list will help RRBs to choose/ indicate the place where they wish to open a banking outlet and coordinate with the SLBC to earmark the centre identified by them. If a bank fails to open the banking outlet in the prescribed period of 1 year as provided above, the SLBC convenor bank may indicate the centre as available for other banks to open a banking outlet. Prior approval of Government Authority as well as RBI are needed if a RRB proposes to undertake government business at any of the banking outlets/part-time banking outlets.

Merger/Closure/ Shifting/Conversion of 'Banking Outlets' by RRBs

RRBs can shift, merge or close all banking outlets (except rural outlets and sole semi-urban outlets) at their discretion. Merger, closure and shifting of any rural banking outlet as well as a sole semi urban banking outlet would require approval of the DCC/DLRC and Regional Office concerned of RBI. However, conversion of any rural or sole semi-urban banking outlet into a full-fledged brick and mortar branch and vice versa would not require such approval. While merging/closing/shifting/converting a rural or a sole semi urban banking outlet, banks and DCC/DLRC shall ensure that the banking service needs at that centre continue to be met, without disruptions.

RRBs are to ensure that customers of the banking outlet, are kept informed of merger/closure /shifting two months in advance so as to avoid inconvenience. However RRBs to ensure that they continue to fulfil their obligations and role entrusted to these banking outlets under the Government sponsored programmes and Direct Benefit Transfer schemes. Also RRBs to ensure that while shifting banking outlets they are shifted within the same or to a lesser population category , i.e., semi urban banking outlets to semi urban or rural centres and rural banking outlets to other rural centres.

Annual plans

RRBs are required to submit their Annual Banking Outlet Expansion Plan (ABOEP), which is approved by Board of Directors, together with the consolidated details of proposals for opening, closing, shifting, merger and conversion of these banking outlets as per Proforma given in these guidelines to Regional Office concerned of RBI, and to NABARD for monitoring.

Manning of ATMs/E-kiosks/CDMs/BNAMs

RRBs are allowed to set up onsite/offsite Automated Teller Machines (ATMs) at centres/places identified by them. Banks at their discretion may post suitable staff member(s) to provide guidance to the customers using the services of these outlets. Such ATMs shall not be reckoned as banking outlets as defined in the circular.

Mobile Branches – Extension to All Tiers

The scheme of mobile branch envisages extension of banking facilities through a well-protected van with arrangements for two or three officials of the bank sitting in it with books, safe containing cash, etc. The mobile unit would visit the places proposed to be served by it on specific days/hours. The mobile offices would be attached to a branch of an RRB.

Regional Rural Banks are allowed to open/operate mobile branches in all Centres. These mobile branches will not be considered as 'Banking Outlets'.

Setting up of Regional Offices, Administrative Offices, Back Offices (Central Processing Centres/Service Branches) and Call Centres, etc.

RRBs shall be allowed to open one Regional Office (RO) for every 50 banking outlets for which they are required to obtain licence from the concerned Regional Office of RBI prior to functioning / opening of these offices. RRBs having up to 50 banking outlets will be under the direct control of the Head Office, without any intermediate tier. for any relaxations in these norms due to geographical / other conditions, it has to be referred to the Empowered Committee (EC) and referred to Central Office, Department of Banking Regulation (DBR) for consideration.

The ROs are not permitted to transact any banking business. RRBs can either shift or close / merge these offices at their discretion without prior approval of RBI, and report the same post-facto to the concerned Regional Office

of RBI at the earliest, but not later than one month from the date of shifting. As regards closure / merger of such offices, the same to be communicated to the concerned Regional Office of RBI for cancellation immediately after the closure / merger of the office under advice to the DSIM of RBI.

RRBs may set up Training Centres, Back Offices (Central Processing Centres (CPCs)/Service Branches), Treasury Branches and Call Centres, etc. exclusively to attend to back office functions and other functions incidental to their banking business after obtaining necessary permission from the concerned Regional Office of RBI. They should not have any interface with customers and will not be allowed to be converted into general banking branches.

RRBs to ensure that administrative offices, training centres, back offices do not have any direct interface with customers for them to be not considered as banking outlets. Banks currently having specific permission to allow customer interface at these back offices (service branches and/or CPCs), have to align with the above instructions within one year from the date of this circular and report compliance to Regional offices concerned of RBI.

Business Facilitator/ Business Correspondent Model

RRBs to follow instructions on Business Facilitators/Business Correspondents as notified in July 2015. They are also required to follow instructions on Customer Education as advised in Master Circular dated July 1, 2015.

The instructions on Business Facilitator/Business Correspondent Model as contained in our Master Circular DBR.CO.RRB.BL.BC.No.17/31.01.002/2015-16 dated July 01, 2015 remain unchanged.

Reporting Requirements

RRBs shall furnish the information on opening of new place of business i.e. branch/office/NAIOs (Non-Administratively Independent Office) as per Proforma I and any change on change in status – merger, conversion, closure, etc. Proforma II given in these instructions to Banking Statistics Division, Reserve Bank of India, Central Office, C-8/9, Bandra-Kurla Complex, Mumbai-400051.

RRBs are also required to report regarding fixed point BC outlets classified as banking outlets, as per Annex VIII on quarterly basis starting from April 01, 2018. In order to furnish the initial statistics, banks have to furnish the first such report to DSIM, Reserve Bank of India (position as on March 31, 2017), not later than one month from the date of issue of this Circular. From the year 2018-19, the reporting on opening of branches to the Department of Banking Regulation, Central Office has been dispensed with.

Licensing of Urban Co-operative Bank (UCB) branches

Introduction

On July 1, 2015 RBI liberalised and rationalised the branch authorisation norms for Financially Sound and Well Managed (FSWM) UCBs in the States that have signed Memorandum of Understanding (MoU) with it, as well as those registered under Multi-State Co-operative Societies Act, 2002. The present policy is given in the following paragraphs.

Eligibility Criteria

- FSWM UCBs will be eligible to open branches/extension counters (ECs) in their approved area of operation beyond the current annual ceiling of 10 per cent and upgrade ECs which are in operation for more than three years, provided they have the required headroom capital in terms of assessed net worth (ANW) per branch, including existing branches and subject to fulfillment of the six FSWM criteria.

Classification of UCBs

Tier I Banks

(i) Banks having deposits below Rs.100 crore operating in a single district;

(ii) Banks with deposits below Rs.100 crore operating in more than one district will be treated as Tier I provided the branches are in contiguous districts and deposits and advances of branches in one district separately constitute at least 95 per cent of the total deposits and advances respectively of the bank; and

(iii) Banks with deposits below Rs.100 crore, whose branches were originally in a single district but subsequently, became multi-district due to reorganisation of the district may also be treated as Tier I UCBs.

Tier II Banks: All other Banks

(*Deposit and advances are reckoned as on 31st March of the immediate by preceding financial year*).

FSWM UCBs should maintain a minimum CRAR of 10 per cent on a continuous basis with minimum Assessed Net Worth (ANW) commensurate with the prevalent entry point capital norms for the centre where branch is proposed / where it is registered. Entry point norms for various categories of UCBs are given as below.

In the tables below A, B, C and D denote centres with the following population:

Category of centre	Population
A	Over 10 lakh
B	5 lakh and above but less than 10 lakh
C	1 lakh and above but less than 5 lakh
D	Less than 1 lakh

I. Entry Point Norms for General Category

Particulars	A	B	C	D
Assessed Net Worth (Rs. lakh)	400	200	100	25
Membership	3000	2000	1500	500

II. Entry Point Capital Norms for Unit Banks /Banks organised by Mahilas/SCs/STs and those organised in less developed States

Particulars	A	B	C	D
Assessed Net Worth (Rs. lakh)(50% of EPN)	200	100	50	12.50
Membership	3000	2000	1500	500

III. Entry Point Norms for Banks organised in least developed States/North-Eastern States/Tribal Regions

Particulars	A	B	C	D
Assessed Net Worth (Rs. lakh)(33.33% of EPN)	133.33	66.67	33.33	8.33
Membership (66.67% of normal membership)	2000	1334	1000	334

- UCB which are categorized as Unit banks and have been extended relaxation in the entry point capital

as indicated, would be eligible to open branches only after augmenting their Assessed Net Worth (ANW) to be computed as per RBI's norms, to the level required for opening a new general category bank at the place where the bank was organised or where the branch is desired to be opened, whichever is higher.

- For example, if a unit bank was organised at a category 'D' centre and it intends to open a branch at a 'B' category centre, such bank's ANW should necessarily be raised to entry point capital prescribed for organising a general category bank at a 'B' category centre.
- Similarly if a bank, other than a unit bank, desires to open a branch at a higher category centre, other than the centre at which it was established, within the district of its registration, the ANW of the bank should at least be equivalent to the entry point capital prescribed for that centre.
- a bank which desires to open a branch at a centre, other than its district of registration but within the state of registration, must have ANW not less than the entry point capital required for organisation of a new general category bank at the highest category centre in that state.

Process of application

UCBs, satisfying applicable norms, to prepare an Annual Business Plan (ABP) for opening of branches (including extension counters and up-gradation of extension counters into full-fledged branches, in their existing area of UCB which are categorized as Unit banks and have been extended relaxation in the entry point capital as indicated, would be eligible to open branches only after augmenting their Assessed Net Worth (ANW) to be computed as per RBI's norms, to the level required for opening a new general category bank at the place where the bank was organised or where the branch is desired to be opened, whichever is higher.

- For example, if a unit bank was organised at a category 'D' centre and it intends to open a branch at a 'B' category centre, such bank's ANW should necessarily be raised to entry point capital prescribed for organising a general category bank at a 'B' category centre.
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- a bank which desires to open a branch at a centre, other than its district of registration but within the state of registration, must have ANW not less than the entry point capital required for organisation of a new general category bank at the highest category centre in that state.

Process of application

UCBs, satisfying applicable norms, are to prepare an Annual Business Plan (ABP) for opening of branches (including extension counters and up-gradation of extension counters into full-fledged branches, in their existing area of operation), for the next 12 months, with the approval of their Board of Directors and submit the ABP, in duplicate, along with specified annexures to the respective Regional Offices of Reserve Bank of India. Normally RBI expects submission of ABPs by end of December of the previous financial year.

Approval for Centres

Eligible banks will be allotted centres strictly in the order of preference given by them. Once a centre is allotted, no request for change in the allotted centre would be entertained.

Authorisation and its Validity Period

After making arrangements for opening of branches, the bank should approach the Regional Offices of Urban Banks Department under whose jurisdiction they operate, in the prescribed form, indicating the exact postal address of the place where the branch is to be opened, for issuance of authorisation within a period of six months from the date of allotment of the centre.

Authorisation will be valid for one year from the date of issue, or one and a half year from the date of allotment of the centre, whichever is earlier.

Extension of period

No extension of time will be granted after the expiry of validity period of licence. In exceptional cases, an extension of time not exceeding six months may be granted by the Regional Offices, under advice to Central Office.

Non-compliance and penalties

Opening of branches without a valid authorisation from the Reserve Bank is an act of violation of Section 23 of the BR Act, 1949, and liable to attract penalties. Where the banks have opened extension counters without complying with the prescribed norms and subsequently approach Reserve Bank of India for up-gradation of the same into full-fledged branches, such banks would not be allotted centres unless they close unauthorised extension counters. Further, a centre where a bank has opened an unauthorised extension counter, such a centre would not be considered for opening a branch in future.

In case, the information/particulars furnished by any bank are found to be incorrect, the Reserve Bank of India will take a serious view in the matter and the bank will be liable for penal action, including debarring it from allotment of centres for a period of three years.

RBI has also given its policy guidelines in respect of Opening of Specialised branches – Central Processing Centres (CPCs)/Retail Asset Processing Centres, Opening of Extension Counters, Up-gradation of Extension Counters into Full-Fledged Branches etc. under the said policy.

PAID UP CAPITAL AND RESERVES OF BANKING COMPANIES

Section 11 of the Banking Regulation Act, 1949 specifies the minimum paid up capital and reserves of banking companies. Before commencing the banking business every bank has to fulfill the conditions under this Section or as directed by RBI in this regard. As on date no bank can start its activities without complying with this provision. The minimum capital are linked to place of business or places of business. A place of business has been defined as “any office, sub-office, sub-pay office and any place of business at which deposits are received, cheques cashed, or moneys lent”. If there is a dispute arises in computing the aggregate value of the paid-up capital and reserves of any banking company, the decision of RBI would be final in terms of Section11(6) of the Banking Regulation Act, 1949.

Section 11 (2) and 11(3) of the Banking Regulation Act, 1949 deal with the capital and reserves of Foreign banks that operate in India as well as that of banks in India.

The following summarises the requirement of capital and reserves under the Banking Regulation Act, 1949 :

Foreign Banks

1. Keep a deposit of Rs. 15 lacs and if it has place of business in Mumbai or Kolkata or both Rs. 20 lacs with RBI.

2. Additionally to keep 20% of the yearly profit in respect of business transacted through branches in India, as per P & L account, with RBI.
3. Central Government can exempt a bank from this requirement on RBI's recommendations for a specified period if the amounts already deposited is adequate.
4. The capital funds will form the assets of the company to which creditors will have first charge on cessation of business.
5. Mode of funds can be Cash, unencumbered securities or partly both. Securities can be replaced by other unencumbered securities or cash or cash equivalents.

Indian Banks

1. If it has a place of business in more than one state Rs. 5 lacs; if such place of business include Mumbai or Kolkata or both, Rs. 10 lacs.
2. If the place of business is only in one state and not including Mumbai or Kolkata, Rs. 1 lac for principal place of business, plus Rs. 10,000 for other places of business in the same district in which principal place of business is situated, plus Rs. 25,000 in respect of each place of business situated elsewhere in the State other than in the same district, total being not in excess of Rs. 5 lacs.
3. If such a bank has only one place of business the amount is restricted to Rs. 50,000.
4. For the banks commencing business after the commencement of the Banking Regulation Act, paid up capital is stipulated at Rs. 5 lacs.
5. If the places of business are in one state only but one or more of them is in Mumbai or Kolkata Rs. 5 lacs plus Rs. 25,000 for each place of business outside these cities and in total not exceeding Rs. 10 lacs.

REGULATION OF PAID-UP CAPITAL, SUBSCRIBED CAPITAL AND AUTHORISED CAPITAL AND VOTING RIGHTS OF SHAREHOLDERS

Section 12(1) of the Banking Regulation Act, 1949 requires that the subscribed capital of the company is not less than half of the authorised capital, and the paid-up capital is not less than half of the subscribed capital. Further, when the capital is increased, the concerned bank will comply with conditions within a period of two years as RBI may allow.

As amended in 2012, under Section 12 (1) (ii) of the Banking Regulation Act, 1949 a banking company's equity capital should consist of only equity shares or equity& preference shares. Such issuance of preference share would be in accordance with RBI's guidelines.

Voting Rights

Under Section 12(2) of the Banking Regulation Act, 1949 a person holding any share/s in a banking company may exercise voting rights on poll, not exceeding10 % of the total voting rights of all the shareholders of the banking company. With effect from 18th January 2013, RBI has powers to increase the same gradually from 10% to 26%. Further under Section 12(1) (ii)(b) preference holders cannot exercise voting rights in respect of shares held by them in a banking company as specified under Companies Act. Under Section 12 (3) no suit can be filed against a registered share holder except by genuine transferee of such shares or on behalf of minors or lunatic for whom such shares held by a registered share holder.

Limits on brokerage/commission /Discount

Section13 of the Banking Regulation Act, 1949 places a ceiling of 2½% of the price (including the premium) at which shares are issued as commission, brokerage, discount or remuneration on the sale of shares of banking companies.

Dividend

In terms of Section 15 of the Banking Regulation Act, 1949 a company can pay dividend only after capitalized expenses, such as preliminary expenses, organizational expenses, commission on shares sold, brokerage, loss incurred etc. are written off.

Returns to be submitted

The Chairman or CEO of the banking company is obligated to furnish to RBI, particulars of extent and value of his holding of shares, either directly or indirectly, in the banking company, as well as any change in the extent of such holding or any variation in the rights thereof or any other information.

SUBSIDIARIES OF BANKING COMPANIES

Section 19 of the Banking Regulation Act, 1949 governs the formation of subsidiaries of banking companies. According this section, banks are allowed to form subsidiary companies for the activities which are permitted under Section 6 (1), including formation of Credit Information subsidiaries under Section 6 of Banking Regulation Act either in India or abroad with prior permission of RBI. The main objective is to prevent trading as well as securing control of Non-banking companies.

Activities which subsidiary companies engage in will not be deemed as a direct or indirect activity of the banking company.

Holding of shares in other companies

Under Section 19(2) of the Banking Regulation Act, 1949 banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, not exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less. Also Section 19 (3) , a banking company cannot hold shares, whether as pledgee, mortagagee or absolute owner, in any company in the management of which any Managing Director or Manager of the banking company is in any manner concerned or interested.

BOARD OF DIRECTORS IN BANKING COMPANIES

In terms of Section 10A of the Banking Regulation Act, 1949 not less than 51% of Board of Directors of a banking company, should have special knowledge or practical experience in any one or more of the following fields : -

(i) accountancy (ii) agriculture and rural economy, (iii) banking, (iv) co-operation, (v) economics, (vi) finance, (vii) law, (viii) small-scale industry, (ix) any other matter which according to RBI to be useful to the banking company. Among them at least two persons having special knowledge or practical experience in respect of agriculture and rural economy, co-operation or small scale industry.

Under Section 10(2), a director of banking company cannot

- have substantial interest in or any way connected with, as employee, manager or Managing agent, any company, other than a Section 8 Company under Companies Act, 2013 (earlier Section 25 company under Companies Act, 1956) or

- be connected with any trading or commercial or industrial concerns (excluding small scale industrial concern)
- be a proprietor of any trading, commercial or industrial concern, (excluding a small scale industrial concern).

On August 2, 2019 Reserve Bank of India has announced through a direction the procedure and criteria for determining the 'fit and proper' status of a person to be eligible to be elected as a director on the Board of Public Sector Banks, vide its circular RBI/DBR/2019-20/71 Master Direction DBR. Appt. No: 9/29.67.001/ 2019-20 August 2, 2019.

A summary of the same is as under:

1. These Directions applies to Public Sector Banks.
2. All PSU banks are to constitute a Nomination and Remuneration Committee consisting of a minimum of three non-executive directors from amongst the Board of Directors ('Board'). Out of which not less than one-half shall be independent directors and should include at least one member from Risk Management Committee of the Board, for undertaking a process of due diligence to determine the 'fit and proper' status of the persons to be elected as directors as per Section 19 (C) of the SBI Act/clause and as per Section 9 (3)(i) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/ 1980.
3. The nominee director from Government of India and the director appointed under Section 19(f) of SBI Act/ Section 19 (c) (3) of Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/ 1980.can't be a part of the committee mentioned in point 2 above.
4. The Non-executive Chairman of the bank can be a member of the committee but can't chair the meetings. Any other directors nominated to the committee can Chair the meetings.
5. The quorum is three, including the Chairman of the Committee. For want of quorum, In case of absence of any nominated directors, the Board may nominate any other non-executive director to attend the committee meeting.
6. The Board can decide the tenure of the committee while constituting the same.
7. A brief procedure has been spelt out by RBI regarding nomination for election, acceptance of application etc. from applicants for Director's post.
8. Brief criteria:
    a. Candidates should be between 35 to 67 years of age as on the cut-off date. Should be at least a graduate.
    b. Candidates should have special knowledge/experience as per Section 19A(a) of the SBI Act / section 9(3A)(A) of the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970/ 1980.
    c. Tenure for such elected director will be for three years and is eligible for re-election: subject to no such director to hold office for a period exceeding six years, whether continuously or intermittently.
    d. Apart from the <u>disqualifications</u> stated in SBI Act/Banking Companies Act 1970/1980 the following also apply:
        i. The candidate should not be a member of the Board of any bank or the RBI or a Financial Institution (FI) or an Insurance Company or a NOFHC holding any other bank.

Explanation: The expression "bank" includes a banking company, a corresponding new bank, State Bank of India, a co-operative bank and a regional rural bank.

ii. A person connected with hire purchase, financing, money lending, investment, leasing and other para banking activities shall not be considered for appointment as elected director on the board of a Public Sector Bank.

However, investors of such entities will not be disqualified for appointment as directors, if they do not have any managerial control in them.

iii. No person may be elected/ re-elected on the Board if he/she has served as director in the past on the board of any bank/FI/RBI/Insurance Company under any category for six years, whether continuously or intermittently.

iv. The candidate should not be engaged in the business of stock broking.

v. The candidate should not be a Member of Parliament or State Legislature or Municipal Corporation or Municipality or other local bodies.

vi. The candidate should not be acting as a partner of a Chartered Accountant firm which is currently engaged as a Statutory Central Auditor of any nationalised bank or State Bank of India or as Statutory Branch Auditor or Concurrent Auditor of the bank in which nomination for election is filed.

9. Professional Restrictions: The candidate should not have any business connection (including legal services, advisory services etc.) with the concerned bank and also should not be engaged in activities which might result in a conflict of business interests with that bank.

10. The candidate should not be having any professional relationship with a bank or any NOFHC holding any other bank.

11. In the event of elected as a Director, the candidate should severe his relationship with such bank or as the case may be.

12. The candidate should not be under adverse notice of any regulatory or supervisory authority/agency, or law enforcement agency and should not be a defaulter of any lending institution.

13. Once a candidate is elected as a director he has to submit the prescribed declarations as enumerated in the circular. Also to submit yearly declaration as required under the directions. Failure to do so or suppression of any information or any non compliance of any of the requirement, will be liable for legal consequences.

Limitation on period of office

As per Section 10(2A) of the Banking Regulation Act other than a Chairman or whole-time Director, no director can hold office continuously for a period beyond eight years. Also a Chairman or other whole-time Director who has been removed from such posts will cease to be a Director and will not be eligible to be appointed as a Director by any process, for a period of four years from the date of his cessation as Chairman or whole-time Director as applicable.

Reconstitution of Board

In the opinion of RBI, if the composition of the Board of Directors requires reconstitution, RBI shall direct the

banking company for such reconstitution through a written communication after giving a reasonable opportunity of being heard. Within two months of such communication, direction of the RBI shall be complied with.

In order to reconstitute the Board of Directors, if it is necessary to retire any Director or Directors, it has to be done through drawing of lots, to decide which Director or Directors shall cease to hold office. Such decision will be binding on every Director of the Board.

If the banking company fails to comply with directions, that Bank through lots drawn as prescribed remove the person who ought to be removed from the membership of the Board of Directors, remove such person from the office of the Director of banking company for compliance of provisions, appoint a suitable person as a member of the Board of Directors in the place of the person so removed. The person thus appointed will be considered as deemed to have been duly elected as a Director who will continue in office till his predecessor would have continued. Any reconstitution or removal in terms of these provisions cannot be challenged in any court. No proceedings of the Board of Directors will become invalid, merely because of any defect in the composition of the Board.

CHAIRMAN/MANAGING DIRECTOR OF A BANKING COMPANY

Appointment of a Chairman of a banking company is subject to the provisions of Section 10 (A), (B), (C),(D) of the Banking Regulation Act. Accordingly one of the Directors a banking company has to be appointed as a whole-time or a part-time Chairman. If the Chairman is appointed on a whole-time basis, he will exercise his powers under the superintendence, direction and control of the Board of Directors. If a Chairman is to be appointed on part-time basis, it requires the prior approval of RBI which may specify conditions thereof. The affairs of the banking company have to be managed by a Managing Director who will exercise his powers subject to the superintendence, control and direction of the Board of Directors.

Period of appointment

The period of appointment of a Chairman/ Managing Director on a whole-time basis will be for a period not exceeding five years, as the board of Directors may fix, and also be eligible for re-election/reappointment as specified in the Banking Regulation Act. A Chairman is allowed to be a Director of a subsidiary of the banking company or a company registered under Section 8 Company under The Companies Act, 2013 (earlier Section 25 company under Companies Act 1956).

Qualifications : Whole-time Chairman/Managing Director

Every whole- time Chairman and every Managing Director of a banking company should have special knowledge and practical experience of the working of a banking company, or of the State Bank of India or any subsidiary bank or a financial institution, or financial, economic or business administration.

A Chairman, appointed on a whole time basis or a Managing Director of a banking company -

- Will be disqualified if he is a Director of any company [other than a subsidiary company or a Section 8 company as provided under Section 10 (2)],is a partner of any firm which carries on any trade, business or industry, or has substantial interest in any other company or firm, or is a Director, manager, Managing agent, partner or proprietor of any trading, commercial or industrial concern, or is engaged in any other business or vocation.

May resign his office through a letter in writing addressed to the company.

Subject to the approval of RBI, a whole-time Chairman or a Managing Director whose term of office has ended or has resigned is allowed to continue till his successor assumes office.

Removal of Chairman/ Managing Director

If in the opinion of RBI any person who, is, or has been elected as whole-time Chairman/ Managing Director is not a fit and proper person, RBI may require the banking company to elect or appoint any other person as Chairman or the Managing Director. If within a period of two months from the date of receipt of such order, the banking company fails to elect or appoint a suitable person, the RBI may remove the first-mentioned person and appoint a suitable person in his place who will be deemed to have been duly elected or appointed, as Chairman or the Managing Director and will hold office for the residual period of office of the person in whose place he has been so elected or appointed.

In the public interest, RBI may permit Whole-time Chairman or the Managing Director undertake part-time honorary work which is not likely to interfere with his duties as Chairman or Managing Director.

Such persons who have been removed by RBI, can appeal to Central Government against the removal The Central Government's decision in the matter will be final and cannot be questioned by any court. In all other cases, RBI's decision will be final.

Powers of RBI to appoint Chairman/ Managing Director

If Chairman or the Managing Director dies or resigns or becomes infirm or incapable of carrying out his duties or is absent on leave or any other circumstances which does not involve vacation of his office, the banking company can make alternate arrangement with the approval of the RBI up to a total period of four months.

Under Section 10 BB, if the position of whole-time Chairman or Managing Director of a banking company lies vacant, and in the opinion of RBI that this may prejudicial to the interests of the bank, it may appoint an eligible person as Chairman on a whole-time basis or a Managing Director. Such a person though may not be a director of that bank, will be deemed as a Director, so long as he holds the post of whole-time Chairman or Managing Director, and will hold office for a period not exceeding three years, as RBI specifies. Such person may also be eligible for reappointment as per the Banking Regulation Act provisions.

Salary and Holding of qualification shares

The whole-time Chairman or a Managing Director appointed by the RBI will draw from the banking company pay and allowances as determined by the RBI and can be removed from office only by the Reserve Bank.

The whole-time Chairman or a Managing Director of by whomsoever appointed and a Director who is appointed by the RBI under Section 10A will not be required to hold qualification shares of the banking company.

Overriding Provisions

Appointment or removal of a whole-time Chairman, Managing Director, Director under the provisions of Section 10 (A), (B), (BB) will over ride all other laws or contracts. A person who is affected by any action taken in terms of these provisions including termination, is not entitled to claim any compensation for any loss.

APPOINTMENT OF ADDITIONAL DIRECTORS

The power to appoint additional directors is vested in RBI under Section 36 AB of Banking Regulation Act.

- In the interest of a banking company and its depositors, through a written order the RBI can appoint, one or more persons to hold office as additional Directors.
- Such a person appointed as additional Director/s
  - will hold office during the pleasure of the RBI, subject to a period not exceeding three years or such further periods not exceeding three years at a time.

- will not incur any obligation or liability by reason only of his being a Director or for anything done or omitted to be done in good faith in the execution of the duties of his office or
- is not required to hold qualification-shares in the banking company. (

Any additional Director so appointed, will not be taken in to account for the purpose of reckoning any proportion of the total number of Directors of the banking company.

The powers conferred under Section 36AB have overriding effect on any other law contract or instrument which is in force.

RESTRICTIONS ON EMPLOYMENT

There are certain restrictions imposed on a banking company under Section 10 of the Banking Regulation Act. They are as under:

A banking company cannot

a. employ or allow a Managing agent to manage its affairs.

b. employ any person who is or at any time in the past has been an adjudicated insolvent, or has suspended payment or has compounded with his creditors, or

   who is, or has been, convicted by a criminal court of an offence involving moral turpitude or whose remuneration or part of whose remuneration takes the form of commission or of a share in the profits of the company.

c. employ a person whose remuneration according to RBI, is excessive.

d. allow a person to manage its affairs, who is a Director of any other company. (excepting a subsidiary of the banking company, or a company registered under section 8 of the Companies Act, 2013. [*The prohibition mentioned in this sub-clause will not apply in respect of any such Director for a temporary period not exceeding three months or such further period not exceeding nine months as the RBI may allow*].

e. employ a person who is engaged in any other business or vocation; or whose term of office as a person Managing the company is for period exceeding five years at any one time (excepting renewal of term of office as specified under the Banking Regulation Act].

CONTROL OVER MANAGEMENT/ DIRECTORS/OTHER PERSONS

As a measure of control over management and other persons of a banking company, Section 36AA of the Banking Regulation Act confers powers to RBI, to remove managerial and other persons from office, under certain circumstances.

If the RBI is satisfied that in the public interest or in the overall interest of the banking company as well as to protect the interests of depositors it is necessary to remove a managerial person, it can remove by a written order with effect from any specified date any Chairman, Director, Chief Executive Officer (by whatever name called) or other officer or employee of the banking company. Before removal, such persons who are being removed would be given a reasonable opportunity to make a presentation to RBI, against the said order.

Pending the consideration of the representation from persons facing removal, in the opinion of RBI any delay in the interim would harm the interests of the bank or its depositors, order such persons not to take part either directly or indirectly in the management of, the banking company. Persons who are facing an order of removal

from RBI, within thirty days from the date of communication of the order, can appeal to the Central Government against the order. After considering the appeal, the Central government may take a decision and communicate the same to the concerned persons who have made the appeal and it's decision would be final in the matter. The decision of the Central Government cannot be questioned in any court.

Such persons who are facing removal order from RBI, cease to be Whole-time Chairman, Managing Director or Director or any other employees as the case may be of the banking company and cannot directly or indirectly, be concerned with, or take part in the management of, any banking company for period not exceeding five years or as stated in the order. Any one violating or contravenes the terms such order shall face punishment of fine up to two hundred and fifty rupees for each day during which such contravention continues. The person who has been removed is entitled to claim any compensation for the loss or termination of office.

Through a written order, RBI may appoint a suitable person in place of Chairman or Director or chief executive officer or other officer or employee who has been removed from his office with effect from such date as it may specify. The person who is thus appointed in the position of the removed employee will hold office for a period not exceeding three years and such further period not over three years at a time and such person will not incur any obligation or liability by reason only of his being a Chairman, Director or Chief Executive Officer or other officer or employee for anything done or omitted to be done in good faith in the execution of the duties of his office.

Supersession of Board of Directors

Under Section 36 ACA, RBI has the powers to supersede the Board of Directors of a Banking Company in certain cases.

If RBI is of the opinion that it is necessary in the interests of a banking company or its depositors and in consultation with Central Government, through a written order, supersede the Board of Directors of such banking company for a period of not exceeding six months (subject to a maximum period of 12 months) or as specified in the order.

Appointment of Administrator

Upon superseding the Board of Directors, the RBI (after due consultation with the Central Government) will appoint, an Administrator (not an officer of the Central Government or a State Government) who has experience in law, finance, banking, economics or accountancy for such period as it determines. The Administrator so appointed, is bound to follow directions issued by the RBI in this regard. Consequent to the supersession of the Board of Directors, the Chairman, Managing Director and other Directors have to vacate their offices.

Powers/Duties/Role of Administrator

The Administrator will exercise all powers, discharge functions and perform duties that are applicable under the provisions of the Companies Act or the Banking Regulation Act or any other applicable law in force, until the Board of Directors is reconstituted.

Committee to assist the Administrator

The RBI in consultation with Central government may also appoint a committee of three or more persons who holding meetings. The RBI will specify salary and allowances payable to the Administrator and the members of the committee constituted and the same to be borne by the concerned banking company.

Time limit for reconstitution of the Board of Directors

Two months before the expiry of the period of supersession as specified in the RBI order issued earlier, the Administrator will call the general meeting of the company to elect new Directors and reconstitute its Board of Directors.

No compensation is payable to any person for the loss or termination of his office in the process. The Administrator will vacate the office immediately after the reconstitution of Board of Directors.

CORPORATE GOVERNANCE

Corporate Governance and its importance

Banks are the backbone of an economy and play a crucial role in the distribution of capital. Hence, the proper governance of banks is essential for economic growth and development of the nation as a whole. According to Cadbury Committee report, corporate governance means the system by which companies are directed and controlled. 'Corporate Governance' in the context of banking denotes, managing the affairs of a banking company by adopting the global best practices so as to protect the interests of all stake holders such as depositors, other customers, investors, employees, regulatory authorities and society at large. Therefore the gamut of corporate governance involves several governance aspects namely regulatory, market, stake holder and internal governance aspects. For a balanced performance of an economy the a country's economic and financial systems have to be stable. If any of these factors is found wanting there could be destabilization of the economy.

Banks are which are highly regulated in India form the back bone of the economy. Any failure of the governance factors will have its chain reaction on other sectors of the economy as banking industry is linked to nearly 80 industries. Therefore banks must follow and act in many ways so as to inspire confidence among all its stake holders. Hence good governance practices are a pre-requisite for a robust banking system in the interest of all. Poor governance in the banking system can lead to bank failures and consequently erode the confidence of depositors and other customers leading to run on banks and will have significant national and international negative fallouts.

Why Corporate governance is important for banking institutions? The reasons are as follows:

- Financial institutions play a pivotal role in an economy. Any mishap therein will be detrimental to the economy and to get back to normalcy, it would take a long time which may impede growth plans.
- Financial institutions, especially banks are highly leveraged and this make them vulnerable to any adverse developments in the economy. Therefore in order to ensure economic stability, governance of these institutions is a must.
- Among financial institutions, banks are highly trusted organizations that deal with funds of the public at large. Anything amiss in its functions will result in loss of trust, leading eventually to the collapse of such institutions and also will have its contagion effect on the economy. Therefore good corporate governance is essential for building of trust among all stake holders in these institutions.
- Banks act as agents for transmission of monetary policies to the public. They also play a vital role in payment and settlement system in an economy. Any weaknesses arising out of poor or inadequate monitoring can be set right with robust internal controls which is an essential part of governance.

Therefore Corporate governance plays a beneficial role in an economy.

Evolution of Corporate Governance in Indian Banking

Though banks in India were highly regulated by RBI, guidelines for corporate governance were very limited before the reforms took place in the banking sector in India. Dominance of Public sector banks with a few private sector banks along with cooperative sector banks formed the space of banking in India previously. However the economic reforms of 1991-92 and subsequent banking reforms changed the scenario, More number of private banks and foreign banks entered the Indian banking scenario and began to function in a competitive manner with Public sector banks and old generation private sector banks in India. Banks were given more freedom in their functions as well as autonomy. Over a period, the share holding of Government of India also came down in Public sector banks, giving way to public shareholding. This has compelled banks to improve their governance standards.

International developments in corporate governance also contributed its share in the development of the same in India during late 1990s and early 2000. Guidelines of the Basel Committee, the Organization for Economic Cooperation and Development (OECD) principles on Corporate governance, developments in US during this period etc. had its impact on corporate governance aspects of banks in India. The South East Asian crisis of 1997 also made its impact about the need for proper corporate governance aspects of banks.

The seeds of corporate governance for banks in India began with the announcement of by Dr. Bimal Jalan, the then RBI Governor who in 2001 constituted an advisory group under Dr. R.H. Patil. This group looked in to the state of corporate governance prevailing in banks made a set of recommendations regarding governance standards in Indian banks in line with international best practices. Subsequently, a group under Dr. A.S. Ganguly was appointed, to study the role of Board of Directors of banks and suggest ways to strengthen the same. This report was shared with all banks and submitted to Central Government also for its consideration in mid 2002. Along with these another study group headed by Mr. M.S. Verma (former Chairman of SBI) was set up to make recommendations on Banking Supervision. This study group submitted its recommendations in early 2003. The Reserve Bank then took measures to strengthen the corporate governance in the Indian banking sector and try to bring it at par with international standards. On 21 August 2002, the then Department of Company Affairs instituted a committee to look into various corporate governance issues in the country.

The economic reforms and banking reforms brought in several changes in banking environment in India including Corporate governance. Increased entry of private and foreign banks, enhanced level of competition between various banks, conferring greater independence to Public Sector bank boards, granting more functional autonomy, appointment of independent directors on boards etc. called for a more enhanced level of corporate governance in banks in India. Though banks are highly regulated, the primary responsibility to develop governance practices rests on themselves. The Banking scams that took place in 1990s pointed to the gaps in disclosure and governance aspects of banks. All these developments resulted in bringing in a need for adoption and enforcement of best corporate governance standards among banks in India.

The April 2001 regulatory compulsion of SEBI on companies including banking companies in India, to follow strict corporate governance practices and disclosures under Clause 49 of the Listing Agreement ushered in a milestone in corporate governance among banks in India. However, in spite of various initiatives taken to entrench best Corporate governance practices among banks, certain impediments such as vast powers enjoyed by Government in appointment of members of board of banks, directive powers of RBI, disclosure practices etc. still exist.

Effect of lack of Corporate Governance

There are glaring national and international examples of involving banks that showed what an ineffective

corporate governance can do to financial institutions and national economies. Enron crisis in early 2000, sub-prime crisis leading to collapse of Lehman Brothers and near collapse of the global financial system in 2008, the recent LIBOR crisis involving several leading American and European banks are all some of the international examples. Harshad Mehta Scam in 1992, Ketan Parekh scandal in 1997, Software giant Satyam Computer's crisis, folding up of Global Trust Bank (which later merged with a PSU Bank) etc. are some of the national examples in this regard. Even the latest Nirav Modi's case, points to the failure of governance aspects on the part of the concerned bank. The Punjab Maharashtra Co-operative Bank crisis which has erupted on September 23, 2019 also reveals the lack of proper corporate governance practices including failure of oversight functions leading to erosion of public confidence in banking institutions.

Good Corporate Governance standards include the following:

1. Establishing code of conduct and ethical behaviour right from the Board of Directors level to all other employees including accountability aspects thereof.
2. Constant review of role, responsibilities as well as accountability aspects of the Board of Directors.
3. Evaluating the effectiveness managing the operations of the bank by senior management.
4. Supervising strategic management and oversee risk management by establishing appropriate procedures for managing risks.

The Basel Committee in1999, had pronounced some important oversight aspects within the organizational structure to maintain proper checks and balances. They are"(i) oversight by the board of directors or supervisory board;(ii) oversight by individuals not involved in the day-to-day running of the various business areas;(iii) direct line supervision of different business areas;(iv)Independent risk management and audit functions". Additionally there was an emphasis on key personnel being 'fit and proper' for their roles. These recommendations convey an undercurrent of governance standards in banks.

Regulatory Bodies involved in Corporate Governance of Banks

Among the financial regulators, RBI and SEBI play complementary roles in corporate governance of banks in India. Prudential norms and associated principles of Basel norms, form the basis of corporate governance in banks. Within RBI, the Board of Financial Supervision is concerned with corporate governance functions which has supervisory oversight of Department of Banking Supervision and Department of Non-banking Supervision and Financial Institutions Division. On the other hand SEBI which regulates securities markets, oversees the mandatory compliance of corporate governance norms in listed banks.

Qualitative Standards in Corporate Governance of Banks

Qualitative standards of corporate governance of a bank is reflected, in the following areas of working of a bank.

- Standard of Ethics in the organization,
- Standards of internal control,
- Role of Board of Directors
- Disclosure standards
- Accounting system
- Risk management systems

Governance and day today management

It is the basic responsibility of operating management consisting of CEO, top management functionaries and line managers. It is the responsibility of operating management to ensure day to day management functions are carried out within the governing standards and plug loopholes by constant review.

Bench marks for evaluating Corporate Governance Standards

The bench marks for evaluation of corporate governance standards of a banking company include the following - model codes for best practices, role of the board of directors and various committees, recommended disclosure requirements, level of transparency, reporting system to various levels including to the board of directors, policies framed by the board, monitoring performances at periodical intervals.

Indian scenario – RBI's initiatives

Due to economic liberalization, banking reforms as well as introduction of prudential regulations in 1990s, the emphasis of regulator shifted from control to governance. Banks were given more freedom as well as autonomy in their functional areas. This called for greater governance standards from the Board of Directors of banks. Keeping in mind the changed scenario several guidelines were issued by RBI to strengthen corporate governance in banks. These guidelines were in line with Basel Committee recommendations such as Role of the Board of Directors, fit and proper criteria of Board members, separation of the post of Chairman and Managing Director, remuneration aspects, role of independent directors, ownership and extent of shareholding in private sector banks and governance thereof. Further recently, guidelines on Non-Operative Financial Holding Companies, Fit and proper status of groups, Prompt Corrective Action etc. were also issued to strengthen Corporate governance of banks in India.

LESSON ROUND UP

- The Banking Regulation Act was enacted with the view to provide a law for the banking companies.
- Licensing which includes the permission provided to banking companies for operating forms a major part of the BR Act.
- Certain eligibility criteria like Background of the banking companies, their sources of funds, their geographical locations are required to be fulfilled before to get licence to run banking business.
- In case of any non-fulfilment of the required conditions on continuous basis the license may be cancelled by RBI.
- When foreign banks want to operate in India, they have to seek permission of RBI for license. The prescribed procedures are almost same as applicable to other banks in the country.
- For private sectors banks continuous authorization policy is prescribed in place of Stop and Go policy.
- Other than licensing, RBI has provided separate guidelines for carrying out the activities of insurance, mutual funds etc.
- For Small Finance Banks & Payment Banks, RBI provides separate licensing norms and a handful number of banks are now operating in India.
- RBI provides detailed guidelines for branch licensing and no bank can operate unless it is licensed under Section 22 of Banking Regulation Act.
- Banks having general permission are allowed to shift, merge or close all 'Banking Outlets' (except

rural outlets and sole semi-urban outlets) at their discretion.

- Merger, Closure and shifting of any rural 'Banking Outlet' as well as a sole semi urban 'Banking Outlet' would require approval of the DCC/DLRC.
- However where general permission has been withdrawn banks have to take the approval of Department of Banking Regulation in order to open the branches.
- A minimum amount of paid up capital has to be maintained both for domestic & foreign banks to start up their operations.
- Under Banking Regulation Act not less than 51% of the directors of the Board of Directors of the banking companies should have practical & special knowledge in subjects like Accountancy, economics, Taxation etc. Recently RBI has issued directions on– Not only that, the RBI holds special power to appoint and/or remove Managing Director/Chairman in specified circumstances.
- Recently RBI has issued directions concerning procedure and criteria for determining the 'fit and proper' status of a person to be eligible to be elected as a director on the Board of Public Sector Banks
- In line with Basel Committee recommendations, RBI has issued Guidelines on corporate governance covering areas such as Role of the Board of Directors, fit and proper criteria of Board members, separation of the post of Chairman and Managing Director, remuneration aspects, role of independent directors etc.

GLOSSARY

- **Organization for Economic Cooperation and Development (OECD)** -- is an intergovernmental economic organisation with 36 member countries, founded in 1961 to stimulate economic progress and world trade.
- **Assessed net worth (ANW)** – book value or shareholders' equity.
- **Financially Sound and Well Managed (FSWM)** – a business, economy, etc. that is controlled in a way that produces good results
- **World Trade Organisation (WTO)** – an intergovernmental organization that regulates international trade.
- **State Level Banker Committees (SLBCs)** – an inter-institutional forum at State level ensuring co-ordination between Government and Banks on matters pertaining to banking development.
- **Unbanked Rural Centre' (URC)** – is defined as a rural (Tier 5 and 6) centre that does not have a CBS-enabled 'Banking Outlet' of a Scheduled Commercial Bank, a Payment Bank or a SFB or a Regional Rural Bank nor a branch of a Local Area Bank or licensed Co-operative Bank for carrying out customer based banking transactions.
- **Point of Sale (PoS)** – the place at which a retail transaction is carried out.
- **E-lobbies** – a facility which is now provided by banks so that their customers can do their banking transactions as per their convenience 24×7 i.e. without any time restriction. E-Lobby provides the facility on bank holidays also.
- **Bunch Note Acceptor Machines (BNAM)** – These machines can be used for both deposits as well as withdrawal of cash.

- **Cash Deposit Machines (CDM)** – an ATM like machine that allows you to deposit cash directly into your account using the ATM cum debit card.
- **E-Kiosks** – a computer terminal featuring specialized hardware and software that provides access to information and applications for communication, commerce, entertainment, or education.
- **Domestic scheduled commercial bank ('DSCB')** – are those banks which are included in the second schedule of RBI Act 1934 and which carry out the normal business of banking such as accepting deposits, giving out loans and other banking services.
- **Corporate Business Correspondents (BCs)** – are retail agents engaged by banks for providing banking services at locations other than a bank branch/ATM
- **Pre-paid Payment Instrument (PPI)** – are methods that facilitate purchase of goods and services against the value stored on such instruments.
- **Payment Banks ('PB')** – a niche bank that can accept demand deposits (up to Rs 1 lakh), offer remittance services, mobile payments/transfers/purchases and their banking services like ATM/debit cards, net banking and third party fund transfers.
- **Foreign Direct Investment (FDI)** – is an investment in the form of a controlling ownership in a business in one country by an entity based in another country.
- **Adjusted Net Bank Credit (ANBC)** – It is the net bank credit plus investments made by banks in non-SLR bonds held in the held-to-maturity category or credit equivalent amount of off-balance-sheet exposure, whichever is higher.
- **Priority sector lending (PSL)** – is an important role given by the Reserve Bank of India (RBI) to the banks for providing a specified portion of the bank lending to few specific sectors like agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections..
- **External Advisory Committee (EAC)** – a committee appointed by RBI for evaluating Applications of Small Finance Banks and Payments Banks.
- **Non-Banking Finance Companies (NBFCs)** – is a company registered under the Companies Act, 1956/2013 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property
- **Micro Finance Institutions (MFIs)** – is an organization that offers financial services to low income populations
- **Non-Operative Financial Holding Company (NOFHC)** – means a non-deposit taking NBFC referred to in the "Guidelines for Licensing of New Banks in the Private Sector"1 issued by Reserve Bank, which holds shares of a banking company and shares of all other financial services companies in its group, whether regulated by Reserve Bank or by any other financial regulator, to the extent permissible under the applicable regulatory prescriptions
- **Local Area Banks (LABs)** – small private banks, conceived as low cost structures which would provide efficient and competitive financial intermediation services in a limited area of operation, i.e., primarily in

rural and semi-urban areas, comprising three contiguous districts.

SELF TEST QUESTIONS

1. Fill in the blanks

   a. Where there is already a place of business, Banks are allowed to open a temporary place of business for a period of _____in an exhibition, mela, conference and similar occasions.

   b. NOFHC shall be registered with RBI as a _____.

   c. Minimum capital for a Small Finance bank is _____.

   d. Payment banks are allowed to hold a maximum deposit of _____ per depositor.

   e. RBI has powers to increase Voting rights of a person holding shares of a bank from _____ % to _____ %.

   f. In case of a banking company _____% of Directors should have special knowledge or practical experience in accountancy, agriculture and rural economy, banking, co-operation etc.

   g. A director of a banking company cannot continuously hold his office for a period beyond ---------- .

   h. The period of appointment of a Chairman/ Managing Director on a whole-time basis will be for a period of _____.

   i. RRBs shall be allowed to open one Regional Office (RO) for every _____ banking outlets for which they are required to obtain licence.

   j. The age limit for a person to be eligible to be elected as a director on the Board of Public Sector Banks is between ---- and ----- years.

2. Say True or False

   a. Foreign banks are required to bring an assigned capital of US $ 100 million up front at the time of opening the first branch in India.

   b. Tier II banks have deposits below Rs. 100 crores.

   c. A banking company's equity capital should consist of only equity shares.

   d. A banking company can hold shares in any company, whether as pledgee, mortgagee or absolute owner, not exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

   e. If a Chairman is to be appointed on part-time basis, no prior approval of RBI is required.

   f. A banking company cannot employ or allow a Managing agent to manage its affairs.

   g. RBI in consultation with Central government can appoint a committee of three or more persons who have experience in law, finance, banking, economics or accountancy to assist the Administrator.

   i. If a person has served as a Director of any bank /FI/ Insurance co./ RBI for a period of six years he cannot be elected/ re-elected as a Director on the Board of a PSU Bank.

   j. Normally, back offices of banks can have direct interface with customers.

3. Answer the following questions.
   a. Discuss briefly the licensing of Private sector banks and RRBs in India.
   b. Write a brief note on branch licensing aspects of banks in India.
   c. What are the powers of RBI with reference to appointment Chairman, Managing Director and other directors of banks?
   d. What are the various powers of RBI regarding control over Directors and other employees of banks?
   e. Write a note on Importance and Evolution of Corporate governance in Banks in India.
   f. Summarize the fit and proper criteria for a person to be elected as a Director in a PSU Bank.

Lesson 4
Regulation of Banking Business

LESSON OUTLINE

- Power of RBI to Issue Directions
- Acceptance of Deposits
- Nomination
- Loans and Advances
- Regulation of Interest Rate
- Regulation of Payment Systems
- Internet Banking Guidelines
- Regulation of Money Market Instruments
- Reserve Funds
- Maintenance of CRR, SLR
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

RBI regulates the banking business in several ways in terms of powers conferred on it by the RBI Act, the BR Act, Nomination Rules 1985, the Payment and. Settlement Systems Act, 2007 (PSSA 2007) etc. In view of the above, this chapter will enable a reader to learn in detail about -

- Various powers of RBI to issue directions under powers conferred by various acts cited.
- Regulation concerning acceptance of deposits.
- Rules and practices on Nomination facility provided by banks to customers.
- Various provisions involved in regulation of Loans and advances.
- Interest rate regulations on Deposits and Advances.
- Payment systems in India and it's regulation.
- Regulatory mechanism of money market and money market instruments.
- Reserve funds to be maintained by Banks in India with RBI.
- Mechanism of maintenance of CRR and SLR.

INTRODUCTION

The topic presented in this chapter deals with certain regulatory aspects of banks in India by RBI. The objective of the chapter is to give a reader a deeper insight and understanding of operational regulations concerning business of banks like interest rates, deposits, advances, payment system, service delivery channel like internet, apart from giving an exposure to money market instruments which are used by banks for compliance as well as investments for maintaining statutory reserves. While covering the contents, sections from the principal applicable laws namely The Reserve Bank of India Act 1934, The Banking Regulation Act, 1949, Payment and Settlement Systems Act, 2007 as well as Nomination Rules (1985) have been incorporated. The contents have been elaborated keeping in mind the usefulness of the same from basic knowledge, compliance as well as advisory roles that would be performed by students in future. In that sense the contents are a mix of Level 1 and 2 orientation. The topic and contents will expose students equip themselves with the required knowledge base if and when an opportunity arises in future.

POWER OF RBI TO ISSUE DIRECTIONS

The RBI derives its powers to issue directions to banks from Sections 21, 35A, 35 AA, 35 AB, 36, 36AA, 36AB, 36ACA of the Banking Regulation Act, 1949.

Under Section 21(2) of the Banking Regulation Act, the RBI has powers to give directions to banking companies, regarding their advances as under :

(a) the purposes for which advances may or may not be made,

(b) the margins to be maintained in respect of secured advances,

(c) the maximum amount of advances/ other financial accommodation that can be made by banking company to any one company, firm, association of persons or individual,

(d) the maximum amount up to which, guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual, and

(e) the rate of interest and other terms and conditions on which such advances or other financial accommodation or guarantees can be given.

It is expected that every banking company complies with all directions given in this regard. Sections 35 A, 35 AA, 35 AB, 36, 36 AA, 36 AB, 36 ACA confers much more broader powers to RBI in respect of regulation of banking companies and also in respect of Board of Directors etc.

Under Section 35 A, the RBI has powers to issue directions in the interest of Banking policy or public interest or safeguarding the interests of a bank/depositors or for securing the proper management of any bank. RBI may issue directions in general as well as to a particular bank or banks or group of banks as the case may be. All banks are bound to follow/comply with such directions issued. The RBI, either on its own or based on representation made to it, can modify or cancel any such direction issued. While doing so, RBI can impose conditions as it may consider necessary.

Under Section 35 AA, the Central Government can authorize the RBI to issue directions to any bank/banks in the matter of initiating insolvency resolution process in respect of loan default, under the Insolvency and Bankruptcy Code, 2016.

Section 35 AB, confers powers on the RBI, to issue directions in respect of resolution of stressed assets i.e. NPAs. For resolution of stressed assets, RBI may advise the bank to form an authority or committee, with members either appointed by RBI or approved by RBI.

Under Section 36, the RBI derives following powers in respect of a bank or banks as the case may be –

caution or prohibit a bank/ banks from entering into any particular transaction or class of transactions and advise any bank;

ii. order a bank to call a meeting of its Directors for the purpose of considering any matter relating to the bank or require an officer of the bank to discuss any such matter with an officer of the RBI;

iii. depute one or more of its officers to the proceedings/meeting of the Board of Directors/any committee/ any other body of the bank.;

iv. instruct the concerned bank to give an opportunity to its officers deputed, be heard at such meetings and also order such officers to send a report of proceedings thereof;

v. require the Board of Directors/committee/any other body of the bank to submit in writing a report regarding any meeting held by such bodies;

vi . depute an any of its officers as an observer observe the manner in which the bank/branches/offices are being conducted and submit a report thereon.

The RBI has powers to appoint any staff at such places as deemed necessary to scrutinize returns, statements and information furnished by a bank/banks for ensuring their efficient performance of functions.

Under Section 36 AA, 36 AB, 36 ACA RBI has extensive powers relating to removal of managerial and other persons from office, to appoint additional Directors, Supersession of Board of Directors respectively as deemed necessary in the interests of the bank/depositors etc. These details have been extensively covered under Chapter 3.

ACCEPTANCE OF DEPOSITS

Accepting deposits is one of the basic functions of banks as per Section 5(b) of the Banking Regulation Act, 1949. Though the Banking Regulation Act, 1949 does not contain any specific provisions for regulating deposits of banks, RBI derives its powers for regulating deposits of banks Section 35A of the said Act. Therefore in the interests of depositors as well banks, RBI regulates the acceptance of deposits through it's directions issued periodically regarding rates of interest applicable on Savings accounts, Non-Resident Indians deposits, minimum and maximum period, rules for premature closure, bulk deposits etc.

Banks accept different types of deposits which can be broadly classified in to Demand Deposits and Time Deposits. Savings Bank account, Current Accounts which are repayable on demand are known as Demand deposits. Fixed deposits, Recurring deposits which are repayable after a certain fixed period are known as Time Deposits. Most of the interest rate structures have been left to the discretion of banks, RBI specifies the rates of interest on Savings bank deposits and NRI deposits. However RBI impresses upon banks to have a Board approved policy on various operational aspects, on the lines of RBI's directions. Banks have to ensure there is no discrimination between depositors in the same class. RBI's master directions on deposits relate to the following areas for commercial banks:

i. Interest Rate framework;

ii. Interest rate on domestic Current Account;

iii. Interest Rate on domestic Saving Deposits;

iv. Interest Rates on domestic Term Deposits;

v. Payment of Additional Interest on domestic deposits;

vi. Interest on overdue domestic deposits;

vii. Floating rate domestic term deposits;

viii. Periodicity of payment of Interest on domestic savings deposits;

ix. Interest payable on the domestic deposit account of deceased depositor;

x. Discretion to pay interest on the minimum credit balance in the composite cash credit account of a farmer;

xi. Penalty on premature withdrawal of domestic term deposit;

xii. Interest rates on Rupee Deposits of Non-Residents;

xiii. Prohibition on marking lien on Rupee Deposits of Non-Residents;

xiv. Penalty on premature withdrawal of NRE deposits;

xv. Foreign Currency (Non-resident) Accounts (Banks) 'FCNR- B' Scheme;

xvi. Manner of calculation of interest on FCNR (B) deposits;

xvii. Calculation of interest on renewal of FCNR (B) deposits;

xviii. Interest payable on the deposit of a deceased FCNR (B) depositor;

xix. Payment of interest on FCNR (B) deposits of NRIs on return to India;

xx. Conversion of FCNR (B) Accounts of Returning Indians into Resident Foreign Currency Accounts/ Resident Rupee Accounts- Payment of interest;

xxi. Resident Foreign Currency Accounts Scheme;

xxii. Prohibitions;

xxiii. Exemptions.

The RBI also issues similar directions in respect of Co-operative banks too.

Depositor Education and Awareness Fund Scheme (DEAF)

As per Section 26 of the Banking Regulation Act, banks have to file an annual report in respect of unclaimed deposits as well as inoperative accounts that are not operated for 10 years. However, in a fresh development relating to unclaimed deposits, effective from May 23, 2014 all unclaimed deposits lying with a bank for a period of ten years or more are to be transferred to Reserve Bank of India towards Depositor Education and Awareness Fund Scheme ('DEAF'). A brief over view of the same is as under. According to the scheme all banks should transfer to the DEAF, "the amounts becoming due in each calendar month (i.e. proceeds of the inoperative accounts and balances remaining unclaimed for ten years or more)" along with the interest accrued thereon, on the last working day of the subsequent month. The amounts to be credited to the DEAF should consist of the credit balance in any deposit account maintained with banks which have not been operated upon for ten years or more, or any amount remaining unclaimed for ten years or more, which include :

(a) savings bank deposit accounts;

(b) fixed or term deposit accounts;

(c) cumulative/recurring deposit accounts;

(d) current deposit accounts;

(e) other deposit accounts in any form or with any name;

(f) cash credit accounts;

(g) loan accounts after due appropriation by the banks;

(h) margin money against issue of Letter of Credit/Guarantee etc., or any security deposit;

(i) outstanding telegraphic transfers, mail transfers, demand drafts, pay orders, bankers cheques, sundry deposit accounts, vostro accounts, inter-bank clearing adjustments, unadjusted National Electronic Funds Transfer (NEFT) credit balances and other such transitory accounts, un-reconciled credit balances on account of Automated Teller Machine (ATM) transactions, etc.;

(j) undrawn balance amounts remaining in any prepaid card issued by banks but not amounts outstanding against travellers cheques or other similar instruments, which have no maturity period;

(k) rupee proceeds of foreign currency deposits held by banks after conversion of foreign currency to rupees in accordance with extant foreign exchange regulations; and

(l) any other amount as RBI may specify.

From the effective date, every month, banks are required to transfer to the DEAF the amounts becoming due in each calendar month balances remaining unclaimed for ten years or more along with the interest accrued thereon, on the last working day of the subsequent month.

If a customer demands repayment whose deposits/unclaimed amount had been transferred to DEAF, banks shall repay the customer/depositor, along with interest if applicable, and lodge a claim for refund from DEAF for an equivalent amount paid to the customer/depositor.

DEAF will pay the interest on a claim only from the date on which the balance in an account was transferred to the DEAF to the date of payment to the customer/depositor. No interest will be paid in respect of amounts refunded if no interest was payable by the bank as per the terms of the deposits to its customer/depositor. RBI will specify the rate of interest payable on the amount transferred to the fund from time to time. If foreign currency deposits are involved banks can claim refund of the eligible amount from the DEAF only in Indian rupees. Banks should claim refunds made by them in each calendar month from the DEAF, on the last working day of the subsequent month. Banks are required to submit returns as specified by the RBI.

DEAF is administered by RBI through a committee constituted for this purpose and has been given specific powers to call for information for any information relating to unclaimed amounts and the inoperative accounts, in general or a bank in particular, as deemed necessary. The income on the funds lying in the DEAF will be utilized by RBI for promoting depositors' interests and for any such purposes as RBI may decide.

NOMINATION

Nomination facility for Deposits, Safe Deposit Locker holders, as well as for articles kept in Safe Custody in a bank including a Cooperative bank, was made available in India from March 1985 by introducing Sections 45 ZA to 45 ZF under the Banking Regulation Act. The procedures to be followed by a Bank are enumerated in Banking Companies Nomination Rules 1985.

Under the nomination facility a customer holding a deposit or a customer jointly holding a deposit with others in a bank may nominate, an eligible person as nominee, to whom such or deposits may repaid, in the unfortunate event of death of the deposit holder/joint holders.

Nomination made in respect of a person can be varied or cancelled by submitting suitable forms specified in this regard. These are as under :

Account	Registration	Cancellation	Variation
Deposit	DA-1	DA-2	DA-3
Safe Deposit Lockers	SL -1	SL-2	SL-3
Safe Custody	SC-1	SC-2	SC-3

Nomination facility is available only in respect of living individual/joint individuals holding deposits with banks. It is not available to business entities except Proprietorship concerns. If nominee is a minor, there is a provision to appoint a person (guardian) who can lawfully represent the minor for receiving deposit on his behalf, if a claim has to be made.

In case of a joint deposit, all joint holders should together nominate/ cancel/variate a nominee. According to RBI's directions Nomination is compulsory in respect of account held by an individual (single name). If the accountholder in such cases refuses to nominate, he has to give the refusal in writing. If the customer declines to give his refusal in writing the concerned bank official should record the same in the account opening form itself.

Banks are required to give an acknowledgement in respect of nomination/cancellation/ variation filed by customers. Banks are required to record on the face of pass books/FDRs the legend "Nomination Registered" in all cases where account holder/s opt for nomination. If agreed by customers, the name of nominee can also be indicated on the face of pass books/FDRs.

Settlement in favour of a nominee in respect of deposit accounts, delivery of contents in respect of a safe deposit locker, delivery of article left for safe custody constitute a full discharge to the banking company of its liability in the respective cases. Further details on the topic can be found in Lesson 5.

LOANS AND ADVANCES

Lending has been core of banking business in terms of the definition of banking under Section 5 (b) of the Banking Regulation Act. Loans and advances of banking companies can be for short term, medium or long term. In terms of securities, loans given for different purposes can also be fully secured or partly secured or unsecured.

The RBI regulates loans and advances through powers conferred by Section 21 of the Banking Regulation Act. It has powers to issue directions in general or in respect of a particular bank. It has also policy making powers in the public interest or in the interest of depositors or in the interest of banking policy. From the point of regulation, RBI may issue directions in respect of purposes for which loan or advance can be made, margins in respect of secured advances, maximum amount of advance that can be extended in respect of a borrower or a group (exposure norm) in relation to, capital, reserves and deposits of banks concerned, maximum amount of non-fund based limits that can be granted i.e. guarantees, letter of credit etc., rate of interest and other terms under which credit/guarantees can be extended.

Depending upon the macro economic scenario the RBI also issues appropriate directions from time to time. Some of the tools of credit control which RBI exercises include Selective credit control which also involves indirectly price control, restrictions on loans and advances under Section 20 of the Banking Regulation Act, such as:

- Advances against its own shares,
- Commitment for granting loans on behalf of its directors,
- Granting loans to companies in which any director is interested or has substantial interest,
- Where a director is a partner or a guarantor.

REGULATION OF INTEREST RATE

RBI regulates **interest rates** of deposits and advances in terms of powers given to it under Section 21(2) and and 35(A). RBI started regulating interest rates on deposits from the year 1964, prior to which it was left to individual banks themselves to decide the same. Till1990s RBI administered interest rates of Deposits as well as Advances. As a part of economic reforms, banking sector reforms took place too.

One of the important reforms carried out in the banking sector was in respect of interest rates on deposits and advances. In order to strengthen the competitiveness the RBI started a process of deregulating interest rates and was able stabilize the same by October 1997. See the box article for a historical account of interest rate deregulation of deposits.

The RBI also regulates interest rates on loans and advances through powers conferred under Section 21(2) and 35 (A). For example, RBI regulates the interest rates chargeable on Priority Sector Advancesand other advances through linking it to the Marginal Cost of Lending Rate (MCLR) of banks. The RBI has also given freedom to banks to determine their own rates for lending depending on individual banks performance, market and economic conditions.

Recognising the high cost of borrowing in India, RBI has been urging banks to pass on the benefits of bench mark Repo rate reductions to borrowers of the banking system (known as "Monetary Transmission") particularly to borrowers belonging to MSME sector and others who opt for floating rate loans.

However such Monetary Transmission was found to be slow by the banking system in India. In order to speed up the process of Monetary Transmission, the RBI had announced vide its circular dated September 4, 2019 that from October 1, 2019 it is mandatory for banks to link all new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises extended to an external bench mark such as Repo rate or Six-month Treasury Bill yield or any other bench mark market interest rate published by Financial Benchmarks India Pvt. Ltd. from October 1, 2019.

Deregulation of Deposit Interest Rates in India – A History

The process of deregulation of deposit interest rates had begun in the 1980s. In April 1985, banks were allowed to set interest rates for maturities between 15 days and up to 1 year, subject to a ceiling of 8 per cent. It was expected that with reasonable rates of interest on maturities, banks would be able to achieve a better distribution of term deposits rather than highly skewed distribution around longer maturities at relatively higher costs. However, when a few banks started offering the ceiling rate of 8 per cent even for maturities of 15 days, other banks followed suit without regard to consideration of profitability and set a single rate of 8 per cent for maturities starting from 15 days and up to one year. The consequence was a shift of deposits from current accounts and, to a lesser extent, from savings accounts to 15-day deposits. As a result of price war among banks, the freedom to set interest rates subject to a ceiling was withdrawn in May 1985. The process of deregulation resumed in April 1992 when the existing maturity wise prescriptions were replaced by a single ceiling rate of 13 per cent for all deposits above 46 days. The ceiling rate was brought down to 10 per cent in November 1994, but was raised to 12 per cent in April 1995. Banks were allowed to fix the interest rates on deposits with maturity of over 2 years in October 1995, which was further relaxed to maturity of over 1 year in July 1996. The ceiling rate for deposits of 30 days up to 1 year' was linked to the Bank Rate less 200 basis points in April 1997. In October 1997, deposit rates were fully deregulated by removing the linkage to the Bank Rate. Consequently, the Reserve Bank gave the freedom to commercial banks to fix their own interest rates on domestic term deposits of various maturities with the prior approval of their respective Board of Directors/**Asset Liability Management Committee (ALCO)**. Banks were permitted to determine their own penal interest rates for premature withdrawal of domestic term deposits and the restriction on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of deposits was removed in respect of deposits of Rs. 15 lakh and above in April 1998. Now banks have complete freedom in fixing their domestic deposit rates, except interest rate on savings deposits, which continues to be regulated.

As a consequence of this several banks have already launched Repo-linked lending rate or Repo-based lending rate products. Under this repo-rate linked interest rates on loans it is expected that banks would revise their lending rates at least once in three months instead of earlier practice of yearly changes. This is expected help in monetary transmission faster to eligible borrowers.

It is also worth noting that the interest rates charged by banks cannot be a matter of scrutiny in court of law, as decided in *Corporation Bank* Vs *D.S. Gowda* [(1994) 5 SCC 213] case.

REGULATION OF PAYMENT SYSTEMS

As on date payment system in India consist of pre-paid payment instruments, card schemes, cross-border in-bound money transfers, Automated Teller Machine (ATM) networks and centralised clearing arrangements. Till the Payment and Settlement Systems Act, 2007 (PSS Act) was legislated, RBI was managing the same with powers available under the Section 58 of RBI Act that as well as Section 35A of BR Act. Section 58 itself was introduced after the Information Technology Act 2000 was enacted. As per the PSS Act only RBI has the power to commence or operate a payment system in India unless any other entity authorised by RBI.

OVER VIEW OF EVOLUTION AND STATUS OF PAYMENT SYSTEM IN INDIA

The beginning – coins and written mode

India has a long history of payment and settlement systems from ancient times. Initially through barter, later through the form of metal coins and subsequently through stamped metal bar was first made use of. Subsequently loan deeds (known as rnapatra or rnalekhya) were in use. This was followed by 'Adesha' i.e. order on banks were also known to have been used. Demand bills and usance bills were also known to be used during Mughal period, part from Pay orders between Royal Treasury and provincial governments. Hundies were in vogue since 12th century in India. Paper money made its entry in India with the advent of Bank of Hindustan during the British regime. Inland promissory notes were introduced by British in 1827.

Paper Instruments

The enactment of Negotiable Instruments Act, 1881 paved the way of formalizing Promissory notes, cheques and bill of exchange as payment instruments. With the increase in transactions through these instruments – especially of cheques – clearing houses were started for payment and settlements in Presidency towns. With establishment of RBI in 1935 clearing houses were brought under it's purview.

Automation

Computerization of clearing house operations in 1980s for settlement is the beginning of modernization of payment system. Subsequently, to speed up clearing, Magnetic Ink Character Recognition (MICR) technology was brought in 1986 ushering in a dramatic change in processing of cheques that speeded up settlement. Cheques were also redesigned to conform to the standards of MICR. As a further step to modernize clearing of cheques, the Cheque Truncation System (CTS) was introduced first in New Delhi in 2008 and now all the erstwhile 66 MICR centres have been made as a part of three grid-CTS systems. Thus a large part of the cheque clearing in the country has been brought under faster clearing process making available funds to customers speedily. Simultaneously cheques were also standardized for fraud proof CTS clearing.

Electronic Payment Systems

Subsequent to computerization of banks electronic payment modes have also been introduced in banks from early 1990s. Electronic Clearing Service (ECS) was the first one to be introduced for crediting large payments

such as dividend, salary, interest payments, etc. as well as ECS Debit to handle "many-to-one payments" such as payment of electricity/telephone/gas and similar payments. Several developments in ECS, culminated in National Automated Clearing House (NACH) by National Payments Corporation of India Limited.

NACH is a funds clearing platform set up by NPCI similar to the existing ECS of RBI. NACH has both Debit and Credit variants and it aims at managing large volume interbank bulk debit/credit transactions, which are repetitive in nature. The main focus of NACH is to handle low value, high-volume transactions based on electronic files. Ideally implementing this mandate will allow transactions to be cleared in real-time mode rather than batch mode. NACH network covers more than 80000 bank branches. The new centralized ACH solution known as NACH is aimed at consolidating the current multiple ECS systems and which will be free of local barriers /inhibitors bringing in harmonization of standards and practices. If any new customer wants to give a fresh ECS mandate to his/her bank, it will be done through NACH henceforth. However all existing ECS mandates whether debit/credit will continue as they are till they are cancelled by customers.

To facilitate larger payments of more than Rs. 2 lakhs in a faster mode between customers to customers and institutions Real Time Gross Settlement (RTGS) was introduced in 2004. This was upgraded in 2013 with straight through credit arrangement. In the year 2004, the first RTGS was introduced in the country which has been upgraded into a new system dedicated to the nation in 2013.

Prior to the introduction of RTGS there was a payment system known as Electronic Funds Transfer system between banks which was limited to only centres where RBI had its office. This was subsequently upgraded to National Electronic Funds Transfer (NEFT) system. As per RBI's announcement vide its circular dated December 6, 2019, NEFT has been made a 24 hour facility with 48 half hourly settlements from December 16, 2019. NEFT system will be available on all days of the year, including holidays. NEFT transactions after usual banking hours of banks are expected to be automated transactions initiated using 'Straight Through Processing (STP)' modes by the banks. The existing discipline for crediting beneficiary's account or returning the transaction (within 2 hours of settlement of the respective batch) to originating bank will continue. Banks are required to send positive confirmations for all NEFT credits.

Payments and Settlements Act & National Payments Corporation of India (NPCI)

With the introduction of Payment and Settlements Act, 2007 (PSSA), the RBI is the designated nodal agency for regulation and supervision of payment systems in India. In the year 2008, an apex organization for operating the retail payment systems in India in the name of National Payments Corporation of India (NPCI), was established on a joint initiative of RBI and Indian Banks Association (IBA) as per provisions of the PSSA for managing Payment & Settlement Infrastructure in India. The objective of NPCI is "to provide infrastructure to India.

the entire Banking system in India for physical as well as electronic payment and settlement systems." NPCI is innovatively engaged in widening the retail payment systems by adopting state-of-the-art technology for bringing in efficiency and safety in the payment systems. Notable contribution of NPCI include RuPay Card products as well as Bharat Interface Money ('BHIM')& Immediate Payment System ("IMPS") money transfer applications, the BHIM being introduced post-demonetization in 2017. Among the retail electronic payment systems, the National Electronic Funds Transfer (NEFT) system of RBI plays a key role. In addition to the NEFT, the IMPS operated by NPCI is convenient for remitting small remittances round the clock through interbank electronic fund transfer service that could be accessed on multiple channels like Mobile, Internet, ATM, SMS, Branch and USSD(*99#). IMPS is an instant money transfer facility instantly within banks across India.

Card products

Banks in India issue a variety of cards such as, Credit, Debit and Pre-paid cards of international card networks

such as Master Card, VISA and American Express. Credit cards are of three types, simple credit cards, co-branded credit cards and corporate credit cards issue to employees. Add-on cards are subsidiary to the principal card and liability devolves to the principal cardholder.

After its formation, NPCI, it has launched, an indigenous card network called 'RuPay'. All these cards can be used in online transactions and in over 2,20,000 ATMs and 28,00,000 Point of Sale (POS) terminals. Regulatory aspect of issuance of card and related issues are already discussed in Lesson 2.

Pre-paid Instruments

In addition to the above, Pre-paid instruments (PPIs) are also used as payment products due to introduction of mobile wallets. Banks and non-banking entities can issue PPIs after getting a licence from RBI in this regard. PPI can be categorized as open, semi-closed and closed. Open category allows cash withdrawal and is restricted to only banks. The PPI guidelines allow for two kinds of PPI, one with minimum KYC and limit up to Rs. 10,000 and the other with full KYC and limit up to Rs. 100,000.NPCI has also launched National Common Mobility Card (NCMC) and National Electronic Toll Collection (NETC) to enable cash-less transactions. It has also launched the National Unified USSD Platform (NUUP). By dialing '*99#' on their mobile phone and transact, Sending and Receiving funds from one account to another bank account, balance enquiry, setting / changing UPI PIN etc. Forty one banks offer *99# service through GSM service providers in 13 different languages including Hindi & English. The Bharat Bill Payments (BBPS) system is floated by RBI and managed by NPCI to enable citizens of India to pay their bills from anywhere in India. RBI vide it's circular dated October 16, 2018 has issued detailed operational guidelines on "Inter operability" of Pre-paid Instruments.

Harmonization of Turn Around Time in respect of failed transactions

In view of increasing customer complaints and dissatisfaction expressed by various user groups of banking services, on 20th September 2019, the RBI has issued a detailed circular concerning harmonization of turnaround time for failed transactions in respect of ATMs, Card Transactions as well as compensation payable in respect of such transactions as per the following table.

Harmonisation of Turn Around Time (TAT) and customer compensation for failed transactions using authorised Payment Systems

Sl. no.	Description of the incident	Framework for auto-reversal and compensation	
		Timeline for auto-reversal	Compensation payable
I	II	III	IV
1	**Automated Teller Machines (ATMs) including Micro-ATMs**		
a	Customer's account debited but cash not dispensed.	Pro-active reversal (R) of failed transaction within a maximum of T + 5 days.	₹ 100/- per day of delay beyond T + 5 days, to the credit of the account holder.
2	**Card Transaction**		
a	Card to card transfer Card account debited but the beneficiary card account not credited.	Transaction to be reversed (R) latest within T + 1 day, if credit is not effected to the beneficiary account.	₹ 100/- per day of delay beyond T + 1 day.

b	Point of Sale (PoS) (Card Present) including Cash at PoS Account debited but confirmation not received at merchant location i.e., charge-slip not generated.	Auto-reversal within T + 5 days.	₹ 100/- per day of delay beyond T + 5 days.
c	Card Not Present (CNP) (e-commerce) Account debited but confirmation not received at merchant's system.		
3	**Immediate Payment System (IMPS)**		
a	Account debited but the beneficiary account is not credited.	If unable to credit to beneficiary account, auto reversal (R) by the Beneficiary bank latest on T + 1 day.	₹100/- per day if delay is beyond T + 1 day.
4	**Unified Payments Interface (UPI)**		
a	Account debited but the beneficiary account is not credited (transfer of funds).	If unable to credit the beneficiary account, auto reversal (R) by the Beneficiary bank latest on T + 1 day.	₹100/- per day if delay is beyond T + 1 day.
b	Account debited but transaction confirmation not received at merchant location (payment to merchant).	Auto-reversal within T + 5 days.	₹100/- per day if delay is beyond T + 5 days.
5	**Aadhaar Enabled Payment System (including Aadhaar Pay)**		
a	Account debited but transaction confirmation not received at merchant location.	Acquirer to initiate "Credit Adjustment" within T + 5 days.	₹100/- per day if delay is beyond T + 5 days.
b	Account debited but beneficiary account not credited.		
6	**Aadhaar Payment Bridge System (APBS)**		
a	Delay in crediting beneficiary's account.	Beneficiary bank to reverse the transaction within T + 1 day.	₹100/- per day if delay is beyond T + 1 day.
7	**National Automated Clearing House (NACH)**		

a	Delay in crediting beneficiary's account or reversal of amount.	Beneficiary bank to reverse the uncredited transaction within T + 1 day.	₹100/- per day if delay is beyond T + 1 day.
b	Account debited despite revocation of debit mandate with the bank by the customer.	Customer's bank will be responsible for such debit. Resolution to be completed within T + 1 day.	
8	**Prepaid Payment Instruments (PPIs) – Cards / Wallets**		
a	Off-Us transaction The transaction will ride on UPI, card network, IMPS, etc., as the case may be. The TAT and compensation rule of respective system shall apply.		
b	On-Us transaction Beneficiary's PPI not credited. PPI debited but transaction confirmation not received at merchant location.	Reversal effected in Remitter's account within T + 1 day.	

INTERNET BANKING GUIDELINES

In the year 2001 the RBI had issued guidelines in respect of internet banking based on recommendations of a Working Group on Internet Banking. The recommendations of the group were accepted by RBI and it had issued guidelines to banks based on the same. The guidelines cover broad areas of the following Information Technology and Security Standards, Legal issues and Regulatory and Supervisory issues. A brief of over view of the same is given under:

Technology & security issues

Banks should :

a. Designate a network and database administrator with clearly defined roles.

b. Have a Board of Directors approved security policy. Segregate duties of Security Officer / Information system security and information Technology division. Information Systems Auditor will audit the information systems.

c. Introduce logical access controls to data, systems, application software, utilities, telecommunication lines, libraries, system software, etc. These may include user-ids, passwords, smart cards or other biometric technologies.

d. Use the proxy server type of firewall so that there is no direct connection between the Internet and the banks system. Install inspection firewall that include security alert.

e. Ensure all the systems supporting dial up services through modem on the same LAN as the application server should be isolated.

f. Use the following alternatives system during the transition, until the Public Key Infrastructure is put in place:

- Make use of SSL (Secured Socket Layer),
- Use of at least 128-bit SSL for securing browser to web server communications and, in addition, encryption of sensitive data like passwords in transit within the enterprise

g. Disable all unnecessary services on the application server such as FTP (File Transfer Protocol), telnet etc. isolate application server from the e-mail server.

h. Maintain proper log of computer accesses, including messages received; reports of security violations (suspected or attempted) and follow up action taken; acquire tools for monitoring systems and the networks against intrusions and attacks; educate their security personnel and also the end-users on an ongoing basis.

i. Undertake periodic penetration tests of the system, which should include:

- Attempting to guess passwords using password-cracking tools.
- Search for back door traps in the programs.
- Attempt to overload the system using DDoS (Distributed Denial of Service) & DoS (Denial of Service) attacks.

ii. Check if commonly known holes in the software, the browser and the e-mail software exist.

j. Carry out penetration testing by engaging outside experts.

k. Enforce access controls against internal and external threats. Have proper infrastructure and schedules for backing up data and test the same periodically. Business continuity should be ensured by setting up disaster recovery sites. These facilities should also be tested periodically.

l. Have proper record keeping of all applications for legal purposes. It is necessary to keep all received and sent messages both in encrypted and decrypted form.

m. Test security infrastructure properly before using the systems and applications for normal operations; upgrade the systems by installing patches released by developers to remove bugs and loopholes, and upgrade to newer versions which give better security and control.

Legal Issues

From a legal point of view following issues need to be taken care of**:**

a. Accounts should be opened only after physical verification of the identity of the customer, though request for opening account can be accepted over Internet. (introduction has been waived by banks).

b. Information Technology Act, 2000, in Section 3(2) provides for a particular technology (viz., the asymmetric crypto system and hash function) as a means of authenticating electronic record, security procedure adopted by banks for authenticating users needs to be recognized by law as a substitute for signature. Any other method used by banks for authentication should be recognized as a source of legal risk.

c. Institute adequate risk control measures to manage secrecy and confidentiality of customers accounts as banks may be exposed to enhanced risk of liability to customers because of hacking/ other technological failures.

d. Banks should clearly notify customers the timeframe and the circumstances in which any stop payment instruction could be accepted as there is very little scope for banks to act on stop-payment instructions from the customers.

e. Banks' liability to the customers on account of unauthorized transfer through hacking, denial of service on account of technological failure etc. needs to be assessed and banks providing Internet banking

should insure themselves against such risks in the light of The Consumer Protection Act, 1986. In 2017 RBI issued directions regarding limiting liability of customers.

Regulatory and Supervisory Issues

1. Only banks which are licensed, supervised and have a physical presence in India can offer Internet banking services. Both banks and virtual banks incorporated outside India and having no physical presence in India, will not be permitted to do so.
2. Products offered is restricted to account holders only and not be offered in other jurisdictions.
3. Services is restricted to only local currency products.
4. The services offered to customers residing abroad by Indian banks (or branches of foreign banks in India) and Indian residents offered banking services by banks operating from abroad are generally not permitted in Internet banking also. The existing exceptions for limited purposes under FEMA i.e. where resident Indians have been permitted to continue to maintain their accounts with overseas banks etc.
5. Overseas branches of Indian banks will be permitted to offer Internet banking services to their overseas customers subject to conforming to regulations of the host country supervisor and the home supervisor (RBI).

Given the regulatory approach as above, banks are advised to follow the following instructions:

a. All banks, need prior approval from RBI to offer internet banking services .
b. Applications should be supported by business plan, cost benefit analysis, operational aspects and arrangements like technology adopted, business partners, service providers and systems and control procedures the bank proposes to adopt for managing risks along with their security policy duly certified by an independent Auditor certifying the compliance of meeting minimum requirements need to be submitted.
c. After the initial approval, if there are any material changes the banks will be obliged to inform RBI. Also the need to inform every breach or failure of security systems and procedure. If necessary RBI would conduct a special audit/inspection.
d. RBI guidelines on Risks and Controls in Computers and Telecommunications will equally apply to Internet banking.
e. Wherever services are outsourced, banks would develop guidelines to manage risks arising out of such service providers, such as, disruption/defective services, personnel of service providers gaining intimate knowledge of banks systems and misutilizing the same etc. effectively.
f. In case of e-commerce transactions, they should follow guidelines regarding protocol for transactions between the customer, the bank and the portal and the framework for setting up of payment gateways.

Further guidelines regarding Inter-bank payment gateways, connectivity security, contractual aspects between payee ad payee's banks, mandatory disclosures, hyperlink – security and other aspects are also covered as a part of internet guidelines of banks.

Apart from the above the RBI has also announced detailed guidelines in respect of Certain UCBs offering internet bank services to their customers in 2011 and revised the same for other UCBs (View only). Subsequently in 2015 RBI had announced uniform guidelines for cooperative banks on internet banking. RBI has prescribed specific norms in this regard. RBI has also issued guidelines on Customer Protection - Limiting Liability of

Customers of Co-operative Banks in unauthorised Electronic Banking Transactions in December 2017. RBI had also announced guidelines on internet banking to RRBs in November 2015.

REGULATION OF MONEY MARKET INSTRUMENTS

RBI regulates money market in India vide powers vested in it by virtue of Sections 45K, 45L and 45W of the RBI Act 1934. The money market is a part of overall financial markets in India. The other components of financial markets include Capital market, Debt Markets and Foreign exchange markets. The money market is a market where instruments of short term duration (up to one year) are dealt in. The instruments which are traded in the money market consist of the following:

- Call/Notice Money
- Commercial Paper
- Certificates of Deposit and
- Non-Convertible Debentures (original maturity up to one year)

One of the significant features of money market is, these instruments offer better liquidity i.e. they can be converted into cash in a very short time and the cost of transactions is low as compared to capital/foreign exchange/debt markets.

RBI regulates the money market through the following ways:

i. Specifying market players and their eligibility for different products
ii. Setting prudential limits for overall transactions
iii. Setting up of Self-regulatory bodies
iv. Setting up of support systems for dealings and settlements

(i) Call / Notice money market

This is an important market for banks as they are predominant participants. Therefore it is also known as inter-bank call money market as majority of the transactions take place only between banks. Under call money market, funds are lent overnight basis.

In the notice money market, funds are lent for a period between 2 to 14 days. The permitted participants in this market are - Scheduled commercial banks (excluding RRBs), Co-operative banks (other than Land Development Banks) and Primary Dealers (PDs) both as borrowers and lenders. Primary Dealers are legal entities (NBFCs) who are registered and licensed by RBI to deal in government securities. They purchase government securities from RBI whenever there is an issue and resell the same to eligible buyers. Thus they create a market for government securities.

The prudential limits for lending and borrowing in call/notice money markets by various players are as follows:

Entity	Lending	Borrowing
Scheduled Commercial Banks	The outstanding not to exceed 25% capital funds on a daily average basis in a reporting fortnight. However banks are allowed to lend a maximum of 50 per cent.	Outstanding not to exceed 100% of capital funds (Tier I + Tier II as per latest audited balance sheet) on a daily average basis in a reporting fortnight. However, banks are allowed to borrow a maximum of 125% of their capital funds on any day, during a fortnight.
Co-operative Banks	No limit.	Daily outstanding not to exceed 2% of aggregate deposits (as at end March of the previous financial year) in case of State Co-operative Banks/ District Central Cooperative Banks/ Urban Cooperative Banks in call/notice money market
Primary Dealers	Up to 25% of their Net Owned Funds on daily average basis in a reporting fortnight.	Up to 25% of their Net Owned Funds on daily average basis in a reporting fortnight.

Banks/PDs/ Co-operative banks have to inform their Board approved prudential limits (as above) to Clearing Corporation of India Ltd. (CCIL) for setting of limits in Negotiated Dealing Settlement -CALL System, under advice to Financial Markets Regulation Department (FMRD), Reserve Bank of India. No non-banking institution other than PDs is allowed to participate in call/notice money market.

Interest rates are left to individual participants to decide. However they have to follow procedures prescribed by the Fixed Income Money Market Dealers Association (FIMMDA) in calculation of interest and documentation. RBI's guidelines on timings, settlement method and reporting of transaction are also to be followed.

RBI vide its circular dated October 29, 2018 has permitted Payments Bank and Small Finance Banks– access to Call/Notice/Term Money Market as under – It is clarified that Payments Banks and Small Finance Banks are eligible to participate in the Call/Notice/Term money market (hereafter referred to as Call money market) both as borrowers and lenders. Such eligibility is valid even prior to the completion of the process to get themselves included in the Second Schedule of Reserve Bank of India Act, 1934.

The prudential limits and other guidelines on Call money market for Payments Banks and Small Finance Banks will be the same as those applicable to Scheduled Commercial Banks in terms of the Master Direction referred above.

These Directions have been issued by RBI in exercise of the powers conferred under section 45W of the Reserve Bank of India Act, 1934 and of all the powers enabling it in this behalf.

(ii) Commercial Paper

It is an unsecured money market instrument issued in the form of a promissory note introduced in the year 1990 to enable highly rated corporates to borrow on short-term basis. It also serves as a additional money market instrument for investment. Later Primary Dealers (PDs) and All-India Financial Institutions (AIFIs) were also permitted to issue CP to borrow funds for meeting their short-term commitments. Companies, PDs, AIFIs are permitted to issue CPs. A company can issue CP subject to satisfying following conditions: i. the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs.4 crore; ii. the company has been sanctioned working capital limit by bank/s or FIs, and iii. the borrowal account of the company is classified as a Standard Asset by the financing bank/institution.

Other terms and conditions of CP Issue

- CP issuer should be credit rated by any one of the approved SEBI registered Credit rating agencies (CRA) with minimum credit rating of 'A3' as per rating symbol and definition prescribed by SEBI.
- At the time of issuance of the CP that the rating should be current and has not fallen due for review.
- Normally CPs would be issued on a stand-alone basis and normally no back-up finance would be provided by banks and AIFIs for its prepayment.
  - However banks can provide back-up finance facility subject to their commercial judgement, prudence and Board of Directors approval.
- Corporate may provide guarantees for CP issuance subject to :-
  - issuer satisfying CP guidelines
  - the guaranteeing company has a one grade better Credit rating than the CP issuing company
  - offer document for CP should disclose about of the guarantor company, its net worth, other companies to which such guarantees have been given, the extent and conditions under which such guarantees offered and the conditions under which the guarantee will be invoked.
  - The quantum of CP issued will be as per the decision of the Board of Directors of the company or as indicated by the credit rating company, whichever is lower.
  - Financing banks can take into account the CP issue while fixing the working capital limits of such CP issuing company.
  - Total amount of CP issue, has to be raised within a period of two weeks from the date of opening of CP issue. Though CPs are to be issued on common date, if issued in parts in different dates the CPs should have a common date of maturity. Renewal of every CP will be treated as fresh issue.
  - CPs issue can be subscribed by individuals, banks, other corporate bodies (registered or incorporated in India), unincorporated bodies, Non-Resident Indians and Foreign Institutional Investors (FIIs). While investing, FIIs have to comply with regulations of Securities and Exchange Board of India as well as provisions of Foreign Exchange Management Act.
  - Form and issuance
  - CPs are issued as Promissory note at a discount to face value as determined by issuer.
  - It can be issued in physical or dematerialized form. Dematerialized form should be issued through any other depositories approved by SEBI.
  - All RBI regulated entities should hold CPs in demat form.
  - CP should be issued in denominations of Rs. 5 lakh and its multiples.
  - Minimum investment by a single investor should be Rs. 5 lacs (face value).
  - CP shall be issued at a discount to face value as may be determined by the issuer.
  - No underwriting or co-acceptance of CP issue is permitted. Options (Put/call) are not permitted on CP.
  - CP should be issued for a minimum tenor of 7 days and a maximum of up to one year from the date of issue. However, the maturity date of the CP shall not go beyond the date up to which the credit rating of the issuer is valid.

- Issue of CP to be done through Issuing and Paying Agent ('IPA').
- The latest financial position of the issuer has to be disclosed to the potential investors.
- After due formalities the issuer has to issue a hard copy of CP or credit the Demat version of CP to the Demat account of the investor. Issuer has also to issue a certificate that the issuer has a valid agreement with the IPA and documents are in order.
- Issuer/IPA should follow FIMMDA guidelines with reference to documentation procedures.
- In addition to the above, issuers should follow RBI directions on Trading and settlement, buy back of CP, duties and obligations.
- RBI has also issued guidelines in respect of IPAs as well as Credit Rating agencies in this regard.

(iii) Certificate of deposits

Certificate of Deposit (CD) is one of the money market instruments in the form of a negotiable usance promissory note. It is issued at a discount to face value either in dematerialised form or as a Usance Promissory Note, against funds deposited by an investor with a bank or other eligible financial institution for a specified time period.

CDs are issued by scheduled commercial banks {excluding Regional Rural Banks and Local Area Banks} and select AIFIs as per RBI directions. The quantum of CD issue by a bank will depend on its funds requirements as well as the umbrella limit fixed by RBI's Department of Banking Regulation.

Minimum amount of CD issue will be for a face value of Rs. 1 lac to an investor and it will be issued in multiples of Rs. 1 lac. CDs can be issued to individuals, corporations, companies (including banks and PDs), trusts, funds, associations, etc. Non-Resident Indians (NRIs), can subscribe to CDs on non-repatriable basis only.

Such CDs cannot be transferred to another NRI in the secondary market. CDs can be issued between 7 days and not exceeding one year, from the date of issue. AIFIs can issue CDs for a minimum period of 1 year and a maximum of 3 years, from the date of issue.

Banks / FIs are also allowed to issue CDs on floating rate of interest basis, subject to their disclosing the method of compiling floating rate in a transparent manner. Banks are allowed freedom to determine the rate of interest on CDs issued by them. The floating rate would have to be reset periodically as per changes in pre-decided bench mark rate and the same need be disclosed in a transparent manner.

CRR and SLR are to be maintained on CDs too by banks. CDs are transferable between different holders and there is no lock-in-period applicable in their case. Trading and settlement are to be executed as per RBI's directions in this regard. No loans can be granted against CDs and banks cannot buy back these CDs before maturity.

Normally CDs are to be issued in Demat form. If any investor insists the same in physical form, the same can be issued with permission of RBI. Physical form will attract stamp duty.

If the maturity date of CD happens to be a holiday then it falls due on the immediate preceding working day.

There is no grace period in the repayment CDs. Banks are required to follow the procedure outlined by RBI in respect of redemption of CDs both in physical and demat forms. Issuing banks are required to follow RBI guidelines in respect of issuing of duplicate certificate, accounting, documentation as well as reporting in this regard.

(iv) Non-convertible debentures of original or initial maturity up to one year

These are debt instruments of original maturity period of one year, issued by companies incorporated under Companies Act (including NBFCs) by way of private placement.

The eligibility for issuance of NCDs is the same as applicable in respect of CP issue (except in case of NBFCs including PDs, in respect of net worth). Companies desirous issuing NCDs should get themselves rated by a credit rating agency approved by SEBI. They should have secured a minimum rating of A2 as defined by SEBI in this respect. The credit rating should be current at the time of issuance of NCD and should not have fallen due for review. NCDs should have a minimum maturity period of 90 days from the date of issuance. Its maximum tenor cannot exceed the validity period of its credit rating. If there is a put/call option, it shall not fall due within 90 days from the date of issue of NCDs. NCDs can be issued with a minimum denomination of Rs. 5 lacs (face value) and in multiples of Rs. 1 lac thereof.

The quantum of NCD to be issued will be as decided by the Board of Directors of the company or as indicated by the credit rating agency for the rating given whichever is less. The total issue amount of NCD will have to be raised within a period of two weeks from the date of opening of the NCD issue. All provisions as applicable under the Companies Act, SEBI guidelines on issue and listing should be followed. A certificate from Auditors regarding compliance of eligibility conditions, proper disclosures regarding financial position of the company should be obtained. NCD can be issued at face value carrying an interest rate or at a discount to the face value as decided by the company and it should be issued within the time limit as permitted under the Companies Act. For every issue of NCD, the company should appoint a SEBI registered Debenture Trustee (DT) who will submit periodical information to RBI as per its directions. NCDs may be subscribed by individuals, banks, Primary Dealers (PDs), other corporate bodies including insurance companies and mutual funds registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). Banks and PDs will invest in NCDs up to the limit as per legal provisions applicable from time to time. Investment by FII will be subject to FEMA rules and regulations including limits up to which they can invest.

Issuer companies, DTs and Credit Rating Agencies should follow applicable guidelines issued by the respective regulatory authorities. Companies should use the disclosure document format issued by FIMMDA for NCD issued. Any non- compliance with RBI directions will be penalized including debarring such companies from NCD market.

RESERVE FUNDS

In terms of Section 17(1) of the Banking Regulation Act 1949, every bank has to create a Reserve fund out of profits for each year before declaration of any dividend and transfer twenty percent of the same to the reserve fund.

Exemptions from transferring to reserves

Based on the recommendation of RBI, the Central Government may exempt a bank from the application of Section 17(1) for a specified period, if the banking company has adequate paid-up capital and reserves in relation to its deposit liabilities (such that the amount in the reserve fund together with the amount in the share premium account, is not less than the paid-up capital of the banking company.)

Foreign banks operating in India

Foreign banks operating in India have to maintain capital and reserves in terms of Section 11 of the Banking Regulation Act, 1949. Apart from the capital to be brought in for starting business in India, they have to keep depositing twenty percent of their profits for each year, in respect of their business conducted through their

branches in India. The amount to be deposited can be in the form of cash or unencumbered approved categories of securities or a mix of both. If the foreign bank operating in India has already deposited adequate amounts with RBI in relation to its deposit liabilities, the Central government may exempt such a foreign bank on the recommendation of RBI from depositing amounts with RBI for a further period as it may determine.

MAINTENANCE OF CRR, SLR

As already seen in Chapter 2 every scheduled bank in India have to maintain in India Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).

Cash Reserve Ratio (CRR)

As on date, every scheduled bank has to maintain with RBI cash reserves under Section 42 (1) of the RBI Act, 1934 an average daily balance of 4% their Net Demand and Time Liabilities ('NDTL') in India. Non-scheduled banks also have to maintain CRR under the Banking Regulation Act Section 18 at 4% of NDTL.

Computation of NDTL

For the purpose of computation NDTL the following liabilities are not to be taken in to account.

a) Paid up capital, reserves, any credit balance in the Profi t & Loss Account of the bank, amount of any loan taken from the RBI and the amount of refinance taken from Exim Bank, NHB, NABARD, SIDBI;

b) Net income tax provision;

c) Amount received from Deposit Insurance and Credit Guarantee Corporation towards claims and held by banks pending adjustments thereof;

d) Amount received from Export Credit Guarantee Corporation by invoking the guarantee;

e) Amount received from insurance company on ad-hoc settlement of claims pending judgement of the Court;

f) Amount received from the Court Receiver;

g) The liabilities arising on account of utilization of limits under Bankers' Acceptance Facility (BAF);

h) District Rural Development Agency (DRDA) subsidy of Rs.10,000/- kept in Subsidy Reserve Fund account in the name of Self Help Groups;

i) Subsidy released by NABARD under Investment Subsidy Scheme for Construction/Renovation/ Expansion of Rural Godowns;

j) Net unrealized gain/loss arising from derivatives transaction under trading portfolio;

k) Income flows received in advance such as annual fees and other charges which are not refundable;

l) Bill rediscounted by a bank with eligible financial institutions as approved by RBI;

Scheduled commercial banks are exempted from including the following for the computation of NDTL–

i. Liabilities to the banking system in India as computed under clause (d) of the explanation to Section 42(1) of the RBI Act, 1934;

ii. Credit balances in ACU (US$) Accounts; and

iii. Demand and Time Liabilities in respect of their Offshore Banking Units (OBU).

iv. The eligible amount of incremental FCNR (B) and NRE deposits of maturities of three years and above from the base date of July 26, 2013, and outstanding as on March 7, 2014, till their maturities/premature withdrawals, and

v. Minimum of Eligible Credit (EC) and outstanding Long term Bonds (LB) to finance Infrastructure Loans and affordable housing loans, as per the circular dated July 15, 2014 of RBI.

Incremental Cash Reserve Ratio

Apart from the above RBI has powers to impose incremental CRR on banks. However as on date there is no incremental CRR prescribed for banks. All SCBs are to maintain a minimum CRR balances up to 95 percent of the average daily required reserves for a reporting fortnight on all days of the fortnight with effect from the fortnight beginning September 21, 2013. No interest on CRR balances is paid by RBI with effect from March 31, 2007.

Returns to be filed

For the purposes of CRR computation, all Scheduled Commercial Banks are required to submit provisional

Return in Form 'A' to RBI, within 7 days from the expiry of the relevant fortnight. The final Form 'A' Return is required to be submitted to RBI within 20 days from expiry of the relevant fortnight.

Penalties for non-maintenance of Cash Reserve Ratio

From June 2006, RBI has started levying penal interest in all cases of default in maintenance of CRR by Scheduled Commercial Banks. If CRR reserves are maintained below the required 95% level on a daily basis - penal interest will be charged at Bank rate+3%for the shortfall on the day of default ; if the shortfall continues next succeeding days penal interest will be Bank rate + 5%, the same rate will be charged for every day of subsequent delay.

All scheduled banks are required to furnish to RBI, the particulars of date, amount, percentage, reason for default in maintenance of requisite CRR and also action taken to avoid recurrence of such default.

Statutory Liquidity Ratio (SLR)

Every bank in India has to maintain liquid assets as per Section 24(2) of the BR Act a specified percentage of its NDTL in the form of cash, gold or unencumbered 'approved' securities. Through an amendment in January 2007 to the Banking Regulation Act, it is provided that RBI can specify SLR for specific assets. Value of such assets should not be less than such a percentage as specified by RBI, subject to a maximum of 40% of a bank's Demand & Time liabilities as on the last Friday of the second preceding fortnight. RBI will specify the percentage of assets to be maintained by banks from time to time.

RBI vide its notification RBI/2018-19/86 DBR.No.Ret.BC.10/ 12.02.001/ 2018-19 dated December 05, 2018 has announced a progressive reduction in maintenance of SLR as under such that by April 11, 2020 it will be 18% of NDTL from the current 19.5% The circular is as under -

"All Scheduled Commercial Banks (including Regional Rural Banks)

Local Area Banks, Small Finance Banks, Payments Banks

Primary (Urban) Co-operative Banks (UCBs)

State and Central Co-operative Banks (StCBs / CCBs)

Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR)

Please refer RBI circular DBR.No.Ret.BC.90/12.02.001/2017-18 dated October 04, 2017 on the captioned subject.

As announced in the Statement on Developmental and Regulatory Policies on December 05, 2018, it has been decided to reduce the SLR requirement of banks by 25 basis points every calendar quarter from 19.50 per cent of their Net Demand and Time Liabilities (NDTL) to

(i) 19.25 per cent from January 5, 2019

(ii) 19.00 per cent from April 13, 2019

(iii) 18.75 per cent from July 6, 2019

(iv) 18.50 per cent from October 12, 2019

(v) 18.25 per cent from January 4, 2020

(vi) 18.00 per cent from April 11, 2020.

The following assets qualify for SLR securities :

(a) Cash or

(b) In Gold valued at a price not exceeding the current market price, or

(c) Investment in

(i) Dated securities issued up to May 06, 2011 as listed in the Annex to RBI Notification dated May 9, 2011;

(ii) Treasury Bills of the Government of India;

(iii) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;

(iv) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme; and

(v) Any other instrument that may be notified by the RBI.

Provided that the securities (including margin) referred to above, if acquired under the Reserve Bank- Liquidity Adjustment Facility (LAF), shall not be treated as an eligible asset for this purpose.

Procedure for Computation of SLR

The procedure to compute total NDTL for the purpose of SLR is very similar to that of CRR as enumerated under the head Computation of NDTL under CRR in the previous paragraphs.

However, Scheduled Commercial Banks are required to include inter-bank term deposits / term borrowing liabilities of all maturities in ‘Liabilities to the Banking System’. Similarly, banks should include their inter-bank assets of term deposits and term lending of all maturities in ‘Assets with the Banking System’ for computation of NDTL for SLR purpose.

Penalty for non-maintenance of SLR

RBI will levy a penalty for non-maintenance of SLR, similar to that of CRR.

Returns to be filed with RBI

Banks are to submit to RBI before the 20th of every month, a Return in Form VIII showing the amounts of SLR held on alternate Fridays during immediate preceding month with particulars of their DTL in India held on such Fridays. If such Friday is a public holiday under the Negotiable Instruments Act, the return should be submitted as on the close of preceding working day.

Certification of computation of DTL

Statutory Auditors of the bank are required to verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled and correctly reflected under DTL/NDTL in the periodical statutory returns submitted to the RBI for the financial year.

LESSON ROUND UP

- The Banking Regulation Act 1949 plays a very important role in framing systems & policies of the banking sector.
- The RBI issues different directions to different banks by taking into account various sections included under the Banking Regulation Act 1949.
- Banks accept demand deposits & time deposits from the depositors based on instructions & guidelines provided by RBI.
- Apart from guiding the commercial banks, RBI also provides guidelines to the cooperative banks.
- A per the guidelines under Banking Regulation Act 1949, the accounts of customers of different banks which lie inoperative for more than 10 years are to be transferred to Depositor Education & Awareness Fund Scheme under RBI.
- Nomination facilities are provided to different depositors/customers are based on Banking Companies Nomination Rules 1985.
- Lending under Section 5 (b) of the Banking Regulation Act of banking companies can be for short term, medium or long term.
- Till the Payment and Settlement Systems Act, 2007 (PSS Act) was legislated, RBI was managing the same with powers available under the Section 58 of RBI Act as well as Section 35A of Banking Regulation Act 1949.
- Apart from different monetary policy matters & issues, RBI has framed regulations for money market instruments too.
- As per Banking Regulation Act 1949, every bank has to create a Reserve fund before they declare dividends out of the profit.
- In exceptional cases where the banks have sufficient paid up capital or deposits for liabilities, such reserve funds need not be created.
- As per Banking Regulation Act 1949, foreign banks operating in India have to maintain specified capital & reserves.
- Last but not the least, every scheduled bank in India has to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) under The RBI Act 1934 and Banking Regulation Act 1949.

GLOSSARY

- **Indian banking System** - Indian Banking System encompasses Agency House Banks, Presidency Banks, Imperial Bank of India, Reserve Bank of India, Private/Joint Stock Banks (Old generation private sector banks), State Bank of India, Associate Banks, Old Nationalized Banks, New Generation Private Sector Banks, Foreign Banks, Co-operative Banks, Regional Rural Banks, Small Finance Banks and Payment Banks and Financial Institutions known as Development Banks and Non-Banking Financial Companies.
- **Reserve Bank of India** - It was established on 1935 as a banker to the central government.
- **State Bank of India** - State Bank of India originated from the three Presidency banks namely Bank of Bengal, Bank of Bombay and Bank of Madras and the successor to these Presidency banks viz Imperial Bank of India.
- **Old Generation Private Bank** - Private sector banks which were operating in India prior to the liberalization year of 1991 are known as Old generation private Sector banks.
- **New Generation Private Bank** - Banks that came into existence subsequent to Narasimham Committee Report I and revised RBI guidelines in 1993 are known as new generation private sector banks.
- **Co-operative Bank** - *Cooperative Banks* are registered under the *Cooperative* Societies Act, 1912 and regulated by the Reserve *Bank of India* under the *Banking* Regulation Act, 1949 and *Banking* Laws (Application to *Cooperative* Societies) Act, 1965.
- **Regional Rural Bank (RRBs)** - RRBs are scheduled banks(Government banks) operating at regional level in different States of India. They were established in 1975 under the provisions of the Ordinance promulgated on September 26, 1975 and followed by Regional Rural Banks Act, 1976.
- **Small Finance Banks** - These banks promote financial inclusion to sections of the economy not being served by other banks, such as small business units, small and marginal farmers, micro and small industries and unorganised sector entities.
- **Payment Bank** - A payment bank aims to further financial inclusion, especially through savings accounts and payments services. Accordingly, a payments bank is not allowed to give any form of loan or issue a credit card.
- **Development Finance Institutions (DFIs)** - Financial institutions which were created to offer cheaper long-term financial assistance "for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear."
- **State Financial Corporations** - The services of State Financial Corporations(SFCs),mainly aims at lending money for creation, technology up-gradation, modernization, expansion and overall development of Micro, Small and Medium Enterprises (MSME), including commercial vehicles. SFCs are also providing financial assistance to manufacturing and service industries of their respective states.
- **Non Banking Finance Corporations (NBFCs)** - NBFC is "a company registered under the Companies Act, 2013 (earlier act of 1956) engaged in the business of loans and advances, acquisition of shares/ stocks/ bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity,

purchase or sale of any goods (other than securities) or providing any services and sale/purchase/ construction of immovable property.

- **Export Import Bank of India**-Export-Import Bank of India is the premier export finance institution of the country. Established in 1982 through an Act of Government of India viz. Export –Import Bank of India Act, 1981
- **National Bank for Agriculture and Rural Development** (NABARD) - NABARD came into existence in July 1982 by transferring the agricultural credit functions of RBI and refinance functions of the then ARDC
- **Small Industries Development Bank of India (SIDBI) -**Small Industries Development Bank of India (SIDBI) was established in April 1990 and it acts as the Principal Financial Institution for Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector as well as for co-ordination of functions of institutions engaged in similar activities.
- **National Housing Bank (NHB)-**NHB is an apex financial institution for housing. NHB has been established with an objective to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions and for matters connected therewith.
- **Scheduled Bank**- A scheduled bank is one which is included in the Second Schedule of RBI Act which enjoins it to have a minimum capital of Rs. 5 lacs and maintain reserves as per the directions of RBI.
- **Non-Scheduled Bank-** Non-scheduled banks are those which are not listed in the Second schedule of the RBI Act, 1934 having a reserve capital of less than 5 lakh rupees.
- **Private Sector Banks -** As the name implies the ownership of these banks rests with private individuals and corporates including foreign entities.

SELF TEST QUESTIONS

1. Fill in the blanks:

   i. Under Sec 35 AA Central Government can authorize the RBI to issue directions to any bank/ banks in the matter of _____.

   ii. Under _____, _____ & _____RBI has extensive powers relating to removal of managerial and other persons from office, to appoint additional Directors, Supersession of Board of Directors.

   iii. RBI specifies the rates of interest on _____ & _____ _____ deposits .

   iv. DEAF is administered by RBI through _____.

   v. Nomination is not available to business entities except _____.

   vi. After its formation of NPCI, it has launched, an indigenous card network called _____.

   vii. PPIs can be categorized as _____, _____,and _____.

   viii. The instruments which are traded in the money market consist of _____, _____, _____, and _____

_____.

ix. CPs can be issued only by _____, _____, and _____ _____.

x. The minimum maturity period of a NCD should be _____.

xi. The Monetary Transmission is predominantly linked to _____ rate of interest loans.

xii. In respect of ATM transaction if a Customer's account is debited but cash not dispensed, the penalty on the card issuing bank is Rs. _____ per _____ of delay beyond T + 5 days, to the credit of the account holder.

2. Write True or False:

i. Section 35AB confers powers on the RBI, to issue directions in respect of resolution of stressed assets i.e. NPAs.

ii. Most of the interest rate structures have been left to the discretion of banks.

iii. Floating rate domestic term deposits are not covered by RBI's Master directions.

iv. All unclaimed deposits lying with a bank for a period of ten years or more are to be transferred to Reserve Bank of India towards Depositor Education and Awareness Fund Scheme.

v. Nomination made in respect of a person can be varied or cancelled by submitting suitable forms specified in this regard.

vi. The RBI regulates loans and advances through powers conferred by Section 21 of the Banking Regulation Act.

vii. In the year 2008, an apex organization for operating the retail payment systems in India in the name of National Payments Corporation of India (NPCI), was established.

viii. Open category PPI allows cash withdrawal and is restricted to only banks.

ix. Only banks which are licensed, supervised and have a physical presence in India can offer Internet banking services.

x. In the notice money market, funds are lent for a period between 2 to 14 days.

xi. By April 2020 SLR ratio has been pegged at 19%.

xii. Open category of PPI is restricted to only Banks.

3. Answer the following questions.

i. What are the powers enjoyed by RBI under Sections 35 A, 35 AA, 35 AB, 36, 36AA, 36AB, 36ACA? Discuss briefly.

ii. What is the responsibility of a bank with regard to deposits that are lying with a bank for 10 years and above? What is the procedure to be followed by a bank under DEAF?

iii. Discuss briefly about the facility of nomination provided by RBI.

iv. How does RBI regulate interest rates on Deposits and Advances?

v. What is the role of RBI in Payment and Settlements Systems Act? Discuss briefly.

vi. How does RBI controls Money Market instruments? What is the role of banks on the same?

vii. What are the guidelines of RBI regarding internet banking?

viii. What are the securities included under CRR and SLR?

For further reading

1. Master circular/Master Directions of RBI at www.rbi.org.in :
2. The Reserve Bank of India Act, 1934
3. The Banking Regulation Act, 1949
4. www.npci.org.in
5. Speeches of The Governor/Deputy Governors/Executive Directors of RBI
6. www.shodganga.com

Lesson 5

Banking Operations

LESSON OUTLINE

- Preparation of Vouchers, cash receipt and payment entries, clearing inward and outward entries, transfer debit and credit entries.
- What is KYC?
- What are the different documents to satisfy KYC?
- How to verify KYC and authenticity of documents?
- Operational aspects regarding opening of all types of accounts.
- Scrutiny of loan applications/documents.
- Accounting entries involved at various stages.
- Operational aspects of CBS environment.
- Back office operations in banks
- Handling of un-reconciled entries in banks
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Banking operations involve accounting, passing of vouchers, opening various accounts for different types of customers (who are regulated by different laws as applicable to them) across different asset and liability products involving cash, clearing and transfer modes. All operations are also done practically through computerized packages involving sophisticated software and hardware. Needless to add such operations require proper follow-up, monitoring and reconciliation while observing directions and guidelines of RBI. In the light of this, the chapter will enable a reader to learn:

- Accounting system and vouchers passed by banks under cash, clearing and transfer mode of transactions
- KYC and associated documentation formalities
- Different types of accounts for different types of persons
- Operational formalities of loans including scrutiny of applications and documentation requirements including drawls and accounting thereof
- Operational environment of CBS operations
- An over view of back office operations and
- Handling reconciliations

INTRODUCTION

The topic presented in this chapter deals with many aspects of operational banking areas such as preparation of vouchers; accounting entries; cash accounting; clearing; KYC; opening of accounts for different types of customers and formalities thereof; loan applications and related formalities, CBS environment, back office and reconciling of accounting entries. The objective of the contents is to give a reader an in depth understanding of major operational domains in which a banker function. The coverage of topics is interspersed with practical examples as found in day to day working of a bank for easy understanding. The contents will reinforce the basic knowledge of banking and add value in thorough understanding of certain nitty gritties involved in operations.

The contents are based on RBI directions and will be useful in practical understanding of certain operational domains of deposits and advances, apart from the technology systems involved. The contents have been elaborated to offer rationale for various procedures adopted by banks. The contents are of Level 1 and 2 orientation enabling students to reinforce themselves with deeper operational knowledge.

PREPARATION OF VOUCHERS

Whenever banks do any transaction for a customer, it results in accounting entries which are to be properly done as per the internal accounting procedures of the bank. To facilitate accounting entries vouchers are passed. Banks being commercial organizations follow double entry system of accounting. Double entry system consists of a debit and an equivalent credit to the respective of heads of accounts.

For certain transactions customers themselves prepare the vouchers as given in the following example.

A & B are having an account in the same branch. A gives a cheque for transferring says an amount of Rs. 10,000 from his account to B; B will fill up a pay-in-slip (credit voucher) with particulars, like date, branch name and place, account number, name of the account holder, amount in figures and words, particulars of cheque and sign the same at the indicated place in the pay-in-place. B will handover the pay-in-slip along with the cheque to the branch. The branch official who accepts the cheque, will verify the particulars of the cheque whether it is in order, whether there is sufficient balance in the account of A and get it authorized from in-charge of the department (if he does not have powers to pass the cheque) and credit the same to the account of Mr. B.

Vouchers are prepared by banks themselves for transactions like debiting of charges towards interest due on loan accounts, locker rent, service charges, insurance charges, standing instructions etc. For this purpose, they would use a debit voucher of the bank, fill up all the required details, get it authorized and debit to the concerned account head and pass on the credit voucher which would have also been filled up by the same department, duly signed by the department-in-charge where debit entry originates.

ACCOUNTING ENTRIES OF TRANSACTIONS

Depositing a cheque for opening a term deposit of Rs. 1,00,000 from own Savings bank account, the resultant entries under the double entry system accounting will be –

- **Debit:** Customer's Saving Bank Account Rs. 1,00,000.
- **Credit:** Term Deposit Account of the customer Rs. 1,00,000.

As it is evident from the above example, credit and debit entries are self- balancing in nature. Thus, in a bank branch there would be a series of transactions of debit and credit during a given day, due to large number of transactions of customers. However due to age old accounting practice in banks, for normal day to day transactions of customers, vouchers are first posted in ledgers (basically these are equivalent 'subsidiaries' in accounting parlance) and later they are entered in journals. This is a diametrically opposite practice of conventional accountancy. Later at the end of the day the credit vouchers and debit vouchers of transactions pertaining to Savings Bank, Current Account, Term deposits, different loans accounts, bills etc. are entered in separate sum-

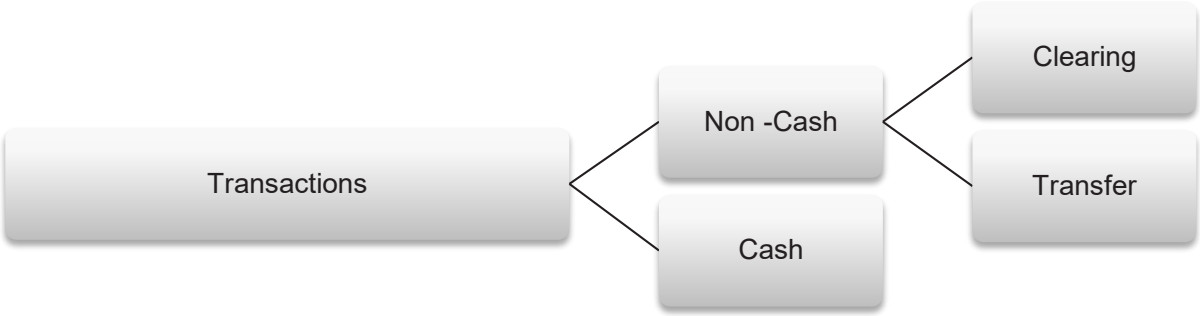
mary voucher sheets/books under cash, clearing, transfer types and thereafter the totals are posted in General ledger. Subsequently trial balance is prepared from the General ledger balances every day.

Before the introduction of computers, banks traditionally were doing all accounting entries manually by-passing physical vouchers for every transaction involving double entry system of accounting as described above. **With computerized system of accounts, preparation of manual vouchers has reduced to a great extent**.

It should be remembered however that the computerized accounting is based on double entry system of accounting only. Hence staff members of banks should have a clear understanding of the basic concepts of preparation of vouchers using double entry system so that there is clarity about accounting entries made through computers.

Transaction types in a bank

In a bank transaction can be classified in to cash and non-cash categories. The non-cash mode is made up of two components namely clearing and transfer. Thus, it can be represented as below:



The transactions may involve Customer to Customer, Customer to Bank, Bank to Customer and Bank to another Bank. For all practical purposes therefore, transaction vouchers may belong to any one of the three modes viz. cash or clearing or transfer.

Instruments/Vouchers used in Banking transactions

The following types of instruments/vouchers are generally being used as Debit vouchers in banks:

i. Cheques of customers.

ii. Banker's cheques (also known as Pay orders). Banker's cheques/Pay orders are issued by the bank of a branch on itself.

[***Note:*** *Banks have stopped issuing Pay order in favor of customers as per RBI directions. They issue these only for settling payments with other banks*].

iii. Withdrawal forms at the counter issued to Savings Bank customers.

iv. Letter of Authority (for debits) issued by customers duly signed by Authorized Signatories for standing instructions/ transfer in respect of specific transactions.

v. Drafts issued the branches of the same bank on one another/ Payable at par drawn on service branches.

vi. Drafts issued by correspondent banks on one another for payment. (Similar to DD issued branches on one another).

vii. Deposit receipts/Recurring deposit pass books, on maturity of the respective deposits.

viii. Interest warrants/Dividend warrants/Refund orders issued by the banks/corporates and payable by the bank/branch as per arrangement with Corporates. [Issuing and paying banks in Merchant Banking].

ix. Bank's Debit vouchers duly authorized by customers/officials of the bank towards transactions where debit to customers' accounts are involved.

x. Travelers cheques/Gift cheques of the bank or other banks as per arrangement.

xi. Debit advices of other branches/banks in respect of certain collection charges etc. (Inter-bank and intra-bank).

It is also a practice in banks to prepare a common/single debit voucher for many payments originating from a single account such as Salary payment, Bonus payment, interest payments on term deposits etc.

The following are being used as Credit Vouchers in banking transactions

i. Pay-in-slips of banks.

ii. Applications for NEFT/RTGS/Pay orders/Gift cheques/Travelers cheques etc. made by customers/ bankers for the respective transactions.

iii. Challans for State/Central Government transactions such as Income Tax, GST, Professional Tax, Estate Duty Tax, Wealth tax, Public Provident Fund, Municipal Taxes, Stamp duty payments etc.

iv. Credit Vouchers prepared by the bank on its stationery for various transactions either on behalf of customeror on its own account.

v. Credit Memo/Advice from other banks in respect of collection items sent to other banks.

It is also a practice in banks to prepare a single/common credit voucher for many debits involving multiple accounts at the same branch and the credit is afforded to a single beneficiary's accounte.g. electricity bill, school fees etc.

Cash receipt and payment entries

Following are some examples:

A. Cash Receipt transaction/entry

Mr. R deposits Rs. 10,000 in his Savings Bank account. The accounting Voucher /Debit entries will be

- Debit– (Cash) A/c – Rs. 10,000. (For cash transaction no separate voucher is passed as per prevailing practice; but it gets reflected in the total of the cash scroll taken in the cash book)
- Credit –Saving Bank account of Mr. R - Rs. 10,000 [through a Pay-in-slip (Credit voucher for Cash entry)].

The transaction set will be reflected as cash transactions in subsidiary books of account as well as in journals.

B. Cash Payment (Withdrawal) transaction/entry

Mr. B &Co., a proprietorship company has issued a bearer cheque to Mr. J for Rs. 3000 and the bearer has come to the branch with the cheque for encashment. The accounting Voucher/Debit entries will be

- Debit – B & Co account – Rs.3000. The cheque itself will form the debit voucher which will be first entered in the ledger account and after due verification will be delivered to the cash department for payment.
- Credit – Cash Account - Rs. 3000 (For cash transaction there is no separate voucher is passed as per prevailing practice; but it gets reflected in the total of the cash payments scroll taken in the cash book).

Clearing outward and inward entries, transfer debit and credit entries.

Clearing Transactions

C. Clearing Outward: Clearing outward the term represents cheques presented by a payee's bank (Collecting bank) on the drawer's bank (Paying bank) through the clearing house at the respective centres. An example to illustrate the clearing outward transaction is given below:

A Limited has deposited a clearing cheque for amount of Rs. 1,00,000 drawn on SBI, with its bank for the credit of its account.

- Debit – Clearing Adjustment Account of Service branch Rs. 1,00,000. (This will ultimately be reflected in the debit raised on the drawee bank i.e. SBI, through the clearing house. The cheque deposited by A Limited will serve as debit voucher. However, as cheques belonging to different banks would be sent to them, a gross debit voucher for the entire clearing of the branch would be passed, in which the amount of Rs. 1,00,000 would also be included).
- Credit – Current Account of 'A' Limited through a Credit Voucher (Pay-in-slip prepared by A Limited at the time of deposit of cheque). However as per clearing house practices the amount so deposited will be available to the customer only after the return time zone as per local clearing house practice.

D. Clearing inward: Clearing inward term represents cheques received by a bank for debiting its customer's accounts with it. In other words, the bank which received the cheques for payment will be the drawer's bank (paying bank) which has to pay the amount of the cheques to the collecting bank) through the clearing house at the respective centres.

An example to illustrate the clearing inward transaction is given below:

Info Limited holder of a Current Account with Canara Bank has issued a salary cheque to Mrs. P for Rs. 8000. Mrs. P maintains a SB account with Bank of India.

The entries during inward clearing:

- Debit – Info Limited account for Rs. 8000 maintained with Canara Bank and the amount would be passed on as a Credit to Bank of India through the clearing house for crediting to the account of Mrs. P. The cheque would have been presented to Canara Bank in their inward clearing by Bank of India through the local clearing house. The cheque itself would serve as the debit voucher in the transaction. The amount of Rs. 8000 would also have been included as a part of total debit raised by Bank of India through clearing house on Canara Bank.
- Credit–Bank of India Savings Bank account of Mrs. P. Pay-in-slip prepared by Mrs. P at the time of deposit of her salary cheque with Bank of India would serve as the credit voucher. However as per clearing house practices the amount so deposited will be available to the customer only after the return time as per local practice. Canara Bank would have included the amount of Rs.8000 as a part of the total credit passed on to Bank of India through the clearing house.

E. Transfer Transaction

Mrs. N has given a cheque for Rs. 2,00,000 from her bank account towards a term deposit to be opened in her name along with a pay-in- slip for crediting her deposit account. Since the transaction is a transaction in the same branch the entries are as follows-

- Debit –SB Account of Mrs. N for Rs. 2,00,000 by way of transfer. The cheque itself will serve as the debit transfer voucher.
- Credit – New Term deposit account of Mrs. N. The pay-in-slip itself will serve as the credit transfer voucher.

The transaction set will be reflected as transfer transaction in subsidiary books of account as well as in journals.

KYC IN BANKS

What is KYC?

KYC stands for Know Your Customer. KYC forms part of Anti-Money Laundering measures taken by the Government of India and RBI, as a part of international agreements. Money laundering activities are those activities in which money earned by illegal means [as defined in the Prevention of Money Laundering Activities Act 2002 (PMLA)] are made to appear as proceeds from legal means. In this process unscrupulous persons/ criminals use banks as conduits for depositing and transferring illegal money. To prevent such attempts of banks being used as conduits in the money laundering process, RBI has issued specific directions/guidelines. In terms of such directions every banking entity must frame policies, procedures and controls duly approved by respective Board of Directors, for managing the risk of money laundering.

From time to time, RBI issues updated KYC directions/guidelines for all financial institutions covering deposits, loans as well as money remittances. This is required to be complied with banks, failing which stiff penalties are levied.

These guidelines cover the following:

(1) Customer Acceptance Policy: This policy must be followed by every bank/financial institution so that accounts are openedfor genuine customers based on stipulated documentary proof. This is also to ensure that:

a) No account is opened in anonymous or fictitious/benami name.

b) No account is opened where the Reporting Entity (RE) is unable to apply appropriate Customer Due Diligence ('CDD') measures, either due to non-cooperation of the customer or non-reliability of the documents/information furnished by the customer

c) No transaction or account-based relationship is undertaken without following the CDD procedure.

d) The mandatory information to be sought for KYC purpose while opening an account and during the periodic updation, is specified.

e) Optional/additional information is obtained with the explicit consent of the customer after the account is opened.

f) REs shall apply the CDD procedure at the UCIC level. Thus, if an existing KYC compliant customer of a RE desires to open another account with the same

"Officially Valid Document" (OVD) means –

- The passport,
- The driving license,
- Proof of possession of Aadhaar number,
- The Voter's Identity Card issued by the Election Commission of India,
- Job card issued by NREGA duly signed by an officer of the State Government, and Letter issued by the National Population Register containing details of name and address.

For this clause, a document shall be deemed to be an OVD even if there is a change in the name subsequent to its issuance provided it is supported by a marriage certificate issued by the State Government or Gazette notification, indicating such a change of name.

Provided that,

a. where the customer submits his proof of possession of Aadhaar number as an OVD, he may submit it in such form as are issued by the Unique Identification Authority of India.

b. where the OVD furnished by the customer does not have updated address, the following documents shall be deemed to be OVDs for the limited purpose of proof of

RE, there shall be no need for a fresh CDD exercise.

(g) CDD Procedure is followed for all the joint account holders, while opening a joint account.

(h) Circumstances in which, a customer is permitted to act on behalf of another person/entity, is clearly spelt out.

(i) Suitable system is put in place to ensure that the identity of the customer does not match with any person or entity, whose name appears in the sanctions lists circulated by Reserve Bank of India.

Customer Acceptance Policy shall not result in denial of banking/financial facility to members of the general public, especially those, who are financially or socially disadvantaged.

2. Risk Management

For Risk Management, Banks shall have a risk based approach which includes the following.

(a) Customers shall be categorised as low, medium and high risk category, based on the assessment and risk perception of the banks.

(b) Risk categorisation shall be undertaken based on parameters such as customer's identity, social/financial status, nature of business activity, and information about the clients' business and their location etc. While considering customer's identity, the ability to confirm identity documents through online or other services offered by issuing authorities may also be factored in.

Provided that various other information collected from different categories of customers relating to the perceived risk, is non-intrusive and the same is specified in the KYC policy

address:- i. utility bill which is not more than two months old of any service provider (electricity, telephone, post-paid mobile phone, piped gas, water bill); ii. property or Municipal tax receipt; iii. pension or family pension payment orders (PPOs) issued to retired employees by Government Departments or Public Sector Undertakings, if they contain the address;

iv. letter of allotment of accommodation from employer issued by State Government or Central Government Departments, statutory or regulatory bodies, public sector undertakings, scheduled commercial banks, financial institutions and listed companies and leave and licence agreements with such employers allotting official accommodation;

c. the customer shall submit OVD with current address within a period of three months of submitting the documents specified at 'b' above.

d. where the OVD presented by a foreign national does not contain the details of address, in such case the documents issued by the Government departments of foreign jurisdictions and letter issued by the Foreign Embassy or Mission in India shall be accepted as proof of address. For undertaking CDD, REs shall obtain the following from an individual while establishing an account-based relationship or while dealing with the individual who is a beneficial owner, authorised signatory or the power of attorney holder related to any legal entity:(a) a certified copy of any OVD containing details of his identity and address (b) one recent photograph (c) the Permanent Account Number or Form No. 60 as defined in Income-tax Rules, 1962, and (d) such other documents pertaining to the nature of business or financial status specified by the REs in their KYC policy.

3. Customer Identification Procedure (CIP)

REs shall undertake identification of customers in the following cases:

a. Commencement of an account-based relationship with the customer.

b. Carrying out any international money transfer operations for a person who is not an account

holder of the bank.

c. When there is a doubt about the authenticity or adequacy of the customer identification data it has obtained.

d. Selling third party products as agents, selling their own products, payment of dues of credit cards/sale and reloading of prepaid/travel cards and any other product for more than rupees fifty thousand.

e. Carrying out transactions for a non-account-based customer, that is a walk-in customer, where the amount involved is equal to or exceeds rupees fifty thousand, whether conducted as a single transaction or several transactions that appear to be connected.

f. When a RE has reason to believe that a customer (account- based or walk-in) is intentionally structuring a transaction into a series of transactions below the threshold of rupees fifty thousand.

g. REs shall ensure that introduction is not to be sought while opening accounts.

For the purpose of verifying the identity of customers at the time of commencement of an account-based relationship, REs, shall at their option, rely on customer due diligence done by a third party, subject to the following conditions:

a. Records or the information of the customer due diligence carried out by the third party is obtained within two days from the third party or from the Central KYC Records Registry.

b. Adequate steps are taken by REs to satisfy themselves that copies of identification data and other relevant documentation relating to the customer due diligence requirements shall be made available from the third party upon request without delay.

c. The third party is regulated, supervised or monitored for, and has measures in place for, compliance with customer due diligence and record-keeping requirements in line with the requirements and obligations under the PML Act.

d. The third party shall not be based in a country or jurisdiction assessed as high risk.

e. The ultimate responsibility for customer due diligence and undertaking enhanced due diligence measures, as applicable, will be with the RE.

Monitoring Transactions

Banks have to undertake on-going due diligence to ensure that their customers transactions match with their knowledge of customers, their business and risk profile; and also importantly the source of funds.

The following types of transactions need proper monitoring:

a. Large and complex transactions including RTGS transactions and those with unusual patterns, inconsistent with the normal and expected activity of the customer.

b. Transactions which exceed the thresholds prescribed for specific categories of accounts.[Depending upon the profile of customers, banks can fix threshold levels of transactions for every individual customer.]

c. High account turnover inconsistent with the size of the balance maintained.

d. Deposit of third party cheques, drafts, etc. in the existing and newly opened accounts followed by cash withdrawals for large amounts.

e. Monitoring should match the risk category of customer. That is to say high risk customer would receive a close and intense monitoring. In short, higher the risk category higher will be the level of monitoring.

f. Banks must institute a system of periodic review of risk categorization of accounts, with such periodicity being at least once in six months, and the need for applying enhanced due diligence measures shall be put in place.

g. In the case of accounts of Multi-level Marketing (MLM) Companies,close monitoring must be done.

Accounts in which many cheque books are sought by a company and/or multiple small deposits (generally in cash) are made across the country in one bank account and/or where a large number of cheques are issued bearing similar amounts/dates, are to be immediately reported to RBI and other appropriate authorities such as Financial Intelligence Unit (India).

What are the different documents to satisfy KYC?

The following table gives different documents required under KYC norms, depending upon the legal status of different customers such as Individuals, Proprietorship, Partnership, Trust, Companies, Trust etc.

Type of Account holder/ Legal entity	Documents for Identity Proof & Proof of Address
Accounts of Individual	For undertaking Customer Due Diligence, Banks shall obtain the following from an individual while establishing an account-based relationship or while dealing with the individual who is a beneficial owner, authorised signatory or the power of attorney holder related to any legal entity: (a) a certified copy of any OVD containing details of his identity and address (b) one recent photograph (c) the Permanent Account Number or Form No. 60 as defined in Income-tax Rules, 1962, and (d) such other documents pertaining to the nature of business or financial status specified by the REs in their KYC policy. Provided that, i) Banks shall obtain the Aadhaar number from an individual who is desirous of receiving any benefit or subsidy under any scheme notified under section 7 of the Aadhaar (Targeted Delivery of Financial and Other subsidies, Benefits and Services) Act, 2016 (18 of 2016). Banks, at receipt of the Aadhaar number from the customer may carry out authentication of the customer's Aadhaar number using e-KYC authentication facility provided by the Unique Identification Authority of India upon receipt of the customer's declaration that he is desirous of receiving any benefit or subsidy under any scheme notified under section 7 of the Aadhaar (Targeted Delivery of Financial and Other Subsidies Benefits and Services) Act, 2016 (18 of 2016) in his account. ii) Banks may carry out Aadhaar authentication/ offline-verification of an individual who voluntarily uses his Aadhaar number for identification purpose. Further, Regulated Entities other than banks may carry out offline verification of a customer if he is desirous of undergoing Aadhaar offline verification for identification purpose.

	In cases where successful authentication has been carried out, other OVD and photograph need not be submitted by the customer. Provided further that in case biometric e-KYC authentication cannot be performed for an individual desirous of receiving any benefit or subsidy under any scheme notified under section 7 of the Aadhaar (Targeted Delivery of Financial and Other subsidies, Benefits and Services) Act, 2016 owing to injury, illness or infirmity on account of old age or otherwise, and similar causes, Regulated Entities shall, apart from obtaining the Aadhaar number, perform identification preferably by carrying out offline verification or alternatively by obtaining the certified copy of any other OVD from the customer. Customer Due Diligence done in this manner shall invariably be carried out by an official of the,Regulated Entities and such exception handling shall also be a part of the concurrent audit as mandated in Section 8 Aadhar Act 2016. . REs shall ensure to duly record the cases of exception handling in a centralised exception database. The database shall contain the details of grounds of granting exception, customer details, name of the designated official authorising the exception and additional details, if any. The database shall be subjected to periodic internal audit/inspection by the, Regulated Entities and shall be available for supervisory review. Explanation 1:Regulated Entities shall, where its customer submits his Aadhaar number, ensure such customer to redact or blackout his Aadhaar number through appropriate means where the authentication of Aadhaar number is not required under section 7 of the Aadhaar (Targeted Delivery of Financial and Other Subsidies Benefits and Services) Act. Explanation 2: Biometric based e-KYC authentication can be done by bank official/business correspondents/business facilitators. Explanation 3: The use of Aadhaar, proof of possession of Aadhaar etc., shall be in accordance with the Aadhaar (Targeted Delivery of Financial and Other Subsidies Benefits and Services) Act, the Aadhaar and Other Law (Amendment) Ordinance, 2019 and the regulations made thereunder. Accounts opened using OTP based e-KYC, in non-face-to-face mode are subject to the following conditions: i. There must be a specific consent from the customer for authentication through OTP. ii. the aggregate balance of all the deposit accounts of the customer shall not exceed rupees one lakh. In case, the balance exceeds the threshold, the account shall cease to be operational, till CDD as mentioned at (v) below is complete. iii. the aggregate of all credits in a financial year, in all the deposit accounts taken together, shall not exceed rupees two lakh. iv. As regards borrowal accounts, only term loans shall be sanctioned. The aggregate amount of term loans sanctioned shall not exceed rupees sixty thousand in a year.

	v. Accounts, both deposit and borrowal, opened using OTP based e-KYC shall not be allowed for more than one year within which identification as per Section 16 is to be carried out. vi. If the CDD procedure as mentioned above is not completed within a year, in respect of deposit accounts, the same shall be closed immediately. In respect of borrowal accounts no further debits shall be allowed. vii. 12A declaration shall be obtained from the customer to the effect that no other account has been opened nor will be opened using OTP based KYC in non-face-to-face mode with any other, Regulated Entities. Further, while uploading KYC information to CKYCR, , Regulated Entities shall clearly indicate that such accounts are opened using OTP based e-KYC and other , Regulated Entities shall not open accounts based on the KYC information of accounts opened with OTP based e-KYC procedure in non-face-to-face mode. viii. Regulated Entities shall have strict monitoring procedures including systems to generate alerts in case of any non-compliance/violation, to ensure compliance with the above mentioned conditions.
In case an individual customer who does not possess any of the OVDs and desires to open a bank account,	A Bank may open a 'Small Account', subject to: i. a, the aggregate of all credits in a financial year does not exceed rupees one lakh; b. the aggregate of all withdrawals and transfers in a month does not exceed rupees ten thousand; and the balance at any point of time does not exceed rupees fifty thousand. c. Provided, that this limit on balance shall not be considered while making deposits through Government grants, welfare benefits and payment against procurements. Further, small accounts are subject to the following conditions: a. The bank shall obtain a self-attested photograph from the customer. b. The designated officer of the bank certifies under his signature that the person opening the account has affixed his signature or thumb impression in his presence. Provided that where the individual is a prisoner in a jail, the signature or thumb print shall be affixed in presence of the officer in-charge of the jail and the said officer shall certify the same under his signature and the account shall remain operational on annual submission of certificate of proof of address issued by the officer in-charge of the jail. c. d. Such accounts are opened only at Core Banking Solution (CBS) linked branches or in a branch where it is possible to manually monitor and ensure that foreign remittances are not credited to the account. e.

	f. Banks to ensure that the stipulated monthly and annual limits on aggregate of transactions and balance requirements in such accounts are not breached, before a transaction is allowed to take place. g. h. The account shall remain operational initially for a period of twelve months which can be extended for a further period of twelve months, provided the account holder applies and furnishes evidence of having applied for any of the OVDs during the first twelve months of the opening of the said account. i. j. The entire relaxation provisions shall be reviewed after twenty four months. k. l. The account shall be monitored and when there is suspicion of money laundering or financing of terrorism activities or other high risk scenarios, the identity of the customer shall be established through the production of an OVD and Permanent Account Number or Form No.60, as the case may be. m. Foreign remittance shall not be allowed to be credited into the account unless the identity of the customer is fully established through the production of an OVD and Permanent Account Number or Form No.60, as the case may be.
Sole proprietary firm	1. CDD of the individual (proprietor) shall be carried out 2. Any two of the following documents as proof of business/ activity in the name of the proprietary firm: a. Registration certificate b. Certificate/licences issued by the municipal authorities under Shop and Establishment Act c. Sales Tax and income tax returns d. CST/VAT/GST certificate(provisional/final) e. Certificate/registration document issued by Sales Tax/Service Tax/ Professional Tax authorities f. IEC (Importer Exporter Code) issued to the proprietary concern by the office of DGFT Or Licence/certificate of practice issued in the name of the proprietary concern by any professional body incorporated under a statute g. Complete Income Tax Return (not just the acknowledgement) in the name of the sole proprietor where the firm's income is reflected, duly authenticated/acknowledged by the Income Tax authorities. i. Utility bills such as electricity, water, and landline telephone bills.

	ii. If the bank is satisfied that it is not possible to furnish two such documents, at its discretion, accept only one of those documents as proof of business/activity subject to field verification of the authenticity of address and business activity. Provided REs undertake contact point verification and collect such other information and clarification as would be required to establish the existence of such firm, and shall confirm and satisfy itself that the business activity has been verified from the address of the proprietary concern.
Account of a company	Certified copies of each of the following – a. Certificate of incorporation; b. Memorandum and Articles of Association; c. Permanent Account Number of the company d. A resolution from the Board of Directors and authority granted to its managers, officers or employees to transact on its behalf; and d. In addition, documents for CDD of individuals in respect of managers, officers or employees holding an attorney to transact on its behalf are to be obtained.. .
Account of a Partnership firm	Certified copies of a. Registration certificate: b. Partnership deed; c. Permanent Account Number of the partnership firm d. Documents, for CDD of the person holding an attorney to transact on its behalf
Account of a Trust	Certified copies of each of the following documents to be obtained: a. Registration certificate; b. Trust deed; and c. Permanent Account Number or Form No.60 of the trust d. Documents, for CDD of, of the person holding an attorney to transact on its behalf.
Account of an unincorporated association or a body of individuals. (Note: Unregistered trusts/ partnership firms shall be included under the term 'unincorporated association'. The term 'body of individuals' includes societies.)	Certified copies of each of the following documents to be obtained: a. Resolution of the managing body of such association or body of individuals; b. Authority granted to transact on its behalf (Resolution); c. Permanent Account Number or Form No. 60 of the unincorporated association or a body of individuals d. Power of attorney granted to transact on its behalf e. Documents, for CDD of the person holding an attorney to transact on its behalf and Such information as may be required by the RE to collectively establish the legal existence of such an association or body of individuals.

Accounts of juridical persons not specifically covered in the earlier part, societies, universities and local bodies like village panchayats.	Certified copies of the following documents to be obtained: a. Document showing name of the person authorized to act on behalf of the entity; b. Documents, for CDD, of the person holding an attorney to transact on its behalf and c. Any other document bank may require establishing the legal existence of such an entity/juridical person such as orders of the concerned Government Department.
Self Help Groups (SHGs)	Under the simplified norms: Id and address proof of all Office bearers to be obtained. a. CDD of all the members of SHG shall not be required while opening the savings bank account of the SHG. CDD of all the office bearers shall suffice. b. No separate CDD as per the CDD procedure mentioned in these directions of the members or office bearers shall be necessary at the time of credit linking of SHGs.
Foreign Students	Banks can open a Non-Resident Ordinary (NRO) bank account of a foreign student based on the following documents: a. His/her passport (with visa & immigration endorsement) bearing the proof of identity and address in the home country; with a photograph and a letter offering admission from the educational institution in India. Provided declaration about the local address shall be obtained within a period of 30 days of opening the account and the said local address is verified. Provided further pending the verification of address, the account shall be operated with a condition of allowing foreign remittances not exceeding USD 1,000 or equivalent into the account and a cap of rupees fifty thousand on aggregate in the same, during the 30-day period. (b) The account to be treated as a normal NRO account, and to be operated in terms of RBI's instructions on Non-Resident Ordinary Rupee (NRO) Account, and the provisions of FEMA1999. (c) Students with Pakistani nationality require prior approval of the RBI for opening the account.

KYC documents for eligible FPIs under PIS

		FPI Type		
Document Type		**Category I**	**Category II**	**Category III**
Entity Level	Constitutive Documents (Memorandum and Articles of Association, Certificate of Incorporation etc.)	Mandatory	Mandatory	Mandatory
	Proof of Address	Mandatory (Power of Attorney {PoA} mentioning the address is acceptable as address proof)	Mandatory (Power of Attorney mentioning the address is acceptable as address proof)	Mandatory other than Power of Attorney
	PAN	Mandatory	Mandatory	Mandatory
	Financial Data	Exempted *	Exempted *	Mandatory
	SEBI Registration Certificate	Mandatory	Mandatory	Mandatory
	Board Resolution @@	Exempted *	Mandatory	Mandatory
Senior Management (Whole Time Directors/ Partners/ Trustees/ etc.)	List	Mandatory	Mandatory	Mandatory
	Proof of Identity	Exempted *	Exempted *	Entity declares* on letter head full name, nationality, date of birth or submits photo identity proof
	Proof of Address	Exempted *	Exempted *	Declaration on Letter Head *
	Photographs	Exempted	Exempted	Exempted *
Authorized Signatories	List and Signatures	Mandatory – list of Global Custodian signatories can be given in case of PoA to Global Custodian	Mandatory - list of Global Custodian signatories can be given in case of PoA to Global Custodian	Mandatory
	Proof of Identity	Exempted *	Exempted *	Mandatory
	Proof of Address	Exempted *	Exempted *	Declaration on Letter Head *
	Photographs	Exempted	Exempted	Exempted *

Ultimate Beneficial Owner (UBO)	List	Exempted *	Mandatory (can declare "no UBO over 25%")	Mandatory
	Proof of Identity	Exempted *	Exempted *	Mandatory
	Proof of Address	Exempted *	Exempted *	Declaration on Letter Head *
	Photographs	Exempted	Exempted	Exempted *
* Not required while opening the bank account. However, FPIs concerned may submit an undertaking that upon demand by Regulators/Law Enforcement Agencies the relative document/s would be submitted to the bank. @@ FPIs from certain jurisdictions where the practice of passing Board Resolution for the purpose of opening bank accounts etc. is not in vogue, may submit 'Power of Attorney granted to Global Custodian/ Local Custodian in lieu of Board Resolution'				

Category	Eligible Foreign Investors
I.	Government and Government related foreign investors such as Foreign Central Banks, Governmental Agencies, Sovereign Wealth Funds, International/ Multilateral Organizations/ Agencies.
II.	a) Appropriately regulated broad based funds such as Mutual Funds, Investment Trusts, Insurance /Reinsurance Companies, Other Broad Based Funds etc. b) Appropriately regulated entities such as Banks, Asset Management Companies, Investment Managers/ Advisors, Portfolio Managers etc. c) Broad based funds whose investment manager is appropriately regulated. d) University Funds and Pension Funds. e) University related Endowments already registered with SEBI as FII/Sub Account.
III.	All other eligible foreign investors investing in India under PIS route not eligible under Category I and II such as Endowments, Charitable Societies/Trust, Foundations, Corporate Bodies, Trusts, Individuals, Family Offices, etc

Accounts under enhanced Due diligence:

Type of Customer	Action point from RE
1. Politically Exposed Person/s	A. REs shall have the option of establishing a relationship with PEPs provided that: (a) sufficient information including information about the sources of funds accounts of family members and close relatives is gathered on the PEP; (b) the identity of the person shall have been verified before accepting the PEP as a customer; (c) the decision to open an account for a PEP is taken at a senior level in accordance with the REs' Customer Acceptance Policy; (d) all such accounts are subjected to enhanced monitoring on an on-going basis; (e) in the event of an existing customer or the beneficial owner of an existing account subsequently becoming a PEP, senior management's approval is obtained to continue the business relationship; (f) the CDD measures as applicable to PEPs including enhanced monitoring on an on-going basis are applicable

2. Client accounts opened by professional intermediaries	REs shall ensure while opening client accounts through professional intermediaries, that: Clients shall be identified when client account is opened by a professional intermediary on behalf of a single client. a. REs shall have option to hold 'pooled' accounts managed by professional intermediaries on behalf of entities like mutual funds, pension funds or other types of funds. b. REs shall not open accounts of such professional intermediaries who are bound by any client confidentiality that prohibits disclosure of the client details to the RE. c. All the beneficial owners shall be identified where funds held by the intermediaries are not co-mingled at the level of RE, and there are 'sub-accounts', each of them attributable to a beneficial owner, or where such funds are co-mingled at the level of RE, the RE shall look for the beneficial owners. d. REs shall, at their discretion, rely on the 'customer due diligence' (CDD) done by an intermediary, provided that the intermediary is a regulated and supervised entity and has adequate systems in place to comply with the KYC requirements of the customers. e. The ultimate responsibility for knowing the customer lies with the RE.
3. Accounts of non-face-to-face customers	REs shall ensure that the first payment is to be effected through the customer's KYC-complied account with another RE, for enhanced due diligence of non-face-to-face customers

Note: For detailed aspects of KYC, please refer to RBI's Master Directions on the topic.

Periodic Updation

According to RBI guidelines, periodic updation of KYC data shall be carried out at least once in every two years for high risk customers, once in every eight years for medium risk customers and once in every ten years for low risk customers as per the following procedure by RBI.

REs shall carry out

i. CDD, as as per these directions, at the time of periodic updation. However, in case of low risk customers when there is no change in status with respect to their identities and addresses, a self-certification to that effect shall be obtained.

ii. In case of Legal entities, RE shall review the documents sought at the time of opening of account and obtain fresh certified copies.

(b) REs may not insist on the physical presence of the customer for the purpose of furnishing OVD or furnishing consent for Aadhaar authentication/Offline Verification unless there are sufficient reasons that physical presence of the account holder/holders is required to establish their bona-fides. Normally, OVD/Consent forwarded by the customer through mail/post, etc., shall be acceptable.

(c) REs shall ensure to provide acknowledgment with date of having performed KYC updation.

(d) The time limits prescribed above would apply from the date of opening of the account/ last verification of KYC

Secrecy Obligations and Sharing of Information:

(a) Banks are to maintain secrecy regarding the customer information which arises out of the contractual relationship between the banker and customer.

(b) Information collected from customers for the purpose of opening of account shall be treated as confidential and details thereof shall not be divulged for the purpose of cross selling, or for any other purpose without the express permission of the customer.

(c) While considering the requests for data/information from Government and other agencies, banks shall satisfy themselves that the information being sought is not of such a nature as will violate the provisions of the laws relating to secrecy in the banking transactions.

(d) The exceptions to the said rule shall be as under:

i. Where disclosure is under compulsion of law

ii. Where there is a duty to the public to disclose,

iii. the interest of bank requires disclosure and

iv. Where the disclosure is made with the express or implied consent of the customer.

Sharing KYC information with Central KYC Records Registry (CKYCR)

Effective from July 2015 Banks are required to share KYC information with the CKYCR in the manner mentioned in the Rules, as required by the revised KYC guidelines in formats prepared for 'individuals' and 'Legal Entities' as the case may be. Government of India has authorized the Central Registry of Securitization Asset Reconstruction and Security Interest of India (CERSAI), to act as, and to perform the functions of the CKYCR vide Gazette Notification No. S.O. 3183(E) dated November 26, 2015.

i. Banks must upload the KYC data pertaining to all new individual accounts opened on or after January 1, 2017 with CERSAI in terms of the provisions of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005.

ii. Banks other than Scheduled Commercial Banks areto upload KYC data pertaining to all new individual accounts opened on or after from April 1, 2017 with CERSAI in terms of PMLA Rules, 2005.

Reporting Requirements to Financial Intelligence Unit – India (FIU-IND)

REs shall furnish to the Director, Financial Intelligence Unit-India (FIU-IND) the following information as per Rule 3 of the PML (Maintenance of Records) Rules, 2005. Director, FIU-IND shall have powers to issue guidelines to the REs for detecting transactions referred to in various clauses of sub-rule (1) of rule 3, to direct them about the form of furnishing information and to specify the procedure and the manner of furnishing information.

The reporting formats and comprehensive reporting format guide, prescribed/ released by FIU-IND and Report Generation Utility and Report Validation Utility developed to assist reporting entities in the preparation of prescribed reports shall be taken note of. The editable electronic utilities to file electronic Cash Transaction Reports (CTR) / Suspicious Transaction Reports (STR) which FIU-IND has placed on its website shall be made use of by REs which are yet to install/adopt suitable technological tools for extracting CTR/STR from their live transaction data.

The Principal Officers of those REs, whose all branches are not fully computerized, shall have suitable arrangement to cull out the transaction details from branches which are not yet computerized and to feed the data into an electronic file with the help of the editable electronic utilities of CTR/STR as have been made available by FIU-IND on its website

While furnishing information to the Director, FIU-IND, delay of each day in not reporting a transaction or delay of each day in rectifying a mis-represented transaction beyond the time limit as specified in the Rule shall be

constituted as a separate violation. REs shall not put any restriction on operations in the accounts where an STR has been filed. REs shall keep the fact of furnishing of STR strictly confidential. It shall be ensured that there is no tipping off to the customer at any level.

Reporting requirement under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)

Under FATCA and CRS, REs shall adhere to the provisions of Income Tax Rules 114F, 114G and 114H and determine whether they are a Reporting Financial Institution as defined in Income Tax Rule 114F and if so, shall take following steps for complying with the reporting requirements:

(a) Register on the related e-filling portal of Income Tax Department as Reporting Financial Institutions at the link https://incometaxindiaefiling.gov.in/ post login --> My Account --> Register as Reporting Financial Institution,

(b) Submit online reports by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report, for which, the schema prepared by Central Board of Direct Taxes (CBDT) shall be referred to.

Explanation: REs shall refer to the spot reference rates published by Foreign Exchange Dealers' Association of India (FEDAI) on their website at http://www.fedai.org.in/RevaluationRates.aspx for carrying out the due diligence procedure for the purposes of identifying reportable accounts in terms of Rule 114H.

(c) Develop Information Technology (IT) framework for carrying out due diligence procedure and for recording and maintaining the same, as provided in Rule 114H.

(d) Develop a system of audit for the IT framework and compliance with Rules 114F, 114G and 114H of Income Tax Rules.

(e) Constitute a "High Level Monitoring Committee" under the Designated Director or any other equivalent functionary to ensure compliance.

(f) Ensure compliance with updated instructions/ rules/ guidance notes/ Press releases/ issued on the subject by Central Board of Direct Taxes (CBDT) from time to time and available on the web site

How to verify KYC and authenticity of documents?

The verification of authenticity of a document submitted by a prospective customer/existing customer at a branch level,must based on the original documents submitted by such customers; however, there are few additional verification methods available, such as given below:

i. Income Tax Department has made available PAN verification facility to a few reputed agencies in India. Therefore, if a customer submits a PAN Card it can be verified from the verification facility through the accredited agencies. All banks have a link with such agencies and through such arrangements PAN verification can be done.

ii. Authentication, of Aadhar Number already available with the Bank can also be done with explicit consent of the customer in applicable cases through the Aadhar data base and biometric data available with Central Identification Registry(CIDR).

iii. In the case of Electricity bills/Telephone bills these can also be verified through the service providers by mentioning the consumer number/telephone number as well as through verification software available on online.

iv. In case of Companies and Directors, the data submitted by such customers can be verified through the website data of Department of Corporate Affairs.

v. In case of certain banks, they employ field personnel who make a visit to the address provided by the prospective customer and physically verify the details provided by such customers.

vi. Also, at the time opening a new account/establishing a new relationship, the customer will be checked against watch lists provided by International/National/Local authorities including Central Banks and Anti-terrorist Organizations. If the names of such customers match with any of such names in the list, a thorough screening will take place to ensure such accounts are not opened. If such names are detected it must be reported to concerned agencies including RBI.

Additional points on verification of KYC documents

Verification of customers' KYC data will also be carried out in case of borrowers too.If third party agencies are involved in, verification of KYC data such agencies will also be evaluated keeping in mind the norms prescribed by RBI. In case identification information available with Aadhar does not contain current address an OVD containing current address may be obtained.Certified copy of OVD containing identity and address shall be obtained at the time of periodic updation from individuals not eligible to obtain Aadhar, except from individuals who are categorized as 'low risk'. In case of low risk customers when there is no change in status with respect to their identities and addresses, a self-certification to that effect shall be obtained.In case of Legal entities, banks shall review the documents sought at the time of opening of account and obtain fresh certified copies wherever it is required.

Operational aspects regarding opening of all types of accounts.

One of the basic functions of a bank is accepting deposits. Deposits constitute the working capital of a bank for doing its business by way of lending and investment. Acceptance of deposits involves paying of interest, which is a cost and therefore from the profitability aspect, most banks try to have an optimum mix of low cost and high cost deposits. Thus,for accepting deposits, banks offer a range of deposit accounts. Basic featuresof deposits are the same across banks. However due to discretionary powers conferred on banks by RBI, banks incorporate attractive and unique features in such accounts to attract customers. For example, Kotak Mahindra bank offers a higher rate of interest on certain Savings Bank Deposit accounts, using the discretionary option when compared to other banks.

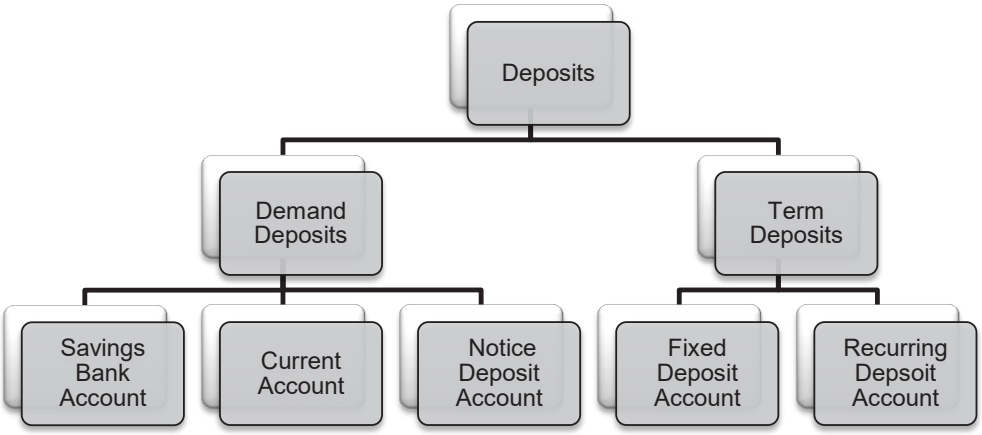
Following are the salient features of different deposit accounts offered by banks in brief.

Deposit accounts offered by banks can be classified under

a. Demand deposit accounts and

b. Term deposit accounts.

Broad Classification of Types of Deposit Accounts



According to Indian Banks' Association, deposits are classified under different types as below:

1) **Demand deposits:** It means a deposit received by a Bank which is withdrawable on demand.

2) **Savings deposits:** It means a form of demand deposit which is subject to restrictions as to the number of withdrawals as also the amounts of withdrawals permitted by a Bank during any specified period.

3) **Term deposit:** means a deposit received by a Bank for a fixed period withdrawable only after the expiry of the fixed period and include deposits such as Recurring / Double benefit Deposits / Short Deposits / Fixed Deposits where Monthly /Quarterly Interest are paid etc.

4) **Notice Deposit:** It means term deposit for specific period but withdrawable on giving atleast one complete banking days' notice.

5) **Current Account:** It means a form of demand deposit wherefrom withdrawals are allowed any number of times depending upon the balance in the account or up to an agreed amount and will also include other deposit accounts which are neither Savings Deposit nor Term Deposit.

Features of Savings Bank Accounts (SB)

a. Savings Bank accounts are meant promoting Savings habit among people.

b. These accounts can be opened by Individuals singly, two or more individuals jointly, certain organizations as permitted by RBI (See box item). Minors' accounts can be opened by their guardians.

c. Business organizations engaged in profit generating activities are generally not permitted to open SB accounts.

d. Minors above the age of 10 are also allowed to open.

e. Self-operated SB accounts under certain conditions as per RBI directions. This is basically to inculcate Savings habit in them.

f. Government Departments, Municipal authorities, political parties, trade/professional/business entities, or associations are not allowed to open these accounts.

g. Cheque book facility is offered in these accounts. Due to electronic banking ATM/Debit Cardare also offered. Internet banking facility is also offered to customers subject to conditions stipulated by banks in this regard. Upon request, Credit card facility is also offered.

h. Cheques can be used for withdrawals or for making any payments. Since the advent of electronic

Organizations which are permitted to open SB accounts are as under:

- Primary Co-operative Credit Society financed by a bank,
- Self Help Groups (Registered or Unregistered) /Farmers Club
- Agriculture Produce Marketing Committees
- Khadi & Village Industries Board
- Societies registered under Societies Act 1860 or any other corresponding law in States or Union territories
- Companies under Section 8 of Companies Act 2013 (Corresponding to Sec 25 of The Companies Act of 1956 or corresponding Act of 1913)
- Government Departments/bodies/ agencies receiving grants/ subsidies for implementation of various Government sponsored Schemes/ Programmes by the Central / State Governments on production of authorization of the concerned Government Ministries/Departments.

banking there are several online payment options available for transfer of money which can be made use of.

i. The number of withdrawals in these accounts is restricted as per RBI directions as these accounts are not meant for business or trading. However there is no restriction on the number of deposit transactions.

Other features of SB Accounts

Before opening an account, every bank would complete the KYC verification process of prospective customers. In case of joint accounts KYC for all joint holders would be done. Every bank will stipulate minimum balance to be maintained in the account. Failure to do so will result in levy of charges as per Banks' schedule of charges. Similarly, there can be charges for issue of cheques books, additional statement of accounts, duplicate pass book, folio charges, SMS charges etc. All such details, regarding terms and conditions for operation of accounts and schedule of charges for various services provided will be communicated to the prospective depositor while opening the account.

Nomination as applicable under Nomination Rules 1985 may also be obtained wherever applicable in these accounts.

Interest rates on Saving Bank account

Interest is generally paid at 4% p.a. on the daily closing balances. Such interests will be credited once in a quarter as per latest RBI directions. Banks also have discretion to pay higher rate of interest (called preferential rate of interest) on deposits held by staff members, senior citizens, retired employees, widows/widower of retired employees; also, on deposits of association of employees in which employees are members etc.

Pass Books

Right from the opening of the account, Pass books are to be issued to customers. if a customer who is not issued cheque book will have to present the pass book to get a withdrawal form from the bank. Pass books are needed to be updated whenever they are presented by customers.

Due to spread electronic banking instead of pass books customers are issued statements either in hard copies or email versions as per agreement with the bank. Also, nowadays banks are providing separate pass book printing machines to enable customers to update their pass book on their own.

Operations in Joint Accounts

Joint Accounts opened by individuals can be operated either by only one person among the joint holders, or more than one according to the arrangements agreed to by the joint holders. Such mandates for operating the account can be modified with the consent of all account holders at any time by them with due intimation to the bank. The Savings Bank Account opened by minor jointly with natural guardian / guardian can be operated by guardian only.

Mandates in case of joint account

The joint account holders can give any of the following mandates for operation as well as the disposal of balance in the above accounts:

(i) **Former or Survivor:** If the account is held by two individuals say D & E, under this mandate D only will have the authority to operate the account. After, the death of D the balance in the account will be paid to E.

(ii) **Either or Survivor:** If the account is held by two individuals say, A & B, it can be operated by any one. Also, it implies that the final balance alongwith interest, if applicable, will be paid to survivor on death of

anyone of the account holders.

(iii) **Anyone or Survivor/s:** If the account is held by more than two individuals say, A, B and C, the final balance alongwith interest, if applicable, will be paid to the survivor on death of any two account holders.

This mandate can be modified by the express consent of all the account holders.

Transfer of accounts

On an application by a customer an account can be transferred from one branch to another free of cost. In such cases all unused cheque leaves must be surrendered to the branch where the account is held. The transferor branch will forward the original account opening form and specimen signature cards after due cancellation of the same to the transferee branch after retaining a Xerox copy of the same.

However, with the introduction of CBS and issuance of multi-city cheques transfer of accounts has become a thing of past.

Conversion of accounts

Savings Bank account rules permit the conversion of individual accounts in to joint accounts. In this case a fresh joint account opening form duly signed by all account holders is to be submitted along with a request letter to convert the existing account in to a joint account. KYC formalities need to be completed in respect of all joint account holders. They need to mention the mandate of operation in such cases.

Closure of accounts

Savings Bank accounts can be closed the request of the account holder. Account holder must submit a letter in writing requesting for closure and along with all unused cheque leaves to the bank.

In case of joint accounts, all joint account holders should sign the request letter for closure and submit the same along with unused cheque leaves to the bank.

The balance in the account to be paid after adding up to date interest in the account and ensuring that all applicable charges are debited to the account as per schedule of charges of the bank.

Inoperative/Dormant Account

A Savings Bank account or a Current account will be treated as an inoperative/dormant account if there are no customer induced transactions for a period of two years and above. Normally in practice if there are no operations in the account for of one year the customer is contacted with a request to operate the account. If the customer does not operate the account even after reminders the account will be classified as inoperative account. Subsequently if there are operations, the same needs to be scrutinized by a higher official and if found genuine, after a proper due diligence, operations may be allowed.

If the customer wants to revive the account a letter needs to be obtained from the account holder regarding the same and the accounts would be transferred from inoperative account to operative accounts.

Inoperative accounts need to be segregated and a strict control should be exercised as it is a fraud prone area. Inoperative SB accounts continue to earn interest on their balances till they are transferred to DEAF of RBI as described below.

If any of such accounts remain inoperative beyond a period of ten years and above the balances are to be transferred to Depositors Education and Awareness Fund (DEAF) of RBI. Subsequently when a claim arises later the same should be claimed from RBI as per directions of RBI in this regard. RBI will pay interest on these accounts from the date of their transfer to RBI. A detailed procedure has been enumerated by RBI in respect of DEAF which needs to be followed by banks. Please refer to Lesson 4 for a detailed coverage on DEAF.

Information to Depositors on Inoperative accounts/Unclaimed deposits

RBI has directed banks to display on their websites details of inoperative accounts in their branches by adopting the following method:

i. Such lists should contain only the name/s of the account holder/s and address

ii. If such accounts are not held by individuals, names of authorized signatories who are authorized to operate the accounts should be displayed.

iii. Account number, type/s of accounts and name of the branch are not to be displayed.

iv. Banks should also provide 'Find' option to enable the members of the public to search the list by name.

v. Banks should also display the process of claiming the same (including forms/documents) from the concerned bank.

vi. Banks should also put in place proper procedures of due diligence for verification of genuineness of the claim.

Salient Features of Current Accountants

1) These accounts are meant for customers who have large number of transactions of credit and debit everyday basis.

2) Current accounts can be opened by individuals, proprietary concerns, partnership concerns, public and private limited companies, trusts, associations, societies and other institutions.

3) Unlike Savings bank accounts, no interest is paid on current account balances (Exception: Accounts of Regional Rural Banks maintained by sponsoring banks or as per RBI directions from time to time).

4) While opening a new account it is usually done with a cash deposit of the stipulated minimum amount.

5) Customers are expected to maintain the minimum balances in their accounts as per the rules of business of the bank concerned.

6) There are no restrictions on the number of withdrawals or deposit transactions that can be routed through a current account.

7) Withdrawals from these accounts normally are to be done through cheque leaves issued to the customers.

8) If a cheque book is issued through a bearer, a separate confirmation is to be obtained from the account holder regarding the receipt of the cheque book by him.

9) Whenever requests for cheque books are received from clients, a banker has to satisfy himself about the genuineness of eachrequest by verifying the signature etc.

10) Even the cheque requisition slip should be signed as per mandate given to the bank and if a cheque book is to be delivered to a bearer then the bearer should carry an authorization from the account holder to obtain a cheque book from the bank.

11) As soon as cheque books are issued to the account holder, the serial number particulars should be noted in the account folio.

12) Based on the mandate of a customer, banks can debit the account of the customer through debit vouchers.

13) ATM Cards/Debit cards, internet banking facility are also provided to the account holders.

14) Normally current accounts cannot be allowed to be opened by pardanashin women, illiterates and blind

persons. However, guardians can operate current accounts of minors.

15) If any overdraft arrangements are made this will be as per rules stipulated by the bank including period, interest rate, quantum and validity of such facility.

16) Nomination facility is available only in the account of proprietary concerns among current accounts.

Term Deposit Accounts/Fixed Deposit accounts

1) Fixed deposits or Term deposits are those deposits that are parked with a bank for specified period at an interest rate offered by a bank. These are generally availed by risk aversion minded depositors for income. Though these deposits carry a fixed interest, banks also offer floating rate of interest-based term deposits.

2) Floating rate of interest term deposits are those whose deposit rates are linked to a bench mark rate and whenever there is change in the bench mark interest rate there will be a revision in the interest rate. For example, Bench mark rate could be 'Repo' rate or Bank rate of RBI.

3) Banks also offer compound interest-based term deposits apart from Recurring/Cumulative deposits.

4) As per RBI directives interest is paid on Fixed Deposits on a quarterly basis or half yearly basis on yearly basis. However monthly interest can be paid at a discounted rate as per RBI directives.

5) Fixed deposits period can vary from a minimum of 7 days to a maximum of 10 years. Accordingly, banks offer interest rate for different periods. These rates can change periodically in tune with RBI's Monetary Policy.

6) It is important to note that fixed deposits up to Rs.1 lakh per person per capacity per bank are mandatorily insured under the scheme of deposit insurance provided by Deposit Insurance and Credit Guarantee Corporation, a wholly owned subsidiary of RBI.

7) Fixed deposits can be withdrawn pre-maturely subject to some penalty as per RBI directives to banks in this regard.

8) Deposit holders can avail loan against pledge of Fixed Deposits receipts; banks offer up to 90% of the principal as loan amount at 1 or 2% higher interest rate than the rate of interest offered on the deposit.

9) Senior citizens are generally paid higher interest rates compared to interest rate offered to public.

10) TDS is applicable on the interest paid by banks as per prevailing Income Tax rules. Exemption from TDS is also granted to General public/Senior citizens against submission of Form 15G or 15H.

Recurring Deposit

A Recurring Deposit or RD (in some banks it is also known by the name Cumulative Deposit) is also a form of term deposit in which depositors can make deposits at regular intervals for a term and earn interest on a compounded basis at the end of the term.

As FDs are rigid in certain respects, a Recurring Deposit is an ideal investment cum savings option.

All banks in India offer a Recurring Deposit Account, for a minimum period of 6/12 months and a maximum period of 10 years, suiting to the needs of depositors. The interest rate remains fixed throughout the term and upon maturity, the depositors will be paid proceeds of the deposit that includes compounded interest earned on the principal amount deposited every month. Interest calculations will be based on monthly balances held in the account.

Recurring deposits can also be closed before maturity if a customer so desires because of emergency situations. Interest would be paid as per the rules of the bank which is like that of the term deposits. No recurring deposits are accepted under Foreign Currency Non-Resident Deposit scheme.

Certificate of Deposit (CD)

This is a variant of term deposit and issued at a discount to face value. These are short-term negotiable money market instrument which attracts stamp duty. A detailed coverage of CDs has been dealt in the earlier chapter.

Cash certificates

These are term deposits which offer interest payments on a cumulative or compounded basis. They are governed by the same rules as applicable to term deposits.

Some operational features of Fixed deposits are covered in the later part of this chapter.

Different types of Accounts that can be opened for different entities:

Following are the operational aspects of deposit accounts

Accounts of an individual

(a) Account opening form must be completed, including all mandatory details.

(b) Documents required as per KYC norms are to be obtained.

(c) Should be advised to nominate a nominee to the account. Nomination must be registered and an acknowledgement must be given to the customer.

Account of a Minor

(a) A minor is a person who has not completed 18 years of age, under Indian Majority Act 1875. A person who is under the custody of a court, remains a minor till he completes 21 years.

(b) As a contract with a minor is void, a minor's account can be opened in the name of a minor, to be operated by his/her guardian. A Guardian could be a Natural guardian or a Legal Guardian or a Testamentary Guardian.

(c) Parents are the Natural Guardians. Legal Guardian is appointed by the Court in the absence of parents. Guardian appointed by Will is known as Testamentary guardian. Whenever a guardian operates the account his fiduciary capacity should be clearly brought out in cheques and other instruments.

(d) A guardian's power to operate the account ceases once the minor attains majority. The moment a minor attains majority, new account opening forms and specimen signature cards etc. should be got signed by him. A letter confirming the balance in the account on the date when the minor became a major should also be obtained so tha

(e) In the case of Hindus and Christians, Father and Mother constitute Natural guardians in that order. In case of Muslims, Father constitutes the first natural guardian and the person named in his Will becomes a guardian of the minor, after his demise. If the father has not named any one in his Will, the father's father becomes the natural guardian after the demise of father. While opening accounts we also accept a guardian appointed under Mental Disabilities Act 1999.

Joint Accounts

(a) When two or more persons jointly open an account, it is called a joint account. As far as possible a joint account should be opened only among close relatives. Account opening form should be signed jointly by all.

(b) A clear operational mandate from the account holders should be obtained, as to who would operate the account.

(c) Photographs, id and address proof all individuals as a part of KYC process are to be obtained.

(d) All joint account holders should jointly nominate a nominee.

Sole Proprietorship Accounts

(a) Business carried out in a firm's name solely by an individual is known as "Sole Proprietorship". Only Current accounts can be opened.

(b) Formalities while opening the account will include compliance with KYC norms.

(c) While opening this account, if it is a new proprietorship account, a declaration in the letter head of the firm should be obtained. If it is an existing proprietorship, any proof regarding its existence such as tax returns, Municipal licence under Shops & Establishment Act should be obtained.

Partnership Accounts

(a) A partnership is a relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all. The relationship is spelt out in a document called, "Deed of Partnership".

(b) The minimum number of partners in a partnership should be 2. The maximum number of partners allowed is 100. These restrictions/revisions are in accordance with Companies Act 2013.

(c) A partnership can be either registered or un-registered. Where partnerships require compulsory registration with Registrar of Firms, while opening partnership accounts, the registration certificate should be obtained.

(d) A minor cannot be admitted to a partnership, but he can be admitted to the benefits of a partnership, with consent from other partners. Hence minor is represented by a guardian in partnerships.

(e) When a minor attains majority, he should within 6 months of attaining majority, has the option to exit the partnership. If he fails to do so, he is deemed as a partner from the date of his admission to the partnership and will be responsible for any liabilities and loss too.

(f) Every single partner can bind a partnership by his action. Hence, while opening a partnership account, signatures from all the partners in their individual capacity as well as the fiduciary capacity of a partner, should be obtained.

(g) If the partnership has applied for registration at the time of opening the account obtain the provisional receipt from the partners as proof.

(h) Clear instructions regarding as to who will operate the account, should be obtained from the partners at the time of opening the account.

(i) If a new partner is admitted, operations in the account can be allowed subject to making changes in the account opening forms and bank's data base. If a partner retires from a partnership, all other remaining partners have to authenticate the transactions. Partnership suffers dissolution on account of death/ retirement/insolvency of any one of the partners unless the Deed provides otherwise.

(j) When a partnership is dissolved, the operations in the account are to be stopped if the account is in debit balance.

(k) In a partnership account any one partner can stop the operations. The bank needs to inform all the other partners about the stopping of operations in the account through a specific letter.

(l) The bank will allow any further transactions, only after all partners jointly authorize the bank to do so, through a letter.

(m) A Hindu Undivided Family (HUF) is not allowed as a partner in a partnership. But individual members of HUF can become members of the Partnership subject to the legal limit of partnership.

(n) Cheques drawn in favour of the firm should not be allowed to be collected in the individual account of a partner. Cheques drawn by a partner in his own favour if sought to be credited to his individual account, should be counter signed by any other partner, so that, the bank is not held liable for conversion.

(o) Documentation to be obtained while opening an account will include -

- Bank's account opening form duly completed and signed by all partners.
- Id and address proof of the firm.
- Photographs and address proof of all the partners; Partnership deed copy.
- Rubber stamp of the firm should be impressed on the application form and partner's signature should be affixed under it.
- Mandate regarding operation of the account.

Limited Liability Partnerships

(a) Limited Liability Partnerships (LLP) were introduced in India in 2009. This legal entity is a combination of traditional partnership and a limited liability aspect of a company. To overcome the limitation placed by Indian Partnership Act regarding total number of partners as well as unlimited liability aspect, LLPs Act was introduced.

(b) LLP can be incorporated for only business purposes; not for charity or philanthropy purposes.

(c) There is no limit on the number of partners in this entity. It is a separate legal entity from Partners. Partners of an LLP enter in to an agreement on mutually agreed terms. The registering Authority of LLP in some states is Registrar of Companies and in some states, it is Registrar of LLPs.

(d) Liability of a partner is limited to the extent of his contribution in the LLP. Personal assets of a partner are not liable except in case of fraud committed by any individual partner.

(e) Should have at least 2 designated partners, out of which, one of them should be resident in India. Designated partners will look after the affairs of the LLP.

(f) One partner is not liable for the acts of misconduct of other partners except in certain circumstances. LLP is having perpetual succession.

(g) An individual/ a company or other LLP can be partners. HUF,NBFC cannot be partners in LLP.

(h) LLP can borrow on its own name on the security of assets; it can create charges on its assets in favour of a lender. LLPs must submit their annual financial statements to ROC/RoLLPs.

For opening an account of LLP, the following documents are needed:

(i) Certificate of Registration of LLP.(Registration of LLP is mandatory)

(ii) LLP Agreement (In the absence of LLP agreement, provision of Schedule I of the Act become applicable).

(iii) Designated Partner identification numbers of all the partners, (minimum no. of designated partners is 2, out of which one must be resident of India, in case where all the partners are Body Corporate, the nominees of such bodies act as Designated Partners).

(iv) Resolution signed by all the partners indicating the authorized signatories.

(v) KYC documents of all the authorized signatories.

Accounts of Companies

(a) Companies are artificial persons which have legal existence. Companies which are incorporated under Companies Act 2013 can open accounts with banks. Companies can be broadly divided in to Private Limited and Public Limited companies.

(b) Private Limited companies cannot issue shares to public and the minimum number of shareholdersare 2 and the maximum number of shareholders are restricted to 200.

(c) Public Limited company can issue shares to public. The minimum number of shareholders are 7 and there is no ceiling of maximum number of shareholders.

(d) Formalities relating to opening accounts of companies will include obtaining the following documents namely

(i) Memorandum of Association and Articles of Association [Memorandum of association usually contains various details such as name of the company, place of registered office, objects, statement of liability and details of capital (division of the share capital). Articles of Association usually contains operational rules for day to day functioning as well as other internal matters.]

(ii) Certificate of Incorporation issued by the Registrar of Companies in whose jurisdiction the company is registered.

(iii) Certificate of Commencement of Business. As per revised Companies Act 2013 provisions, a company with a share capital can commence business or exercise borrowing powers after a declaration is filed with Registrar of Companies that the paid-up capital is not less than Rs. 5 lacs (public Company) or Rs. 1 lac (private company) or as applicable. Such declarations should be obtained and kept on record.

(iv) Copy of Board resolution certified by the Chairman to open an account with the bank. Operating instructions regarding execution of documents, the name/s of director/s other executives authorized to sign etc.

(v) Copy of latest Audited Balance sheet and Profit and Loss account, List of present directors duly certified by the Chairman, Address of the registered office along with the KYC documents pertaining to the Company should also be obtained along with KYC documents in respect of authorized signatories.

(vi) All account opening forms should be signed by authorized signatories. Photographs of authorized signatories as per KYC norms should be obtained.

(vii) All documents should contain the company's seal (Embossing Stamp).

(viii) In case of change of constitution, the company has to inform to the bank. In case of death of a director, as a company is a legal entity having perpetual existence, its account should not be stopped.

(ix) A fresh resolution by the board of directors, authorizing the new directors and their specimen signatures should be submitted to the bank.

Accounts of Trusts

A trust is a body created by a person/s (called "Author/s") for the benefit of another person/s (called "Beneficiary") or for a cause and managed by a person or a group of persons (known as "Trustee/s").

(a) There is a document through which a trust is created known as "Trust Deed". Trusts can be created for private purposes or for public purposes. A trust can be a registered body or an unregistered body. The

property belonging to a trust is normally handled by trustees as per the terms and conditions contained in the trust deed. While opening such accounts the original trust deed should be called for.

(b) This deed should be scrutinized to identify the rights and duties of trustees and to ensure that no undue onus is placed on the bank. A certified true copy along with rules, bye-laws should be studied to know the rights, powers, duties and restrictions of the trustees while operating the account.

(c) If it is a public trust, trust registration certificate should be obtained. If the trust is a private trust concerned registration certificate issued by competent authorities should be obtained.

(d) Specific resolution for operation in the account should be obtained from the trustees as to who among them will operate the account. Account opening form should be signed by all trustees. KYC documents of the Trust should also be obtained.

(e) A trustee can't appoint any other person as a proxy unless the trust deed provides. Balance confirmation letter should be obtained from the trustees on a half yearly basis and the same must be kept on record.

(f) If there are changes in the board of trustees, a resolution in this regard signed by all trustees, should be obtained and kept on record. Any of the trustees can stop payment of a cheque. In case if a trustee dies, the operations in the account should be stopped unless the trust deed states otherwise. In case of lunacy of a trustee, operations in the account should be stopped, unless the trust deed allows the trust to continue.

(g) Bankruptcy/insolvency of a trustee does not affect the trust. Normally no over drawings to be allowed in the trust account. Cheques collected on behalf of trust should not be credited to a trustee's account as otherwise the bank maybe held for "conversion".

Accounts of Clubs and Associations

(a) Clubs, Societies and Associations are bodies of members, who come together for a common cause. Generally, a non-trading clubs, societies and associations approach banks to open accounts. Such bodies do not share profits with members.

(b) Clubs can be registered or unregistered. Accounts of unregistered clubs, societies and associations cannot be opened as individual members are not liable for debts of the body, hence suits can't be enforced.

(c) While opening of accounts of Clubs and Associations obtain the account opening form along with photos of the office bearers, address proof of all the office bearers, certified true copy of the original certificate of registration, certified true copy of memorandum of association, certified true copy of the rules, regulations, bye-laws, resolution of managing committee appointing the authorized persons to operate the account. (To be certified true by The Chairman/Secretary). KYC documents of the Club/ Association should also be obtained.

(d) The type of account to be opened should be specified in the resolution. Resolution should be in terms of rules, regulations, bye-laws of the body.

(e) Upon the death of the Chairman/Secretary/ Treasurer, cheques signed by any one of them before their death, can be passed after due enquiry.

(f) Cheques in the name of clubs/associations/societies should not be collected and credited to the accounts of office bearers. Otherwise the bank may be liable for conversion.

Accounts of Co-operative Societies

Co-operative societies are bodies formed by individuals under Central Co-operative Societies Act or State Co-operatives Act. They require registration from designated authorities such as Central Registrar of Co-operatives or State Registrar of Co-operatives. Co-operative societies receive their capital from members and can indulge in legally permitted activities.

(a) For opening an account, first obtain true copy of the letter from Registrar of co-op societies permitting the opening of the account with a bank. Obtain Copy of latest balance sheet, Certified list of office bearers, Certified true copy of resolution of general body or managing committee appointing persons authorized to operate the bank accounts, Specimen signatures and photographs of persons authorized to operate the account. Latest KYC documents of the society should also be obtained apart from the KYC documents for all office bearers authorized to operate the account.

(b) If there is any change in office bearers/ managing committee, a certified true copy of resolution of managing committee incorporating the change to be obtained and kept on record with the existing account opening forms.

Accounts of Special Types

(1) Lunatics

(a) A banker does not knowingly open the account of a lunatic, as he is incompetent to contract. If after opening an account when a banker comes to know the lunacy of the account holder, operations in the account should be stopped until a Court of competent jurisdiction gives an order, or a banker has a solid proof the account holder's sanity. A solid proof includes written report from a competent specialist like a psychiatrist/psychologist.

(b) Drunkards in their drunken state are of unsound mind and are incompetent to contract. Contracts entered in the drunken state are void. Therefore, a banker stands to lose if he knowingly opens a drunkard's account.

(2) Illiterate persons

(a) They can enter in to contractual relationships. Hence a banker opens accounts of illiterates with some precautions.

(b) Since illiterate persons do not know to read/write, their thump impressions are obtained in lieu of signatures. For males, their left-hand thumb (LHT) impression is obtained and for females, their right-hand thumb (RHT) impression is obtained. These thumb impressions are got witnessed/attested by known witnesses.

(c) Other forms of identification such as Photographs, Address proof etc. are obtained as per KYC norms. Photographs are properly to be affixed along with seals to prevent substitution. Due to the presence of photographs, the need for witness stands reduced at every withdrawal transaction.

(3) Blind person

(a) A blind person, if mentally sound can enter in to contract. If a blind person can sign he should be asked to sign account opening forms. Also, a blind person should be properly informed of the care he should take regarding the pass book, deposit receipts which will be issued to him.

(b) He/she should come in person to open the account.

(c) If the blind person wants to open an individual or joint account, he/she may be allowed to do so.

(d) While opening the account itself, the branch official should read out the rules of business and other terms and conditions in presence of a witness and accordingly obtain the signature of the witness.

(e) If the blind person is literate, in addition to thumb impressions, signature should also be obtained in the account opening forms. This should be countersigned by the Manager.

***[Note:** While opening an account for illiterate and blind persons, mark the account as "illiterate" or "blind" across the Account Opening Form.]*

(4) Executors and Administrators

- An Executor is one who is appointed in terms of a Will of a person (known as 'Testator'). An Administrator is a person appointed by a Court to manage some one's estate or property, when an owner of a property dies without leaving a Will or leaves a Will without naming an Executor or an Executor dies before the maker of the Will or the appointed Executor refuses to undertake the responsibilities.

  (i) Before opening the account, a banker should obtain certified copies of "Probate" or "Letters of Administration" and keep the same on record. The operations in these accounts will be in terms of these documents. If there are more than one Executor or Administrator, the account will bear all their name under the style.

  (ii) Account opening forms should be signed by all Executors/Administrators as mentioned in the document. KYC documents of the individual Executor or Administrators are to be obtained.

  (iii) In case of accounts having more than one Executor or Administrator, clear mandate should be obtained regarding the operations in the account. Any one of the Executors/Administrators can stop the payment of a cheque pertaining to the account. In case of revocation all of them should jointly sign a letter and authorize the bank to do so.

  (iv) Executors/administrators cannot delegate their authority to any one and a banker should not honour cheques signed by such delegatee. In case an Executor or Administrator becomes lunatic his authority stands terminated.

  Under this circumstance, a banker should not honour cheques drawn by such Executor/ Administrator but seek instructions from fellow Executors/Administrators or the Court as the case may be.

  (v) Bankruptcy of an Executor/Administrator will not affect the bank account. A banker should always be on guard to prevent any misappropriation of funds held in the account by Executors/ Administrators. Otherwise the bank will be held liable for Conversion.

- Liquidators: Are appointed by a Court to disposeoff properties and assets of institutions as well as collect the amount from debtors and settle the claims of creditors while winding up of a company. While opening an account of a Liquidator, first the terms of court order appointing the Liquidator should be studied and understood.

  (i) In case of voluntary liquidation of a company wherein a Liquidator has been appointed, terms in resolution of the company to open account should be studied. Such a resolution must be certified by Chairman of the meeting (winding up).

  (ii) If an account is to be opened it should be titled as Liquidator a/c of _____ (name of the company). We must obtain account opening form duly signed by the Liquidator. Also obtain all other KYC documents pertaining to the individual/s appointed as Liquidator/s.

Certain Operational aspects of Deposit Accounts

(1) Operation in Minor's Account

When a deposit account of a minor is opened, the proof of birth should be verified with reference to the school / birth certificate and a certified copy of it should be kept on record.

The birth date of the minor must be properly noted in the Customer/ Account Master. Constant watch has to be kept on accounts of minors and their attaining majority, particularly where the accounts are operated by the guardians of the minor, because the erstwhile minor may question withdrawals from his account by the guardian after he attains majority. To eliminate this risk and to safeguard the Bank's interest, it is necessary to keep a watch on such accounts. At present in the Core banking system this information is generated and made available to branches at the beginning of every month.

If withdrawal/cheque signed by the guardian, is presented for payment, after the date on which the minor became major, the erstwhile minor must be contacted, and his instructions sought. If he cannot be contacted, the withdrawal form/ cheque should be returned with reason. "Mr./Miss/Mrs._____ ____ has since attained majority."

(2) Tax Deducted at Source (TDS)

As per the prevailing regulations, Income Tax must be deducted at source (TDS) if the annual interest paid to the customer/s exceeds Rs. 40,000 (For senior citizens it is Rs. 50,000) during FY 2019-20. The rate at which income tax is to be deducted is as notified from time to time by Income Tax authorities.

Exemption from deduction of tax is applicable for Shareholders (members) and Nominal Members of Co-operative banks as per Income Tax regulations applicable from time to time. Therefore, at the time of accepting or renewing any deposit, this aspect must be confirmed and accordingly dealt with.

If any depositor such as Senior Citizen (one who has completed 60 years of age as defined by Income Tax department) claims exemption from deduction of TDS, they should be asked to submit duly filled in Form No. 15H to the Bank within the time limit specified under the Income Tax Act. Three copies of the Form No15H are taken and one form is returned to the customer after acknowledging the same. One such form is forwarded for onward submission to Income Tax Department. If an eligible Depositor fails to submit Form 15G or 15H, then TDS must be deducted at the appropriate rate as advised by Head office of the respective banks.

(3) Premature closure of Term Deposits

If a deposit account is closed before its maturity a letter signed by the depositor/s as per operating instructions on the account opening form should be obtained.

The interest rate payable will be 1% less than the actual rate of interest applicable for the period for which the deposit has remained with the bank, prevailing as on the date when the deposit account was opened, as given in the examples below: -

Example 1

Where the interest is payable on simple interest basis on the deposit at the time of opening and if such a deposit is sought to be prematurely closed, then the interest payable on the deposit will also be the applicable rate for the period for which the deposit remained with us less 1% on simple interest basis. Any excess interest will have to be recovered from the customer as given in the following example.

- Customer X has kept a Fixed Deposit of Rs. 10,000 for 36 months at a simple interest rate of say 10%. After two years he approaches the bank for closing the deposit prematurely. The rate of interest applicable for two-year period at that point of time when the customer opened the FD was, say 6%.

- The customer will be paid simple interest on Rs. 10,000 at the rate of 6-1= 5%
- The bank will have to recover the excess interest paid i.e. 10-5=5% on Rs. 10,000 for two years from the customer.

Example 2

Where the interest is payable on a compounded basis on the deposit at the time of opening and if such a deposit is sought to be prematurely closed, then the interest payable on the deposit will be applicable rate for the period for which the deposit remained with us less 1%. Any excess interest will have to be recovered from the customer as given in the following example.

- Customer A has kept a compounding interest deposit of Rs. 20,000 for a period of 36 months at an interest rate of say 9% p.a. (paid on a compounded basis).
- After 18 months the customer approaches us for a premature repayment. If the deposit rate applicable for 18 months at the time of opening the deposit, is say 7.5% p.a.
- Therefore, the customer will be paid compounded interest at the rate of 7.5 – 1 = 6.5% for 18 months.
- Excess interest paid in this case will be recovered from the customer.

Note: Under Core banking environment calculations as mentioned above are done by computers.

(4) Auto renewal of Deposits

Many banks have introduced auto renewal of deposits to overcome the problem of late renewal of deposits and its attendant problems like interest for intervening period etc.

Under the scheme of auto renewal, a depositor will be given two options.

i. At the time of accepting the deposit itself option for automatic renewal of the term deposit receipts at the rate of interest prevailing on the date of maturity Or

   Option to await the customer's instruction for disposal of Maturity proceeds. Such instructions to be given one week before the date of maturity.

ii. Separate form is printed for accepting the Auto renewal instructions from the depositor.

iii. The bank branches can get the forms filled up for the existing depositors one week before the date of maturity and enter the details in the core banking system.

iv. In case getting the instructions from the depositor is not possible even then the receipts from the cut-off date would be Auto renewed.

v. While sending the maturity notices to existing depositors, they should be made aware of the process.

vi. Term Deposit products like NRE, NRO, FCNR, Tax Saver Term deposits etc. do not come under the purview of the Auto renewal process.

vii. Generally, all the Term Deposit receipts on which lien are marked would also be excluded from the Auto renewal process.

(5) Addition/Deletion of in the name of the Depositors

Addition/Deletion of a depositor is allowed in the deposit accounts provided all the existing account holder/s express their consent in writing to the Bank.

(6) Mode of Payment of Term deposit of Rs. 20,000 and over

Under the prevailing Income Tax laws, the limit for repaying the maturity proceeds of a term deposit **in cash** is

up to Rs.20,000.

If the maturity proceeds together with interest is Rs. 20,000 and over, it must be paid either by credit to the account the depositor/depositors concerned or by way of crossed pay order.

When the depositor/s has more than one term deposit maturing on the same or on different dates even though the amount individual deposits is less than Rs.20,000, whether mature on the same date or on different dates the aggregate of all such deposits should be taken in to consideration for this purpose.

(7) Death of a depositor

In case of a death of a depositor the same must be dealt with as per the survivorship instructions. In case of death of a sole depositor the balance in the account will be paid to the Nominee as per the claim settlement procedure spelt out by the Bank concerned.

(8) Dealing with "Stop payment of cheques"

Whenever Savings Bank, Current Account and Cash Credit account holders give "Stop payment Instructions" of the cheque/s issued by them the following precautions need to be observed by a bank:

- Before accepting the instruction, it is to be verified whether the authorised signatory has signed the instruction. If this is not, then it should be insisted for an authorized signatory's signed instruction.
- Banker must ensure that before they accept the instruction whether the cheque has already been passed. If the cheque has already been passed bank cannot accept the instruction.
- If the concerned cheque has not been passed already,it is to be verified whether the instruction contains the cheque number, the payee's name, date of the cheque, and the amount of the cheque. It is also needing to be ascertained the reason for stopping the payment of the cheque.
- If the instruction is otherwise satisfactory, an acknowledgement is given to the customer and then the stop payment instruction is entered in the proper field in the Core banking system pertaining to the account and must be authorized.
- If a cheque for which a "Stop payment" instruction has been received from a customer, is presented in clearing or across the counter, the same should be returned to the presenter.
- Before returning, the concerned cheque should be defaced with the words "Payment Stopped by the drawer" and then it should be returned with cheque returning/objection memo indicating the appropriate reason for return.
- Immediately the cheque returning charges should be debited to the customer's account.
- In case of joint accounts and Partnership firms any one of the joint account holders/partners can give the "Stop payment of Cheque" instruction.
- If the same must be revoked all the account holders/partners should jointly sign the revocation instruction.

(9) Deposits Maturing on a Holiday

As per the Master Circular of RBI RBI/2010-11/92 UBD.PCB. MC. No. 11 /13.01.000/ 2010-11 dated July 01, 2010 on Interest rates on Rupee Deposits, in respect of a term deposit maturing on a Sunday or Holiday the bank shall pay interest at the contracted rate till the next working day at the contracted rate –

- On the maturity value in case of reinvestment deposits and recurring deposits.
- On the original principal amount in case of ordinary term deposit (based on 365 days in a year).

(10) Coverage under Deposit Insurance and Credit Guarantee Corporation (DICGC)

Deposits held by customers such as savings, fixed, current, recurring, etc. are insured up to Rs. 1,00,000 per depositor for deposits held by them in the same capacity and in the same right at all the branches of the Bank taken together. The following deposits are not covered by DICGC:

(i) deposits of foreign governments

(ii) deposits of Central/ State Governments

(iii) deposits of State Land Development Banks with the State cooperative banks

(iv) inter-bank deposits

(v) deposits received outside India, and

(vi) deposit specifically exempted by the DICGC with the previous approval of the Reserve Bank. The premium for the insurance cover is borne by the Bank.

(11) Interest Rates on Deposits

Interest rates on Term Deposits are subject to periodical changes. The latest rates of interest as well as the maturity values based on the same are to be provided to customers. There should not be any mistake in quoting rates to the customers. Quoting wrong rates sometimes results in monetary loss to the Bank which should be avoided.

Scrutiny of loan applications/documents.

Types of borrowers & loan applications

Different customers of banks may approach a bank for loans for various needs. The borrowers can be

(a) Individuals/Self-Help groups/Joint Liability groups

(b) Sole proprietary firms

(c) Partnership firms

(d) Hindu Undivided Families

(e) LLPs

(f) Companies

(g) Statutory Corporations

(h) Trusts

(i) Co-operative Societies

As different laws are applicable to these types of borrowers, procedures evolved by banks in respect of these borrowers are also different. A detailed coverage regarding different types of credit facilities and types of borrowers are provided in Lesson 12.

Different types of loan applications/formats have been made available by banks depending upon the type of loans that are extended. For example, for Priority Sector loans there are different loans applications; for advances up to Rs. 2 lakhs and above Rs. 2 lakhs there are specific forms; for SME borrowers there is a specific form etc. However, what is important is to note is that proper loan application has to be given to the borrower to enable him to submit the same after it's due completion.

SCRUTINY OF LOAN APPLICATIONS/DOCUMENTS

This is known as pre-sanction procedure which is followed in all banks. There are various stages in the same and they are as follows:

Receipt of Loan applications & other formalities

In terms of BCSBI guidelines standardized loan applications are collected in respect of different borrowers. Most of the banks also provide check lists to help borrowers regarding documents to be submitted along with application in support of their loan proposals. The staff members of the bank also brief customers regarding requirements. Now-a-days these details are also provided in the website of respective banks along details of various schemes and down loadable application forms.

It has to be ensured that application forms submitted by borrowers are properly filled with the required details such as Name, age, father's/husband's name, present address, telephone/mobile contact numbers, email id, employer's name and id, salary details/business income/ annual profit, details of existing bank borrowings etc., details of security offered, guarantors details, etc. These details are to be obtained at the initial stage itself, so that these will be useful later, at the time of recovery. Signatures of the applicant along with those of guarantors are also to be obtained. These are to be verified with reference to documents submitted by the applicant. As KYC norms are also applicable to loan applications,required checks in that regard is also to be done. In the case industrial/business borrowers their business address, factory address/godown address/Administrative office address/Head office etc. are to be obtained.

Thirdly it must be ensured that the borrower submits all applicable information such as Salary particulars of borrower and Guarantors, Income Tax returns/Assessment order, quotation for assets to be purchased in case of consumer loans/car/estimates for house/demand letter for fees to be paid in case of education etc. In case of industrial/ business borrowers financial statements/cash flow/projected balance sheet/ quotations for machinery purchase/ stock purchase etc. are required to be submitted. In short it should be ensured that documents as specified by internal guidelines are required to be obtained.

Fourthly it must be ensured that the particulars entered in the loan application match with the data contained in the enclosures which are submitted along with the application form.

Verification/Scrutiny of application helps a bank to advise a customer to rectify any omission or commission. Also, it can help a bank to reject if it doesn't conform to the norms. Proper scrutiny of a loan application will reveal the eligibility of a borrower to avail the loan in terms of internal guidelines.

Also, a proper scrutiny will lead to proper evaluation of the proposal in terms of various directions of RBI including prudential exposure and risk management aspects. The required degree of scrutiny may vary depending upon the amount of loan applied for.

The following aspects will be considered for evaluating a proposal in terms technical feasibility, economic viability as well as commercial prudence.

1. Whether the activity proposed included under banned list or negative list as per policies of Government /RBI /banks (e.g. Financing Commercial real estate/oil extraction unit/Steel units etc.)
2. Will the quantum of finance exceed the exposure norms as prescribed by RBI?
3. Whether the borrower has relevant experience in managing similar activity? If not what other arrangements are made by him?
4. Back ground of promoters.
5. Performance of existing units/ Projected performance of the unit in comparison to peer units.
6. Technical feasibility aspects.

7. Inputs availability for sustained viability of the unit.
8. Financial analysis of the unit including promoters' stake in the unit.
9. Capacity of the unit to break even and generate profitability.
10. Guarantees, main and collateral securities offered.
11. Borrowers status in terms of credit report from credit rating agencies/other banks
12. History of conduct of the accounts with other banks.

Thus, a detailed scrutiny of a proposal will help a bank to arrive at a prudent credit decision. It will also enable the processing/sanctioning of proposal less time consuming.

Allowing drawals and accounting entries involved at various stages.

While sanctioning loans/advances for working capital to trading, manufacturing and other activities against stocks, book debts/receivables etc. banks fix the quantum of finance based on drawing powers fixed for the borrowers in cash credit accounts. Banks also fix up drawing powers in respect of certain securities like shares, selective credit control items. The drawing power fixed for a borrower indicates the maximum quantum of finance a borrower can avail during a stipulated period. In respect of trading concerns and manufacturing concerns the drawing power fixed for a customer may vary on a month to month basis due to the value of stocks held by the borrower. Also, in the case of shares too due to fluctuating market prices, the drawing power will undergo changes.

Let us understand the concept of drawal limit through the following examples:

Drawls in respect of Term Loans

In respect of term loan, the drawal limit is limited to the extent of finance sanctioned and availed indicates the drawing power. Subsequent payments made by the borrower will gradually reduce the finance availed. For example, if a trader is sanctioned Rs. 20 lacs loan on the security of properties worth Rs. 50 lacs and the loan is repayable in 5 years, at the end of the 1st year the outstanding will be Rs.16 lacs, at the end of 2nd year outstanding will be Rs. 12 lacs and so on. The outstanding indicates the drawing power utilized by the borrower.

Drawls in respect of Cash Credit accounts

In practice drawls in respect Cash Credit accounts are fixed based on the value of Securities, less the margin prescribed in respect of each security. However, the drawl in the cash credit account will be limited to the limit sanctioned or drawl fixed based on securities whichever is lower. The following example will illustrate the concept of drawls or Drawing Power as it is commonly known in banking.

Details	Example 1 (Against stocks only)	Example 2 (Against Stocks with Sundry Creditors)	Example 3 (Against Stocks, Book Debts with Sundry Creditors)
Sanctioned Limit (A)	50	50	50
Value of Stocks (B)	80	80	80
Less Sundry creditors (C)	0	30	30
Paid Stocks (D) =(B-C)	80	50	50
Less Margin for stocks - 25% of D (E)	20	12.5	12.5
DP for stocks (F)	60	37.5	37.5
Book Debts (G)	Nil	Nil	25

Margin for book debts – 40% of G (H)	Nil	Nil	10
D P for book debts (I)	Nil	Nil	15
Total D P (F+I)	50**	37.5	50**
** Though total DP comes to 60, it cannot Exceed 50 which is the sanctioned limit.			** Though total DP comes to 52.5, it cannot Exceed 50 which is the sanctioned limit.

ACCOUNTING ENTRIES INVOLVED IN VARIOUS STAGES OF A LOAN

Term loans are usually disbursed in one or more instalments depending upon the sanction terms or need of a borrower. For example, in case if a term loan for house construction loan may be released in instalments as and when various stages of construction is completed. In respect of education loans loan may be released in one or two or three instalments as per demand from an educational institution on the student.

i. At the time of release of loan generally the following entries are passed: (Example of a housing loan where the house is under construction)

   Debit: Loan Account of the borrower

   Credit: DD issued in favour of the builder (for direct payment to the builder)

ii. At the time of debiting interest amount to the loan

   Debit: Loan account of the customer

   Credit: P& L Account –Interest on Loans

iii. At the time of repayment of interest & instalment amount by the borrower

   Debit: Borrower's Savings Bank account (Amount of instalment+ interest)

   Credit: Loan account of the borrower (Amount of instalment+ interest)

iv. At the time of debiting service charges to the customer account

   Debit: Customer's loan account

   Credit: P&L account – Income head: Service charges

   The service charge debited to the borrower's account, should be recovered by the following debit to the borrower's account:

   Debit: Borrower's Savings Bank account

   Credit: Customer's loan account.

v. At the time of paying/renewing insurance policy on the house

   Debit: Customer's loan account

   Credit: DD Issued account or NEFT account in favour of Insurance Company

Simultaneously **Debit:** Borrower's Savings Bank account

Credit: Customer's loan account

[*Sometimes in respect of examples iv and v to reduce the accounting entries the accounting is done by* ***Debit:*** *Borrower's SB account and* ***Credit:*** *Income head & Debit: SB account of the borrower and DD issued or NEFT account respectively*.]

Note: *Now-a-days under the core banking in the case of Equated Monthly Instalment paid by a customer from every instalment some portion of the repayment will be adjusted towards interest and the balance towards principal amount. In initial stages the proportion of credit towards the interest will be higher and towards the end of repayment period, the credit towards the principal will be higher. Interest calculations are done through the software used by the respective banks. The example given above illustrates the manual system of passing entries, for proper understanding.*

OPERATIONAL ASPECTS OF CBS ENVIRONMENT

Introduction

CBS stands for Core Banking Solutions. It signifies, a banking process where a customer's transactions are done in a centralized manner through the data stored in a central computer server in a bank. The centralized data is made use by branches which are net worked together for handling customer's transactions across various geographical locations. CBS is one of the shining examples of Technology and Communication coming together in one platform.

CBS is the advanced stage of computerization of banks, which commenced during late 1980s in India. The Narasimham Committee also recommended computerization of banks in its report for efficient customer service and proper housekeeping of banks. CBS operations are carried out though tailor made software provided by specialized software companies. Depending upon the size and uses by banks, the software varies.

Need for CBS

The need for CBS arose in view of several adverse factors noticed in customer service provided by banks due to manual processing of transactions. Inordinate delays in processing transactions, pass book updation, poor housekeeping, revenue leaks, delays in MIS generation etc. were responsible for introduction of CBS.

Essential Requirements for CBS

The following are the essential frame work needed for CBS namely Central Data Centre, Disaster recovery sites, Business process re-engineering, Software, Networking and trained personnel.

1. Central Data Centre ('CDC'): This houses the Central server for the entire bank that facilitates online transactions. All delivery channels are linked to this centre which provides 24x7availability of data for processing. It should be operational throughout the year for a smooth functioning of the bank. Powerful equipment of enough storage capacity forms the main hardware in these sites.
2. Disaster Recovery Sites: Every computer site is prone to failure due to technical reasons. To avoid any such disruptions in centralized data centre, as a risk management measure, most of the banks maintain a back-up system of servers which will ensure non-stop availability of data for processing transactions as well as managing various delivery channels.
3. Business process re-engineering: This is to realign the existing business process in an organization in the light of introduction of new technologies. In the banking sector most of the banking transactions were done manually/partly through computers before the introduction of CBS. Therefore, to reap the full benefit of the introduction of CBS, existing business practices were modified through business process re-engineering. Several leading companies specialized in business process re-engineering were involved in bringing about the desired changes in banks in this regard.
4. Software: CBS software consists of branch modules in respect of various functions, modules for various associated delivery channels such as ATM, tele-banking, internet banking and other inter-face software for connecting to RTGS, NEFT, CTS and other payment gateways.
5. Networking: Networking of branches to the central server as per standard specifications through Wider

Area Network is required with backup network such as Integrated Services Digital Network (ISDN). "ISDN is an internationally accepted communication standards for simultaneous digital transmission of voice, video, data, and other network services over the traditional circuits of the public switched telephone network."

6. Trained personnel: Skilled and trained manpower is a pre-requisite for implementation and maintenance of uninterrupted CBS.

Reserve Bank of India has been encouraging all banks to switch over to CBS in the interests of Customer service, proper housekeeping, timely reconciliation and balancing and tallying of books of account, preparation of MIS, submission of returns etc. Due to variety of benefits accruing to the banks, large number of banks in India have successfully implemented CBS.

Uses of CBS to Banks

CBS is useful to banks in the following functional activities:

i. Opening of accounts
ii. Recording/handling of routine Transactions even from remote branches
iii. Interest calculations on all products
iv. Pass book updation/Statements of Accounts generation
v. Cash deposits and withdrawals
vi. Clearing and Money transfers
vii. Managing accounts of various types
viii. Generation of Statements for Reporting and Management Information System
ix. Customer Relationship Management

CBS is seamlessly linked to both onsite and offsite ATMs facilitating cash withdrawals, Fund transfers, Cheque book requisitions, mobile banking/internet banking. This feature enables customer convenience of doing transaction at their will. As CBS is also linked to CTS, clearing of cheques is also speeded up. CBS helps better housekeeping and plugs income leaks. Similarly, execution of standing instructions is done promptly. Intra-bank operationson behalf of customers also become easy. Payments like Utility bill payments, tax payments etc. can be conveniently done by customers. Thus, there are several advantages flow to customers and banks.

Transactions flow in CBS

Transactions flow in CBS begins with login to the system by staff members of banks. For this purpose, each staff member is allotted a user id and the concerned staff member must create his own password. While logging in to the system every staff member must use his/her login id and password. Always staff members must maintain confidentiality of their passwords.

Once a transaction is entered by a staff member it is filtered through maker-checker protocol in the system. When a transaction is initiated at a lower level (clerical/teller) the same needs to be authorized by a senior supervisory level official, if the transaction exceeds the authority level fixed for such lower level staff. Once the transaction passes through the system, the transaction will be validated by the system. The user (i.e. the staff) will receive an indication whether the transaction is complete or not. While validating the transaction the system will analyse the account number, authority level of staff who puts through the transaction, authority level of supervisory official who authorizes the transaction and other points of validations as per set parameters as applicable to the respective transaction.

The process of accounting through the CBS

There are different levels of software in the CBS that are involved while accounting a transaction. One level of software takes care of transactions and another level takes care of postings of entries in the general ledger. There is a connecting inter-face between these two levels.

While accounting a transaction in the CBS entries are passed through an intermediary stage known as balancing account(also known as 'temporary parking account'). The following example illustrates the same:

Let us assume that Mr. K has given a cheque for Rs. 1,00,000 towards a term Deposit account in his name. The entries through the system will be:

Debit: Mr. K's Saving Bank Account Rs. 1,00,000

Credit: Balancing Account Rs. 1,00,000

Simultaneously the following entries will also be done in the system

Debit: Balancing Account: Rs. 1,00,000

Credit: Term deposit Account of Mr. K: Rs.1,00,000.

Similarly, in respect of transactions where a single debit results in,multiple credit and vice versa known as Batch transactions the following accounting entries will be generated.

Let us say a company gives a single cheque of Rs. 2,00,000 with a request to credit a sum of Rs. 20,000 being a lumpsum payment to 10 different staff members' SB accounts maintained with the branch.

Debit: Current Account of the Company: Rs. 2,00,000

Credit: Balancing account Rs. 2,00,000

Debit: Balancing Account: Rs. 2,00,000

Credit: Individual SB Account of 10 staff members (each Rs. 20,000): Rs. 2,00,000

Other routine operational aspects under CBS

Startup activities: A day start up activity should be done by the Data Base Administrator (DBA). Usually in every branch, a senior officer is designated as a DBA. In small branches the branch head himself may perform this function. Every day after the startup an entry should be made in the log book or register should be signed to indicate as to who has initiated the day start up. Startup activities should be performed at the commencement of business hours. Before doing so, security checks (including check sum verification)as per internal guidelines should be carried out. Along with these verifications of banking date is also to be done.

Begin of Day operations: Every day a branch commences its work with 'Begin of the day' (BOD) first. Only after this is performed the staff members will be able to login with their individual id and passwords to put through other transactions.

End of the Day operations at branches: Like BOD transaction every branch will have to do the End of Day (EOD) process to complete the day end routines. Back up of the day's transactions is taken during the EOD and statements are also generated. Once EOD is done staff members will not be able to access the transactions modules, but they may be able to access enquiry modules.

Operational aspects of Day end activities at branches

Every branch must carry out the following day end activities through their designated DBA or branch head as the case may be:

i. Checking of supplementary activities and deletion of special users.

ii. Minimum balance calculated.

iii. Products calculated for debit balances in current account.

iv. Generation of mandatory reports as per internal guidelines.

v. Taking up of Day end back-up and recording the same in the register meant for that purpose. These are to be stored securely as per procedure recommended in internal guidelines.

vi. Activation of fall back procedures.

vii. Log book updation. (Recordings).

viii. Filing reports in their respective files.

ix. Shut down of the system and locking of server room.

During the day end the following reports namely Access log, Supplementary, Audit trail, Transaction number report for each transaction entered are also be generated.

EOD at CDC

Also, at the CDC there will also be EOD operation usually late in the night,say around 10 or 11 p.m. By doing EOD at CDC, branches will be cut-off from the main host server at the CDC so that branches do not do any transaction after the EOD commences. Back up is also taken at CDC in which the entire data of the bank is stored at CDC level. During back up process all data gets updated and posted. Reports are also generated during the EOD process. After the EOD process a separate Start of the Day process is also done at CDC so that branches will be able to have access the CDC server. ATM transactions and other such transactions that have taken place during the EOD run gets recorded once the Start of the Day process commences. EOD and SOD at CDC covers the entire branch network across the bank.

Operational aspects of Controls in CBS

1. Password controls: As access to computerized banking is only through pass words, staff members should ensure the following:

   (a) Maintain the secrecy of their individual pass words. This applies to all levels of staff members. Several frauds have taken place due to the disclosure of pass words or not changing of pass words.

   (b) Pass words for certain critical and sensitive operations such as access to Master Data, access to operating system, taking of back-up, disk space creation etc. should be confined only to the Head of the branch or DBA.

   (c) The operating system pass words should be held under joint control of the Head of the branch and other designated official. It should be held in sealed cover and to be opened only in the presence of two officials. Immediately it should be changed, and the new pass word should be held in joint custody.

   (d) Pass word register is to be maintained for recording and updation.

2. Transaction controls: Transaction controls are maintained at the data base level and every branch must ensure the following:

   (a) Date must be authorized by the Head of the branch or the DBA.

   (b) Software control accepts only the current date and rejects any back date or future dated

transactions.

(c) In case of unused work stations, they are to be logged off. Work stations which are manned, only to be connected to the network.

(d) Every software problem is entered in the register meant for that purpose and follow-up action is taken.

(e) Printing of special batch reports, their checking and filing of the same appropriately.

3. Personnel control: Branch must maintain the following controls in respect of staff who are involved in the operations under CBS.

   (a) Clear allotment of work and proper segregation of duties.

   (b) Rotation of duties at regular intervals.

   (c) Ensuring authorization limits are defined for various level of staff and documented.

   (d) Ensuring deletion of pass words of transferred/retired employees. Also ensure that no access is given to employees who are facing suspension/disciplinary action.

4. Logical access control: Logical access control deals with safety of CBS assets, maintaining of data integrity etc. To ensure logical access control the following need to be ensured:

   (a) Staff should be given access levels on need only basis that too to specific menus/files that relate to their work, and servers.

   (b) File maintenance access should be restricted to limited number of staff with proper approval and periodical review.

   (c) Encryption of Pass word files in the system for restricting the access.

   (d) Security violation alerts should be given immediate attention.

   (e) Access to work stations are restricted after working hours.

   (f) Access to sever/modem is to be restricted and controlled.

5. Security control: The following need to be ensured for a proper security control aspect under CBS environment.

   (a) In case of power failure or mechanical failures the system restarts with proper completion of entries and records.

   (b) Anti-virus of latest version is in place in branches/servers.

   (c) Periodical release of security patches by software vendors are applied to the systems.

   (d) Back-ups are properly taken and stored including that of off-site stored back-ups.

   (e) Unauthorized amendments are not accepted by the system.

   (f) Authenticate changes made in parameters and user levels are authorised.

   (g) Ensure all modules are implemented.

   (h) Exceptional transaction reports are generated and verified on a day to day basis.

   (i) All GL codes authorised by controlling office/HO exist in the system.

   (j) Important Pass Words are kept in a sealed cover with the Manager /Branch Head so that in case of need/absence of staff it can be used.

Responsibilities of Banks under CBS

In these days of information technology, banks are increasingly becoming vulnerable to cyber-attacks and electronic frauds such as hacking, ransomware attacks and other malicious activities. Therefore,there is an imperative need for banks to have proper counter threat mechanisms to thwart, arrest and minimize such attacks. RBI has issued specific guidelines in this behalf in the year 2011 after the acceptance of the report by G. Goplakrishna Committee. Also, in the year 2013 RBI has additionally issued guidelines on the topic. Subsequently in the year 2016 through its circular Ref. No: DBS.CO/CSITE/BC.11/33.01.001/2015-16 dated June 2, 2016 advised banks about Cyber Security Frame work to be put in place. A gist of the above are as follows:

1. All banks should have their Board of Directors approved Information Technology Policy including the structure, environment of the concerned bank's IT system. The policy should be updated in the light of developments that take place from time to time.
2. Banks also should have a separate Information Security Policy through which they can identify and implement appropriate information security management measures/practices keeping in view their business needs. The policies need to be supported with relevant standards, guidelines and procedures.
3. Senior management should ensure the implementation of a safe IT Operation environment. Policies and procedures defined as a part of IT Operations should support bank's goals and objectives, as well as statutory requirements.
4. Board and senior management have the responsibility for an effective governance mechanism and risk management process for all outsourced operations.
5. All banks to have an effective Information System Audit that include
   a. Determining effectiveness of planning and oversight of IT activities.
   b. Evaluating adequacy of operating processes and internal controls.
   c. Determining adequacy of enterprise-wide compliance efforts, related to IT policies and internal control procedures.
   d. Identifying areas with deficient internal controls, recommend corrective action to address deficiencies and follow-up, to ensure that the management effectively implements the required actions.
6. Various IT related frauds need to be included in the fraud reporting system and banks should take adequate steps to mitigate such risks.
7. Banks should also frame policies, standards and procedures to ensure continuity, resumption and recovery of critical business processes, at an agreed level and limit the impact of the disaster on people, processes and infrastructure (includes IT); or to minimise the operational, financial, legal, reputational and other material consequences arising from such a disaster. There should also be clearly spelt out plans of Disaster recovery and business continuity.
8. There needs to be commitment from the Board of Directors/Senior Management towards the process of consumer education initiatives by providing adequate resources, evaluating the effectiveness of the process and fine-tuning and improving customer education measures on an ongoing process.
9. The Risk Management Committee at the Board-level needs to put in place, the processes to ensure that legal risks arising from cyber laws are identified and addressed. It also needs to ensure that the concerned functions are adequately staffed and that the human resources are trained to carry out the relevant tasks in this regard.

10. Banks to have operational Risk Group and this group needs to incorporate legal risks as part of operational risk framework and take steps to mitigate the risks involved in consultation with its legal functions within the bank. Also, the legal department /functionaries within the bank needs to advise the business groups on the legal issues arising out of use of Information Technology with respect to the legal risk identified and referred to it by the Operational Risk Group.

11. To address the need for the entire bank to contribute to a cyber-safe environment, the Cyber Security Policy should be framed by banks. It should be distinct and separate from the broader IT policy / Information Security policy so that it can highlight risks from cyber threats and measures to address / mitigate these risks.

12. While identifying and assessing the inherent risks, banks are required to reckon the technologies adopted, alignment with business and regulatory requirements, connections established, delivery channels, online / mobile products, technology services, organisational culture, internal & external threats.

13. Depending on the level of inherent risks, banks are required to identify their riskiness as low, moderate, high and very high or adopt any other similar categorisation.

14. Riskiness of the business component also may be factored into while assessing inherent risks.

15. While evaluating the controls, Board oversight, policies, processes, cyber risk management architecture including experienced and qualified resources, training and culture, threat intelligence gathering arrangements, monitoring and analysing the threat intelligence received vis-à-vis the situation obtaining in banks, information sharing arrangements (among peer banks, with IDRBT/RBI/CERT-In), preventive, detective and corrective cyber security controls, vendor management and incident management & response are to be outlined.

16. Testing for vulnerabilities at reasonable intervals of time is very important. The nature of cyber-attacks is such that they can occur at any time and in a manner that may not have been anticipated.

17. Hence, it is mandated that every bank to set up a Security Operations Centre to ensure continuous surveillance and keeps itself regularly updated on the latest nature of emerging cyber threats.

18. Banks depend on technology in providing cutting-edge digital products to their customers and in the process collect various personal and sensitive information. They as owners of such data, should take appropriate steps in preserving the Confidentiality, integrity and availability of the same, irrespective of whether the data is stored/in transit within themselves or with customers or with third party vendors; the confidentiality of such custodial information should not be compromised in any situation and therefore suitable systems and processes across the data/information lifecycle need to be put in place by banks.

19. Every bank should have a Cyber Crisis Management Plan (CCMP) and it should be a part of the overall Board approved strategy.

20. As cyber-risk is different from many other risks, the traditional Business Continuity Plan /Disaster Recovery arrangements may not be adequate and hence needs special attention keeping in view the nuances of the cyber-risk.

21. In India, CERT-IN (Computer Emergency Response Team – India, a Government entity) provides proactive and reactive services as well as guidelines, threat intelligence and assessment of preparedness of various agencies across the sectors, including the financial sector.

22. CERT-IN also has come out with National Cyber Crisis Management Plan and Cyber Security Assessment Framework. CERT-In/NCIIPC/RBI/IDRBT guidance may be referred to by banks while formulating the CCMP which should address the following four aspects:

(i) Detection

(ii) Response

(iii) Recovery and

(iv) Containment.

23. Banks are expected to be well prepared to face emerging cyber-threats such as 'zero-day' attacks, remote access threats, and targeted attacks. Also, banks should take necessary preventive and corrective measures in addressing various types of cyber threats including, but not limited to, denial of service, distributed denial of services (DDoS), ransom-ware / crypto ware, destructive malware, business email frauds including spam, email phishing, spear phishing, whaling, vishing frauds, drive-by downloads, browser gateway fraud, ghost administrator exploits, identity frauds, memory update frauds, password related frauds, etc.

Sharing of information on cyber-security incidents with RBI

(i) RBI has observed that banks are hesitant to share cyber-incidents faced by them. However, the experience indicates that collaboration among entities in sharing the cyber-incidents and the best practices would facilitate timely measures in containing cyber-risks.

(ii) Banks need to report all unusual cyber-security incidents (whether they were successful or were attempts which did not fructify) to the RBI. Banks are also encouraged to actively participate in the activities of their Chief Information Security Officers' Forum coordinated by Institute for Development and Research in Banking Technology (IDRBT) and promptly report incidents to Indian Banks – Center for Analysis of Risks and Threats (IB-CART) set up by IDRBT.

BACK OFFICE OPERATIONS IN BANKS

In financial services institutions such as Banks, depending on functionalities, an office can be divided in to Front office, mid office and back office. Front offices are those offices consist of client-facing staff members on a day to day basis. In this case, typically, an operating branch. Mid offices consistof staff who look after risk management, research, compliance and follow-up departments, as well as technology centres. Back offices consist of Centralised Processing Centres such as Clearing, KYC Verification and account opening, Cheque book issue, Demat transaction processing, Processing of Retail and other Loans such as MSME, Data processing, Reconciliation, Treasury and forex operations, etc.

The following broadly cover specific functions of some of the back offices in a bank:

i. Deposit related: Reminder generation in respect of maturing deposits, posting of service charges, interest calculation, obtaining confirmations etc. KYC scrutiny and centralised opening of accounts, handling of customer complaints etc.

ii. Loans related: Loan origination management, servicing of loans, follow-up, recoveries (collections), Calculation of interest and EMIs, posting various entries relating to various charges, interest, penal interest etc.

iii. Compliance: Various report generations for internal and external users, Implementation of customer grievance decisions.

iv. Accounting: Maintenance of GL and other books of accounts, preparation of financial statements, reconciliation of various accounts and follow-up of pending items.

v. Demat: Settling transactions.

vi. Digital banking: Handling/Trouble shooting/Resolving issues relating to internet banking, mobile

banking, ATMs, Other smart card related operations including PINS, Pass words etc.

HANDLING OF UN-RECONCILED ENTRIES IN BANKS

Banks while doing their business have to carry out reconciliation of the following:

i. Reconciliation of inter branch entries in respect of various transactions.

In every bank, daily, a lot of inter-branch transactions are done in which one leg of a transaction is done in one branch and other leg of the transaction is done in another branch which is involved in the transaction. Usually such transactions are done through a routing account known as Inter-branch account (Also known as HO account in some banks.

Let us see an example in this regard. A Demand Draft is issued by a branch in Mumbai on behalf its customer 'A' in favour of another customer 'B' at Delhi. The Mumbai branch will issue the DD on its own service branch at Delhi. For this transaction, Mumbai branch will debit its customer's account for DD and crediting the amount of DD to Inter-branch Account. At the time of payment at Delhi Service branch, (after due verification of DD) it will debit Inter-branch account with the amount of DDand crediting the amount of DD to 'B's account. From the point of reconciliation, after the payment of the said DD, there won't be any pending item relating to this transaction in the inter-branch account. This is how reconciliation is done in respect of such transactions. Since there could be many transactions, reconciliation would be done at a centralized back office.

However as per RBI's study the major problem before computerization was noticed in reconciliation of pending entries in intra-branch entries pertaining to Other assets/Sundry Assets and Suspense accounts.

Suspense account is a parking account for a temporary period in respect of those transactions where particulars of transaction are incomplete or absent. After the full information are available the relevant credit entry to this account is reversed and credited to the proper account. Similarly, when interest/ dividend etc. are paid by debit to suspense account on behalf a company pending adjustments with the branch where the main account of the company is held. Upon payment by the company of the total of such amounts, the amount is credited to suspense account. The suspense account would be nullified by proper credit from the company concerned towards such interest/dividend payments. If reconciliation is done it will be known as to how many such items in suspense are outstanding and remedial action could be taken to resolve them. Otherwise large number of pending entries (especially credit entries) in Suspense account may give rise to frauds through siphoning of funds. Similarly pending debit entries also need to be reconciled to avoid any fraudulent debits with intent to siphon-off funds. Hence reconciliation must be done in these accounts. Similar is the case of Sundry Deposits account.

ii. Reconciliation of accounts maintained with other banks including RBI.

Every bank maintains a Current Account with RBI through which reserve maintenance, clearing adjustments, payment adjustments such as RTGS/NEFT/ECS etc. repo/reverse repo transactions and other adjustments are done. Banks must always keep this account properly funded to meet any contingencies. For this purpose, banks reconcile the balances in this account against payables with the help of statement of account obtained from RBI daily and accordingly fund this account. Due to computerization of banks and RBI, the account statement is downloaded electronically and reconciled. Similar type of reconciliation is done when securities are sold or bought with Subsidiary General Ledger account maintained by RBI. Also, banks are mandated to reconcile their investment account balances with Public Debt Office of RBI every quarter/month depending upon the volume of transactions.

In addition to the above banks in different locations (other than metros/State Capitals) maintain their bank account with other banks for the purposes of receivable/payable in respect of clearing adjustments/

collections/cash management etc. These accounts are operated by the respective branch officials at these locations. As a standard procedure these accounts are to be reconciled keeping in mind no items of P& L nature, collections, clearing remain pending. Due to computerization of banks status of accounts can be ascertained online and reconciliation is done so that proper balance is maintained in these accounts to meet any commitment or deploy any excess funds in these accounts for revenue generation.

iii. Reconciliation of accounts with Correspondent banks in India/abroad.

When a bank conducts a foreign exchange transaction, Nostro accounts are involved. Nostro accounts are those accounts maintained by banks from India in an overseas country in the local currency. When transactions pertaining to credit/ receivable to India result in the credit to this account and similarly when payments are to be made to overseas entities debits are made to this account. When banks receive intimation of credit in their Nostro account they trace out the relevant transaction and pass on the credit to the concerned beneficiary in India. Similarly, when payments are to be made they will pass on instructions to the correspondent bank which maintains the account to effect payments by debiting this account. Hence these accounts are reconciled on a day to basis for credits and pending items and accordingly action is taken.

iv. Reconciliation of transactions with third party service providers and sub-contractors.(For example,ATM management services)

With proliferation of ATMs across India (It is more than 2,00,000 ATMs across India as on date!) banks employ third parties/vendors for loading cash as well as collecting cash deposited by account holders in ATMs. To avoid any fraud in this respect banks monitor activities centrally in respect of ATMs. Monitoring also involves reconciling of cash loading and collection transactions and balances held at ATMs.

v. Reconciliation of transactions with other intermediaries: The rapid spread of electronic payment mechanisms through Point of Sale, Internet, e-Commerce portals, mobile commerce portals etc. involve Merchants. Such payments made by users are done through certain intermediary agencies such as Payment gateways, Aggregators etc. In the case of e-Commerce and Mobile commerce transactions, these are supported by platforms provided by third party intermediaries. For example – Paytm.

In the cycle of transactions when payments are made by users of theseservices, first it is credited to the account of the intermediary. Thereafter it is forwarded to the credit of concerned merchants. Any delay in the transmission of payments made by users to the merchants will make the users lose the confidence in the payment system as well as bring in suspicion on traders and intermediaries. Hence banks have to ensure that payments made by users are properly reconciled by intermediaries receiving these payments and also ensure such payments are also passed on to Merchants.

Annexure-I

Nomination Facility

The nomination facility is intended to facilitate expeditious settlement of claims in the accounts of deceased depositors and to minimise hardship caused to the family members on the death of the depositors.

Provisions in the B R Act 1949

The B R Act 1949 was amended by Banking Laws (Amendment) Act, 1983 by introducing new Sections 45ZA to 45ZF, to enable a banking company to:

a. make payment to the nominee of a deceased depositor, the amount standing to the credit of the depositor.

b. return articles left by a deceased person in its safe custody to his nominee, after making an inventory of the articles in the manner directed by RBI.

c. release contents of a safety locker to the nominee of the hirer of such locker, in the event of the death of the hirer, after making an inventory of the contents of the safety locker in the manner directed by RBI.

The Banking Companies (Nomination) Rules, 1985

For making nomination in a prescribed manner the Government of India in consultation with the RBI framed, The Banking Companies (Nomination) Rules, 1985. These Rules, along with new Sections 45ZA to 45ZF of the B R Act, 1949 regarding nomination facilities were brought into force with effect from 1985.

Nomination Rules, 1985 were framed for providing:

i. Nomination Forms for deposit accounts, articles kept in safe custody and contents of safety lockers.

ii. Forms for cancellation and variation of the nominations.

iii. Registration of Nominations and cancellation and variation of nominations, and

iv. matters related to the above.

Forms to be used under Nomination Rules

The nomination can be made, cancelled or varied in the prescribed form as follows:

Facility	Deposit Account	Safe Custody	Safety Locker (Sole Hirer)
Nomination	DA1	SC 1	SL 1
Cancellation	DA2	SC 2	SL 2
Variation	DA3	SC 3	SL 3

Nomination facilities in respect of safe deposit locker / safe custody articles

Sections 45ZC to 45ZF of the Banking Regulation Act, 1949 provide for nomination and release of contents of safety lockers / safe custody article to the nominee and protection against notice of claims of other persons. Banks are guided by the provisions of Sections 45 ZC to 45 ZF of the Banking Regulation Act, 1949 and the Banking Companies (Nomination) Rules, 1985 and the relevant provisions of Indian Contract Act and Indian Succession Act.

In the matter of returning articles left in safe custody by the deceased depositor to the nominee or allowing the nominee/s to have access to the locker and permitting him/them to remove the contents of the locker, the Reserve Bank of India, in pursuance of Sections 45ZC (3) and 45ZE (4) of the Banking Regulation Act, 1949 has specified the formats for the purpose.

In order to ensure that the amount of deposits, articles left in safe custody and contents of lockers are returned to the genuine nominee, as also to verify the proof of death, banks have devised their own claim formats and follow the procedure, as suggested by the Indian Banks' Association for the purpose.

Nomination Facility – Sole Proprietary Concern

Banks extend the nomination facility also in respect of deposits held in the name of a sole proprietary concern.

Nomination Facility in Single Deposit Accounts

As per Allahabad High Court direction "the Reserve Bank of India issue guidelines to the effect that no Savings

Account or Fixed Deposit in single name be accepted unless name of the nominee is given by the depositors. It will go a long way to serve the purpose of the innocent widows and children, who are dragged on long drawn proceedings in the Court for claiming the amount, which lawfully belongs to them".

Therefore, banks generally insist that the person opening a deposit account make a nomination. In case the person opening an account declines to fill in nomination, the bank explains advantages of nomination and asks him to give a specific letter to the effect that he does not want to make a nomination. In case the person opening the account declines to give such a letter, the bank records the fact on the account opening form and proceed with opening of the account if otherwise found eligible. Banks cannot refuse to open an account merely because that the person opening the account refused to nominate.

Acknowledgement of Nomination & Registering the nomination

In terms of Nomination Rules 2 (9), 3 (8) and 4 (9) applicable to Banking Companies they acknowledge in writing to the depositor(s) / locker hirers (s) the filing of the relevant duly completed Form of nomination, cancellation and / or variation of the nomination. Such acknowledgement is given to all the customers irrespective of whether the same is demanded by the customers or not.

In terms of Nomination Rules 2 (10), 3 (9) and 4 (10) banks are required to register in their books the nomination, cancellation and / or variation of the nomination. The banks should accordingly act to register nominations or changes therein, if any, made by their depositor(s) / hirers.

Incorporation of the legend "Nomination Registered" in pass book, deposit receipt etc. and indicating the Name of the Nominee in Pass Books / Fixed Deposit Receipts

When an account holder has opted for the nomination facility, it has to be indicated on the passbook so that, in case of death of the account holder, his relatives can take suitable action with the bank. This practice holds good for term deposit receipts too. Also, if a customer agrees, banks can indicate the name of the Nominee in the Pass Books / Statement of Accounts / FDRs.

Separate nomination for savings bank account and pension account

As Banking Companies (Nomination) Rules, 1985 are distinct from the Arrears of Pension (Nomination) Rules, 1983 a separate nomination is necessary in terms of the Banking Companies (Nomination) Rules, 1985 in case a pensioner desires to avail of nomination facility.

Nomination facility in respect of deposits

i. Nomination facility can be availed by individuals including a sole proprietary concern.

ii. Nomination can be made only in favour of individuals. As such, a nominee cannot be an association, trust, society or any other organisation or any office-bearer thereof in his official capacity. Due to this any nomination other than in favour of an individual will not be valid.

iii. There cannot be more than one nominee in respect of a joint deposit account at any time.

iv. Banks allow variation/cancellation of an existing nomination by all the surviving depositor(s) acting together. This is also applicable to deposits having operating instructions "either or survivor".

v. In the case of a joint deposit account the nominee's right arises only after the death of all the depositors.

vi. Witness in Nomination Forms: Under Nomination Rules, in various Forms prescribed, only the thumb-impression(s) of illiterate customers are to be attested by two witnesses. Signatures of the account holders need not be attested by witnesses.

vii. Nomination in case of Joint Deposit Accounts: Nomination facility is available for joint deposit accounts

also. Banks are, to ensure that their branches offer nomination facility to all deposit accounts including joint accounts opened by the customers.

Nomination in Safe Deposit Lockers / Safe Custody Articles

(i) Nomination facilities are available only in the case of individual depositors and not in respect of persons jointly depositing articles for safe custody.

(ii) Section 45ZE of the B RAct, 1949 a minor can be a nominee for obtaining delivery of the contents of a locker. However, banks must ensure that when the contents of a locker were sought to be removed on behalf of the minor nominee, articles arehanded over to a person who, in law (i.e. a guardian), is competent to receive the articles on behalf of the minor.

(iii) In respect of lockers hired jointly, on the death of any one of the joint hirers, the contents of the locker are only allowed to be removed jointly by the nominees and the survivor(s) after an inventory was taken in the prescribed manner. In such a case, after such removal preceded by an inventory, the nominee and surviving hirer(s) may keep the entire contents with the same bank, if they so desire, by entering into a fresh contract of hiring a locker.

Settlement of claims in respect of deceased depositors – Simplification of

Accounts with survivor/nominee clause

If a depositor/s had made a valid nomination or where the account was opened with the survivorship clause (“either or survivor”, or “anyone or survivor”, or “former or survivor” or “latter or survivor”), the payment of the balance in the deposit account to the survivor(s)/nominee of a deceased deposit account holder represents a valid discharge of the bank’s liability provided:

a. the bank has established with proper care and diligence, the identity of the survivor(s) / nominee and the fact of death of the account holder, through applicable documentary evidence;

b. there is no injunction or restraining order from any competent court on the bank from making the payment from the account of the deceased; and

c. it has been made clear to the survivor(s) / nominee that he would be receiving the payment from the bank as a trustee of the legal heirs of the deceased depositor, i.e., such payment to him shall not affect the right or claim which any person may have against the survivor(s) / nominee to whom the payment is made.

d. If payment made to the survivor(s) / nominee, based on the foregoing conditions, it would be deemed as a full discharge of the bank’s liability.

e. Any further demand on production of legal representation is superfluous and will be viewed as inconvenience to the survivor(s) / nominee. This would be viewed seriously by RBI. Therefore, banks should not demand production of succession certificate, letter of administration or probate, etc., or obtain any bond of indemnity or surety from the survivor(s)/nominee, irrespective of the amount standing to the credit of the deceased account holder.

Accounts without the survivor / nominee clause

If a deceased depositor had not made any nomination or for the accounts other than those styled as “either or survivor” (such as single or jointly operated accounts), banks are required to adopt a simplified procedure for repayment to legal heir(s) of the depositor and within their risk management framework fix a minimum threshold limit, for the balance in the account of the deceased depositors, up to which claims in respect of the deceased depositors could be settled without insisting on production of any other documentation except a letter of indemnity.

Premature Termination of term deposit accounts

In the case of term deposits, banks are required to include a clause in the account opening form itself to the effect that in the event of the death of the depositor, premature termination of term deposits would be allowed. Terms and conditions in such cases should also be specified in the account opening form. No penalty will be applicable on such premature withdrawals.

Treatment of flows in the name of the deceased depositor

If banks receive credits in the name of the deceased depositors after their death, banks should adopt any one of the following methods to avoid hardship to the survivor(s) / nominee of a deposit account.:

i. The bank can obtain an authorization from the survivor(s) / nominee of a deceased account holder to open an account styled as 'Estate of Shri/Smt. _____, the Deceased' where all the pipeline flows in the name of the deceased account holder could be allowed to be credited. However, no withdrawals will be permitted till final settlement.

   OR

ii. The bank can obtain an authorization to return the pipeline flows to the remitter with the remark "Account holder deceased". The survivor(s) / nominee / legal heir(s) could then approach the remitter to settle such payments in the name of the appropriate beneficiary.

Interest payable on the deposit account of deceased depositor

In the case of a term deposit standing in the name/s of

i. a deceased individual depositor, or

ii. two or more joint depositors, where one of the depositors has died,

for payment of interest on matured deposits in such cases should be based on the Board of Directors approved policy of the respective banks which should be disclosed to depositors.

In case of a deceased individual depositor/sole proprietorship concern, interest should be paid only from 1st May 1983, or from the date of death of the depositor, whichever is later, till the date of repayment to the claimant/s at the rate of interest applicable to savings deposit as on the date of payment.

Time limit for settlement of claims

Banks should settle the claims in favour of survivors/nominees in respect of deceased depositors and release payments within a period not exceeding 15 days from the date of receipt of the claim. This is however subject to the production of proof of death of the depositor and suitable identification of the claimants to the bank's satisfaction.

At periodical intervals banks should report to the Customer Service Committee of the Board of Directors, the details of the number of claims received pertaining to deceased depositors / locker-hirers / depositors of safe custody article accounts and those pending beyond the stipulated period, giving reasons thereof.

Claim Forms to be made available

For facilitating timely settlement of claims on the death of a depositor/s, banks are to provide claim forms for settlement of claims. Formats of claim forms are to be put on the bank's website.

Access to the safe deposit lockers / Return of safe custody articles to Survivor(s) / Nominee(s)/ Legal heir(s)

The generality of nomination rules which are applicable to deposit accounts also apply to safe deposit lockers/

safe custody articles.

However, the following specificguidelines in this regard are, applicable:

Access to the safe deposit lockers / return of safe custody articles (with survivor/nominee clause)

On the death of a sole locker hirer, the nominee should be given access of the locker and liberty to remove the contents.

If **a locker was hired jointly with the instructions to operate it under joint signatures**, and the locker hirer(s) have nominated a nominee, upon the death of any of the locker hirers, the bank should give access of the locker and the liberty to remove the contents jointly to the survivor(s) and the nominee(s).

If **a locker was hired jointly with survivorship clause** and the hirers instructed that the access of the locker should be given over to "either or survivor", "anyone or survivor" or "former or survivor" or according to any other survivorship clause, banks should follow the mandate in the event of the death of one or more of the locker-hirers.

Precautions to be taken before handing over the contents of locker:

(a) Banks to take proper care and caution in identifying the survivor(s) / nominee(s) and should have proper documentary evidence in respect of the death of the locker hirer.

(b) Banks should ensure that there are no order/s from a competent court restraining the bank from giving access to the locker of the deceased; and

(c) Banks should make the survivor(s) / nominee(s) understand that access to locker / safe custody articles is given to them only as a trustee of the legal heirs of the deceased locker hirer i.e., such access given to him shall not affect the right or claim which any person may have against the survivor(s) / nominee(s) to whom the access is given.

Banks are required to follow a similar procedure in respect of return of articles placed in the safe custody of the bank. Banks should be aware that the **facility of nomination is not available in case of deposit of safe custody articles by two or more persons.**

Access to the safe deposit lockers / return of safe custody articles (without survivor/nominee clause)

In case where the deceased locker hirer had not made any nomination or where the joint hirers had not given any mandate regarding the access to one or more of the survivors by a clear survivorship clause, banks are required to adopt procedure drawn up in consultation with their legal department/advisers for giving access to legal heir(s) / legal representative of the deceased locker hirer. Similar procedure should be followed for the articles under safe custody of the bank.

Preparing Inventory

Banks should prepare an inventory before returning articles left in safe custody / before permitting removal of the contents of a safe deposit lockeras per RBI's Notification DBOD.NO.Leg.BC.38/ C.233A-85 dated March 29, 1985. Banks are not required to open sealed/closed packets left with them for safe custody or found in locker while releasing them to the nominee(s) and surviving locker hirers / depositor of safe custody article.

Further, if the nominee(s) / survivor(s) / legal heir(s) wish to continue with the locker, banks may enter into a fresh contract with nominee(s) / survivor(s) / legal heir(s) and adhere to KYC norms in respect of the nominee(s)/ legal heir(s)

LESSON ROUND UP

- Banks follow double entry system of accounting and also prepare vouchers according to this system, that is to say for every debit entry there is a supporting debit voucher/s and for every credit entry there is a supporting credit voucher/s for the designated account heads. The same principle is followed for all the three types of transaction modes viz, cash, clearing and transfer.
- As banks run the risk being used as conduits in money laundering, they follow the guidelines of 'Know Your Customer' (KYC) issued by RBI while opening accounts of customers, granting loans, making remittances. KYC guidelines of RBI cover Customer Acceptance Policy, Customer Identification Procedures, Monitoring Transactions and Risk Management. Banks also forward mandatory reports at periodical intervals to FIU-IND. Under Customer Identification procedures banks obtain specified documents from different legal entities while opening accounts. They also open 'Small account' for persons who are unable to provide any of the OVDs and adopt simplified procedure while opening accounts of such persons. Banks also open accounts (with some restrictions) under simplified norms for such persons/entities who are unable to provide proper documentary evidence of id and address for specific time period.
- Banks open different types of deposit accounts such as demand deposits which include savings bank deposits, current accounts, notice deposits and term deposits that include fixed deposits, recurring deposits etc. for their customers under the broad guidelines provided by RBI. Customers for whom banks open accounts include individual, joint individuals, minors, sole proprietary concerns, partnership firms, LLPs, Companies, trusts, clubs and associations, cooperative societies, special customers like illiterate persons, blind, executors and administrators, liquidators etc.
- Banks also are statutorily required to comply with TDS norms of Income-Tax Department while paying interest, except in cases where customers submit specific exemption forms. They also follow operational rules regarding paying interest on premature closure of term deposit accounts; pay interest on deposits if they mature on a holiday; auto renew deposits in the absence of disposal instructions, provide insurance cover for deposits under DICGC.
- Banks deal with different types of borrowers. They follow relevant documentation procedures at pre-sanction and post-sanction stages. They scrutinize, process and sanction loans/advances as per set procedures.
- Banks have adopted core banking solution (CBS) environment in operational banking to improve customer service as a part of computerization of banking operations. CBS has been adopted by banks to bring in efficiency and improve productivity and profitability in banking operations. Essential requirement for CBS include central data centre, disaster recovery sites, business process re-engineering, software, networking and trained personnel. In view of the risks involved in CBS, banks have various controls such as password controls, transaction controls, personnel control, logical access control, security control. Banks shoulder specific responsibilities in terms of RBI 's directives on CBS. They are also responsible for reporting any cyber frauds that are attempted or took place in their banks. Banks also have established back offices for deposit related, loan related, compliance, accounting, Demat and digital banking functions for increasing efficiency and better customer service. Banks carry out voluminous transactions across inter-branch, inter-bank, correspondent banks, third party service providers and intermediaries which necessitates reconciling their transactions to eliminate/ minimize risk of frauds, settle and square-up transactions, and improve confidence among parties involved in the transactions.

GLOSSARY

OVD- Officially Valid Documents

CKYCR -Central KYC Records Registry ()

CERSAI- Central Registry of Securitisation Asset Reconstruction and Security Interest of India

CIDR- Central Identification Registry

SELF TEST QUESTIONS

1. Fill in the blanks:
   a. Banks being commercial organizations follow _____ system of accounting.
   b. Non-cash mode of transactions consists of _____ and _____.
   c. Withdrawal forms at the counter issued to Savings Bank customers is a form of _____ voucher.
   d. Applications for NEFT/RTGS/Pay orders/Gift cheques/Travelers cheques etc. are examples of _____ vouchers.
   e. Clearing inward term represents cheques received by a bank for _____ its customers' accounts with it.
   f. KYC forms part of _____ measures taken by the Government of India and RBI.
   g. Letter issued by the National Population Register containing details of name and address is one of the _____.
   h. Monitoring should _____ of customer.
   i. Periodic updation of KYC data shall be carried out at least once in _____ for high risk customers.
   j. Saving Bank account or a Current account will be treated as an inoperative/dormant account if there are no customer induced transactions for a period of _____.
   k. Recurring Deposit is also a form of_____.
   l. Guardian appointed by Will is known as _____ guardian.
   m. LLP can be incorporated for only _____ purposes.
   n. _____are appointed by a Court to dispose off properties and assets of institutions.
   o. In case an individual customer who does not possess any of the OVDs and desires to open a bank account, a bank can open _____ account.
   p. FATCA stands for _____
   q. For variation in nomination in case of deposit account _____ for needs to be obtained.
2. Write True or False
   a. When a deposit account of a minor is opened, the proof ofbirth should be verified with guardian's filled up particulars in the account opening forms.
   b. Exemption from deduction of tax is applicable for Shareholders (members) and Nominal Members of Co-operative banks.
   c. Many banks have introduced auto renewal of deposits to overcome the problem of late renewal of deposits and its attendant problems.

d. In case of joint accounts and Partnership firms any one of the joint account holders/partners can give the “Stop payment of Cheque” instruction.

e. In respect of a reinvestment term deposit maturing on a Sunday or Holiday, interest is payable on the maturity value in respect of such holidays.

f. Deposits held by customers such as savings, fixed, current, recurring, etc. are insured up to Rs. 10,00,000per depositor.

g. A proper scrutiny of loan application will lead to proper evaluation of the proposal in terms of various directions of RBI.

h. The drawl in the cash credit account will be limited to the limit sanctioned or drawl fixed based on securities whichever is lower

i. Central Data Centre, Disaster recovery sites, Business process re-engineering, Software, Networking and trained personnel form part of essential frame work for CBS.

j. Mid offices consist of Centralised Processing Centres such as Clearing, KYC Verification and account opening, Cheque book issue, Demat transaction processing, Processing of Retail and other Loans such as MSME, Data processing, Reconciliation, Treasury and forex operations.

k. If a minor is appointed as a nominee he needs to be represented by a guardian.

l. Accounts opened by a PEP requires enhanced due diligence.

m. Under Transaction control, date must be authorised only by DBA.

n. Recurring deposit is a form of Term Deposits.

o. Banks should settle the claims in favour of survivors/nominees in respect of deceased depositors in a month.

p. Inter-bank deposits are covered under DICGC deposit insurance.

q. A guardian can be natural guardian or a legal guardian or a testamentary guardian.

3. Answer the following questions.

a. What is the peculiarity of accounting in banks?

b. Name the vouchers used by banks.

c. Explain the Customer acceptance policy and monitoring of transactions done by banks as a part of KYC.

d. How to verify the authenticity of KYC documents submitted by customers to banks? Elaborate.

e. Discuss briefly the salient features of Savings bank accounts.

f. Discuss operational aspects of Partnership accounts.

g. Write a note on Scrutiny of loan applications.

h. How the drawls in a Cash credit account are fixed? Illustrate with an example.

i. What are the essential requirements of CBS?

j. What are the operational controls under CBS? Discuss each of these controls.

k. Write a note on reconciliation functions in a bank.

For further reading

1. Banking Law and Practice – P.N. Varshney
2. Practice and Law of Banking – M.L. Tannan
3. Master Circulars/Directions of RBI
4. Recommendations of various committees of RBI on Information Technology/ Cyber Security
5. Circulars of Indian Banks Association
6. Credit Appraisal - Dr. T.C.G, Namboodiri

Lesson 6
IT in Banking

LESSON OUTLINE

- Overview of Banking Services and IT related Risk and controls
- Components and Architecture of CBS
- Core Business Processes Flow and Relevant Risks and controls
- Reporting System and MIS
- Data Analytics and Business Intelligence
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Information technology is rapidly entering the traditional banking business. With the globalization trends world over it is difficult for any nation big or small, developed or developing, to remain isolated from what is happening around. Since the early nineties, every bank in India has done some IT improvement efforts. In the light of this, this chapter will enable a reader –

- To understand the importance of Information technology in Banking and risks associated with as well controlling the same.
- To understand the Components and Architecture of CBS, Process flow, Risks and controls.
- To understand the concept and importance of MIS.
- To gain an over view about Data Analytics and Business Intelligence.

INTRODUCTION

Information technology has played a revolutionary role in the working of banks since 1990s in India. Multiple product and services offered by banks based on information technology have resulted into faster, accurate and efficient payment systems in banking industry. However, changes in banking processes happen on an ongoing basis due to changes in Information Technology for the benefit of customers as well as for the banks. Therefore for a student of banking there is an imperative need to know about Information Technology based services offered by banks. However, in any business there are risks. So also with banking as well as with services provided by banks using Information Technology. A student of banking also needs to be aware of such risks as well as how to manage the same so that banking business can be safe.

Therefore the contents of this chapter cover relevant topic and are of Level 1 orientation so that students become familiar with IT based banking and recent emerging trends in digital banking and fintech.

Technology plays a vital role by ushering in a fundamental shift in the functioning of banks, when compared to manual system of operations earlier. It helps banks in bring improvements not only in their internal functioning but also enable them to provide better customer service. Technology has broken all boundaries in bringing seamless banking and encouraged speedier cross border banking business.

In India, till 1980 there was a slow progress in electronic automation of banks due to lack of Information Technology (IT) development in India as well as resistance from trade unions in the banking industry for its implementation. However, in the aftermath of a report by Dr. Rangarajan Committee in 1983, initiatives were taken to introduce in Information Technology based banking in a phased manner to address several key problems such as customer service, housekeeping, productivity and decision making that were plaguing the banking industry. However, from early 1990s the pace was accelerated in banks due to implementation of computerization resulting in total branch automation and core banking in banks, which continues till today.

In providing IT based banking, banks would have to undertake extensive Business Process Re-engineering (BPR) and tackle issues like:

a. How best to deliver innovative products and services to customers,

b. Designing an appropriate organizational model to fully capture the benefits of technology and business process changes brought about.

c. How to exploit technology for deriving economies of scale?

d. How to create cost efficiencies, and

e. How to create a customer- centric operational model?

To understand the role of technology in banking services, first we have to analyze services that the banking sector offers and understand the customer`s requirements.

The Indian Banking industry, which is governed by the Banking Regulation Act, 1949 and Reserve Bank of India Act, 1934 can be broadly classified into two major categories as non-scheduled banks and scheduled banks. Scheduled banks comprise commercial banks and the co-operative banks. In terms of ownership, commercial banks can be further grouped into nationalized banks, the State Bank of India and it's associate banks (since merged), Regional Rural banks and Private Sector banks including foreign banks operating in India.

IT Considerations

Since the early nineties, each Indian bank has taken initiatives in IT improvement and implementation. The

first and foremost compulsion is the fierce competition. While deciding on the required architecture for the IT consideration is given to following realities.

(1) **Meeting Internal Requirement:** The requirements of the banks are different individually depending upon their nature and volume of business; focus on a particular segment, spread of branches and a like. Many a time's banks do have the required information but it is scattered. The operating units seldom know the purpose of gathering the information by their higher authorities.

(2) **Effective in Data Handling:** As stated earlier the banks have most of the required data but are distributed. Further the cost of collection of data and putting the same to use is prohibitively high. The accuracy and timeliness of data generation becomes the causalities in the process. Best of the intentions on computerization are wished away because there is non-visible reduction in cost /efforts/ time required for the required data gathering.

(3) **Extending Customer Services:** Addressing to rising customers' expectations is significant particularly in the background of increased competition. In case bank A is unable to provide the required service at a competitive price and in an accurate manner with speed. There is always a bank IT at its next-door waiting to hire the customer. Awareness of customers about the availability of services and their pricing as also available options have brought into sharp focus the issue of customer satisfaction.

(4) **Creative Support for New Product Development:** It has become necessary for the banks to vitalize the process of product development. Marketing functionaries needs a lot of information not only from the outside sources but also from within the banks. Banks are looking to retail segment as the future market places for sales efforts. Having full-fledged information of existing customer is the key for this purpose. The emergences of data requirement and an appropriate architecture to support the same are significant issues to be handled in this regard.

(5) **End-user Development of the Non-Technical Staff:** Banking being a service industry, it is the staffs at counters that deliver the products. In Indian scenario, virtual banking is likely to have a few more years to establish. The dependence on counter staff is unavoidable. The staffs are large in number and the majority is non-technical. The customer satisfaction levels at the counter determine the ultimate benefit of IT offensive. Giving due consideration to this aspect in choosing architecture in necessary.

Trends in Information Technology

Certain trends have been visualized of information technology in banking sector all over the world.

(1) **Outsourcing:** Outsourcing is one of the most talked about as also a controversial issue. The drivers for getting in to outsourcing are many to include gaps in IT expectations and the reality, demystification of computerization in general and IT in particulars, trend towards focusing on core competencies, increased legitimacy of outsourcing and intention of getting out of worries and sort of up gradation of hardware and software versions. Not that the practice is new as earlier it was refused to as 'buying time' or 'service bureau'. What is needed is the clear of outsourcing, beside a definite plan to be more competitive after outsourcing. It is necessary to have checks and balances to monitor vendor performance. Cost aspects merit consideration, as also a decision on the part of the process to be outsourced shall be significance. Exit route and resource on the amount of failure after outsourcing are the other issue to be looked onto. Notwithstanding these risks, outsourcing has come to say.

(2) **Integration:** One of the IT trend is moving from hierarchy to team approach. The purpose is to see an alternative to retooling, to react speedily and to develop capabilities rather than exploiting them. Such integration is necessary so as to address to prevalent situations:

(a) Functions needing data and not getting from others.

(b) Sending data to those who do not want to require them.

(c) Global data exist but do not travel to required business functions.

Indian banks seem to follow this trend through the sincere redesign as described earlier. Instead of vertically divided pyramid type organizational set-ups, banks are now being to have separate group like finance, international consumer banking, industrial/commercial credit etc.

(3) **From Solo to Partnership:** With the development of IT, two things are taking place simultaneously. The work force as a percentage of total staff is going down and spending on IT as percentage of total spending is going up. The forms of partnership can include binding by superior service, accommodation in service sharing network, equal partnership and situations, where survival is threatened. At times, the partnership becomes necessary to get out of areas where there is no competitive advantage. Low development cost or wider geographical coverage is the aspects that create such partnership. Instances are not frequent, where joint ventures have been found with the IT vendors. E Collaborations between the banks and fintech companies are increasing to provide the best of electronic banking services.

(4) **Distinctive Edge:** It is always said that many use but a few make use of IT. Historically, the emphasis is on using IT for large volumes like payrolls, balancing the books, the consolidation etc. That realization on having IT as matter of competitive edge has come about very lately. It is recognized that customer service is not an easy thing to provide, but IT is used as a mean. It does give value additions and erases barriers for competitors to enter. Banks understand that the cost of cultivating the new customer is 5 to 6 times of retaining the old one. Customer normally switches banks due to poor service. The appreciation of these facts has compelled the banks world over to look upon IT as an instrument to create distinctive edge over competitors. The private sector banks that were established in 1990's as a part of finance sector reforms did make good of IT to have an edge over the others. The foreign banks operating in India have also been able to market IT superiority as a distinctive edge. The public sector banks are still to make use of IT in this regard, although they are blessed with huge information base all across the country. While steps are mooted in this direction by leading public sector banks, more offensive postures are necessary.

(5) **IT as Profit Centre:** In the embryonic phases, IT was looked upon a means to get rid of high processing cost and time and to convert the manual operation with high volume/low complexity in two mechanical ones. With the evolutionary the process, it was seen as the best means of generating, MIS. The same approach gave the status of DSS to IT. All along, IT has been recognized as the service function in Indian Banks. However, the new trend that is emerging is considering IT as a profit centre. The cost benefit analysis of having IT or otherwise in one part. But having IT set up to generate income for the organization is the new beginning. Getting jobs from outside the bank for processing data and the like are the current trends. The outsourcing done by others is the business, cater to by these organizations the trend of this kind is not deserved in Indian situation particularly banks. The Banks have been able to just manage what is to consider as their responsibility as IT, within the individual banks.

(6) **Prospering in Down Market:** The trend suggests that when there is a down turn in the market place, Pro-active corporations take the benefit of available unutilized resources to upgrade and revisit technology issues. This is seen as the right time to establish the R & D centre for IT. There are false notions about technology and its capability. Some misconceptions include:

a) Best-fit possible technology is implemented.

b) System solution is good enough and there is need to look into user expectations.

c) Innovations are generally successful.

d) Success is related only to novel ideas.

e) Technology is the sole determinant of business success, and

f) Measures and standards i.e. audit and inspection issues stand in the way of innovation.

The time available to debate on similar issues is ample and these false notions get clarified during the down market. Eventually, the decision makers reach a consensus that IT is not a panacea but it is an enabler that too when well supported by BRP (Business Process Reengineering), human resources initiatives, physical infrastructure and responsive organization set up.

(7) **Leading to Downsizing:** The IT initiative is making the organization lean and flat. For IT functionaries downsizing means transferring computing power from mainframe to the personal computer and workstations. Downsizing is a typical issue faced with associated problems. Absence of top management commitment, lack of understanding of the prevalent IT infrastructure, doing too much and too fast and undertaking the exercise without a framework for controlling the downsizing operations are primarily the situations that create adversities in downsizing. In any case the trend of downsizing is very much existent in the IT environment.

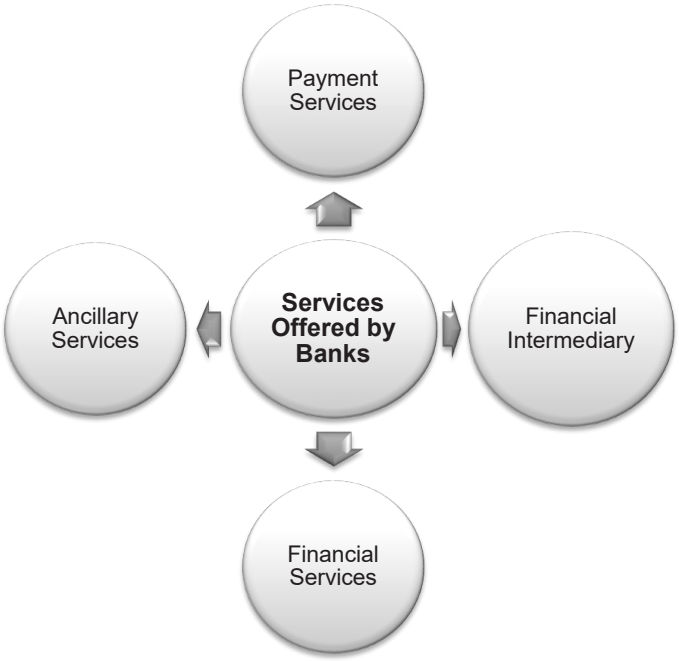
(8) **Getting Competitive Intelligence:** IT is now seen as a resource for gathering and dissemination of executive information system (EIS). The purpose is to minimize that the bombarding and focusing on the relevance, accuracy and timeliness of the information particularly about the competitors such information enhances follow up and tracks early warning on competitor move and also customer expectations.

As far as Indian banks are concerned individually, they have to compete with other banking industry participants as also with other players in the financial sector. The competition from for insurance and government notes and saving, mutual funds and the like is always forthcoming particularly because of attendant tax benefits. Collection of required information and using the same for business purpose is constrained by the availability of the information, its volume and diversity. As such it may take some time for this trend to be visible in Indian banking scenario.

OVER VIEW OF BANKING SERVICES AND IT RELATED RISKS AND CONTROLS

Services Offered by Banks

The services offered by banks can be broadly classified into four categories:



1. **Payment services**: The Payment service is vital aspect of the entire money flow of the economy. Earlier cheques, demand drafts, mail transfers, telegraphic transfers etc. used to be the main modes in the payment system, which have now been replaced with direct online money transfer with the evolution of technology.
2. **Financial intermediary:** This is one of the oldest functions of banks which enables the banks to accept the funds from depositors and then lend this money to deserving borrowers after completion and compliance of certain norms. This is the main core business of the banking system and will continue as long as the banking system exists.
3. **Financial Services**: Financial services include new services which were launched by different financial institutions with time. These services include investment banking, foreign exchange business, line of credit services, wealth management and broking services. These services generate income for the commercial bank in the form of fee based income and commissions etc., which is also termed as non-fund income for banks.
4. **Ancillary Services**: Other services that the banks offer to the common man along with the essential banking services. These ancillary services form a very minuscule of the services offered by the banks. Typical ancillary services include safe deposits lockers for valuables; collections, Demat accounts, On line Trading, selling gold/bullion, cheque pick up facility, door step banking, cash management etc.

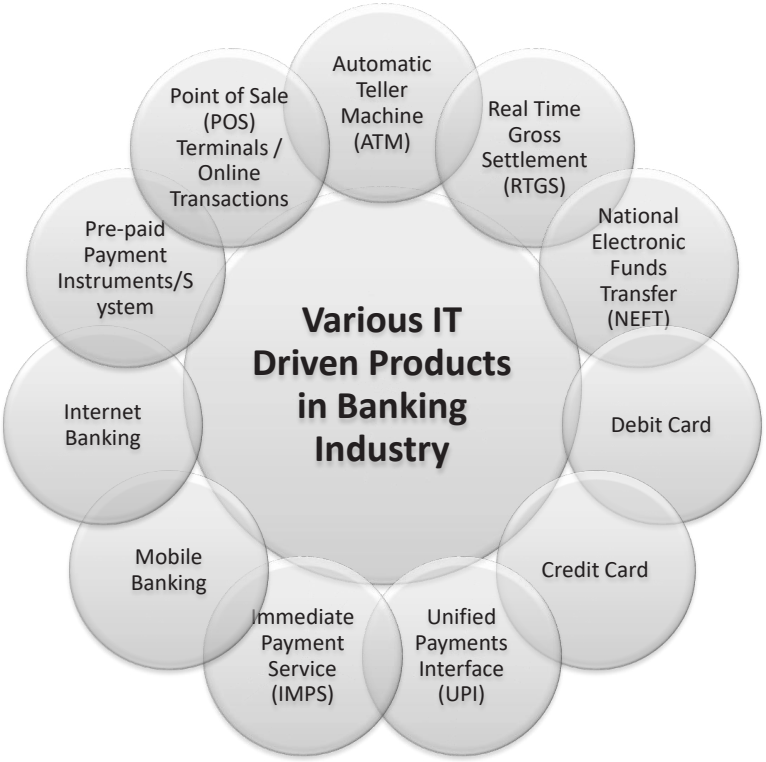
With years, banks also introduce new services to their customers. The Indian banking industry is passing through technology transition phase. Customers have more and better choices in choosing their banks, as all the banks are using the technology as a tool and trying to improve their customer acquisition. A competition has sprung up within the banks operating in India. With stiff competition and advancement of technology, the services provided by banks have become more easy and convenient.

In a technically advanced environment, a bank's operations are highly dependent on the integrity of its technology systems. Its success depends to a great extent, on its ability to use increasingly rich databases and make timely decisions connected to banking industry changes. The performance of a financial organization performance is negatively impacted if it experiences system interruptions, errors, or even if it falls behind its competitors concerning

the information technology, which it uses, and the way it is using it. So, every bank has to be committed to an ongoing process of upgrading, enhancing and testing its technology, so it can effectively meet sophisticated client requirements, market and regulatory changes and internal needs for information management.

Information technology risk includes the failure to respond to these requirements, as well as many other issues such as: human error, internal fraud through software manipulation, external fraud by intruders, obsolesce in applications and machines, reliability issues, mismanagement, and of course the effect of natural disasters. This risk is definitely manageable, but it takes a significant amount of skill to do it, and maybe the most important thing is that a strong team is needed, constituted both of economic, banking and engineering experts.

Various IT Driven Products in Banking Industry



Real Time Gross Settlement (RTGS)

Introduced in 2004, Real-Time Gross Settlement (RTGS) systems are specialist high speed funds transfer systems where the transfer of money takes place from one bank to another for settlement of transactions. “Gross settlement” means the transaction is settled on one-to-one basis through RBI. “Settlement” means that once processed, payments are final and irrevocable. RTGS systems are typically used for high-value transactions that require and receive immediate money transfers. RBI works as an intermediary between banks working on specified hourly batch basis. Increasing adoption and usage trends of RTGS by corporates and individuals were observed in higher volumes and values. Total volume of RTGS transactions were 1366.30 lakh and value of transactions were Rs. 171552061 crores in 2018 -2019 (Source: RBI Bulletin Nov 2019, Payment System Indicators.)

National Electronic Funds Transfer (NEFT)

National Electronic Funds Transfer (NEFT) is an electronic funds transfer system maintained by the Reserve

Bank of India (RBI). Started in November 2005, NEFT is a facility enabling bank customers in India to transfer funds between any two NEFT-enabled bank accounts on a one-to-one basis. It is done via electronic messages. Unlike RTGS, fund transfers through the NEFT system do not occur in real-time basis. NEFT settles fund transfers in half-hourly batches with 23 settlements. Total volume of EFT/NEFT transactions were 23188.87 lakh and value of transactions were Rs.22793698 in the year 2018-19. (Source: RBI Bulletin Nov 2019, Payment System Indicators).

Debit Card

A debit card (also known as a bank card, plastic card or check card) is a plastic payment card that can be used instead of cash when making purchases. It is similar to a credit card, but unlike a credit card, the money comes directly from the user's bank account when performing a transaction. Following actions can be performed using a debit card. Total volume of card payment transactions were 160462.56 lakhs and value of transactions were Rs.4512210/-cores. Debit card payment transactions volumes were 142738.96 and value of debit card transactions were Rs. 3904264 crores in the year 2018-19. Usage of debit cards at ATM`s were 98596.15 lakh whereas usage of debit cards at Point of Sales (POS) were 44142.81 lakh. (Source: RBI Bulletin Nov 2019, Payment System Indicators).

Credit Card

A credit card is a payment card issued to users (cardholders) to enable the cardholder to pay a merchant for goods and services based on the cardholder's promise to the card issuer to pay them for the amounts so paid plus the other agreed charges. The card issuer (usually a bank) creates a revolving account and grants a line of credit to the cardholder, from which the cardholder can borrow money for payment to a merchant or as a cash advance. In other words, credit cards combine payment services with extensions of credit. Credit Card payment transactions volumes were 17723.61 and value of Credit card transactions were Rs. 607946 crores. Usage of credit cards at ATM`s were 97.71 lakh whereas usage of credit cards at Point of Sales (POS) were 17625.90 lakh in the year 2018-19. (Source: RBI Bulletin Nov 2019, Payment System Indicators).

Unified Payments Interface (UPI)

Unified Payments Interface (UPI) is an instant real-time payment system developed by National Payments Corporation of India facilitating inter-bank transactions. The interface is regulated by the Reserve Bank of India and works by instantly transferring funds between two bank accounts on a mobile platform. In this, instead of using beneficiary's IFSC code and account number, it uses the virtual ID. Total volume of UPI transactions were 5350.40 million and value of transactions were Rs.8769.70 billion in the year 2018-19. (Source: NPCI, Retail Payment Statistics, Nov 2019).

Immediate Payment Service (IMPS)

Immediate Payment Service (IMPS) is an instant real-time inter-bank electronic funds transfer system in India. IMPS offers an inter-bank electronic fund transfer service through mobile phones. Unlike NEFT and RTGS, the service is available 24/7 throughout the year including bank holidays. It is managed by the National Payments Corporation of India (NPCI) and is built upon the existing National Financial Switch network. Total volume of IMPS transactions were 17529.09 lakh and value of transactions were Rs.1590257.00 Crores in the year 2018-19. (Source: RBI Bulletin Nov 2019, Payment System Indicators).

Mobile Banking

Mobile banking is a service provided by a bank or other financial institution that allows its customers to conduct

financial transactions remotely using a mobile device such as a smart phone or tablet. Unlike internet banking, it uses software usually called an Application (commonly known as 'App'), provided by the financial institution for the purpose. Mobile banking is usually available on a 24-hour basis. Total volume of Mobile Banking transactions were 62003.19 lakh and value of transactions were Rs.2958407.00 crones in the year 2018-19. (Source: RBI Bulletin Nov 2019, Payment System Indicators).

Internet Banking

It is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website. The online banking system will typically connect to or be part of the core banking system operated by a bank and is in contrast to branch banking which was the traditional way customers accessed banking services. Today, "virtual banks" (or "direct banks") have only an internet presence, which enables them to lower costs than traditional brick-and-mortar banks.

Pre-paid Payment Instruments/System

Pre-paid instruments are payment instruments that facilitate purchase of goods and services against the value stored on these instruments. The pre-paid payment instruments can be issued in the form of smart cards, magnetic stripe cards, internet accounts, internet wallets, mobile accounts, mobile wallets and paper vouchers etc. Total volume of Prepaid Payment Instruments / System transactions were 46072.29 lakh and value of transactions were Rs.213324 crores in the year 2018-19. (Source: RBI Bulletin Nov 2019, Payment System Indicators).

Point of Sale (POS) Terminals / Online Transactions

There are more than 10 lacs POS terminals in the country, which enable customers to make payments for purchases of goods and services by means of credit/debit cards. To facilitate customer convenience banks have also permitted cash withdrawal using debit cards issued by the banks at POS terminals. Actual Numbers of POS in India were 3722229 in the year 2018-19.

Automatic Teller Machine (ATM)

Automatic Teller Machine is the most popular devise in India, which enables customers to withdraw their money 24 hours a day, 7 days a week. It is a device that allows customers who have an ATM card to perform routine banking transactions without interacting with a human teller. In addition to cash withdrawal, Automatic Teller Machines (ATMs) can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry, statement of account generation etc. Actual Numbers of ATM in India were 221703 in the year 2018-19.

E-cheques

E-cheques (Electronic Cheques) are a form of electronic tokens designed to make payments through the internet and performs the same functions as a conventional paper cheque.

As the cheque is in an electronic form, it can be processed in fewer steps and has more security checks than a standard paper cheque, like authentication, public key cryptography, digital signature, encryption, etc.

With the amendments in Negotiable Instruments Act, 1881, an e-cheque has become legalized since 2002. These cheques make the transfer process faster, due to the use of conventional encryption.

Society for Worldwide Inter-bank Financial Telecommunications (SWIFT):

SWIFT, as a co-operative society was formed in May 1973 with 239 participating banks from 15 countries with

its headquarters at Brussels. It started functioning in May 1977. RBI and 27 other public sector banks as well as 8 foreign banks in India have obtained the membership of the SWIFT. SWIFT provides have rapid, secure, reliable and cost effective mode of transmitting the financial messages worldwide. At present more than 3000 banks are the members of the network. To cater to the growth in messages, SWIFT was upgrade in the 80s and this version is called SWIFT-II. Banks in India are hooked to SWIFT-II system.

SWIFT is a method of the sophisticated message transmission of international repute. This is highly cost effective, reliable and safe means of fund transfer.

a) This network also facilitates the transfer of messages relating to fixed deposit, interest payment, debit-credit statements, foreign exchange etc.

b) This service is available throughout the year, 24 hours a day.

c) This system ensures against any loss of mutilation against transmission.

d) It serves almost all financial institution and selected range of other users.

It is clear from the above benefit of SWIFT that it is very beneficial in effective customer service. SWIFT has extended its range to users like brokers, trust and other agents.

Cash Dispensers:

Cash withdrawal is the basic service rendered by the bank branches. The cash payment is made by the cashier or teller of the cash dispenses is an alternate to time saving. The operations by this machine are cheaper than manual operations and this machine is cheaper and fast than that of ATM. The customer is provided with a plastic card, which is magnetically coated. After completing the formalities, the machine allows the machine the transactions for required amount.

IT RELATED RISKS AND CONTROLS

Classifying IT risk

Identification, analysis, measurement and management of IT risk, requires specialized knowledge and skill. IT risk management has to be done in every organization, and each has its own unique IT risk profile. Technology risks have a deep impact on financial ,operations , regulatory and reputation of the banks IT risks can be classified according to their impact on the organization, as listed below:

1. Security risk
2. Availability risk
3. Performance risk
4. Compliance risk

Security risk – The risk that information will be altered, accessed, or used by unauthorized parties. Sources of security risk could be: external attacks, malicious code, physical destruction, inappropriate access, unsatisfied employees, variety of platform and messaging types.

Potential impacts associated with them are - corruption of information, external fraud, identity theft, theft of financial assets, damage to reputation and damage to assets.

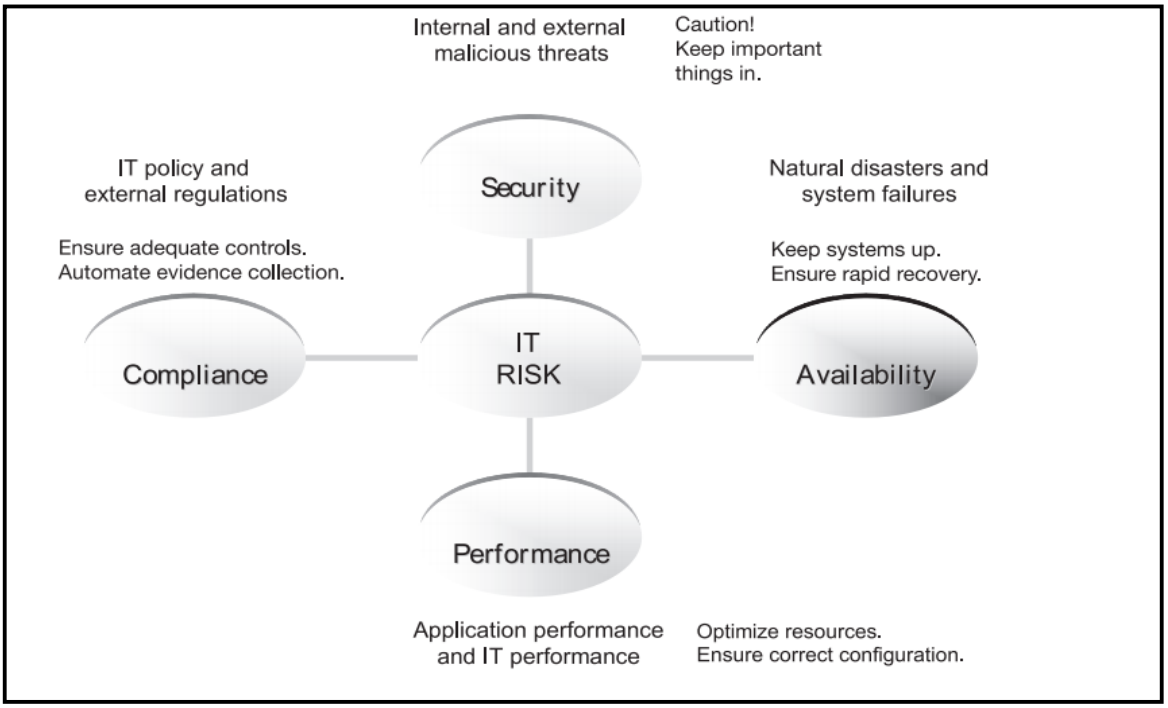
Availability risk – The risk that information or applications will be inaccessible due to system failure or natural disaster, including recovery period. Sources of availability risk are - hardware failures, network outages, data

centre failures, *force majeure*. Potential impacts associated with them are- abandoned transactions and lost sales, reduced level of customer, partner, or employee confidence, interruption or delay of business critical processes, reduced IT staff productivity.

Performance risk – The risk that under performance of systems, applications, or personnel, or IT as a whole will diminish business productivity or value. Sources of performance risk are - poor system architectures, network congestion, inefficient code, inadequate capacity. Potential impacts associated with them are - reduced customer satisfaction and loyalty, interruption or delay of business critical process, lost IT productivity.

Compliance risk – It is a risk of information handling or processing will fail to meet regulatory, IT or business policy requirements. Usually, it involves penalties, fines, or loss of reputation from failure to comply with laws or regulations, or consequences of non-compliance with IT policies. Sources of compliance risk are - regulations unique to each jurisdiction, legal actions, internal IT safeguards supporting compliance, inadequate third-party compliance standards. Potential impacts associated with them are - damage to reputation, breach of client confidentiality, litigation.

These four areas of IT risk are shown in below mentioned figure, each with its own set of drivers and potential impacts.



Controls required for managing IT risks

An effective control mechanism is required managing risks in IT areas. These controls are:

i. **Preventive controls**: This is a control mechanism that stops and reduce errors and mistakes from occurring. Good layout of forms or screen to a large extent reduces the likelihood of mistakes happening while inputting the data;

ii. **Detective controls**: They identify the errors after they are committed. This is done through what is known as validation protocols or programmes.

iii. **Corrective controls**: These controls eliminate or reduce errors after identification of such data with errors or irregularities.

The basic purpose of these controls is to prevent the occurrence of errors or irregularities in the system. Secondly in spite of such prevention if such errors or irregularities occur they need to be detected and eliminated or corrected.

In addition to generic controls mentioned above, depending upon the nature of controls that can be exercised in managing risks are as follows:

Physical controls: These are the controls that restricts physical access to IT assets such as computers, servers, computer room, media, documentation, data storage places, other hardwares/components etc. The first restriction to be put, is to ensure that only authorized persons are allowed access for repairs, maintenance servicing etc. through a prior log in entry in a register, validated by a proper authentication.. Care should also be taken to see such persons are not allowed access to data stored. Access to system and software is to be restricted through PINs, Passwords or biometric verification. Similarly, access register/log should be maintained to record access to the system by various users. Clear segregation of machines should be done such that machines which are meant for operations are not used for developing or testing software and vice-versa. Similarly hard copies of various transactional reports should be kept under proper security and access should be given to these to only authorized persons/staff. Preventive checks of disaster prevention equipments such as Fire alarm, fire extinguishers, smoke detectors, CC TV cameras, physical locking arrangements etc. should be done on routinie basis. Similarly hardware servicing at periodical intervals should also be done to prevent failures through AMCs.

Internal controls: These controls are in-built computers, for checking accuracy and reliability of data. Indirectly they ensure operational efficiency and safeguard assets too. there are two types of Internal controls: They are (i) Accounting controls (ii) Administrative controls. These controls also ensure that adherence to procedures and policies formulated by a bank.

Accounting controls form part of the Software and can be seen in the form of –

Administrative control flows through spelt out policies of responsibility and procedures. One may also see existence of controls in the following activities such as:

- validation/authorization of :
  - transactions relating to limits, authorizations on bank`s software, passing of cheques and vouchers,
  - drawing powers, defective / incorrect drawn cheques, stop payment orders, reactivation of dormant and inoperative accounts, standing instructions, money transfer transactions etc.
- pre-transaction verification of due dates, rates of interest etc.

Operational controls: These are embedded in software itself to ensure data integrity, consistency apart from processing. Check sum verification is another example of operational control exercised during day begin operations. Double checking concept of inputter and authorizer of every system transaction should be introduced by banks to control operations risk.

Additionally the following controls are also available for banks to monitor system and its operation by authorized personnel/.

Audit trail: Recording of all events that occur in a system on a chronological order. There are two types of Audit trails - Accounting Audit trail and Operations Audit trail.

Accounting Audit trail maintains chronological order based record of processes that had taken place within the system involving data and information. Operations Audit trail gives a chronological record of access to a terminal, user id, data, time of access, authorization record etc. which are generated by the system itself. This will provide evidence in case of any violations or unauthorized use.

Data encryption: This is control measure involved while transmitting data from one place to another using encoding process. It is a fixed algorithm based and uses a key word. At the receiving end the encryption is decoded. At both ends if the codes match, it indicates that message has not been altered and thus integrity of the transmitted message is confirmed. If there is no matching, then it triggers an investigation. This process is also used for electronic funds transfers.

COMPONENTS AND ARCHITECTURE OF CBS

Introduction to CORE Banking

The world is changing rapidly and technology is considered to be the key driver for these changes around us. Many activities are handled electronically due to the acceptance of information technology at home as well as at workplaces. The Indian customers are moving towards the internet banking. The ATM and the Net transactions are conventionally adopted. But the customer is clear on one thing that he wants net-banking to be simple and secure. CORE is a generic term for the delivery of banking services and products through the electronic channels such as the telephone, the internet, the mobile phone etc. The concept and scope of CORE banking is still evolving. It facilitates an effective payment and accounting system thereby enhancing the speed of delivery of banking services significantly.

Several initiatives have been taken by the Government of India as well as the Reserve Bank of India (RBI) to facilitate the development of CORE banking in India. The government of India enacted the IT Act, 2000, which provides legal recognition to electronic transactions and other means of electronic commerce. The RBI has been preparing to upgrade itself as regulator and supervisor of the technologically dominated financial system. It issued guidelines on the risks and controls in computer and telecommunication systems to all the banks of India, advising them to evaluate the risks inherent in the systems and put in place adequate control mechanisms to address these risks. It is also advising banks from time to time on the same in the light of new developments. Core Banking System replaced the manual banking operations to process the transactions faster and accurate. CBS replaced the branch banking concept to One Bank as the customer can do anywhere banking transactions from any branch of the bank.

Banking business has evolved over a period and grown exponentially encompassing an entire range of products and transactions under a wide umbrella. All such activities undertaken by banks are called CORE banking viz. “Centralized Online Real-time Environment”. This basically means that the entire bank’s branches access applications from centralized data centres. It also means that the deposits made are reflected immediately

on the bank's servers and the customer can withdraw the deposited money from any of the bank's branches throughout the world. These applications now also have the capability to address the needs of corporate customers, providing a comprehensive banking solution. The CORE banking policy has to be approved by the Board of Directors. The policy fits into the banks overall Information Technology and Information security policy and ensures confidentiality, integrity and accountability of information and information processing security system within a bank, and ensures confidentiality, integrity and accountability of information and information processing security system.

What is CORE Banking?

CORE (Centralized Online Real-time Environment) banking enables anytime anywhere banking. The bank customers can operate their accounts from anywhere on a 24X7 basis. The customers are no more the customer of a branch, they become the bank's customers. Thus CBS is a step towards enhancing customer convenience through anywhere and anytime banking. This is achieved through the centralized processing of transactions. All transactions are processed at central site called as Data Centre where all the data relating to core branches reside.

Thus the core banking in simple terms is a highly efficient "customer accounting" and transaction processing engine for high volumes of back office transactions. The main purpose of a core banking system is thus to give banks the ability to process large transaction volumes in a fast and efficient way. Core banking also handles transactions such as interest and fee calculation, pre-processing for statement printing, end-of-day processing, and consolidation of daily individual transactions as "accounting entries" which are posted into the bank's general ledger system according to its chart of accounts structure for the daily trial balance sheet preparation. The CBS process is convenient for both - customers and banks.

Need for CORE Banking

In order to meet requirements and needs of the IT modernization as per direction given by Reserve Bank of India, Core Banking Solution (CBS) is being implemented across India covering all the urban cooperative banks also. Core Banking Solution (CBS) is networking of all the bank's branches which enables customers to operate their accounts and avail account related services from anywhere at any time on CBS network, regardless of where a customer maintains his account, as the customer is no more the customer of a branch; he becomes the customer of the bank. Thus CBS is a step towards enhancing customer convenience through "Anywhere and Anytime Banking"

Technological requirement for Core Banking Solution (CBS)

In core banking solution all servers are centrally located at a place called "The Central Data Centre". All

branches are connected to this data centre through a leased line or any other network connectivity with security and redundancy built in. Most of the servers like Application server and Database server are placed behind the firewall and protected from unauthorized access. In order to manage load and also to build redundancy, multiple servers performing the same function are clustered. All servers are not in same local area network (LAN). They are segregated using the concept of virtual local area network (VLAN) which has its own built in security.

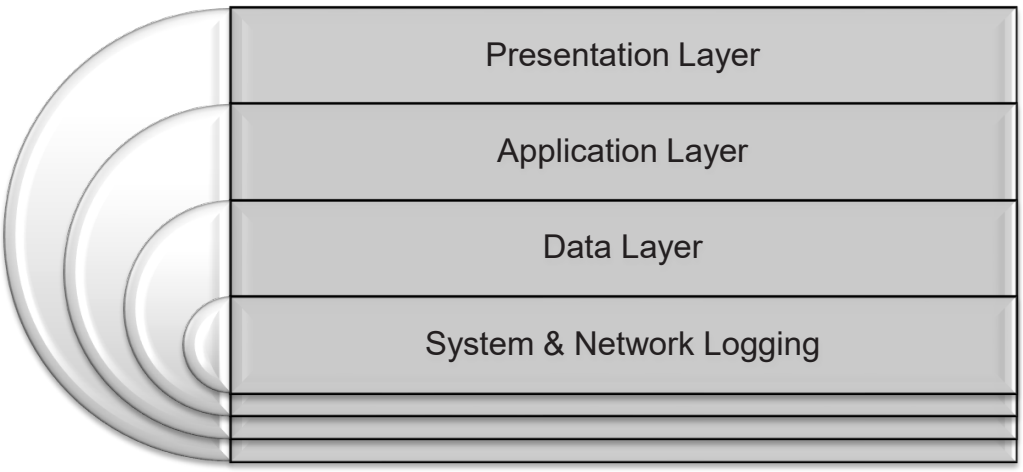
Technology Requirements

CORE banking environment consist of –

- Central Database Server that stores the data of the bank.
- Application architecture /Central Application Server that run the CORE banking solution (CBS) centrally accessed by branches.
- Necessary infrastructure to provide for internet banking and Automated Teller Machine (ATMs).
- Authentication techniques.
- Information Security system.

Application Architecture Requirements

A computer-based application may be built as a huge software, or may be structured to run on a client–server environment, or even have three or multi-tiered architecture. A computer application typically separates its three main tasks- (i) interactions with the user, (ii) processing of transactions as per the business rules and (iii) the storage of business data. These three tasks can be viewed as three layers, which may run on the same system (possibly a large, proprietary computer system), or may be separated on to multiple computers (across the Internet), leading to three-tier or multi-tier architecture.



These layers can be briefly described as follows.

- **Presentation Layer:** This layer is responsible for managing front-end devices, which include browsers on personal computers, Personal Digital Assistants (PDAs), mobile phones, Internet kiosks, Web TV etc. The presentation layer takes care of user interface related issues like display details, color, layout, image etc. It also has important responsibilities in user authentication and session management activity
- **Application layer**: It contains the business logic (for processing of data and transactions) and

necessary interfaces to the data layer. It processes requests from the presentation layer, connects to the data layer, receives and processes the information and passes results back to the presentation layer. It is responsible for ensuring that all business rules are incorporated in the software. The issues of scalability, reliability and performance of the services to a great extent depend upon the application layer architecture.

- **Data Layer**: The data layer uses a database package to store, retrieve and update application data. The database may be maintained on one or multiple servers. A database package also supports back-up and recovery of data, as well as logging of all transactions.
- **System & Network logging**: "Logging" basically means recording of activities. All computers are automatically programmed to create a record of activities. Operating systems, database packages and even business applications produce a 'log' of various tasks performed by them. Most operating systems keep a log of all user actions. Log files are the primary record of suspicious behavior. Log files alert the administrator of data base system, to carry out further investigation in case of suspicious activity and help in determining the extent of intrusion. Log files can also provide evidence in case of legal proceedings. The administrator has to select types of information to be logged, the mechanisms for logging, locations for logging, and locations where the log files are stored. The information required to be logged should include login/logout information, location and time of failed attempts, changes in status, status of any resource, changes in system status such as shutdowns, initializations and restart, file accesses, change to file access control lists, mail logs, modem logs, network access logs, web server logs, etc. The log files must be protected and archived regularly and securely.

Challenges in CORE Banking Solution

The security and availability of IT systems, networks and data is critical importance in terms of ensuring business continuity. Any security breach can lead to problems. Security breaches can be classified into three categories. They are –

1. Serious criminal intent (fraud, theft of commercially sensitive or financial information).
2. Hackers attack, Phishing attacks (defacement of web sites or „denial of service" - causing web sites to crash).
3. Flaws in systems design and/or set up.

All of these threats have potentially serious financial, legal and reputational implications. Many banks are finding that their systems are being probed for weaknesses hundreds of times a day but damage/losses arising from security breaches have so far tended to be minor. However, some banks could develop more sensitive burglar alarms, so that they are better aware of the nature and frequency of unsuccessful attempts to break into their system. The most sensitive computer systems, such as those used for high value payments or those storing highly confidential information, be likely to be the most carefully secured. Complex encryption software is used to protect account information. However, there are no perfect systems. Accounts are prone to hacking attacks, phishing, malware and illegal activities.

Cyber Crime

What is Cyber Crime?

As the use of internet is increasing, a new face of crime is spreading rapidly from in-person crime to nameless and faceless crimes involving computers. Cyber crime includes all unauthorized access of information and

break of security like privacy, password, etc. with the use of internet. Cyber crimes also include criminal activities performed by the use of computers like virus attacks, financial crimes, sale of illegal articles, online gambling, e-mail spamming, cyber phishing, cyber stalking, unauthorized access to computer system, theft of information contained in the electronic form, e-mail bombing, physically damaging the computer system, etc.

Cyber stalking

Online harassment and online abuse all comes under stalking. The term "stalking" generally involves harassing or threatening behavior that an individual engages in repeatedly, such as following a person, appearing at a person's home or place of business, making harassing phone calls, leaving written messages or objects, or vandalizing a person's property. Cyber stalking shares important characteristics with offline stalking; many stalkers (online or off line) are motivated by a desire to control their victims. A major damaging effect of online abuse is a victim avoiding his/her friends, family and social activities.

Intellectual Property Crimes

Intellectual property consists of a person's creations such as articles, books, paintings, photos or any such intellectual content. Any unlawful act by which an owner of such intellectual property is deprived completely or partially of his rights is an offence and this is known as intellectual property crime. The common form of IPR violation/crime may be said to be software piracy, infringement of copyright, trademark, patents, designs and service mark violation, theft of computer source code, etc.

Bot Networks

The word botnet is made from two words - robot and network. A cyber crime is called 'Bot Networks', when hackers remotely take control upon computers by using malware software. Computers can be co-opted into a botnet when they execute malicious software. A botnet's originator can control a group of computers too remotely.

Hacking

In general, the word 'hacking' means seeking and exploiting weakness and security of a computer system or a computer network for unauthorized access. The person who does hacking is known as hacker. A Hacker uses his/her computer expertise and some tool or scripts to hack any computer system.

Internet Time Thefts

Basically, Internet time theft comes under hacking. It is the use by an unauthorized person, of the Internet hours paid for by another person. The person who gets access to someone else's Internet Service Provider given user ID and password, either by hacking or by gaining access to it by illegal means, uses it to access the Internet without the person's knowledge.

Cracking

It is a dreadful feeling to know that a stranger has broken into user computer systems without user's knowledge and consent and has tampered with precious confidential data and information. A Cracker differs from the hacker because hacker is hired by companies to audit network security or test software but cracker do the same work for their own profit or to harm others.

Phishing

Phishing means acquiring information such as usernames, passwords, credit card details, personal detail etc.

by electronic communication. Phishing commonly uses fake emails or fake messages which contain link of virus/ malware infected fake websites. These websites request user to enter their personal details. Then get hold of these and commit a fraud.

Voice Phishing

The term is a combination of “voice” and “phishing”. Voice phishing is used to gain access of private, personal and financial information from the public. Voice phishing uses a landline telephone call to get information.

Carding

It means false ATM cards i.e. Debit and Credit cards used by criminals for their monetary benefits through withdrawing money from the victim’s bank account.

E-Mail/SMS Spoofing

A spoofed E-mail/ SMS may be said to be one, which misrepresents its origin. It shows its origin to be different from which actually it originates. Here an offender steals identity of another in the form of email address, mobile phone number etc. and send the message via internet.

Cross-site Scripting

Cross-site scripting (XSS) is a type of computer security vulnerability. By cross-site scripting attacker can bypass the predefined access permissions of website. Reflected XSS is the most frequent type of XSS attack. Reflected XSS attack is also known as non-persistent XSS. Scripting languages like java script, VBScript etc. are used for Reflected XSS attack.

Cyber Squatting

Squatting is the act of occupying an abandoned or unoccupied space. Cyber-squatting is the act of registering a famous domain name and then selling it to needy for a high cost. It means where two persons claim for the same Domain Name either by claiming that they had registered the name first or by right of using it before the other or using something similar to that previously.

Cyber Vandalism

Vandalism means destroying or damaging property of another. Thus cyber vandalism means destroying or damaging the data when a network service is stopped or disrupted. It may include within its purview any kind of physical harm done to the computer of any person.

Cyber Trespass

It means to access someone’s computer without the proper authorization of the owner without disturbing, altering, misusing, or damaging data or system by using wireless internet connection.

Cyber Trafficking

It may be trafficking in drugs, human beings, arms weapons etc. which affects large number of persons through internet. Trafficking in the cyberspace is also a gravest crime.

Cyber crime & Social Networking:

Cyber criminals use social media for not only to commit crime online, but also for carrying out real world crime owing to “over-sharing” across these social platforms. This risk is associated with our identities. Identity theft

can happen to anyone who exposes too much personal information online on various social networking sites. To protect one self, get to know the security and privacy settings, and configure them to protect from identity theft. One in five online adults (21 percent) have reported of becoming a victim of either social or mobile cyber crime and 39 percent of social network users have been victims of profile hacking, scam or fake link.

CORE BUSINESS PROCESS FLOW AND RELEVANT RISK CONTROLS

The transaction flow in CBS is described as under:

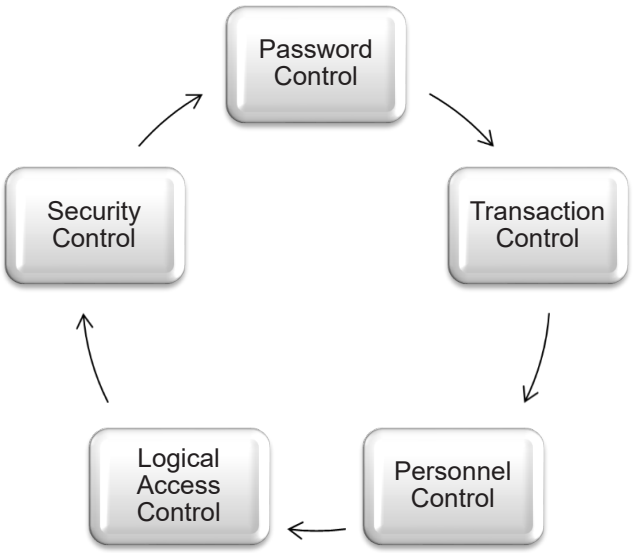
First the user log in after the day begin is activated at the branch. Once log in is successful the user is allowed to access different product modules. Let us take an example to understand the process flow in the CBS system. Assume that Mr. X has come to the branch to withdraw Rs. 1,00,000/- from his SB account through a cheque.

The cheque is given to the user who after verifying the cheque for its validity, enters all particulars of the cheque in the system. According to the branch procedures the user has only powers up to pass cheques only up to Rs. 5,000/- Therefore his transaction has to be verified and authorized by a senior official of the branch who has been given powers to pass cheques up to Rs. 5,00,000/-.

Since the powers of the user is restricted up to Rs. 5000/- as soon as the user enters the cheque data it is transmitted to what is known as maker checker functionality in the system through which the senior official (who has more power to pass the cheque) will authorize the transaction after due verification. Once this transaction is registered by the host server flashes back a message to the user whether the transaction is successful and complete. During the entire process the CBS system validates account number, cheque number, date, balance in the account, authority level of teller and senior official etc. as per the parameters for validation already set and stored in the system.

This is how the flow of the transactions normally takes place in the core banking for all transactions.

Controls in the flow of transactions under CBS



The following controls forms part of transactions flow in CBS:

1. **Password control**: Every authorized user/operator is given a User id and Password for login in to the system. **These are required to be kept confidential by the respective user.** The preventive aspect in this is to change passwords at suitable intervals. In the case visiting officials who come to the branch for

inspection, investigation or temporary postings etc. they are given guest login arrangement with a user Id and password. This should be deleted as soon as their work is over. Also if an existing authorized user is no more associated with the branch/bank due to long leave, outside deputations, transfers, retirement, sickness, suspensions or death etc. they should be deactivated.

2. **Transaction control**: Inactive work stations or desktops or terminals are to be logged off. Only those who are present their workstation or terminals should be enabled for transactions. Authorization of date in the system should be done by designated officials only. Reports such as special batch reports should be checked and authenticated by designated officials. Software problems encountered in operations should be recorded and rectification work should be carried out with the help of authorized officials/ vendors.
3. **Personnel control**: Job rotation at periodical intervals as per bank's policy should be done and a written record is maintained in this regard. it should be ensured proper clear distribution duties is affected. Similarly, authorization limits for various levels of staff is fixed and documented.
4. **Logical Access control**: To ensure logical access control give access to menus to Staff on "need" only basis. Restrict file maintenance access to a few staff documented approval. This needs review at regular intervals. Encrypt Pass word files for restricted access. Give top priority to Security violations and ensure that they are investigated and remedial action is taken. Restrict access to work stations during and after, office hours. Completely restrict access to sever room and modem installations.
5. **Security control: To maintain security control under CBS,** Ensure proper remedial action, in case of power failure or mechanical failures. Also ensure system restarts with proper completion of entries and records which were in midway when the power was disrupted. Install latest Anti-virus version in servers.

Updating patches whenever or wherever made available by software vendors should also applied on an ongoing basis. Take proper back-ups at appropriate times and ensure its proper storage either on-site or off-site. Ensure only authorized amendments are accepted by the system. Authenticate/ authorize parametric changes and user levels. Unauthorized amendments are not accepted by the system. Ensure all authorized modules are installed and activated. Generate exception transaction reports on a daily basis and they are scrutinized. Ensure all authorized GL codes from Head office / controlling departments are in existence. Keep important Passwords in a sealed cover with Branch Head /Manager for easy access in case of need /absence of staff.

REPORTING SYSTEM AND MIS

Banking business environment is characterized by battle for the customer, as need to grow in volume has given way to selective growth strategies (rather than messages about a slowing of new business). an undeniable competitive advantage is provided by robust, reliable and useful systems for measuring customer profitability or value, both current and potential, in connection with budgeting and pricing methodologies. This is due both to their capacity to identify where to generate value and to the capacity to direct the actions of branches and sales staff, identifying the real profitability of each customer in order to focus on those making the greatest contribution to the margin while at the same time that working on the profitability of those who at present contribute less. This is achieved by a proper Management Information System.

Management Information System (MIS)

MIS Means Management Information System. Business organizations, use and manage information systems to revitalize business process, improve business decision making with information technologies, gain competitive advantage on the market. As described by World Bank, Management Information System (MIS) is a system that

helps management in making, carrying out and controlling decisions. In effect, a project/ program monitoring system is a Management Information System that provides information for making decision by the management. In the design of the MIS, the following six basic stages of a MIS, in their sequential order, are followed:

1. Identification of information needs,
2. Collection of information,
3. Classification of the information collected,
4. Storage,
5. Retrieval,
6. Analysis,
7. Decision.

Key elements of MIS are –

1. Internet technologies - as platform for business and commerce;
2. Collaboration processes among all business stakeholders – in networked enterprises;
3. Global markets and the international dimension, Foundation Concepts, Decision support - in Business and
4. Banking - Information technologies and Banking applications, an approach to computing, Systems and information channels and Developing business.

Objectives of MIS

Objective of MIS is to make available timely and meaningful data for decision making by managements. The main focus therefore of MIS is that of converting raw and massive date in to meaningful pieces of information that would be useful. As timing is the essence of any decision, MIS should provide timely information.

Characteristics and uses of MIS

- The MIS of a Bank whose branches are so well-spread becomes a pivotal point of study as it caters to many segments of the society (urban and rural) and offering a diversified portfolio of services like credit cards, loans, bank accounts, etc. Thus, it becomes absolutely essential for a bank to maintain an accurate mass record of all transactions of every individual or corporate. One cannot ignore the fact that every record / data should have a reliable back-up in case of any uncertainty like System Crashing', 'Virus Attack', etc.
- MIS helps to validate our theoretical understanding.
- Leads a better understanding of an organization by top management, without which the efficient management of that organization would become difficult.
- While computers cannot create business strategies by themselves they can assist management in understanding the effects of their strategies, and help enable effective decision-making. MIS systems can be used to transform data into information for useful for decision making. Computers can provide financial statements and performance reports to assist in the planning, monitoring and implementation of strategy.
- MIS provides a valuable function in that they can collate into coherent reports of unmanageable volumes

of data that would otherwise be broadly useless to decision makers.

- Not only do MIS allow for the collation of vast amounts of business data, but they also provide a valuable time saving benefit to the workforce. Where in the past business information had to be manually processed/compiled for filing and analysis, data can now be entered quickly and easily onto a computer by a data processor, allowing for faster decision making and quicker reflexes for the enterprise as a whole.

Business Intelligence and Data Analytics

The term intelligence has been used by researchers in artificial intelligence since the 1950s. Business intelligence ('BI') became a popular term in the business and IT communities only in the 1990s. In the late 2000s, business analytics was introduced to represent the key analytical component in BI. More recently big data and big data analytics have been used to describe the data sets and analytical techniques in applications that are so large (from terabytes to Hexabytes) and complex (from sensor to social media data) that they require advanced and unique data storage, management, analysis, and visualization technologies. Business intelligence and data analytics (BI&DA) is a unified term and deals with big data analytics. BI&DA is a collection of decision support technologies for gathering, providing access to, and analyzing data for the purpose of helping enterprise users (executives, managers and analysts) make better and faster business decisions. The term implies having a comprehensive knowledge of all of the factors that affect the business. It is imperative that companies have an in depth knowledge about factors such as the customers, competitors, business partners, economic environment, and internal operations to make effective and good quality business decisions. Business intelligence enables firms to make these kinds of decisions. Enterprises aim at enabling knowledge to executives, managers and analysts to make better and faster decisions.

Business Intelligence (BI) and Customer Relationship Management (CRM)

CRM and BI form an integral part of a bank's strategy. BI allows banks to pull together usable information from disparate systems. CRM and BI tools provide a bank with the ability to look at customer data and use it to drive business. Integrating BI capabilities into applications is important. Banks are choosing to implement data warehousing solutions to consolidate data from diverse sources into one easy-to-use database to facilitate time critical decision support. Banks can track and respond to business trends and analyze data in the light of business perspectives. Banks can utilize BI to focus on:-

- Customer acquisitions/profitable accounts
- Track customer needs
- Identify cross-selling opportunities
- Provide customer satisfaction at levels hitherto not even dreamt of.

CRM can be an effective method by which banks can attract new customers and retain existing customers. It involves reorienting bank operations around the needs of the most profitable customers. CRM enables banks to segment customer bases. Tailor make appropriate products for different segments and add personalized services.

CRM is a key component of the bank's growth strategy. Many banks are now participating in strategic partnerships with IT companies. These are not just limited to outsourcing initiatives. Banks are looking at partnerships to obtain timely and predictable returns on their IT investments. The benefits accruing to banks from strategic alliances include one-stop-shopping experience and procurement of best product/s, carefully integrated and fine-tuned.

DATA ANALYTICS

Data Analytics plays a significant role in virtually every field, where data could be collected and stored. Data Analytics is vastly different from data analysis. While data analysis, by convention, connotes statistics, data analytics goes beyond statistics, into the fields of computer science (via machine learning subsuming new wave of artificial intelligence) and operations research. In fact, Dr. Jim Gray of Microsoft, refers to it as the fourth paradigm of science with theoretical, experimental and computational paradigms being the others that preceded it in the evolution of science. Interestingly, all the four complement one another and all are required in sufficient proportion to conduct meaningful research/practice in numerous fields nowadays. Service industries including banking derive immense advantage from data analytics. Analytics is of three types:

(i) Descriptive

(ii) Predictive and

(iii) Prescriptive.

Descriptive analytics concerns various ways of depicting the past and present data using Statistics and Online Analytical Processing, whereas **predictive analytics** answers questions like what is going to happen based on the past data using data mining, text mining and web mining. However, **prescriptive analytics** provides insights from the data that is not necessarily predictive in nature using operations research and optimization techniques.

LESSON ROUND UP

Information Technology based banking was introduced in India since late 1980s for bringing in efficient customer service, better housekeeping and internal controls, improving productivity as well as faster decision making. As products and services offered are IT based, they are also subject to risks such as Security, Availability Performance and Compliance risks. However, these risks can be managed with the help of controls such as Preventive, Detective and Corrective controls. Additionally, Physical control, internal control and operational controls can also be exercised to safe guard the interest of banks and customers. Large number of banks today are on the platform of CORE banking for facilitation bank wide transactions simultaneously across several geographical locations with the help of Cetral Data Centres. Core banking also has certain inherent risks which can be managed through appropriate controls such as Password control, Logical access controls, Personnel controls and Security controls. With the introduction of IT based system banks are able to generate MIS for faster decision making. Also banks nowadays use analytical methodologies such as Business intelligence and data analytics to study customer requirements for offering tailor made products and services.

GLOSSARY

BPR, NEFT, RTGS, UPI, IMPS, Mobile Banking, Internet Banking, Security risk, Availability risk, Performance risk, Compliance risk, Preventive controls, Detective controls, Corrective controls, Physical controls, Internal controls, Operational controls, Data encryption, Audit trail, Core Banking, Presentation Layer, Application layer, Data Layer, System & Network logging, Cyber crimes, Virus attacks, spamming, cyber phishing, cyber stalking, e-mail bombing, cyber squatting, Bot Networks, Time thefts, Hacking, Cracking, Carding, Cross-site Scripting, Spoofing, Password Control, Logical access control, Personnel control, Transaction control, Security control, Business Intelligence, Data Analytics, Client Relationship Management.

SELF TEST QUESTIONS

1. Fill in the blanks
   a. ..... is the most popular devise in India, which enables the customers to withdraw their money 24 hours a day
   b. ..... means acquire information such as usernames, passwords, credit card details, personal detail etc. by electronic communication.
   c. ..... is a risk of information handling or processing will fail to meet regulatory, IT or business policy requirements.
   d. ..... is a collection of decision support technologies for gathering, providing access to, and analyzing data for the purpose of helping enterprise users (executives, managers and analysts) make better and faster business decisions.
   e. Analytics is of ..... types. They are ..... , ... and .....
2. Write True or False
   a. Fund transfers through the NEFT system do not occur in real-time basis.
   b. CORE banking enables anytime anywhere banking.
   c. ATMs can only be used for withdrawals of money.
   d. Application layer contains the business logic (for processing of data and transactions) and necessary interfaces to the data layer.
   e. Cyber crime includes all unauthorized access of information and break of security like privacy, password, etc. with the use of internet
3. Answer the following questions briefly
   1. What are IT related risks and controls? Mention briefly about them.
   2. Write a short note on cyber crime
   3. What is the importance of the MIS for a bank
   4. What is core banking? What are the controls in Core Banking process flow?

For Further Reading

1. Article by Ana Savić Managing IT-Related Operational Risks
2. http://shodhganga.inflibnet.ac.in/bitstream/10603/84085/16/16_chapter4
3. A Study of Information Security Systems for core Banking in urban co-operative Banks of Pune & Mumbai”
4. Latest Face of Cybercrime and Its Prevention In India, Vineet Kandpal HMI Technology Pvt. Ltd. Almora
5. Management Information System (MIS) in Banking Sector, Khaja Mohammad Fathe Ali
6. Data Analytics: A Phenomenal, Pervasive, Productive and Profitable Paradigm - Dr. V. Ravi, Professor, IDRBT.

Lesson 7

Payment and Collection of Cheques and other Negotiable Instruments

LESSON OUTLINE

- Negotiable Instruments Act
- Endorsements
- Role and Duties of a Paying Bank
- Forged Instruments
- Bouncing/Return of Cheques and its Implications
- Role and Duties of a Collecting Bank
- Cheque Truncation System
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

To provide an insight of various negotiable instruments and the role of a bank in collecting and paying these instruments.

The chapter will enable the reader to learn about:

- What are negotiable instruments?
- Important Provisions of Negotiable Instruments Act, 1881.
- Collection and Payment of Negotiable Instruments.
- Working of clearing house.

INTRODUCTION

The topics covered in this chapter deals with payment and collection of cheques and other negotiable instruments like of Bill of exchange, promissory notes and cheques, etc. The objective of the chapter is to familiarize a reader to the various types of negotiable instruments, the statutory role and responsibilities of a banker, related aspects like crossings, endorsements, forgeries, implications of dealing with forged instruments, liabilities thereof, duties of a collecting and paying banker as set out in the Negotiable Instruments Act, 1881. In addition, an overview of the modern Image based cheque collection process under Cheque Truncation System (CTS) is also given to make the reader familiar with the current process that is in vogue in banking.

For an easy understanding of a student, materially important sections from a professional banker's point of view from the Act are discussed.

The contents are presented in such a way that it would help a student to equip himself with basic knowledge, operational practicalities as well as for advisory role in future should he chooses to take. The contents are a mix of level 1 and 2 orientations.

Types of Negotiable Instruments

The Negotiable Instruments Act (NI Act) was passed in 1881 and was subsequently amended in 1988 and the again in 2002. The act as on date has 147 sections. The Act is applicable to whole of India. Negotiable instrument is as such specifically not defined in the Act. Section 13 states "A Negotiable Instrument" (NI) means a promissory note, bill of exchange or cheque payable either to order or to bearer. A negotiable instrument may be made payable to two or more payees jointly, or in the alternative to one of the two, or one or some of several payees. All negotiable instruments are in written form and contains an unconditional undertaking (promise) or unconditional order.

Following are some of the important sections of Negotiable Instrument Act, with some explanations.

• Section 4 of Negotiable Instruments Act:

Defines the features of Promissory Note

Note the following terms, where A signs instruments as –

(a) "I promise to pay B or order Rs.1000.00"

(b) "I acknowledge myself to be indebted to B in Rs.1000.00, to be paid on demand, for value received." (c) "Mr. B, I Owe You Rs.1000.00"

(d) "I promise to pay B Rs.1000.00 and all other sums which shall be due to him."

(e) "I promise to pay B, Rs.1000.00, first deducting from it any money which he may owe me."

(f) "I promise to pay B, Rs.1000.00, seven days after his marriage with C"

(g) "I promise to pay B, Rs.1000.00, after the death of D, provided he leaves me enough money to pay."

(h) "I promise to pay B, Rs.1000.00 and deliver my blue shirt on 1 January of next year"

In above illustrations only a and b are promissory notes and the rest (c to h) are not.

A "**Promissory note**" is an instrument in writing 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.

• Section 5 of Negotiable Instruments Act:

For section 4 and 5 note that a promise or order to pay is not "conditional", by reason of the time for payment of the amount or any installment thereof being expressed to be on the lapse of a certain period after the occurrence of a specified event which, according to the ordinary expectation of a common man, is certain to happen, although the time of its happening may not be certain. For example, while signing bill of exchange, if the drawer adds certain conditions, it will be treated as incorrect drawn negotiable instrument.

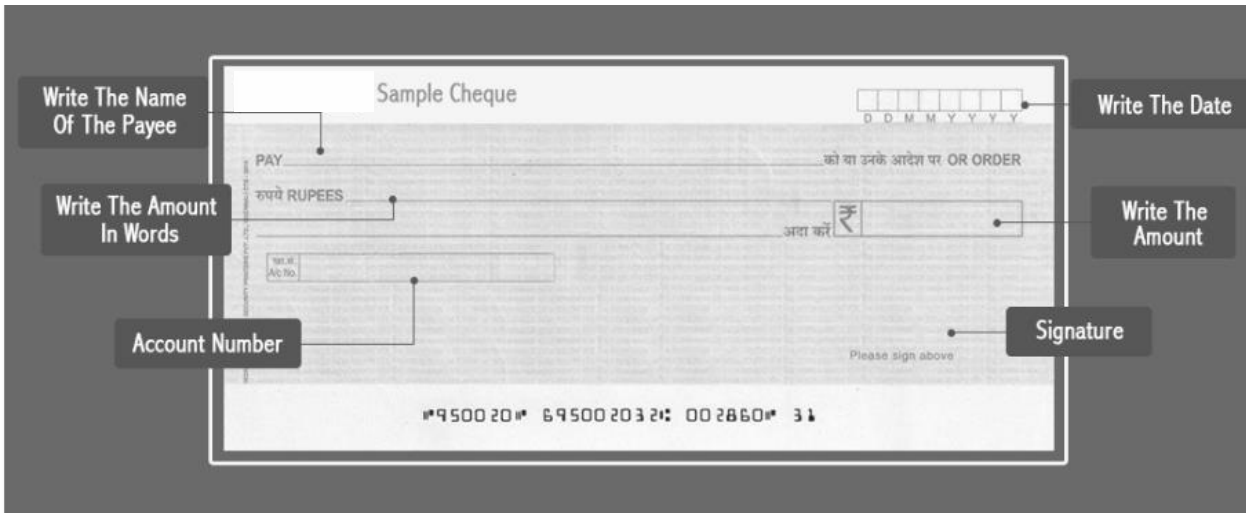
> A "**bill of exchange**" is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument.

Sum payable is "certain", although it includes future interest or is payable at an indicated rate of exchange. Person is "certain", although he is mis-named or designated by description only.

• Section 6 of Negotiable Instruments Act:

A cheque is an example of Bill of exchange which is drawn on a banker in the form of physical paper (Cheque Book issued by the bank.) In modern banking system, the cheque in the electronic form" means a cheque drawn by using any computer resource and signed in a secure system with digital signature (with or without biometrics signature) and asymmetric crypto system or with electronic signature, as the case may be. (meanings as assigned in Information Technology Act) "A truncated cheque" means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving the payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.Cheque Truncation System replaced the manual processing of clearance of cheques with Image based solutions with various benefits like faster clearance, cost savings and accurate processing.

> A "**cheque**" is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form.



Parties to a Negotiable Instrument

• Section 7 of Negotiable Instruments Act:

Define the role of three parties of negotiable instruments – Drawer, Drawee and Payee.

Example: Mr. Dinesh Sawant, issues a cheque of Rs. 12,000.00 from his savings account with State Bank of India, Fort Branch to Kalpataru Housings Society as monthly rent, then in this case - Mr. Dinesh Sawant is Drawer, State Bank of India, Fort Branch is drawee and Kalpataru Housing Society is payee.

Section 8 of Negotiable Instruments Act: The "holder" of NI means any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto.

Section 9 of Negotiable Instruments Act: The "holder in due course" means any person who for consideration became the possessor of NI, if payable to bearer or the payee or indorsee thereof if payable to order, before the amount mentioned in it became payable and without having sufficient cause to believe that any defect in the title of the person from whom he derived his title.

> The maker of a bill of exchange or cheque is called the "drawer"; the person thereby directed to pay is called the "drawee". When in the bill or in any indorsement thereon the name of any person is given in addition to the drawee to be resorted to in case of need, such a person is called "drawee in case of need". After the drawee of a bill has signed his assent upon the bill, or if there are more parts thereof than one, on one of such parts, and delivered the same, or given notice of such signing to the holder or to some person on his behalf, he is called the "acceptor." The person named in the instrument, to whom or to whose order the money is to be paid is called "payee".

The difference between the "holder" and the "holder in due course" can be understood from following:

1. **Consideration** – it is a must to become "holder in due course" but not essential to be a "holder." For example, if A issues a cheque to a C – a charitable institution, C cannot become holder in due course. However, If A issues cheque to G – an owner of grocery shop, from where purchases are done, G becomes holder in due course.
2. **Possession** – to be a holder in due course, the possession of the instrument, before it becomes due, is a must. For example, if a bill of exchange is payable on June 25, 2018, the possessor (payee or endorsee) must possess the said bill before this date (even if consideration exits).
3. **Defect in the title of Negotiable Instrument** – in order to become holder in due course the instrument must be received after taking care that it is free from any defect and the title is good. If P, a partner of a firm, endorses a cheque in favour of a Partnership firm, in the name of X, to pay off his personal debts. Here X cannot be holder in due course as apparently the validity of partner's title over the cheque is doubtful.

• Section 10 of Negotiable Instruments Act:

Payment in due Course: Any person liable to make payment under a negotiable instrument, must make the payment of the amount due thereunder in due course in order to obtain a valid discharge against the holder.

A payment in due course means a payment in accordance with the apparent tenor of the instrument, in good faith and without negligence to any person in possession thereof.

A payment will be a payment in due course if:

(a) it is in accordance with the apparent tenor of the instrument, i.e., according to what appears on the face of the instrument to be the intention of the parties;

(b) it is made in good faith and without negligence, and under circumstances which do not afford a ground for believing that the person to whom it is made is not entitled to receive the amount;

(c) it is made to the person in possession of the instrument who is entitled as holder to receive payment;

(d) payment is made under circumstances which do not afford a reasonable ground believing that he is not entitled to receive payment of the amount mentioned in the instrument; and

(e) payment is made in money and money only.

Under Sections 10 and 128, a paying banker making payment in due course is protected.

Some examples, where the payment of cheque, is not a payment in due course –

1. Payment of a postdated cheque (Cheque bearing a date 20 July, 2018 is paid on 15 July, 2018)
2. A cheque bearing crossing in the name of "State Bank of India", is paid to when presented by "Bank of India"
3. A cheque, the payment of which was already countermanded (stopped) by the drawer, is paid when presented.

Inland and foreign instrument

• **Section 11 & 12 of Negotiable Instruments Act:** Inland and Foreign instrument – A NI drawn or made in India, and made payable in, or drawn upon any person resident in India shall be deemed to be an inland bill and any such instrument not so drawn, made or made payable shall be deemed to be a foreign instrument.

Some examples of inland and foreign instruments –

1. A, a seller from Mumbai, draws a bill on B, a buyer from Baroda, payable at Kolkata – Inland
2. A, a seller from Nasik, draws a bill on B, a buyer from London, payable at Mumbai – Inland
3. A, a seller from Baroda, draws a bill on B, a buyer from London, payable at New York – Foreign
4. A, a seller from Mumbai, draws a bill on B, a buyer from Baroda, payable at London – Inland

Negotiation – Better Title to Transferee

• **Section 14 of Negotiable Instruments, Act:** Negotiation – when a NI is transferred to any person, so as to constitute that person the holder thereof, the instrument is said to be negotiated.

The difference between transferability and negotiability – In case of a commodity the transferor cannot pass on a better title than what he has, to the transferee, as a general rule. It is not so in case of NIs, where the transferee can get better title than the transferor.

For example, If A sells a TV set (commodity) to B which is actually stolen by A and B purchases it after paying price (consideration) and without the knowledge that it is stolen one, later on if it is revealed and proved that it is a stolen set, B will have to return the TV set to true owner (in spite of paying consideration and not being aware of the fact that it was a stolen one.) However, had it been a cheque (NI) where B was not aware that A from whom he had taken it for consideration and in good faith, without having knowledge of the defect in the title, can have better title than A.

ENDORSEMENTS

• **Section 15 and 16 of Negotiable Instruments Act:** Indorsement (endorsement) – when the maker or holder of a NI signs the same, otherwise than as maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto for purpose of receiving an additional endorsements as sufficient space may not be there on the back of the page (Allonge), he is said to indorse (endorse) the same and is called as indorser (endorser).

If the endorser signs his name only, the endorsement is said to be "in blank", and if he adds a direction to pay the amount mentioned in the instrument to or to the order of a specified person, the endorsement is said to be "in full". For example A issues cheque to B for Rs. 5000 /- and B endorse cheques to C and write on the back of the cheque as "Pay C "and signs with the name, will be considered as endorsement in full. The person so specified is "indorsee (endorsee)" of the instrument.

Other types of endorsements in addition to "in blank" and "in full" endorsements –

1. "Conditional" where the endorser excludes his own liability or makes it conditional (the right of endorsee to receive the amount due on the instrument depends on happening of a specified event, which may or may not happen) (Section 52)
2. "Restrictive" where the right to negotiate or receive the amount is restricted or excluded. e.g. "Pay A only" (Section 50)
3. Sans Recourse (without liability) where the endorser excludes his liability. e.g. "Pay to A without recourse to me." (Section 52)
4. Facultative where the right of a endorsee to give a notice of dishonour to the endorser is waived, in writing.

Characteristics of Negotiable Instruments under various sections

• **Section18 of Negotiable Instruments Act:** Where the amount undertaken or ordered to be paid is stated differently in figures and in words, the amount stated in words shall be the amount undertaken or ordered to be paid. For example, The amount in words in cheque is mentioned as Rs. Six thousand only and in the figures it is mentioned as Rs.60000/-, cheque should be paid with Rs. 6000 /-

• **Section 19 of Negotiable Instruments Act:** A promissory note and a bill of exchange, in which no time is for payment is specified, and a cheque are payable on demand.

• **Section 21 of Negotiable Instruments Act:** In a promissory note or bill of exchange the expressions "at sight" and "on presentation" mean "on demand". The expression "after sight" means, in a promissory note, after presentation and in bill of exchange, after acceptance, or noting for non-acceptance or protest for non-acceptance.

• **Section 22 of Negotiable Instruments Act:** "Maturity" of a promissory note or bill of exchange is the date at which it falls due.

Every promissory note or bill of exchange which is not expressed to be payable on demand, at sight or on presentation is at maturity on the third day after the day on which it is expressed to be payable. ("Days of Grace")

• **Section 23,24 & 25 of Negotiable Instruments Act:** In calculating the maturity date of promissory note or bill of exchange, made payable at stated number of months after date or after sight, the period stated shall be held to terminate on the day of the month which corresponds with the day on which the instrument is dated, or

presented for acceptance or sight. If the month in which the period would terminate has no corresponding day, the period shall terminate on the last day of such month.

In calculating the date at which promissory note or bill of exchange made payable a certain number of days after date or sight, the day of the date, or presentation, sight shall be excluded.

When the day on which a promissory note or bill of exchange is at maturity is a public holiday (or Sunday or any other day declared as public holiday by notification), the instrument will be due on next preceding business day.

Examples:

1. A bill dated 31st August, 2018 payable 3 months after date will be due on 3rd November, 2018. (since November has 30 days, the 3 months period will complete on November 30. Adding 3 days of grace, the 3rd day of grace will be the due date which is 3rd November)
2. A bill dated 1st January 2018, payable 30 days after date will be due on 3rd February, 2018. (31 days of January, day of the bill to be exclude so 30 days completed on 31st January. Adding 3 days of grace, the 3rd day of grace being the due date, it will be 3rd February 2018.)
3. If the above bill in example 2, is payable 30 days after sight and is accepted on 5th of January 2018, the due date of the bill would be 7th February 2018. (excluding date of acceptance 26 days of January plus 4 day of February will make 30 days. Thereafter adding 3 days of grace, the third day of grace will be 7th February 2018, which will be the due date.)
4. If the same bill in example 2, is payable one month after date, the due date would 4th February 2018. (excluding date of bill that is 1st January, from 2nd of January one month will be completed on 1st of February. Adding 3 days of grace the third day of grace would be 4th February 2018.)
5. if the same bill in example 2, is payable one month after sight and is accepted on 5th January, the due date would be 8th February 2018. (excluding date of acceptance that is 5th January, from 6th of January one month will be completed on 5th February. Adding 3 days of grace, the third day of grace that is 8th February 2018 will be the due date.)

• **Section 26 of Negotiable Instruments Act:** Every person capable of contracting, according to the law to which he is a subject, may bind himself and be bound by the making, drawing, acceptance, endorsement, delivery and negotiation of a NI.

Minor may draw, endorse, deliver and negotiate such instrument so as to bind all parties except himself.

• **Section 27 & 28 of Negotiable Instruments Act:** Every person capable of binding himself or of being bound, may so bind himself or be bound by a duly authorized agent acting in his name.

An agent who signs his name to a NI without indicating thereon that he signs as agent, or that he does not intend thereby to incur personal responsibility, is liable personally on the instrument.

• **Section 30 of Negotiable Instruments Act:**. The drawer of a bill or cheque is bound, in case of dishonour by the drawee or accepter thereof, to compensate the holder, provided due notice of dishonour has been given to or received by the drawer.

• **Section 31 of Negotiable Instruments Act:** 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.

• **Section 36 of Negotiable Instruments Act:** Every prior party to a negotiable instrument is liable thereon to

a holder in due course until the instrument is duly satisfied.

• **Section 38 of Negotiable Instruments Act:** Example: A (drawer) draws a bill to his own order on B (drawee) who accepts it (acceptor). A afterwards endorses the bill to C, C to D, and D to E. As between E and B, B is principal debtor and A, C and D are sureties. As between E and A, A is the principal debtor and C and D are sureties. As between E and C, C is the principal debtor and D is surety.

• **Section 43 of Negotiable Instruments Act:** A negotiable instrument made, drawn, accepted, endorsed or transferred without consideration, or for a consideration which fails, creates no obligation of payment between the parties to the transaction. But if any such party has transferred the instrument with or without endorsement to a holder for consideration, such holder, and every subsequent holder deriving title from him, may recover the amount due on such instrument from the transferor for consideration or any prior party thereto.

• **Section 46 of Negotiable Instruments Act:** The making, acceptance or endorsement of a promissory note, bill of exchange or cheque is completed by delivery, actual or constructive.

NI payable to bearer is negotiable by the delivery thereof.

NI payable to order is negotiable by the holder by endorsement and delivery thereof.

• **Section 79 & 80 of Negotiable Instruments Act:** When interest at a specified rate is expressly made payable on a promissory note or bill of exchange, interest shall be calculated at the rate specified, on the amount of the principal money due thereon, from the date of the instrument, until tender or realization of such amount, or until such date after the institution of a suit to recover such amount as the court directs.

When no rate is specified in the instrument, interest will be calculated at the rate of 18% p.a.

• **Section 85 & 85A of Negotiable Instruments Act:** Where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course. Order cheques can be transferred by endorsement and delivery from one person to another.

When a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any endorsement whether in full or in blank appearing, thereon, and notwithstanding that any such endorsement purports to restrict or excludes further negotiation.Bearer cheques can be transferred by mere delivery from one person to another.

Where any draft (DD – Demand Draft) payable to order on demand, purports to be endorsed by or on behalf of the payee, the bank is discharged by payment in due course.

• **Section 87 & 88 of Negotiable Instruments Act:** Any material alteration of a NI renders the same void against anyone who is a party thereto at the time of making such alteration and does not consent thereto, unless it was made in order to carry out the common intention of the original parties. Any alteration in the cheques need to be authenticate by the drawer with full signature. Signature of the drawer on the negotiable instrument is a mandate of the drawer therefor any material alteration in the cheques change the customer`s mandate. Example alteration in payee`s name, date, amount in words or figures. Opening of crossing etc. requires drawer`s full signature.

Any such alteration, if made by endorsee, discharges its endorser from all liability to him in respect of the consideration thereof.

• **Section 89 of Negotiable Instruments Act:** Where a NI has been materially altered but does not appear to have been so altered, or where a cheque is presented for payment which does not at the time of presentation appear to be crossed or to have had crossing which has been obliterated, –

Payment thereof in due course, shall discharge such a person or bank from all liability thereon.

Where the cheque is an electronic image of a truncated cheque, any difference in apparent tenor of such electronic image and the truncated cheque shall be a material alteration and it shall be the duty of the bank or the clearing house, as the case may be, to ensure the exactness of the apparent tenor of electronic image of the truncated cheque while truncating and transmitting the image.

Any bank or a clearing house which receives a transmitted image of a truncated cheque, shall verify from the party who transmitted the image to it, that the image so transmitted to it and received by it, is exactly the same.

Noting

• **Section 99 of Negotiable Instruments Act:** When a promissory note or bill of exchange has been dishonoured by non-acceptance, or non-payment, the holder may cause such dishonour to be noted by a notary public upon the instrument, or upon a paper attached thereto.

Such note must be made within a reasonable time after dishonour, and must specify the date of dishonour, the reason if any for dishonour, or if the instrument has not been expressly dishonoured, the reason why the holder treats it as dishonoured, and the notary charges.

Protest

• **Section 100 & 101 of Negotiable Instruments Act:** When a promissory note or bill of exchange has been dishonoured by non-acceptance or non-payment, the holder may, within a reasonable time, cause such dishonour to be noted and certified by a notary public. Such certificate is called a protest. The protest must contain –

(a) Either the instrument itself or a literal transcript of the instrument.

(b) The name of the person for whom and against whom the instrument protested.

(c) A statement (payment, acceptance, better security) that has been demanded of such person by the notary public.

(d) Date, place and time of dishonour.

(e) The subscription of notary public making the protest.

(f) The name of the person by whom, of the person for whom, and the manner in which, such acceptance or payment was offered and effected.

Compensation

• **Section 117 of Negotiable Instruments Act:** The compensation payable in case of dishonour of a promissory note, bill of exchange or cheque, by any party liable to the holder or any endorser shall be determined by the following rules –

(a) The holder is entitled to the amount together with the expenses incurred in presenting, noting and protesting.

(b) When the person charged resides at a place different from that at which the instrument was payable, the holder is entitled to receive such sum at the current rate of exchange between two places.

(c) The endorser is entitled to the amount paid with interest from the date of payment until tender or realization thereof, together with all expenses caused by the dishonour and payment.

(d) When the person charged and such endorser reside at different places, the endorser is entitled to receive such sum at the current rate of exchange between two places.

(e) The party entitled to compensation may draw a bill upon the party liable to compensate him, payable at sight or on demand, for the amount due to him. Such bill must be accompanied by the instrument dishonoured and the protest, if any. If such bill is dishonoured, the party dishonouring is liable to make compensation thereof in the same manner as in the case of original bill.

Presumptions

• **Section 118 of Negotiable Instruments Act:** Until the contrary is proved, the following presumptions shall be made to negotiable instrument.

(a) Consideration – that every negotiable instrument was made or drawn for consideration, and that such instrument, when it was accepted, endorsed, negotiated or transferred, was accepted, endorsed, negotiated or transferred for consideration.

(b) Date – that every negotiable instrument bearing a date was made or drawn on such date.

(c) Time of acceptance – that every accepted bill of exchange was accepted within the reasonable time after its date and before its maturity.

(d) Time of transfer – that every transfer of negotiable instrument was made before its maturity.

(e) Order of endorsements – that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

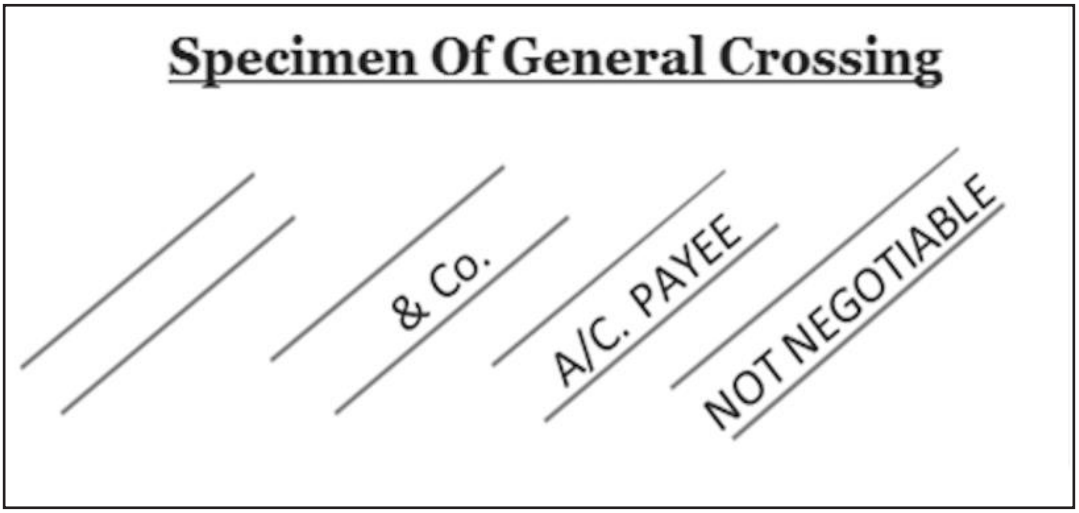
(f) Stamp – that a lost instrument was duly stamped.

(g) Holder is a holder in due course.

Crossing of a cheque

• **Section 123 of Negotiable Instruments Act:** Where a cheque bears across its face an addition of the words “and company” or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply, either with or without the words “not negotiable”, that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally. Crossed cheque cannot be paid on the bank branch counter for cash payment and has to be paid through clearing process.

• **Section 124 of Negotiable Instruments Act:** Where a cheque bears across its face an addition of the name of a banker, either with or without the words “Not Negotiable”, that addition shall be deemed a crossing and the cheque shall be deemed to be crossed specially, and to be crossed to that banker. (in special crossing, two parallel transverse line are not necessary) .Special crossed cheques need to be mandatory collected by the bank whose name is mentioned between the two parallel lines and where the payee`s account is maintained. Special crossing make the cheque more safe and reduces the risk of wrong credit .



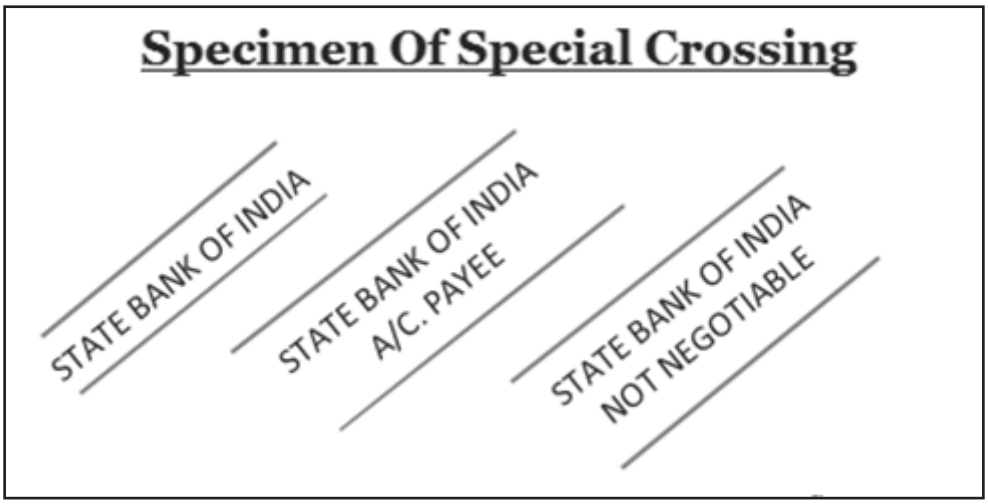
• **Section 125 of Negotiable Instruments Act:** Where a cheque is uncrossed, the holder may cross it generally or specially.

- Where a cheque is crossed generally, the holder may cross it specially.
- Where a cheque is crossed generally or specially, the holder may add the words "Not Negotiable"
- Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker, his agent for collection.

• **Section 126 of Negotiable Instruments, Act:** Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker.

- Where a cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed, or his agent for collection.

• **Section 127 of Negotiable Instruments Act:** Where a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof.



• **Section 128 of Negotiable Instruments Act:** Where the banker on whom a crossed cheque is drawn has paid the same in due course, the banker paying the cheque, and (in case such cheque has come to the hands

of the payee) the drawer thereof, shall respectively be entitled to the same right, and be placed in the same position in all respects, as they would respectively be entitled to and placed in if the amount of the cheque had been paid to and received by the true owner thereof.

• **Section 129 of Negotiable Instruments, Act:** Any banker paying a cheque crossed generally otherwise than to a banker, or a cheque crossed specially otherwise than to a banker to whom it is crossed, or his agent for collection, being a banker, shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid.

• **Section 130 of Negotiable Instruments, Act:** A person taking a cheque crossed generally or specially, bearing in either case the words "not negotiable", shall not have, and shall not be capable of giving, a better title to the cheque than that which the person from whom he took it had.

• **Section 131 of Negotiable Instruments, Act:** A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title of the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment.

A banker receives payment of a crossed cheque for a customer within the meaning of this section notwithstanding that he credits his customers' account with the amount of the cheque before receiving payment thereof.

It shall be the duty of the banker who receives payment based on an electronic image of a truncated cheque held with him, to verify the prima facie genuineness of the cheque to be truncated and any fraud, forgery or tampering apparent on the face of the instrument that can be verified with due diligence and ordinary care.

• **Section 131A of Negotiable Instruments Act:** These provisions shall apply to any draft, as defined in section 85A, as if the draft were a cheque.

Penalties for dishonour of a cheque

Chapter XVII of the Negotiable Instruments Act, 1881 provides for penalties in case of dishonour of certain cheques for insufficiencies of funds in the accounts. Sections 138 to 147 deal with these aspects.

Chapter XVII has been amended by the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002. The amendments have provided the drawer with more time to send notice, made the punishment for the offence more stringent, given power to court for condonation of delay in filing of complaint, excluded liability of government nominated directors, made provision for summary trial of cases under the Chapter and time bound disposal of cases, have relaxed the rules of evidence, and made the offences under the Act compoundable.

The working of the provisions of Chapter XVII for a period of more than a decade had brought to the fore front various lacunae and shortcomings from which it suffered. It was seen that there were enormous delays in the disposal of the cases filed under Section 138 and the drawer of the cheques, by taking shield of various technicalities and procedures were frustrating the very object of the Chapter.

Further Chapter XVII amended by the Negotiable Instruments (Amendment) Act, 2015. The amendment focused on clarifying the jurisdiction related issues for filing cases for offence committed under section 138 of the Negotiable Instruments Act, 1881. The Negotiable Instruments (Amendment) Act, 2015, facilitates filing of cases only in a court within whose local jurisdiction the bank branch of the payee, where the payee delivers the cheque for payment through his account, is situated, except in case of bearer cheques, which are presented to the branch of the drawee bank and in that case the local court of that branch would get jurisdiction. The Negotiable Instruments (Amendment) Act, 2015 provides for retrospective validation for the new scheme of determining the jurisdiction of a court to try a case under Section 138 of the Negotiable Instruments Act, 1881.

The Negotiable Instruments (Amendment) Act, 2015 also mandates centralisation of cases against the same drawer.

With a view to address the issue of undue delay in final resolution of cheque dishonour cases so as to provide relief to payees of dishonoured cheques and to discourage frivolous and unnecessary litigation, Parliament enacted the Negotiable Instruments (Amendment) Act, 2018 and notified by the Central Government on 1st September, 2018.The Amendments Act strengthen the credibility of cheques and help trade and commerce in general by allowing lending institutions, including banks, to continue to extend financing to the productive sectors of the economy. The Negotiable Instruments (Amendment) Act, 2018 inserted two new sections i.e. Section 143A dealing with Power to direct interim compensation and Section 148 dealing with Power of Appellate Court to order payment pending appeal against conviction.

Dishonour of Cheque for Insufficiency, etc., of Funds in the Account

Section 138 of the Act provides that where any cheque drawn by a person on an account maintained by him with a banker for payment of any amount of money to another person from out of that account for the discharge, in whole or in part, of any debt or other liability, is returned by the bank unpaid, either because of the amount of money standing to the credit of that account is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from that account by an agreement made with that bank, such person shall be deemed to have committed an offence and shall, without prejudice to any other provision of this Act, be punished with imprisonment for a term which may be extended to two years', or with fine which may extend to twice the amount of the cheque, or with both.

Provided that nothing contained in this section shall apply unless –

(a) the cheque has been presented to the bank within a period of six months from the date on which it is drawn or within the period of its validity, whichever is earlier;

(b) the payee or the holder in due course of the cheque, as the case may be, makes a demand for the payment of the said amount of money by giving a notice; in writing, to the drawer of the cheque, within thirty days] of the receipt of information by him from the bank regarding the return of the cheque as unpaid; and

(c) the drawer of such cheque fails to make the payment of the said amount of money to the payee or, as the case may be, to the holder in due course of the cheque, within fifteen days of the receipt of the said notice.

Presumption in Favour of Holder

As per Section 139 of the Act, it shall be presumed, unless the contrary is proved, that the holder of a cheque received the cheque of the nature referred to in section 138 for the discharge, in whole or in part, of any debt or other liability.

Defence which may not be allowed in any Prosecution under Section 138

Section 140 states that it shall not be a defence in a prosecution for an offence under section 138 that the drawer had no reason to believe when he issued the cheque that the cheque may be dishonoured on presentment for the reasons stated in section 138.

Offences by Companies

According to Section 141(1) of the Act, if the person committing an offence under section 138 is a company,

every person who, at the time the offence was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.

Provided that nothing contained in this sub-section shall render any person liable to punishment if he proves that the offence was committed without his knowledge, or that he had exercised all due diligence to prevent the commission of such offence.

Provided further that where a person is nominated as a Director of a company by virtue of his holding any office or employment in the Central Government or State Government or a financial corporation owned or controlled by the Central Government or the State Government, as the case may be, he shall not be liable for prosecution under Chapter XVII.

Further Section 141(2) states that notwithstanding anything contained in sub-section(1), where any offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to, any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

Explanation: For the purposes of section 141 (a) "company" means anybody corporate and includes a firm or other association of individuals; and (b) "director", in relation to a firm, means a partner in the firm.

Cognizance of Offences

As per Section 142(1) of the Act, notwithstanding anything contained in the Code of Criminal Procedure, 1973 -

(a) no court shall take cognizance of any offence punishable under Section 138 except upon a complaint, in writing, made by the payee or, as the case may be, the holder in due course of the cheque;

(b) such complaint is made within one month of the date on which the cause of action arises under clause (c) of the proviso to Section 138.

Clause (c) of the proviso to Section 138 provides that the drawer of such cheque fails to make the payment of the said amount of money to the payee or, as the case may be, to the holder in due course of the cheque, within fifteen days of the receipt of the said notice.

Provided that the cognizance of a complaint may be taken by the Court after the prescribed period, if the complainant satisfies the Court that he had sufficient cause for not making a complaint within such period;

(c) no court inferior to that of a Metropolitan Magistrate or a Judicial Magistrate of the first class shall try any offence punishable under Section 138.

Further, Section 142(2) provides that the offence under Section 138 shall be inquired into and tried only by a court within whose local local jurisdiction –

(a) if the cheque is delivered for collection through an account, the branch of the bank where the payee or holder in due course, as the case may be, maintains the account, is situated; or

(b) if the cheque is presented for payment by the payee or holder in due course, otherwise through an account, the branch of the drawee bank where the drawer maintains the account, is situated.

Explanation: For the purposes of clause (a), where a cheque is delivered for collection at any branch of the bank of the payee or holder in due course, then, the cheque shall be deemed to have been delivered to the branch of the bank in which the payee or holder in due course, as the case may be, maintains the account.

Validation for Transfer of Pending Cases

Section 142A (1) of the Negotiable Instrument Act states that notwithstanding anything contained in the Code of Criminal Procedure, 1973 or any judgment, decree, order or direction of any court, all cases transferred to the court having jurisdiction under section 142(2), as amended by the Negotiable Instruments (Amendment) Ordinance, 2015, shall be deemed to have been transferred under this Act, as if that sub-section had been in force at all material times.

As per Section 142A(2), notwithstanding anything contained in Section 142(2) or Section 142(1), where the payee or the holder in due course, as the case may be, has filed a complaint against the drawer of a cheque in the court having jurisdiction under section 142(2) or the case has been transferred to that court under Section 142(1) and such complaint is pending in that court, all subsequent complaints arising out of section 138 against the same drawer shall be filed before the same court irrespective of whether those cheques were delivered for collection or presented for payment within the territorial jurisdiction of that court.

Section 142A(3) states that if, on the date of the commencement of the Negotiable Instruments (Amendment) Act, 2015, more than one prosecution filed by the same payee or holder in due course, as the case may be, against the same drawer of cheques is pending before different courts, upon the said fact having been brought to the notice of the court, such court shall transfer the case to the court having jurisdiction under Section 142(2), as amended by the Negotiable Instruments (Amendment) Ordinance, 2015, before which the first case was filed and is pending, as if that sub-section had been in force at all material times.

Power of Court to try Cases Summarily

Section143 (1) of the Act provides that notwithstanding anything contained in the Code of Criminal Procedure, 1973 all offences under Chapter XVII of the Act shall be tried by a Judicial Magistrate of the first class or by a Metropolitan Magistrate and the provisions of sections 262 to 265 (both inclusive) of the Code of Criminal Procedure, 1973 shall, as far as may be, apply to such trials.

Provided that in the case of any conviction in a summary trial under this section, it shall be lawful for the Magistrate to pass a sentence of imprisonment for a term not exceeding one year and an amount of fine exceeding five thousand rupees.

Provided further that when at the commencement of, or in the course of, a summary trial under this section, it appears to the Magistrate that the nature of the case is such that a sentence of imprisonment for a term exceeding one year may have to be passed or that it is, for any other reason, undesirable to try the case summarily, the Magistrate shall after hearing the parties, record an order to that effect and thereafter recall any witness who may have been examined and proceed to hear or rehear the case in the manner provided by the Code of Criminal Procedure, 1973 .

As per Section143(2), the trial of a case under this section shall, so far as practicable, consistently with the interests of justice, be continued from day to day until its conclusion, unless the Court finds the adjournment of the trial beyond the following day to be necessary for reasons to be recorded in writing.

Section1433) states that every trial under this section shall be conducted as expeditiously as possible and an endeavour shall be made to conclude the trial within six months from the date of filing of the complaint.

Power to Direct Interim Compensation

Section 143A(1)Negotiable Instruments Act provides that notwithstanding anything contained in the Code of Criminal Procedure, 1973, the Court trying an offence under section 138 of the Negotiable Instrument

Act,1881(Dishonour of cheque for insufficiency, etc., of funds in the account) may order the drawer of the cheque to pay interim compensation to the complainant –

(a) in a summary trial or a summons case, where he pleads not guilty to the accusation made in the complaint; and

(b) in any other case, upon framing of charge.

Section 143A (2) states that the interim compensation under sub-section (1) shall not exceed twenty per cent. of the amount of the cheque.

Section 143A (3), the interim compensation shall be paid within sixty days from the date of the order under sub-section (1), or within such further period not exceeding thirty days as may be directed by the Court on sufficient cause being shown by the drawer of the cheque.

As per Section 143A (4), if the drawer of the cheque is acquitted, the Court shall direct the complainant to repay to the drawer the amount of interim compensation, with interest at the bank rate as published by the Reserve Bank of India, prevalent at the beginning of the relevant financial year, within sixty days from the date of the order, or within such further period not exceeding thirty days as may be directed by the Court on sufficient cause being shown by the complainant.

Section 143A (5) provides that the interim compensation payable section 143A may be recovered as if it were a fine under section 421 of the Code of Criminal Procedure, 1973.

As per Section 143A(6), the amount of fine imposed under section 138 or the amount of compensation awarded under section 357 of the Code of Criminal Procedure, 1973, shall be reduced by the amount paid or recovered as interim compensation under this section.

Mode of Service of Summons

According to Section 144 of the Act, a Magistrate issuing a summons to an accused or a witness may direct a copy of summons to be served at the place where such accused or witness ordinarily resides or carries on business or personally works for gain, by speed post or by such courier services as are approved by a Court of Session.

Where an acknowledgment purporting to be signed by the accused or the witness or an endorsement purported to be made by any person authorised by the postal department or the courier services that the accused or the witness refused to take delivery of summons has been received, the Court issuing the summons may declare that the summons has been duly served.

Evidence on Affidavit

Section 145 of the Act provides that notwithstanding anything contained in the Code of Criminal Procedure, 1973, the evidence of the complainant may be given by him on affidavit and may, subject to all just exceptions be read in evidence in any enquiry, trial or other proceeding under the Code of Criminal Procedure, 1973.

The Court may, if it thinks fit, and shall, on the application of the prosecution or the accused, summon and examine any person giving evidence on affidavit as to the facts contained therein.

Bank's Slip Prima Facie Evidence of Certain Facts

According to Section 146, the Court shall, in respect of every proceeding under this Chapter, on production of Bank's slip or memo having thereon the official mark denoting that the cheque has been dishonoured, presume the fact of dishonour of such cheque, unless and until such fact is disproved.

Offences to be Compoundable

Section 147 of the Act provides that notwithstanding anything contained in the Code of Criminal Procedure, 1973, every offence punishable under the Negotiable Instrument Act Act shall be compoundable.

Power of Appellate Court to Order Payment Pending Appeal against Conviction

Section 148(1) provides that notwithstanding anything contained in the Code of Criminal Procedure, 1973, in an appeal by the drawer against conviction under section 138 of the Negotiable Instrument Act, 1881(Dishonour of cheque for insufficiency, etc., of funds in the account), the Appellate Court may order the appellant to deposit such sum which shall be a minimum of twenty per cent. of the fine or compensation awarded by the trial Court.

The amount payable shall be in addition to any interim compensation paid by the appellant under section 143A.

Section 148(2) states that the amount referred to in sub-section (1) shall be deposited within sixty days from the date of the order, or within such further period not exceeding thirty days as may be directed by the Court on sufficient cause being shown by the appellant.

As per Section 148(3) the Appellate Court may direct the release of the amount deposited by the appellant to the complainant at any time during the pendency of the appeal:

It may be noted that if the appellant is acquitted, the Court shall direct the complainant to repay to the appellant the amount so released, with interest at the bank rate as published by the Reserve Bank of India, prevalent at the beginning of the relevant financial year, within sixty days from the date of the order, or within such further period not exceeding thirty days as may be directed by the Court on sufficient cause being shown by the complainant.

Role and Duties of Paying Bank

Under section 31 of NI Act, it is the duty of a bank to honour the cheque of a customer subject to fulfillment of certain conditions (Customer as a creditor has right to ask his money back from his banker who is debtor). Otherwise the bank has to compensate the drawer (customer) for any loss or damage caused due to non-payment. The conditions to be fulfilled include –

1. The drawer should have sufficient and properly applicable funds in the account from which the cheque is issued.

   Drawer may have more than one account in the same branch of the bank or different branches of the same bank; he cannot expect bank to combine the balances in his different accounts to honour the cheque. Similarly the drawer's balance includes the funds, which are not yet realized, the balance may be sufficient but not applicable. If a competent court has issued order to the bank, restraining from making payment, the balance in the drawer's account may be sufficient but not applicable.

   If more than one cheque are received for payment simultaneously, and the balance in the account is not sufficient to honour all the cheques; it is the decision of the bank to decide which cheque(s) is(are) to be honoured. This is because it is the duty of a customer to ensure, at the time of issuing cheque, that adequate balance is available in the account. However, bank's decision under such situation depends on – (a) who is the payee? A government department, statutory payments will have priority over individuals. (b) May be maximum number of cheques and maximum amount of liability is paid. (c) The dates of the cheques issued earlier are paid first. (d) Amount of the cheques (if cheque(s) of very small amount is/(are) dishonoured, the reputation in the market is damaged to a large extent).

2. Demand made must be in order. This means-
   (a) cheque used is from the cheque book issued by the bank.
   (b) cheque is signed by authorized person whose signature is on bank's record.
   (c) cheque is presented within business hours on a working day.(due to technology available, any branch banking and payment through ATMs are also possible)
   (d) cheque is not outdated / postdated.

Under following circumstances, even if sufficient balance is available in the drawer's account and the presentation is also proper, the paying bank should not honour the cheque –

(a) Death of a drawer, in case of accounts in the name of individuals (single or joint), proprietor, HUF and partnership. Even if the cheque bears the date before the death of a drawer, such cheque should be returned. The status at the time of payment (when the drawer is deceased), matters. In case of joint savings account with either or survivor operative instructions, a fresh cheque with the signature of the survivor should be issued. In case of HUF account, the next senior most male coparcener will become Karta, after the death of Karta. In case of partnership accounts, the cheque can be honoured with the consent of other partners. In case of death of a director of company the cheque can be passed, since the company is a separate legal entity, different from the director and has perpetual existence.

(b) Insanity and Insolvency of the drawer – insanity and insolvency bring an end to the operative instructions. Insanity should be certified by a competent medical practitioner (not MBBS doctor). Competent court serves notice of insolvency and the balance in the account is vested thereafter with official receiver.

(c) Liquidation of company – here the liquidator is appointed by the court to look after the operations in the account.

(d) Payment countermanded by the drawer – the drawer who has right to issue cheque, has equal right to stop (countermand) the payment of cheque. Only drawer can effectively stop the payment of the cheque. The stop payment instructions must be given in writing and the bank, after noting the date and time of receipt of the instructions, and making entry in the system, must issue proper acknowledgement for the same.

(e) Cheques issued or endorsed in favour of company, government department, corporate bodies etc, even if they are open (uncrossed) and bearer should not be paid in cash. These entities must clear the cheques by depositing them in their account with their bankers.

Paying bank gets protection in following circumstances.

(a) If payment is made in due course. (section 10)

(b) In case the cheque bears endorsements, the endorsements are in order (chain is not broken, even if they may not be genuine). (section 85)

(c) Material alteration on the cheque which is not apparent at the time of payment. (section 89)

DISHONOUR/RETURN OF CHEQUES AND IT'S IMPLICATIONS

When a banker dishonours a cheque of a customer, appropriate reason in writing, duly signed by its official must be given. Such cheque may either be returned across the counter or through the clearing. Following are common reasons for which the cheques are returned.

(a) Refer to drawer - In the past, banks used to return cheques with this reason when there was no sufficient balance in the drawer's account to honour the cheque. However, after addition of section 138 in NI Act, it is now expected that no such reason for insufficiency of funds be given. Some authors are of the opinion that when the drawer of the cheque becomes insane, the cheque signed by him should be returned with the reason "refer to drawer". Except this situation, the reason should not be used.

(b) Not arranged for – basically it means, the drawer has not arranged funds in the account to honour the cheque.

(c) Effects not clear, present again - where drawer has deposited cheque/(s) which is(are) sent for the clearing but not yet realized.

(d) Funds expected, present again – where the drawer has submitted some bills for collection, the payment of which is expected to be received.

(e) Exceeds arrangements – when the over draft / cash credit facility sanctioned to the drawer will exceed the limit, if the cheque is honoured.

(f) Payment countermanded (stopped) by the drawer.

(g) Drawer's signature differs / required.

(h) Cheque is outdated (stale) / post dated.

(i) Amount in words and figures differs. – although in such cases NI Act says that amount stated in words should be honoured, the general practice followed amongst bankers is to return such cheques.

(j) Cheque crossed to two banks (unless the presenting bank is acting as an agent for another bank, whose crossing appears on the cheque.)

FORGED INSTRUMENTS

Forged instrument means signature of a person fraudulently put by somebody else. A negotiable instrument containing the forged signature of its drawer, maker or acceptor is totally ineffective and the holder cannot enforce payment on them. If A forges B's signature on a cheque and gives to C, who accepts it for consideration; acquires no title. In case such a holder obtains payment, the true owner can sue for recovery. In the absence of genuine signature of the drawer, maker or acceptor, the instrument is totally worthless and not even the holder in due course acquires any title thereto. The forged signature cannot be ratified because the forger does not have authority to act on behalf of the person whose signature is forged.

A negotiable instrument with forged signature of endorser does not pass on valid title to the endorsee even if he is bonafide holder for value. The true owner will remain entitled to it and payment made to wrong person will not discharge the drawee, acceptor or the maker of the instrument. The paying banker however gets statutory protection against payment of cheques with forged endorsement but not with forged signature of the drawer.

ROLE AND DUTIES OF A COLLECTING BANK

When a person receives cheque in his favour, if it is open (uncrossed) and bearer, he can go the bank on which it is drawn and en-cash the same (receive cash across the counter). However if it is a crossed and order cheque, he has to deposit it in the bank where he has account. Thereby he appoints his bank as his agent, who collects the payment for its customer from the bank on which the cheque is drawn. The bank thus acts as a Collecting Bank and performs the function of agency for its customer. While doing so, the collecting bank acts either as an agent of customer where the customer is allowed to withdraw money, after the bank receives it from

the drawee bank or as holder for value where the customer is allowed to withdraw money before the cheque is realized (this is called as cheque purchased).

The most important aspect of collection of cheque for a collecting bank is to avoid conversion. Conversion means wrongful or unlawful interference (using, selling, occupying or holding) with another person's property. Negotiable instruments are included in the term "property" and hence banker may be charged for conversion if it collects cheques for a customer who has no title or defective title to the instrument. The basic principle is that rightful owner of the goods can recover the same from anyone who takes it without his authority and in whose hands it can be traced. When the banker acts as an agent of its customer for the collection of his cheques, he cannot escape this liability.

Section 131 and 131A provides statutory protection to the collecting banker, when it collects cheques and demand drafts for its customer. However to avail the protection, collecting banker must fulfill the following conditions.

1. **Cheque must be a crossed cheque** – since the protection is not available to un-crossed (open) cheques, but only for crossed cheques, the collecting bank should ensure that before the cheques are sent to paying bank, each cheque is affixed with a special crossing stamp, bearing the name of collecting bank. Customers should also be advised to cross the cheques before they are deposited.
2. **The payment must be received for the customer** – bankers should ensure that person depositing cheque for collection has an account with the bank (savings, current or other). The general practice followed by the bankers is, they first open the account of customer and then extend this cheque collection facility to them.
3. **Collecting bank should have acted in good faith and without negligence** – 'good faith' means the bank should have acted bonafide and honestly(whether negligently or not). 'Without negligence' means with reasonable care and without doubt about the genuineness of the validity of title of the customer. Some examples of negligence are as under:
   (a) The account of customer is not properly KYC complied.
   (b) The endorsement(s) is(are) not genuine. To ascertain genuineness of endorsement is the duty of collecting banker.
   (c) No enquires are made in case of doubtful cases e.g. – a customer of ordinary means deposits a cheque of large amount, cheques payable to corporate bodies are endorsed by the authorized signatories for the credit of their personal accounts or for the credit of accounts of their relatives.
   (d) Cheque bearing "Not Negotiable" crossing is negotiated further.
   (e) Cheque bearing "Account Payee only" crossing is collected for the account, other than the payee. The words "Account Payee", though not mentioned in NI Act, they are still considered to be a part of the law due to highly extensive practice and usage of this custom. The RBI vide its circular issued to banks, have advised that an account payee cheque is required to be collected for the payee constituent only.

Duties of Collecting Bank

- To present the cheque for collection in reasonable time, else will be liable for damages if customer incurs, due to delayed presentation.
- RBI vide its circular has advised banks as under:

(a) Banks are required to give immediate credit up to Rs. 15,000.00 of outstation / local cheques deposited by all savings, current and cash credit customers – after satisfying about proper conduct of the account by the customer. In the event of the cheque being returned unpaid, the bank can recover interest in conformity with applicable interest rate directive of RBI. No interest to be charge for the period from the date of credit of outstation cheque to date of its return. Where cheque is credited to a savings account no interest will be charged if the cheque is returned. A notice regarding the availability of facility should be displayed prominently at each branch.

- If the delay in collection of outstation cheques / instruments is beyond 10days in the case of cheques lodged at and drawn on state head quarters and beyond 14 days in all other cases, banks should pay interest at the rate as applicable for appropriate tenure of fixed deposit for the period of delay. Further, banks should also pay penal interest at the rate of 2 percent above fixed deposit rate for abnormal delay caused by the branch in collection of outstation instruments.
- While the cheque drop facility may be made available to the customers, the facility of acknowledgement of cheques at the regular collection counter should not be denied to them. No branch should refuse to give an acknowledgement on cheques being tendered by the customers at their counters. Customers should be made aware of both options available to them.

CHEQUE TRUNCATION SYSTEM

The salient features of the Cheque Truncation System (CTS) are as under:

- Truncation is the process of stopping the flow of the physical cheque issued by a drawer to the drawee branch. The physical instrument will be truncated at some point en-route to the drawee branch and an electronic image of the cheque would be sent to the drawee branch along with relevant information like the MICR fields, date of presentation, presenting banks etc. thus the physical movement of cheques across branches would not be required, except in exceptional circumstances. This would effectively reduce the time required for payment of cheques, the associated cost of transit and delay in processing, etc., thus speeding up the process of collection.
- The system thus enhances customer service, reduces reconciliation problems, eliminates logistic problems etc. Cheque truncation is also a more secure system than the current exchange of physical documents in which the cheques move from one point to another, thus not only creating delays but inconvenience to the customer in case the instrument is lost in transit or manipulated during the clearing cycle. It is thus an important efficiency enhancement initiative in the payment system area, undertaken by RBI.
- The images captured at the presenting bank level would be transmitted to the Clearing House and then to the drawee branches with digital signatures of the presenting bank. Thus each image would carry the digital signature, apart from the physical endorsement of the presenting bank, in a prescribed manner. In order to ensure only images of requisite quality reach the drawee branches, there will be a quality check process at the level of the Capture Systems and Clearing House Interface. In addition, drawers could consider using holograms, bar-coding, or such other features, which would add to the uniqueness of images.
- To ensure security, safety and non-repudiation the PKI (Public Key Infrastructure) is being implemented across the system. The banks will send the captured images and data to the central clearing house for onward transmission to the payee/drawee banks. For the purpose RBI will be providing the banks software called the Clearing House Interface (CH I). The clearing house will process the data and arrive at the settlement figure for the banks and send the required data to payee/drawee banks for processing

at their end. It will be the responsibility of the drawee bank Capture System to process the inward data and images and generate the return file for unpaid instruments.

- The criteria for banks participating in the cheque truncation system are – (i) Membership of the clearing house in the NCR and (ii) Membership of the Indian Financial Network (INFINET). In respect of banks who are not members of INFINET, they may become the sub-members of the direct members or may use the infrastructure of the other banks having INFINET membership.
- Imaging of cheques can be based on various technology options. The cheque images can be black and white, Grey Scale or coloured. Black and White images do not reveal all the subtle features that are there in the cheques. Coloured images increase storage and network bandwidth requirements, so it was decided that the electronic images of truncated cheques will be in grey scale technology.
- As all the payments will be made on the basis of images, it is essential to ensure the quality of the images. RBI will be specifying the image standards to the member banks. The presenting bank is required to perform the quality audit during the capture itself. Further quality audit will be done at the gateway before onward transmission to clearing house. The drawee bank can ask for the physical instrument if it is not satisfied about the image quality for payment processing.
- All the local cheques can be presented in the CTS. Cheques on banks situated outside the NCR, provided such banks have branches in the NCR region can also be presented. CTS also supports intercity clearing and high value clearing. The on-us instruments (where the presenting and drawee branches are of the same bank) are not allowed.
- Customers should use dark coloured ink while writing cheques. The use of rubber stamps should not overshadow the clear appearance of basic features of the cheques (date, payee's name, amount and drawer's signature).
- Under CTS, after the capture of image, the physical cheque will be warehoused with the presenting bank. In case the beneficiary or any other connected persons require the instrument, the payee bank could issue a copy of image, under its authentication, which is called Image Replacement Document (IRD). NI Act section 81(3) permits the usage of such IRDs.
- It would be obligatory for presenting bank to warehouse the physical instruments for the prescribed statutory period. In case a customer desires to get a paper instrument back, the instrument can be sourced from the presenting bank through the drawee bank.

LESSON ROUND UP

– Negotiable Instruments Act governs the Negotiable Instruments. A negotiable Instrument"(NI) means a promissory note, bill of exchange or cheque payable either to order or to bearer. The Act further defines a Promissory note" as an instrument in writing 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." In the same way Bill of Exchange and Promissory Note have also been defined.

– Due to an amendment to NI Act, now the definition of cheque includes the electronic image of a truncated cheque and a cheque in the electronic form. Parties to a cheque include drawer, drawee, Payee, drawee in case of need as well as 'Acceptor'; it also includes Holder, Holder in due course. The payment made a bank in accordance with the apparent tenor of the instrument, in good faith and

without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of amount mentioned therein is known as Payment in due course. Negotiation said to take place when a NI is transferred to any person, so as to constitute that person the holder of that NI. When the maker or holder of a NI signs the same, other than as a maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed to the NI, he is called as an Endorser. Types of endorsements include Blank, conditional, restrictive, sans recourse, and facultative. The NI Act also covers the characteristics of the NIs and acts of various parties involved.

– The act deals with duties and responsibilities of a paying bank through Section 85 and 85A. It also defines the duties and responsibilities of a collecting bank through Section 131 and 131A. To get legal protection under section 131, generally banks collect cheques only after the establishment of a contractual relationship through opening of an account.

– When a NI is materially altered without the consent of parties involved, it makes the instrument void. When a promissory note or bill of exchange is dishonoured by non-acceptance, or non-payment, the holder may take remedial action through 'Noting' and 'Protest' as per Sections 99,100 & 101. In case of dishonour of a promissory note or a bill of exchange the holder is entitled for compensation in terms of section 117.

– When a cheque bears across its face, two parallel transverse lines, an addition of the words "and company" or any abbreviation thereof, between or of two parallel transverse lines simply, either with or without the words "not negotiable", the cheque is said to be crossed. The banker on whom crossed cheque is drawn will pay the same only to a banker. When a cheque is dishonored for financial reasons penalties for dishonour are applicable on a drawer in terms of sections 138 to 147.

– Cheque Truncation System CTS) has been adopted in India in clearing of cheques to enhance customer service, reduce reconciliation problems, eliminate logistic problems and minimize frauds. CTS is subject to detailed rules procedures prescribed by RBI in this regard.

GLOSSARY

Negotiable Instrument, Promissory Note, Bill of Exchange, Cheque, Holder, Holder in due Course, Payment in due Course, Endorsement, Crossings – General and Special, Material alteration, Forgery, Collecting Bank, Paying Bank, Noting and Protesting, Holder for value, CTS.

SELF TEST QUESTIONS

1. Fill in the blanks:

   (i) Negotiation of an order cheque is completed by ..... and .....

   (ii) A bill dated December 31, 2018 payable 2 months after date, falls due for payment on .....

   (iii) A cheque dated July 17, 2018 presented for payment on July 15, 2018 will be returned with the reason .....

   (iv) Is Mr. Vasant, issues a cheque to his friend Mr. Prashant, from his account with Bank of India, Andheri branch – then Payee is ....., Drawee is ..... and Drawer is..... .

   (iv) IRD stands for .....

2. Write True or False:
   (i) For Holder in due course, the consideration is must but for holder it is not essential.
   (ii) A Bill of Exchange, drawn by Mr. John, a foreigner, in Delhi, payable at Mumbai is a foreign bill.
   (iii) "Account Payee" crossing is a special crossing.
   (iv) A minor cannot draw a cheque.
   (v) A paying is protected if drawer's signature is cleverly forged.
3. Answer the following questions.
   (i) What is Payment in due Course? Give some examples of payments which are not considered as payment in due course.
   (ii) What are the duties of a Collecting Banker?
   (iii) Explain provisions of Section 138 to 142 of N.I. Act.
   (iv) Which are various types of Bills of Exchange?
   (v) Explain Cheque Truncation System, in brief.

For further reading

1. Negotiable Instruments Act, 1881
2. Banking Law And Practice by P.N. Varshney, Published by: Sultan Chand & Sons, Reprint 2017.
3. RBI's Master Circulars/Master Directions
4. Banking Law & Practice by M.L. Tannan
5. Negotiable Instruments by M.S. Parthasarathi
6. Negotiable Instruments Act, J.C. Verma, Bharat Law House Private Ltd., New Delhi

Lesson 8
Case Laws on Responsibilities of Paying Bank

LESSON OUTLINE

To learn about various provisions and case laws applicable for paying banker in terms of

- Section 10
- Section 31
- Section 85
- Section 89
- Section 128
- Section 138 of the Negotiable Instruments Act, 1881
- LESSON ROUND UP
- SELF-TEST QUESTIONS

LEARNING OBJECTIVES

After study of this chapter the students will be able to explain the role and responsibilities of a paying bank as well as protection it can get in terms of case laws as decided by various courts. For an easy understanding facts of the cases along with the judgments containing the stand taken by court(s) are given in a summarized version.

INTRODUCTION

The contractual relationship between a banker and a customer is a complex one and manifold mostly based on principles and practice and usage of bankers for years. Many of those practices and usages have been recognized by the courts and to such an extent that they have been accepted as implied terms of contract between the bank and the customer.

A cheque drawn by a customer is a mandate to the banker to pay the amount according to the apparent tenor of the cheque. At the same time, it's a responsibility of the customer reciprocally that he will draw the cheques in such form as to enable the banker to fulfill its obligations, and therefore customer need to give clear instructions and free from ambiguity. For example, the payee`s name on the cheque should be certain. Customer A issues cheque to the payee B or C is not a clear mandate to the bank to whom to make the payment of the cheque. Another example where customer issues a cheque with date as 29th March but the year is not mentioned. In such case bank will dishonor the cheque with reason incomplete date or year not mentioned.

The Negotiable Instruments Act, 1881 (the "NI Act") offers protection to a paying bank in terms of Section 85 & 85 A in respect of Cheques and DDs provided these instruments are paid in due course. While NI Act provides certain protection to the banks, it also casts certain duties and obligations on the banks, in its capacity as paying banker. These responsibilities are provided under Sections 10, 31, 85, 89 and 128 of the NI Act.

Section 10 of the NI Act : Payment in due course is one made in accordance with the apparent tenor of the instrument that is according to instructions appears on the face of the instrument according to the intention of the parties (Section 10 of the NI Act).

To qualify as payment in due course, the payment will have to comply with the following:

(a) payment should be made to the person entitled to the payment;

(b) it should not be made before the due date;

(c) it should not be made with the knowledge that it may impair the rights of the holder to receive money or under reasonable grounds for believing that the holder in due course is not entitled to receive payment; and

(d) the payment must be made in good faith and without negligence under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment.

If the payment complies with the above requirements, then it will get the protection as a payment in due course. Actually, it is difficult to list down good faith and / or negligence, it will depend on the facts and circumstance of each and every case. Payment in Due Course provides a protection to the banker in case he has acted with due diligence and take necessary actions while making the payment to the customer according to the mandate of the cheque.

Case Law: Whether the Paying Bank was bound to keep ultraviolet lamp and scrutinize cheques even if alteration is not noticed on visual examination?

Facts of the case

A partnership firm opened a current account with a branch of Bank of Maharashtra, Wagle Industrial Estate, Thane. As cases of forgery of cheques were frequently occurring in that locality, all branches were provided with ultraviolet lamp for examining the cheques, except this branch at Thane.

On 26th May 1967 one Mr. Shah, opened an account in the name of Imperial Tube and Hardware Mart as a

proprietary concern with another nationalized Bank viz. Union Bank of India.

On 29th May 1967 a cheque was presented for Rs. 6500 in clearing in favour of Imperial Tube and Hardware Mart on Bank of Maharashtra by Union Bank on behalf of Mr. Shah. The cheque was passed by Bank of Maharashtra and debited to the account of the drawer namely Automotive Engineering Company (AEC). Later, AEC raised an objection towards the debit of the cheque on account of forgery. The cheque which was originally issued for an amount of Rs. 95.98 in favour of one Mr. G. R. Pardawala seemed to have been chemically altered with reference to date, payee's name as well as the amount of the cheque. AEC wanted Bank of Maharashtra to compensate the loss.

Bank of Maharashtra did not compensate AEC but filed a suit in a court. The trial court held that bank was negligent by not providing ultraviolet lamp at the branch though it agreed that no infirmity is noticed on visual examination of the cheque in question. The Bank had appealed to the district court in the matter and they too passed a judgement similar to that of trial court. Bombay High Court too held the Bank for negligence by not providing the ultraviolet lamp. The matter was taken to Supreme Court on further appeal by the Bank.

Decision of the Supreme Court

The Supreme Court held that that there is nothing in the NI Act, which makes it obligatory for the bank to subject every cheque to examination under ultraviolet ray lamp, though it could be prudent to examine under the said light. The bank will not be deemed as failed to take reasonable care in passing the cheque for payment without subjecting it for further scrutiny under ultraviolet ray lamp, as material alteration was not visible on the cheque. The Supreme court ruled in favour of the bank. (*Bank of Maharashtra Vs. M/s. Automotive Engineering Co.,* 1993, 2SCC-97).

What the law requires is to ensure that the alteration is not apparent and visible to the naked eye. In this case the original amount and the name of the payee was chemically altered. To prevent such frauds, normally a transparent cell tape should be pasted over the payee's name and amount.

Section 31 of the NI Act reads as 'The drawee of a cheque, having sufficient funds of the drawer in hands, properly applicable to the payment of such cheque must pay the cheque when duly required to do so and, in default of such payment must compensate the drawer for any loss or damage caused for such default.

A banker is entitled to refuse payment of a cheque drawn in a form whose identity is doubtful or when it is irregular or when it is undated or incomplete The relationship between the customer and the banker also creates certain obligations on the customer. The customer must take due and proper care not to mis-lead the bank. For any negligence on the part of the customer, the customer shall be responsible. If the customer draws a cheque which facilitates fraud, he is guilty of breach and will be responsible to the banker for any loss sustained by the banker as a direct consequence of breach of duty. The negligence should be directly connected to the transaction itself. This will depend on the facts and circumstances of each case.

Under the provisions of Section 31, the bank is liable only to the drawer of the cheque. The holder of the cheque has no right to enforce payment from the bank, except under Section 128.

When a cheque bearing forged signature or joint signatures of the customer, is presented, there is no mandate to the bank to pay and if any payments are made under such circumstances a bank stands to lose the legal protection. Banker need to be careful in tallying the flow of signature on the cheque with specimen signature held as per the bank record at the time of account opening or any amendments subsequently. In a promissory note if insertions are made without the consent of the promisor it makes the instrument invalid under the eyes of law. If alterations are made in a promissory note, the burden of proof, falls on the person who seeks to enforce the negotiable instrument, failing which he cannot enforce his rights. If any alteration is made in an

instrument, which is not apparent to the naked eye, the banker will not be held liable for payment, provided he had taken other precautions in terms of payment in due course. Though a customer (drawer) may be negligent, if a bank makes payment of a forged cheque, the bank will be held liable. If the material alteration on cheques were visible and if they were not authenticated by the drawer's initials, the payment made by a bank was not according to the apparent tenor of the instrument and as such the bank cannot get protection under Section 89 of NI Act. A paying banker also is also affected by the provisions of Consumer Protection Act in addition to that of NI Act.

Case Law : A banker is not absolved of his liability on forged cheque if it has acted negligently, even if the customer was negligent.

Facts of the case

Lala Pirbhu Dayal (LPD) was a customer of Jwala Bank. On 16th March 1936 cheque No. 23958 for Rs. 57-8-0 was presented at the bank alleged to have been signed by the plaintiff LPD in favour of one Bhai Kashi Nathji. The Bank honoured the cheque and paid the amount to the person who presented the cheque. LPD complained to the Bank that he had not drawn cheque of Rs. 57-8-0 debited to his account. The bank did not accept LPD's contention and refused to make good the amount and maintained that the cheque was passed in the usual course and his signature was fully tallied with his specimen signatures. Unable to recover any money from the bank, LPD filed a suit to recover his money.

The trial court judge found that though the signature on the forged cheque did not tally with LPD's signatures and held that bank was not legally liable to return the amount of the cheque to LPD as it has not been shown that the payment of the same was made by it dishonestly and knowing that it was a forged cheque. The court also took cognizance of the matter that other persons had also access to the box containing the cheques remained unlocked during day time at LPD's home and held him negligent for leaving his cheques in an unlocked box and dismissed the case. LPD filed an appeal against the trial court judgement before the Allahabad High Court.

Decision of the Allahabad High Court

A banker is not absolved of his liability on forged cheque, even if the customer was negligent in keeping the cheque book under lock and key as required by the rules of the bank. The Court held that it is the duty of the employees of the bank to be able to identify the signature of the customers and if they fail to discharge their duty and thereby suffer loss, there is no reason why the customer should make good that loss. (*Lala Pirbhu Dayal* vs. *Jwala Bank Ltd.*, AIR 1938 All. 374)

Section 85 of the NI Act: (a) Where the cheque is payable to order is indorsed by or on behalf of the payee, the drawee is discharged by payment in due course.(b) where a cheque is drawn in favour of a bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any indorsement in full or blank and notwithstanding any such indorsement purports to restrict or exclude further negotiation.

This section ensures that a bearer cheque does not lose its character by any indorsement on the same, but the protection is available only if the payment is in due course. It must appear that the holder is the person entitled to payment of the cheque though the bank need not bother itself about the genuineness of indorsement.

Cheque honoured without reference to the crossing is negligent. However, in case of any irregularity, if the bank make enquiries and is satisfied and makes payment thereafter, , the bank will be considered as not being negligent.

This section does not extend protection to the banker if the payment is made on a forged cheque. Mandate of the customer to the bank to pay the cheque signed by him, which is recognized by Section 85 is not available to

the bank in a case of forged cheque. If a customer is aware of forgery whereby his banker debits his account, but fails to inform the bank till the chances of recovery from the forger is materially prejudiced, it was decided that the customer was precluded from claiming the amount.

CASE LAWS

1. Liability of a Paying banker under a forged cheque

Facts of the case

M/s Canara Sales Corporation (CSC) was maintaining a current account with Canara Bank. The bank account was operated by the authorized signatory of CSC namely the Managing Director. Cheque books of CSC were in the custody of the Accountant of CSC, who cleverly forged the signature of the Managing Director in 42 cheques involving an amount of Rs. 3.26 lakhs over a period of time. The forgery came to light when another accountant of the company scrutinized the accounts of the company. As soon as the fraud came to light, CSC filed a claim with the bank for recovery. When CSC did not get any response they filed a case in the local court which delivered the judgement against the bank. The matter finally went to the Supreme Court.

Decision of the Supreme Court

Supreme Court stated that one of the the banker-customer relationship being that of a debtor and creditor; bank being debtor of a customer in case of savings, current or fixed deposit account, will have no authority to debit the customer's account with a cheque bearing forged signature of the customer. When customer's signature is forged, there is no mandate to the bank to pay.

(*Canara Bank* Vs *Canara Sales Corporation and Others*, 1987) ????????????????[insert the correct citation] Plz check

In this matter, the Supreme Court relied on its own earlier decision in the matter of *Bihta Cooperative and Cane Marketing Union Ltd.* v. *Bank of Bihar* (AIR 1967 Supreme Court 389) which is cited below.

2. If one of the signatures in a joint account is forged, it is not a mandate for the banker to pay

Facts of the case

Bihta Co-operative Development and Cane Marketing Union Ltd. ('BCDCM') was maintaining an account with Bank of Bihar. The account of ('BCDCM' was jointly operated by the Authorized signatories of BCDCM namely The Joint Secretary and Treasurer. In the month of April 1948 the bank made a payment amounting to Rs. 11,000 on the strength of a loose cheque leaf. This loose cheque leaf did not belong to the cheque book issued to BCDCM by the bank. This was bearing two signatures that of Joint Secretary and the Treasurer. It appears that the signature of the Joint Secretary was forged. After the bank made the payment, the forgery came to light and accordingly BCDCM lodged a claim on the bank for recovering the amount of the forged cheque paid by the bank. As they did not succeed, they filed a case against the bank for recovering the money.

The bank took a stand that though there is some negligence on their part, they were taking shelter on the grounds of dishonest employees of BCDCM. The bank subsequently went in appeal to Supreme Court against the judgement of lower court.

Decision of the Supreme Court

The Hon'ble Supreme Court's decision in the matter is summarized as below.

A cheque was drawn on a cheque form issued by the banker to somebody other than the drawer, the banker would not be justified in refusing its payment, if the cheque was otherwise in order. The drawer's order to the banker does not become invalid because the form of the cheque was not issued to the drawer. The cheque in question was a loose cheque-form surrendered by some other customer of the bank. It is invalid not because it was drawn on a form not issued to the customer but because the signature of one of the joint account holder (drawer) was forged. In a jointly operated account, if one of the signatures is forged there is no mandate to the bank. (Bihta Co-operative Development and Cane Marketing Union Ltd vs. Bank of Bihar and others. 1967)

3. What is a proper way of payment in due course?

Facts of the case

The bank, instead of making payment to the partner of the firm or its authorized person, handed over cash to one of its own employee, who accompanied the partner who was to pay the cash to the wholesalers. However, before they could reach the wholesalers, the bank employee absconded.

Decision of the Supreme Court

Supreme Court held that this was not "payment in due course" as it was not made to the holder (partner, his agent or servant) instead made was made to their own employee by the bank. (*Bank of Bihar* v. *Mahabir Lal*, AIR 1964, 397)

4. Payment made under mistaken belief

Facts of the case

M/s. A received a cheque from their customer, who purchased goods from them. The cheque was sent to A's banker, Union Bank for collection. On receiving advice from Union Bank, having realized the cheque, M/s. A delivered the goods to the customer. The paying bank, United Bank of India, later on found that the drawer's signature on the cheque was forged and filed suit for recovery of amount from Union Bank and M/s A. .

The Court found that the forgery was so cleverly done that even the drawer found it difficult to deny his signature on the forged cheque. The High Court therefore held that the paying bank was neither negligent nor careless in paying the cheque. The payment was made under mistaken belief.

Decision of the Court

According to section 72 of Indian Contract Act, a person to whom money has been paid by mistake must repay it. But the rule is qualified by the doctrine of equity. Payee must repay money to the payer if the position of former is not altered to his detriment. In this case the position of payee was changed before the mistake was detected. He therefore cannot be held liable. The Court held that Union Bank and M/s A were therefore not liable to the United Bank of India. (AIR 1978, Calcutta, 169)

Section 89 of the NI Act: If the alternation of a cheque is not apparent and the bank has made payment in due course, in good faith and not acting negligent, then such payment shall not be questioned by the reason of that the instrument was altered or the cheque crossed.

Now since truncated cheques are transmitted, it shall be the duty of the collecting bank or the clearing house, as the case may be, to ensure exactness of the electronic image while truncating and transmitting the same. Collecting bank need to take necessary precautions while scanning the cheques on the scanner before submitting the truncated images of the cheques to the drawee bank for payment through clearing house. The

receiving party of such truncated cheque shall also ensure from the other party transmitting the image, that the image transmitted is exactly the same.

Protection under this section is available to the Bank only if the (a) alteration is not apparent; and (b) the instrument is paid in due course and in good faith and without negligence.

Case Law: Liability of a Bank in respect of a cleverly forged cheque

Facts of the case

On 1-7-1946 One Mr. Brahma issued cheque for Rs. 256/- payable to Mr. J. M. Das Gupta from his account in which the bank used to allow overdrafts against securities given for such overdrafts from time to time in the form of marketable shares. The cheque was sent by post, but the it did not reach the said payee. Mr. Brahma use to allow his clerks to prepare the cheques and he used to sign. Mr. Brahma was informed by his bank by a letter dated 24-7-1946, that after paying a sum of Rs. 2,34,081/-, against the said cheque the drawer's account had been overdrawn to the extent of Rs. 2,19,460/-.

It was later found that Mr. Brahma did not draw any cheque or authorize any payment of Rs. 2,34,081/-. He had issued the said cheque for Rs. 256/=. During the transit of the cheque was intercepted and stolen. The amount and the name of the payee had been cleverly altered to Rs. 2,34,081/- with the name of the payee as S. Dass & Co. in place of J.M. Das Gupta, the original payee. These alterations and forgeries were not visible to the naked eyes. The cheque was collected on behalf of S. Dass & Co by Hindustan Industrial Bank Ltd. Mr. Brahma sued his bank, S. Dass & Co. and Hindusthan Industrial Bank Ltd., through whom the collection of the cheque was made for negligence and wrongful conversion or unlawful appropriation of the proceeds of the cheque.

After lengthy deliberations over a period of time the Calcutta High Court gave a judgement in the matter, the summary of which is below:

Decision of the High Court

The Calcutta High Court held that since no alteration or obliteration was visible at the time of payment, the payment was made according to the apparent tenor of the cheque. Further since drawer had on other occasions also issued cheque signed by him and written by others, the bank suspicion could not have aroused. The court also held that the words "liable to pay" appearing in section 89 included a liability to pay under an overdraft agreement as much as it applied to an ordinary deposit account. As regards exceeding the overdraft limit, the court held that no definite limit was fixed at the time and it fluctuated according to the securities deposited. Hence the paying bank was absolved of negligence. However, the court held S. Dass & Co. as well the collecting bank for negligence and conversion. (*Brahma Shum Shere Jung Bahadur and Other* Vs *Chartered Bank of India and Others*, AIR 1956, 399)

Section 128 of the NI Act: Section 126 and 127 of the NI Act, specifies how crossedcheques should be paid.

When a cheque is crossed generally it should not be paid otherwise than to a banker. When a cheque is specially crossed, it shall not be paid to a banker otherwise than to whom it is crossed. If a cheque is specially crossed more than once, then the bank can refuse payment, except when it is crossed in favour of an agent of the first crossed bank. Under these sections, responsibility of the paying bank is very clearly spelt.

Due to changes in technology and with a view to provide efficient and quick service to the customers, the banking system has undergone tremendous change and one such important change was that the physical movement of cheques from one branch / bank to another branch/bank for payment has been stopped. Magnetic Ink Character Recognition (MICR) Clearing has been replaced by Image based cheque truncation system

(CTS). In CTS, a mirror image of the cheque is sent by the branch/bank where the cheque is deposited by its customer to the drawee bank where the cheque is to be paid.

Truncated Cheques:

The collection and payment of the cheques in India is governed by the various provisions of NI Act, 1881. Since the manual processing of cheques and through MICR Clearing was time taking process and require physical instrument to be presented to the bank for payment in due course. The process of truncation requires the banker to convert the cheque data to electronic form for the purposes of safe keeping or to forward the images of cheques at the request of the banker to provide information on cheques as and when requested. Cheque in the electronic form means a cheque which contains the exact mirror image of a paper cheque and id generated, written and signed in a secure system ensuring minimum safety standards with the use of digital signatures (with or without biometric signature) and asymmetric crypto system.

Under the cheque truncation system all cheques are transmitted electronically. The original cheques are retained by the collecting banker At the branch or place where the cheques are scanned.

Provision and Process:

Truncation of cheques can be done by the clearing house or the bank which collects the truncated version of the cheque.

Section 6 (b) of the NI Act, defines a truncated cheque as a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.

As per Section 81 of the NI Act, the banker who receives the payment is also supposed to retain a copy of the cheque even after payment has be done. Section 89 of the NI Act provides that any difference between the original cheque and the truncated image should be construed as material alteration. In such cases, it is obligatory on the part of the clearing house or the bank to ensure correctness of the truncated image while transmitting the image.

An explanation has been added to Section 131 of the NI Act, which states that ‘it shall be the duty of the banker who received payment based on an electronic image of a truncated cheque to ensure that there is no fraud, forgery or tampering apparent on the face of the instrument’.

According to Section 64 (2) of the NI Act, where an electronic image of a truncated cheque is presented for payment, the drawee bank is entitled to demand any further information regarding the truncated cheque from the bank holding the truncated cheque in case of any reasonable suspicion.

Section 138 to 142 of the NI Act: Cheque bouncing

Under Section 138 of the NI Act, dishonour of a cheque is a criminal offence liable to be punished with 2 years imprisonment.

The following are required to be satisfied to make the dishonour an offence under the provisions of the NI Act.

1. Existence of a legally enforceable debt or other liability by the drawer of the cheque towards another person (will be payee or holder of the cheque, as the case may be) and a cheque is drawn to discharge the debt or liability.
2. Cheque is returned due to insufficient funds or exceeds the amount agreed upon to be paid by the bank.

3. Cheque should be presented within its validity(i.e.) 3 months from the date of issue.
4. Notice in writing is sent within 30 days to the drawer along with the receipt of information from bank about failure of payment of cheque
5. The payee or holder doesn't receive the payment within 15 days of the receipt of the notice to the drawer

Cheques issued towards payment of debt will only attract the provisions of Section 138. Cheques given for donation or post dated cheques issued for security purposes or undated cheques will not be covered under this section.

Case Law: Sec 138 – Dishnour of Post Dated Cheques offered as a Security in case of Loan Accounts

Facts of the case

Sampelly Satyanarayan Rao (appellant) is the director of the company which is engaged in power generation activities. Indian Renewable Energy Development Agency Limited (respondent), a Government of India enterprise, is engaged in the field of renewable energy development. On 15th March ,2011 both the parties entered into a loan agreement by means of which the respondent consented to grant a loan of Rs. 11.50 Crore for the purpose of establishing 4.00 MW Biomass Power project. Clause 3.1 (iii) of the said loan agreement provided that post dated cheques should be issued by the appellant as a security for discharge of loan instalments (principal and interest). The post dated cheques carried different dates based on the due loan instalments .The said post dated cheques were dishonoured and complaint was filed by the respondent. Issues involved in the case was whether the dishonor of post dated cheques issued as a security by the appellant will attract Section 138 of the Act , 1881.

Decision of the Court

Supreme Court held that whether a post dated cheque has been issued for the discharge of an outstanding liability shall depend on the nature of transaction and Section 138 of the NI Act, 1881 shall be attracted only on the date of the cheque there is a legally recoverable outstsnding debt or liability. Further the court held that although according to clause 3.1 (1) of the loan agreement provided that postdated cheques are given as security, however, the expression "security" must be understood to refer to cheques that have been issued by the appellant for payment of the loan instalments to discharge the existing outstanding debt or liability. The relevant extract of the judgement is provided below:

"Once the loan was disbursed and instalments have fallen due on the date of the cheque as per the agreement, dishonour of such cheques would fall under Section 138 of the Act. The Cheque undoubtedly represent the outstanding liability." Further the post dated cheques were described as a security in the loan agreement but in essence the issuance of the same was for the purpose to repay the loan instalments for satisfaction of the outstanding liability thus in the judgement the court held that is this case loan transaction in which the loan has been granted to the borrower and the repayment of the loan instalments is due on the date of the cheque.

LESSON ROUND UP

– The N I Act governs the framework of role and responsibilities of a paying banker. It also offers legal protection to banks which are involved in paying various negotiable instruments such as cheques and others. The paying bank is duty bound to pay customers' cheques in accordance with Sections 10, 31,

85, 89 and 128 to get the protection of the NI Act. In a promissory note if insertions are mad without the consent of the promisor it makes the instrument invalid under the eyes of law. If alterations are made in a promissory note, the burden of proof, falls on the person who seeks to enforce the negotiable instrument failing which he cannot enforce his rights. If any alteration is made in a NI which is not apparent to the naked eye, a banker will not be held liable for payment, provided he had taken other precautions in terms of payment in due course. Though a customer (drawer) may be negligent, if a bank makes payment of a forged cheque, the bank will be held liable. In case of a cheque, payment is deemed to have been made, when it is physically handed over by the cashier to the customer and not otherwise.

GLOSSARY

NI Act: Negotiable Instruments Act

BCDCM: Bihta Co-operative Development and Cane Marketing Union Ltd.

COPRA 1986: Consumer Protection Act .

NC: National Commission

SELF TEST QUESTIONS

1. Write true or false
   a. A banker gets protection if he makes payment in due course.
   b. A forged cheque is a mandate to pay.
   c. Inspite of negligence of a customer, if a bank pays a forged cheque it is liable to the customer.
   d. If a forgery is not evident to the naked eye in a cheque, on payment of such cheques in due course, a bank is not liable.
   e. Banks are legally bound to examine a cheque under Ultra violet lamp before paying the same.

For further reading

Case Laws from Various Sources (All India Reporter etc.) through internet.

Lesson 9
Case laws on Responsibility of Collecting Bank

LESSON OUTLINE

To learn about provisions and case laws applicable for collecting Bank in terms of

- Section 131
- Section 131A of the Negotiable Instruments Act, 1881
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

To learn about role, responsibilities and protection available to a collecting banker through various case laws including English Case laws, principally in terms of Sections 131/131 A of Negotiable Instruments Act, 1881.

INTRODUCTION

Bank's rights and responsibilities as a collecting bank are governed by Section 131 of the Negotiable Instruments Act, 1881(the" NI Act") Needless to say this section also offers legal protection to banks when they collect various negotiable instruments like cheques, pay order, demand drafts etc. in good faith and without negligence. Section 131 imposes duty of due diligence , care and good faith on the banker and banker will not incur any liability to the true owner of the negotiable instrument, for collecting a negotiable instrument on behalf of a customer, in case the title to the negotiable instrument is proved defective. It may be noted that Demand Drafts (DD) were not included in instruments originally covered by NI Act. Subsequently when frauds started to increase in the collection of DDs, they were also covered by inserting Demand Drafts under section 131A.

In manual clearing and Magnetic Ink Character Recognition (MICR) clearing r the physical copy of the negotiable instrument deposited with a bank was sent to the drawer branch of the bank where it was drawn/ or where the account is maintained and the cheque book issued , As a result the clearing settlement of cheques and and the collection time t was 3 to 4 business days. With new emerging payment systems and advancement in technology, the Reserve Bank of India and National Payment Corporation of India (NPCI) introduced Image Based Cheque Truncation System which allowed banks to transmit truncated negotiable instruments for collection purposes, instead of sending the original instruments, which lead to reduction in cost and time.

In 2003, the NI Act was amended to include the responsibilities of the collecting bank, based on a truncated image of the instrument. The collecting bank shall verify the prima facie genuineness of the instrument and any fraud or forgery or tampering apparent on the face of the instrument that can be verified with due diligence and ordinary care.

It's a duty of the collecting bank to collect instruments deposited by customers after taking due precautions in the matter as normal prudence would require. Unless this is done, the bank may not get legal protection, as borne out by various case laws discussed in the chapter.

All the case laws are based on the section 131 and 131A of NI Act and a reference to the concerned case citations have also been given for an easy reference.

It is also to be noted that important case laws pertaining to England have also been included to draw a parallel, as our NI Act is based on English law.

The topic and contents will impart a practical knowledge in understanding the role and responsibilities of a collecting bank. Facts of each case as a back ground, as well decisions of courts, to the extent required is also explained in the case laws.. After a study of this chapter thereafter , students should be able to understand and explain the role and responsibilities of a collecting bank as well as protection it can get in terms of case laws as decided in various courts.

Contents

Court cases and judgments under Section 131 & 131 A of NI Act.

Section 131 and 131A

Let us start with Section 131, 131 A and its explanation given under the NI Act.

Section 131

Section 131 reads as under: "A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves

defective, incur any liability to the true owner of the cheque by reason only of having received such payment.

Explanation I: A banker receives payment of a crossed cheque for a customer within the meaning of this section notwithstanding that he credits his customer's account with the amount of the cheque before receiving payment thereof. Crossed cheques means that payment of the cheque cannot be made in cash on the bank`s branch counter. Crossing can be general or special crossing.

Explanation II: It shall be the duty of the banker who receives payment based on an electronic image of a truncated cheque held with him, to verify the prima facie genuineness of the cheque to be truncated and any fraud, forgery or tampering apparent on the face of the instrument that can be verified with due diligence and ordinary care."

Section 131A

Application of Chapter to drafts. – The provisions of this Chapter shall apply to any draft, as defined in section 85A, as if the draft were a cheque."

Conditions applicable for protection under Section 131 and 131A: The NI Act does not provide an absolute immunity or protection to the bank. Protection to a collecting bank is subject to compliance by the bank provided the following conditions are fulfilled :

a. banker acting in good faith and without negligence in receiving payment;

b. should have received the payment for and on behalf of its customer; and

c. the cheque should have been crossed generally or specially to himself.

It follows from the above that to fulfill these conditions, a banker should have performed some duties in this regard. To prove that the banker has acted in good faith and without negligence, he should have taken the following precautions:

a. Opening of accounts: The bank should have complied with proper KYC procedures while opening the new account by obtaining proof of Identity and current address; Also it should have made proper enquiries and background checks as per bank's policy of opening of new accounts. KYC documents submitted by the customer should have been independently verified through verification policy of the bank. The banker need to classify its customers according to their risk profile and monitor account operations and transactions right from the opening of the account. Any suspicious activity and profile mismatch in the account should be investigated and monitored. If the banker fails to do observe regular monitoring of transactions and investigation may be considered negligent. ` In the recent times RBI has been very active on stipulation of KYC norms, to ensure that due and proper care is taken by banks while opening and maintenance of accounts.

b. Crossing cheques: At the time of acceptance of the cheque/DD for collection the bank should ensure that the cheque is crossed either generally or specially in favour of its customers, on behalf of whom the bank is acting as a collecting bank. If the cheque is not crossed the customer should be requested to cross the cheque or if the cheque is specially crossed to some other banker, the banker should refuse to collect the same. If a cheque is crossed to particular account holder and if it is sought to be credited to another account, then such requests are required to be rejected, failing which a bank may be considered negligent.

c. Verification of instruments: Before accepting the instrument, a banker should verify the payee name , valid date, amount in words and figures and signature on the cheque in order to ensure any material

defect apparent on the instrument. Collecting Bank is responsible for the correctness of the cheque before presenting the cheque for collection.

d. Status of accounts: The general nature of credits and debits in an account should be ordinarily correspond to employment, profession, business etc. of the account holder. Any large value credits which does not seem appropriate in relation to the employment or profession of the account holder should receive due attention of the banker. Banker need to investigate the legal source of funds to rule out misappropriation, fraud or money laundering activities. Any account over a specific value of credit are required to be monitored at regular intervals by the bank.

e. Collection cheques payable to third parties: The collecting bankers are required to make necessary enquires before collection of cheques tendered by customers on behalf of third parties.

Due diligence and close monitoring required by the bankers for :

(a) large value transactions , patterns, inconsistent with the normal and expected activity of the customer, which have no apparent economic rationale or legitimate purpose

(b) Transactions which exceed the thresholds prescribed for specific categories of accounts.

(c) High account turnover inconsistent with the size of the balance maintained.

(d) Deposit of third party cheques, drafts, etc. in the existing and newly opened accounts followed by cash withdrawals for large amounts."

Failure to adhere to these will amount to negligence on the part of collecting bankers within the meaning of Section 131 of NI Act.

The following case laws will give the reader a clear understanding of the roles and responsibilities of the banker, as enumerated by various courts.

Case 1. Test of negligence in respect of a collecting banker

Mr. Gopinathan (Mr. G) was a trader from Allepy in Kerala who used to purchase goods from M/s. Hurry Dass Auddy of Kolkata from 1953 onwards and make payments thereof through Demand Drafts (DD) purchased from Alleppey branch of Central Bank of India (CBI)drawn in favor of their New Market branch at Kolkata. These DDs were made payable to Hurry Dass Auddy or order. These DDs were delivered to M/s. Hurry Dass Auddy through a friend of Mr. G at Calcutta. In October 1953 Mr. G purchased a DD for Rs. 4000 and sent the same to M/s. Hurry Dass Auddy in the usual manner. It was intercepted during transit, and was presented before the Kolkata-Shambazar branch of CBI by someone with a forged endorsement in his favour purporting to be that of the payee. The payment was obtained from the New Market branch by Shambazar branch by the fraudster through local clearing. (in those days there was no centralized payment mechanisms like Service branches for payment of DDs) However there appeared to be some irregularities in the endorsement on the backside of the DD. Later when G came to know the facts approached CBI for compensation. CBI refused to pay on the ground that the payment of DD was in the usual course. G filed a case against the bank at the local court, which ruled that the bank is liable to pay. The Bank appealed in the District court which also delivered the judgement directing the bank to pay. The Bank further contested the matter before the Kerala High Court.

Decision of Kerala High Court

The Kerala High Court, in this case, observed – "The test of negligence under sec.131 of N. I. Act, is whether the payment considered in the light of the circumstances, antecedent and present, was so much out of ordinary

course that it ought to have aroused doubt in the banker's mind and caused him to make enquires" e.g. if circumstances create doubt or suspicion about the right of the customer to the cheque, the banker must make proper enquiries and take adequate provision. Failure to this will be considered negligence on its part. Ordinarily a banker owes duty towards his customer, but law make him responsible to the true owner of the cheque. In case of negligence, the collecting banker will not get statutory protection. Hence CBI was ordered to compensate Mr. (Central Bank of India Vs. Gopinathan Nair and others AIR 1970 Ker 74).

Case 2. Duty of a collecting bank to check endorsements

Facts of the case

On 10th November 1960 Reliable Hire Purchase Co. Pvt. Ltd. (RHC) issued cheque drawn on Indian Overseas Bank in favour of SM Ltd. and handed over to Mr. R to enable him purchase a vehicle. Mr. R forged the endorsement on the cheque in favour of M &Co. of which he himself was a director. On the very next day he deposited the cheque in United Commercial Bank for collection and to be credited to the account of M & Co. The United Commercial Bank guaranteed the endorsement and the cheque was duly collected and credited to the account of M and Co. When subsequently true facts came to light, the drawer of the cheque (RHP), claimed the amount of the cheque and damages from both – the collecting bank and the paying bank.

Decision of courts

The trial judge held that the paying bank did not make the payment in due course and was liable for suit amount. The collecting bank acted negligently and hence was liable to the paying bank.

The Division Bench of the High Court, on the appeal of both the banks, held that paying bank was justified in accepting as to the reliability of the endorsement which was guaranteed by the collecting bank. Hence the paying bank was not liable but the collecting bank was liable for conversion as it should have made enquires about the genuineness of the endorsement for the following reasons:

(i) A company endorsing a cheque drawn in its favour to another company is not a usual feature.

(ii) The endorsement was by the sales manager of SM Ltd, which again should have aroused suspicion as to where sales manager has authority to endorse on behalf of company.

(iii) The cheque was of unusually high amount and the endorsement was undated.

(iv) SM Ltd was in the business of selling vehicles, while M and Co in transport business. So why should SM Ltd pay to M and Co?

The collecting bank was held liable to pay the amount of the cheque to the drawer of the cheque who was deemed to be true owner of the cheque. The United Commercial Bank Ltd vs. Reliable Hire Purchase Co. Pvt. Ltd. And others (1976, IIMLJ p.286).

Case 3. Fictitious and fraudulent endorsements – responsibility of collecting bank

Facts of the Case

Bank draft, for Rs. 10,000 was purchased at Bareilly in favour of M/s. Mithanlal Mangal Sain. It was encashed through Canara Bank by fictitious endorsement and credited to the account of Universal Traders. The endorsement was purported to be done by Mangal Sain in Urdu. Mangal Sain signed on behalf of the firm but had not revealed the capacity in which he signed. The person in the collecting bank who examined the endorsement did not know Urdu and merely relied on the confirmation by the second payee and confirmed it.

Decision of Delhi High Court

It was held that once the endorsement was found to be suspicious, it was the duty of the collecting bank to verify it from independent source.

Hence Canara Bank was held for negligence as a collecting bank fails to take utmost care in verifying the genuineness of endorsement and was ordered to pay compensation. Canara Bank vs. Govind Ram Rajinder Kumar and others (1981, 51, Company Cases 476).

Case 4. Collecting bank's responsibility in respect of newly opened account

Facts of the case

A current account was opened in Indian Bank, Salem branch by one Mr. S. M. Desai. Another person purchased a demand draft from Catholic Syrian Bank, Singanallur (a nearby town to Salem) for Rs.20.00 in favour of M/s. Desai and Co. payable at it its Cochin branch. The said draft was forged by altering- (i) the amount to Rs. 29,000.00, (ii) payee's name to Mr. S.M. Desai and (iii) draft payable at Cochin to, Salem branch. The demand draft was collected through the newly opened current account of Mr. S. M. Desai, in Indian bank and the amount was withdrawn.

Subsequently when the forgery was detected, the drawee (paying) bank filed a suit for Rs. 29,000.00 against the collecting bank, on the ground of conversion. The collecting bank contended that there was no negligence as the draft was collected for properly opened account.

The evidence before the High Court showed that the person who had taken Mr. Desai to the Indian bank to open a new account, had told the Manager that Mr. Desai was a man from Indore and wanted to open a bank account to be able to purchase carpets from Salem. He had never mentioned that he knew Mr. Desai or they had any business relationships or even as Mr. Desai being a bona fide customer and account could be opened in his name. Mr. Desai had not even given his permanent address and had admitted that he was opening account for the first time.

Decision of the High court

The Court held that, "where a bank allowed a customer to open an account on the recommendation of a customer who could not be said to be respectable and without testing the credentials of the person desirous of opening the accounts, cannot be considered to have acted without negligence even if it has acted in good faith" Hence the collecting bank was negligent in both – opening the account and collecting the draft shortly after opening the account. The collecting bank may have acted in good faith but have not acted without negligence and hence could not get statutory protection of Section 131. (Indian Bank Vs Catholic Syrian Bank Ltd.AIR 1981 Mad 129).

Case 5 - Axis Bank Vs Punjab National Bank & another

Facts of the case

One Mr. A, approached the branch of Axis Bank at Pithampura at Delhi, submitting necessary forms and documents. Axis Bank sends a letter of thanks to the customer as address verification and the customer collected a cheque book from the bank on production of the thanks letter. Two months later, Mr. A, deposited certain demand drafts purported to be issued by PNB from Kurukshetra. The drafts were presented for payment by Axis Bank and was also cleared by PNB. Later PNB informed Axis Bank that the drafts were not issued by them and the demand drafts were actually issued in favour of Registrar, Delhi University for an amount of

Rs.100/-. Upon receiving the information, Axis Bank immediately froze the account and initiated the same to PNB.

PNB filed a claim against Axis Bank under the provisions of the Debt Recovery Tribunal Act (the "DRT Act"), which was ordered in favour of PNB. Axis filed an appeal before the appellate tribunal, which was also decided in favour of PNB. Axis then appealed to the High Court at Delhi.

Decision of the High Court:

The court observed that" The standard of care expected from a banker in collecting the cheque does not require him to subject the cheque to a minute and microscopic examination. To fasten the responsibility for cheating on account of fabrication, the forgery or tampering must be such as can be detected from the face of the instrument by applying ordinary care and diligence."

Further, in this case, the High Court found that there was no proximate connection between the opening of the account or the deposits of the forged instruments so as to treat the said events as intimately associated with each other. There was no undue hurry shown by the fraudster in making the withdrawals. It is not the case of PNB that the forgery could have been detected by the collecting bank from the face of the instruments. The fact that the forgery could not be detected by the centralized draft payable centre of PNB itself shows that the collecting bank could not have entertained any doubts as to the genuineness at the time of receiving the drafts from the customer or for making them over to the drawee bank for collection. The DRAT has found PNB also to negligent in these transactions as PNB ,service branch should have detected the fraud at the time of making the payment of the drafts.

The Court decided that Axis Bank was wrongly denied the immunity of a collecting banker under Section 131.

Therefore, it is very important for the banks to observe due care and diligence in the ordinary course of business of opening accounts and processing payments.

Case 6. Liability on account of negligence of third parties

A trader RKB of Delhi, under a contract, supplied goods to Government department and received its full payment. The contract bills submitted by suppliers were usually audited by Government Auditor before payment of the bill amount. The Government Auditor while auditing some bills of the trader, fraudulently omitted to make cancellation on the inspection notes and handed over uncancelled inspection notes to another person by name MCJ. MCJ opened account in the name of RKB with a bank and presented bill purporting to be drawn by RKB accompanied by one of the stolen inspection notes. The bank sent the bill for collection and credited the account of RKB on collection. MCJ withdrew the amount subsequently. Similarly, another bill was also collected in the same manner and MCJ withdrew the amount. When the fraud came to light, the Government (i.e. Union of India) filed a suit against the bank to recover money on the ground of conversion.

Observation and decisions of the Court

The trial court at Delhi observed that bank which collected the bills on behalf of MCJ was merely acting as collecting agent and there was no evidence that the officials of the Government were deceived into issuing the cheques. The bank further failed to produce any evidence to show that it acted without negligence by opening the account on the recommendation of any reliable introducer of the account. The court, therefore, held that the manner in which the account was opened by the Bank and allowed operations does not show the absence of negligence and is entitled to avail of protection under Section 131.

The High Court of Delhi held that the Banker had no means, machinery or material to scrutinize whether the

bills and the inspection notes on which the bills were based was forged and the two uncancelled inspection notes were obtained by RKB by means of fraud. It was the Govt. Department who had the means of knowledge to ascertain whether the inspection notes accompanying the two bills were fraudulently kept uncancelled and whether or not any payment was due under the particular acceptance of tender.

The Court held that negligent conduct of the Government Dept was the real cause of the loss and the Government Dept. was therefore stopped from claiming the amount from the bank. (Union of India vs. National Overseas and Grindlays Bank Ltd., 1978, 48 Company cases 277 Del.)

Case 7. Collecting Bank's Role and responsibility

(Keshrichand Jaisukhlal vs. Shillong Banking Corporation Ltd. (1965, company case 514 (S.C.))

On December 9, 1946, one Mr. K J a customer of Shillong Banking Corporation (SBC) for collection two cheques for Rs. 8,200 and Rs. 600 respectively drawn on the Bharati Central Bank, Shillong. On receipt of the cheques, SBC credited the account of KJ a sum of Rs. 8,800. SBC then sent the cheques to the Bharati Central Bank, Shillong (BCB) for collection. Instead of paying cash, BCB sent a cheque dated December 9, 1946 for Rs. 8,800 drawn by it on the Nath Bank, Shillong in favour SBC.

SBC accepted this cheque on its own responsibility without consulting KJ. On December 10, 1946, SBC presented the cheque to the Nath Bank for payment. The Nath Bank returned the cheque with the remark "full cover not received". SBC orally informed KJ of the non-payment of the cheque on the Nath Bank, and on December II, 1946 under oral instructions from KJ, represented the cheque to Nath Bank for payment. The Nath Bank again returned the cheque with the remark "full cover not received", and the SBC thereupon debited KJ's account with the sum of Rs. 8,800. On the same day, SBC wrote to the BCB demanding cash payment of the two cheques drawn on them and dated December 9, 1946. KJ also contacted SBC.

Under instructions from KJ, SBC accepted from BCB a demand draft for Rs. 8,800 dated December 13, 1946 draw on its Calcutta Head Office towards payment of the two cheques. SBC presented the draft to the BCB Calcutta for payment, but instead of making payment, BCB Calcutta wrote on December 16, 1946 requesting SBC to obtain payment from its Shillong Branch. The SBC communicated this advice to KJ. After several days SBC presented the draft to the BCB Shillong for payment, but the draft was not paid. On January 2, 1947, the BCB closed its business and was placed under moratorium.

On January 11, 1947, SBC wrote to the KJ stating that it was holding the demand draft as also the cheque on the Nath Bank and would be glad to receive further instructions in the matter for necessary action. As KJ refused to give any instructions, SBC continued to hold the securities on account of KJ. In respect of the draft, SBC duly preferred a claim in the liquidation of the BCB and was admitted as a preferential creditor for the amount of the draft. On January 28, 1947, KJ wrote to SBC alleging that it had accepted the demand draft at its own risk and responsibility and was bound to give credit to the appellant for the sum of Rs. 8,800. The dealings between KJ and SBC continued, and the last entry in his account as done on December 29, 1950. On February 26, 1953, a petition was presented in the Assam High Court for the winding up of SBC. By an order dated May 24. 1953, SBC was ordered to be wound up. On June 28, 1954 the liquidator of SBC presented an application to the Assam High Court under s. 45(D) of the Banking Companies Act, 1949 for settlement of the list of debtors and interest against KJ who did not agree with the claim. Subsequently KJ filed a suit against SBC. The lower courts at Assam upheld the liquidator's settlement but KJ went in appeal to Supreme Court in the matter.

It was observed that the bank had acted in good faith and in the interest of the customer, when it accepted cheque instead of cash. The customer had also approved all the steps taken by the collecting bank in the matter of collecting draft.

The Supreme Court summarized the duties of collecting bank as – "a banker entrusted by his customer with the collection of a cheque is bound to act according to the directions given by the customer, and in the absence of such direction, according to usage prevailing at the place, where the banker conducts his business and applicable to the matter in hand. The banker is also bound to use reasonable skill and diligence in presenting and securing payment of the cheque and placing the proceeds to his customer's account and in taking such other steps as may be proper to secure the customer's interest." In this case, by a majority decision, the Supreme Court dismissed the claim of KJ.

Case 8. Collecting Bank's negligence

Indian Overseas Bank v. Industrial Claim Concern 1989 (2) LW 437 (SC)

Facts of the case

Suit was filed by the defendant for recovery of loss it claimed to have sustained on account of the alleged negligence and conversion on the part of the bank. The matter reached Supreme Court on appeal by the bank. Though the trial court decided that the bank was negligent in allowing the firm to open a 'fictitious account' and permitting the customer to withdraw proceeds and also close the account.

Decision of the Court

The Supreme Court held that the facts and materials available on record did not show that the bank has acted negligently. Though the Supreme Court made certain observations on banking practice, it concluded that the bank was not negligent and protection under Section 131 of the NI Act was available to the bank.

Case 9. Responsibilities of collecting bank in the case of substituted agent

Facts of the case

The firm Ishwarbhai Lalbhai Patel and Co. deposited a cheque in their favour drawn on Lakshmi bank, Bandara for collection with Punjab National Bank, Gondia. PNB had no branch at Bandara, hence they sent the cheque to Lakshmi bank, Gondia for collection. The cheque was passed and a pay order was issued to PNB for receiving payment at its Gondia branch. In spite of presenting the pay order twice the payment was not received and the third time when the cheque was presented to Lakshmi bank it had suspended the payment. Shortly thereafter Laxmi Bank went into liquidation. A suit was filed by the firm for realization of cheque on PNB.

Decision of the High court

The court held that the acts of Lakshmi Bank,Gondia, as substituted agent would be binding on the customer and PNB would not be responsible to the customer unless it had received the payment in its hand and credited the same to the account of customer. The collecting banker collects the amount of the cheque from the paying banker through its own branch at the place of the paying banker. If there is no branch of the collecting banker at that place, it appoints another banker, having branch at that place, as its agent for collection. The status of such agent banker is a sub agent or a substitute agent.

After weighing all aspects of the case the court did not find any negligence on the part of Punjab National Bank as it could not collect the money from the paying bank in spite of its reasonable efforts.

(Punjab National Bank, Gondia vs. Iswarbhai Lalbhai Patel and Co. (AIR 1971, Bombay 348) The following are the English Case laws with the reference to negligence of a Collecting Banker.

Case 10. Negligence in case of a Stolen cheque

Facts of the case

A cheque in transit was stolen, collected through a bank and money was withdrawn by a thief by forging signature of the payee and posing himself as payee.

Decision of the court

The collecting bank was held liable to make good the amount to the true owner, since it acted negligently while opening the account by not making proper enquiries or asking suitable references. [English Court Decision Ladbroke vs. Todd (1914,30 TLR 433).]

Case 11. Negligence while opening accounts

Facts of the case

An account was opened for a new customer after completing the necessary formalities. The account was opened by accepting a third party cheque for collection instead of depositing cash. On making enquires with the customer he produced a forged letter issued by his employer giving him power to deal with cheque. When it was later on found that the cheque was stolen.

Decision of the court

The bank was held negligent for failure to make necessary enquiries from the employer as to whether the customer who was employee had power to deal with cheque. (Harding vs. London Joint Stock Bank, 1914, 3).

Case 12. Negligence of Conversion

It was held that a non-negotiable crossing is only one of the factors amongst others to be considered to decide about the banker's negligence and that the mere taking of a non-negotiable cheque cannot be held to be evidence of negligence on the part of banker. It is the duty of banker to ensure that the cheque is crossed specially to himself and if the cheque is crossed to some other banker they should refuse to accept it. Similarly, where the cheque is crossed to a specific account then crediting the same to another account without necessary enquiries would make him liable on the grounds of negligence. (Crumpling vs. London Joint Stock Bank Ltd., 1911-13).

Case 13. Negligence of conversion

Facts of the case

The MD of a company paid into his personal account large number of cheques which were issued in favour of the company.

Decision of the Court

The bank was held negligent on account of conversion. (The Underwood Ltd. Vs. Bank of Liverpool Martin Ltd., 1924 1KB 775.)

Case 14. Negligence while opening accounts

Facts of the case

Two clerks of stock broker stole bearer cheques belonging to their employer and collected through accounts; one opened in the name of one such clerk and other opened in the name of his wife.

Decision of the Court

The bank was held negligent in opening the accounts as it did not ask the employers name while opening account of that clerk and in his wife's case the name of the employer of her husband and his occupation. (Savory Company vs. Lloyds Bank, 1932 2KB, 122)

Case 15. When there is no negligence of conversion bank is not liable

Facts of the case

An agent deposited in his personal account, a few cheques, favouring his principal. The bank was charged for conversion. The bank, however, defended that there was implied authority from principal to his agent to use his private account for such purpose.

Decision of the Court

The bank was not held liable since it was found that the principal had in fact authorized his agent to use his personal account. (Australia and New Zealand Bank vs. Ateliers de Constructions Eletriques de Cherleroi, 1967, 1 AC 86 PC).

Case 16. Negligence of conversion

Facts of the case

The Manager of a company, was permitted to draw cheques per pro his employer and he drew some cheques payable to himself and collected in his personal account.

Decision of the Court

The bank was held negligent for collecting these cheques because it did not make proper enquiries. (Morrison vs. London county and Westminster Bank, 1914-15, all ER Rep 853)

Case 17. Failure to take precautions

Facts of the case

The Nu-Stilo Footwear Limited (NFL) were manufacturers of ladies footwear. Their Secretary and Works Accountant fraudulently deposited a total of 9 cheques payable to NFL in to his newly opened personal account with Lloyds Bank, in false name by giving reference of his real name. During the preliminary enquiry before the account was opened the bank was informed that the account opener had recently come to the town with the intention to start his own business. The nine cheques were then deposited in the account. When the fraud came to light, NFL sued Lloyds Bank for collecting these cheques and sought compensation.

Decision of the Court

The Court held that the collecting bank was negligent for not taking necessary precaution because the amounts

of cheques collected were inconsistent with the business of account holder. (Nu-Stilo Footwear Ltd. vs. Lloyds Bank, 1956, 7 P 121)

Case 17. Negligence of the bank in making payment with forged signatures

Facts of the Case

Mrs Rosali opened a Saving Bank Account with Syndicate Bank in the year 1983 under Account No.5623/14. Every month, she used to deposit her rental income Rs.750 to Rs.800/- in the said account. On 01.07.1985, she withdrew a sum of Rs.1500/- under a cheque bearing No.332771 and on 03.11.1986, she withdrew a sum of Rs.10,000/- under a cheque bearing No.332772. Except these two withdrawals, she has not withdrawn any money during that period. Her balance as on May 1987 ought to have been a sum of Rs.52,900.55. But, to her shock and surprise, when she verified with the bank, she found that she had only balance of Rs.127.55 and one Mr.Thomas, who is her messenger and relative used to transact with the Bank on her behalf, has forged her signatures in the cheque slips and withdrawn a total sum of Rs.52,900.55, without her knowledge.

The Bank Officials, who should have shown proper care, while passing cheques containing forged signatures, has failed to do so, resulting in withdrawal of Rs.52,900.55 by the said Thomas fraudulently. The defendant Bank Officials had passed the cheques without due care and by gross negligence, which amounts to dereliction of duty and misconduct in the course of employment. Had due diligence shown by the Bank Officials by proper comparison of the specimen signatures of the plaintiff kept in the custody of the Bank with, the cheques presented by the said Thomas ought not have passed the forged cheques.

Based on her complaint to the Mylapore Police Station against the said Thomas, the Police has registered a case and the Trial ended in conviction for two years of Rigorous Imprisonment. Since the defendant Bank has negligently passed the cheques containing four signatures, they are liable to pay a sum of Rs.52,900.55 with interest at the rate of 18%.

Decision of the Court

Court, on going through the materials placed, holds that the respondent bank was never negligent in honouring the cheques. Hence, they are protected under Section 131 of the Negotiable Instrument Act, 1881. In the absence of justification on the part of the plaintiff for allowing the said Thomas to handle her passbook and cheque book and representing to the bank implicitly and explicitly that Thomas is her representative, she is estopped from alleging negligence on the part of the respondent bank. Therefore, the conduct of the respondent Bank estops her from questioning the bank for honoring the cheques of the plaintiff. Even if it is not signed by her, but due to lookalike signatures, the bank cannot be held responsible. The evidence of DW1 to DW6 narrate the care and caution exercised by the bank officials while passing the cheques. Therefore, their evidence cannot be just ignored, in the absence of contra evidence. As pointed out by the lower appellate Court, the reasoning of the trial Court is bad and bereft of details for his conclusion that the signatures found in the cheques are forged. Therefore, even though there is no legal impediment to exercise the power under Section 73 of the Indian Evidence Act, 1872, without resorting to expert opinion under Section 45 of the Indian Evidence Act, 1872, the manner in which the power under Section 73 of the Indian Evidence Act, 1872 exercised is always subject to judicial scrutiny. First and foremost, the plaintiff/appellant ought to have proved the case of forgery by letting in plausible evidence, which is well within her limitation, but miserably failed to do. Next, in the absence of reasoning and the process undertaken by the trial Court to arrive at the conclusion that signatures found in the disputed signatures are forged, since finding deserves to be reversed. The lower appellate Court has rightly reversed the trial Court finding by allowing the first appeal.

(In the High Court of judicatures at Madras – Mrs Rosali Versus Syndicate Bank , Myloapore , Madras , pronounced on 23.08.2017) Source Indiankanoon.org/doc/36266551.)

LESSON ROUND UP

Protection is available to a collection bank under Section 131 of the NIAAct, only when the following conditions are satisfied:

- The bank should collect the instrument only for its customers;
- The cheque should be crossed generally or specially;
- The collected proceeds are deposited only into the account of the customer or to the account of the endorsee;
- The collecting bank should have acted in 'good faith', mans the banker had no reasonable ground to believe that the customer is not entitled to receive payment of the amount mentioned therein;
- The collecting bank should have acted without negligence (i.e.) all account opening KYC and monitoring should be done in accordance with the policy and normal practice. Opening of account and deposit of the cheque, if forms part of the same scheme, where the account itself was opened for enchasing the instrument fraudulently, then it could lead to an inference that the bank is negligent;
- Collection based on truncated instruments should be verified for apparent fraud, forgery or tampering on the face of the instrument by ordinary care and due diligence.

GLOSSARY

Good faith, Without negligence, Crossed cheque, General crossing, Special crossing, Negligence, Third party cheques, Truncated cheque,Due diligence.

SELF-TEST QUESTIONS

1. **Write True or False**
   a. Section 131 A extends protection to banks when they collect DDs.
   b. Under Section 131 collecting bankers also get protection for collecting uncrossed cheques.

c. If documents are lost against which the bank has advanced money, the bank can debit the customer's account.

d. If circumstances create doubt or suspicion about the right of the customer to the cheque, the banker must make proper enquiries and take adequate precaution.

e. If an endorsement was found to be suspicious, it is the duty of the collecting bank to verify it from independent source.

[As the chapter is entirely based on case laws descriptive questions are not given.]

For further reading

Case Laws from Various Sources (All India Reporter etc.) through internet.

Lesson 10
Various Government Schemes

LESSON OUTLINE

- Pradhan Mantri Jan Dhan Yojana (PMJDY)
- MUDRA Bank Yojana
- National Equity Fund
- Sukhanya Samridi Account
- Pradhan Mantri Jeevan Jyoti Beema Yojana (PMJJBY)
- Pradhan Mantri Suraksha Bima Yojana (PMSBY)
- Atal Pension Scheme
- Pradhan Mantri Vaya Vandana Yojana.
- Pradhan Mantri Fasal Bima Yojana (PMFBY)
- Pradhan Mantri Employment Generation Programme (PMEGP)
- Deendayal Antodya Yojana – NRLM
- Deendayal Antodya Yojana – NULM
- Differential Rate of Interest Scheme
- Self Employment Scheme for Rehabilitation of Manual Scavengers
- Prime Minister's Awas Yojana –Urban
- Prime Minister's Awas Yojana – Gramin
- Standup India Scheme for financing SC/ST
- Women Entrepreneurs
- Rural Self Employment Training Institutes (RSETI)
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

To have an over view of the Government schemes by way of –

- Background.
- Objectives of the schemes.
- Formalities relating to account opening formalities (where applicable).
- The salient features of the scheme.
- Documents required.
- Eligibility.
- Benefits.
- Details of the scheme.
- Conditions to be fulfilled.

INTRODUCTION FOR STARTING GOVERNMENT SCHEME

Indian Government, at all levels, announces Welfare Schemes for a cross section of the society from time to time. These schemes could be either Central, State specific or a collaboration between the Centre and the States. In this section, we have attempted to provide an easy and single point access to information about several welfare schemes of the Government and their various aspects including eligible beneficiaries, types of benefits, scheme details etc.

PRADHAN MANTRI JAN-DHAN YOJNA (PMJDY)

Hon'ble Prime Minister, Sh. Narendra Modi on 15th August 2014 announced "Pradhan Mantri Jan-Dhan Yojana (PMJDY)" which is a National Mission for Financial Inclusion. Financial Inclusion is the provision of banking services at an affordable cost, to the disadvantaged sections of the society, who are hitherto excluded and deprived of the Financial Services, to enable them to improve their standard of living. The task is gigantic and is a National Priority.

Purpose of the Scheme

With the slogan "Mera Khata - Bhagya Vidhaata", Pradhan Mantri Jan-Dhan Yojana (PMJDY) aims to ensure access to financial services, namely, Banking/ Savings & Deposit Accounts, Remittance, Credit, Insurance, Pension in an affordable manner.

Account can be opened in any bank branch or Business Correspondent (Bank Mitr) outlet. Accounts opened under PMJDY are being opened with Zero balance. However, if the account-holder wishes to get cheque book, he/she will have to fulfill minimum balance criteria.

Documents required for opening account

An account can be opened by presenting any one of the following officially valid document:

i. the passport,

ii. the driving licence,

iii. the Permanent Account Number (PAN) Card,

iv. the Voter's Identity Card issued by Election Commission of India,

v. job card issued by NREGA duly signed by an officer of the State Government,

vi. the letter issued by the Unique Identification Authority of India containing details of name, address and Aadhaar number, or

vii. any other document as notified by the Central Government in consultation with the Regulator:

Provided that where simplified measures are applied for verifying the identity of the clients the following documents shall be deemed to be officially valid documents : –

a. identity card with applicant's Photograph issued by Central/State Government Departments, Statutory/ Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, and Public Financial Institutions;

b. letter issued by a Gazetted officer, with a duly attested photograph of the person.

Reserve Bank of India (RBI), vide its Press Release dated 26.08.2014, has further clarified that those persons who do not have any of the 'officially valid documents' can open "Small Accounts" with banks. A "Small Account" can be opened based on a self-attested photograph and putting his/her signatures or thumb print in the presence of officials of the bank. Such accounts have limitations regarding the aggregate credits (not more than Rupees one lakh in a year), aggregate withdrawals (nor more than Rupees ten thousand in a month) and balance in the accounts (not more than Rupees fifty thousand at any point of time). These accounts would be valid normally for a period of twelve months. Thereafter, such accounts would be allowed to continue for a further period of twelve more months, if the account-holder provides a document showing that he/she has applied for any of the Officially Valid Document, within 12 months of opening the small account.

Benefits

Special benefits under the scheme include:

1. Interest on deposit as applicable.
2. Accidental insurance cover of Rs. 2 lac.
3. No minimum balance required to be maintained in the account.
4. Life cover of Rs. 30,000 payable on death of the beneficiary, subject to fulfillment of eligibility condition.
5. Easy transfer of money across India.
6. An overdraft facility of Rs. 10,000 after satisfactory operation of the account for 6 months. There will be no conditions attached for over-draft of up to Rs. 2,000.
7. Access to pension and insurance products.

Conditions to be fulfilled to avail overdraft facility are:

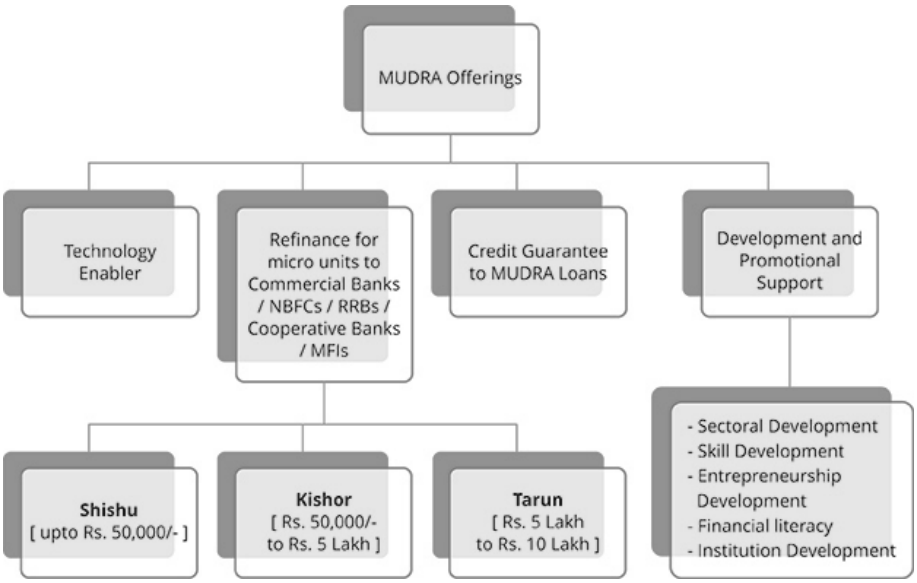
1. Satisfactory operation for 6 months.
2. Facility to only earning member of the family, preferably a woman.
3. Age of the applicant should be between 18 years to 65 years.
4. Period of sanction will be 36 months subject to annual review.
5. Loan amount will be – 4 times of average monthly balance, or 50% of credit summations in the account for preceding 6 months or Rs. 10,000/- whichever is less.
6. Interest rate not exceeding 2% above base rate of the bank.

7. No processing fee is applicable.

PRADHAN MANTRI MUDRA YOJANA (PMMY)

Micro Units Development and Refinance Agency Ltd. [MUDRA] is an NBFC supporting development of micro enterprise sector in the country. MUDRA is a public sector institution for providing loans to small entrepreneurs launched on 08/04/2015. MUDRA provides refinance support to Banks / Micro Finance Institutions (MFIs) for lending to micro units having loan requirement up to 10 lakh. MUDRA provides refinance to micro business under the Scheme of Pradhan Mantri MUDRA Yojana. The other products are for development support to the sector. It targets mainstream young, educated or skilled workers and entrepreneurs who cannot have access to credit from regular banking system.

The bouquet of offerings of MUDRA is depicted below. The offerings are being targeted across the spectrum of beneficiary segments.



Purpose of MUDRA Loan

Mudra loan is extended for a variety of purposes which provide income generation and employment creation. The loans are extended mainly for:

i. Business loan for Vendors, Traders, Shopkeepers and other Service Sector activities

ii. Working capital loan through MUDRA Cards

iii. Equipment Finance for Micro Units

iv. Transport Vehicle loans

MUDRA Scheme

MUDRA has launched following three loan instruments, as given below:

1. Shishu (the starters) upto Rs. 50,000.
2. Kishor (the mid stage finance seekers) above Rs. 50,000and upto Rs. 5 lakh.
3. Tarun (growth seekers) Above Rs. 5 lakh and upto Rs. 10 lakh.

Under Credit Guarantee Fund for Micro Units (CGFMU) for loans under MUDRA scheme, guarantee is offered by National Credit Guarantee Trust Company for which following loans are eligible:

All loans sanctioned under PM MUDRA Yojana by Commercial banks, MFIs and Non-Banking Finance Companies [these are called Member Lending Institutions (MLI)] – in the categories of Shishu, Kishor and Tarun and overdraft up to Rs. 5,000.00 under PM Jan DhanYojana. In these loans, the Member Lending Institutions should not obtain any collateral security or 3rd party guarantee from the borrower.

Types of funding support from MUDRA

1. Micro Credit Scheme (MCS) for loans up to 1 lakh finance through MFIs.
2. Refinance Scheme for Commercial Banks / Regional Rural Banks (RRBs) / Scheduled Co-operative Banks.
3. Women Enterprise programme.
4. Securitization of loan portfolio.

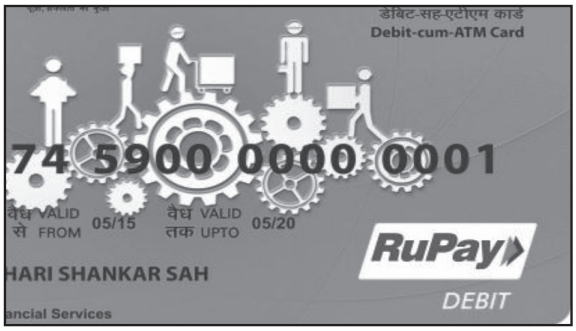
1. Micro Credit Scheme: It is offered mainly through Micro Finance Institutions (MFIs), which deliver the credit up to Rs.1 lakh, for various micro enterprise activities. Although, the mode of delivery may be through groups like SHGs/JLGs, the loans are given to the individuals for specific income generating micro enterprise activity. The MFIs for availing financial support need to enroll with MUDRA by complying to some of the requirements as notified by MUDRA, from time to time.

2. Refinance scheme for Banks: Different banks like Commercial Banks, Regional Rural Banks and Scheduled Cooperative Banks are eligible to avail of refinance support from MUDRA for financing micro enterprise activities. The refinance is available for term loan and working capital loans, up to an amount of 10 lakh per unit. The eligible banks, who have enrolled with MUDRA by complying to the requirements as notified, can avail of refinance from MUDRA for the loan issued under Shishu, Kishor and Tarun categories.

3. Women Enterprise programme: To encourage women entrepreneurs, the financing banks / MFIs may consider extending additional facilities, including interest reduction on their loan. At present, MUDRA extends a reduction of 25bps in its interest rates to MFIs / NBFCs, who are providing loans to women entrepreneurs.

4. Securitization of loan portfolio: MUDRA also supports Banks / NBFCs / MFIs for raising funds for financing micro enterprises by participating in securitization of their loan assets against micro enterprise portfolio, by providing second loss default guarantee, for credit enhancement and participating in investment of Pass Through Certificate (PTCs) either as Senior or Junior investor. PTC is a certificate that is given to an investor against certain mortgaged backed securities that lie with the issuer.

MUDRA Card



MUDRA Card is an innovative product which provides working capital facility as a cash credit arrangement. MUDRA Card is a debit card issued against the MUDRA loan account, for working capital portion of the loan. The borrower can make use of MUDRA Card in multiple withdrawal and credit, to manage the working capital limit in a most efficient manner and keep the interest burden minimum. MUDRA Card will also help in digitalization of MUDRA transactions and creating credit history for the borrower. National Payment Corporation

of India (NPCI) has given RuPay branding to MUDRA Card and separate BIN / IIN for the same, by which credit history can be tracked. MUDRA Card can be operated across the country for withdrawal of cash from any ATM / micro ATM and make payment through any 'Point of Sale' machines.

The design of the MUDRA card as approved by Department of Financial Services (DFS), GoI and NPCI is given below. Banks can customize the same by incorporating their logo and name.

National Equity Fund

Objective

The objective of the Scheme is to provide equity type support to Micro and Small Enterprises (MSE) as defined under MSME Act 2008 and thereby improving their acceptability for team financing by primary lending institutes (PLIs). The fund is administered by SIDBI in participation with Government of India.

Secondly, the objective is to afford equity type support to entrepreneurs for setting up projects in small scale sectors for undertaking expansion, modernization, technology up-gradation and diversification by existing small scale sector and for rehabilitation of viable sick units in the SSI sector.

Eligibility

i. New as well as existing entrepreneurs in the MSE sector.

ii. Sanction of refinance in respect of term loan for the projects by SIDBI is a prerequisite.

iii. The complete requirements of the projects in the form of equity assistance, the term loan and working capital will be provided by one agency viz. a nationalized bank or State Finance Corporation.

Features

1. Lending institutions to provide equity type of soft loan scheme under this scheme.
2. Project cost can be upto Rs. 50 lakh (including margin for working capital) for MSE sector.
3. Amount of Assistance – 25% of the project cost subject to a maximum Rs. 10 lakh per project.
4. Debt Equity Ratio – 1.875 : 1 (excluding state subsidy for working capital).
5. Minimum promoters' contribution should be 10% of the project cost.
6. The rate of interest imposed by banks/SFCs for the various project will be as per RBI guidelines.
7. Repayment period – 7 years including moratorium up to 3 years.
8. Security – No security or collateral nor coverage under DICGC guarantee scheme is needed, as the credit risk is borne by SIDBI.

Procedure for Availing Assistance

- A separate application is to be furnished for availing assistance under the NEF Scheme. Entrepreneurs while requesting for term loan assistance from financial institutions can specify the amount of NEF assistance in their financing proposal.
- Eligible applicants will submit five copies of the application, duly completed to Zila Sainik Board (ZSBs), along with the project report.
- ZSB will maintain four copies of the application form and return one copy to the applicant duly endorsed.

- ZSB will transfer one copy to Rajya Sainik Board (RSB) and other three copies of the form along with the project plan to the concerned branch of the banks for the sanction of loan.
- Also, the copy of the letter should be transferred by ZSBs to SIDBI and the District Lead Bank Officer, for necessary information. One copy of the application form receipted will be reimbursed by the bank to the ZSB for their record. The borrowers will be intimated by the Secretary, ZSB about the sanction of loans.

SUKANYA SAMRIDDHI ACCOUNT YOJANA

Objective

Sukanya Samriddhi Account is Government of India backed savings scheme targeted at the parents of girl child. It is a Girl Child Prosperity Account. The Sukanya Samriddhi Yojana was launched as a part of the Beti Bachao, Beti Padhao campaign by the Modi government on 22 January 2015 after seeking the subjugating conditions of the girl children in the country. The scheme encourages parents to build a fund for the future education and marriage of a girl child.

Features of the scheme:

1. **Who will open this account:** A Sukanya Samriddhi Account can only be opened by the parent/legal guardian for a maximum of two female children. An exemption is provided by presenting a medical certificate from an authorized medical institution for twins and triplets.
2. **Age Criteria:** A Sukanya Samriddhi account can only be opened for a girl child anywhere between her birth and 10 years of age.
3. **Residential status:** This account can only be opened for a girl child who is a resident of India. This scheme is unavailable for a girl child having non-resident status. Even if the parents or the legal guardians are non-residents, then also this scheme will not be available to them. If the girl child becomes a non resident after opening this account, then this change should be intimated to the concerned post office/ bank within 1 month of such change after which the account gets closed.
4. **Account in the name of the girl child:** Sukanya Samriddhi account must always be opened in the name of a girl child and not in the name of her parents or legal guardians. They will only deposit an amount in the account on behalf of the minor girl child.
5. **Number of accounts:** A single parent/legal guardian can open only one account for every girl child in the family. A maximum of two accounts for two girl children can be opened in one family.
6. **Where to open this account:** This account is opened in the authorized branches of Post Offices or

commercial banks like State Bank of India, Bank of Baroda, Punjab National Bank, Bank of India, Canara Bank, Andhra Bank, UCO Bank, and Allahabad Bank, to name a few.

7. **Documents required:** There are certain documents required to open this account-
   - Birth certificate of the girl child
   - Address and identity proof of the depositor (parents or the legal guardians)- Aadhaar card, PAN card, passport, ration card, driving license.
   - In case of twins or triplets, a medical certificate proving the order of birth of children.
   - Certificate stating the nature of a relationship with the girl child. In cases where this account is opened by the biological parents of the girl child, the birth certificate will serve the requirement of this certificate. But in the case of the adopted girl child, this certificate becomes necessary.
8. **Threshold of deposits:** Sukanya Samriddhi account can be opened with a minimum deposit of Rs.250 per account. A maximum limit on the amount of deposit to this account has been set at Rs.1.50 lakhs per account per financial year. There is no limit in the number of deposits in a month or a fiscal year.
9. **Mode of payment of deposits:** The cheque or the demand draft should be in the name of the-
   - For Banks/Financial institutions- Concerned Bank Manager
   - For Post Office- Concerned Postmaster

   The parent or the guardian is required to write the girl child's name and the account number on the back of the cheque or draft while making the payment of deposit.
10. **Account Transferability:** The option to transfer the Sukanya Samriddhi Account from the post office to post office, bank to bank, post office to the bank, and bank to post office on furnishing certain documents is available.
11. **Penalty:** A penalty of Rs.50 will be imposed if there is a failure in meeting the minimum deposit requirements.
12. **Rate of Interest:** The scheme is currently offering a rate of interest of 8.1% (to be notified by government) for 2018-19. This interest is compounded on yearly basis.
13. **Maximum duration of deposit:** The maximum duration for which a parent/guardian is required to deposit an amount in this account is 14 years. After the end of this duration, no more money is required to be deposited to this account and it will continue to accumulate interest until it matures/closed.
14. **Closure of Account:** This account gets closed after it attains maturity after completing the tenure of 21 years. The money lying in this account including the interest is paid to girl child after attaining 18 years of age and on submission of an account closure application along with address and identity proof, proof of residence and citizenship.
15. **Taxation aspects:** The total maturity amount and the interest earned on this account is fully exempted from taxation under section 80C of Income Tax Act 1961 and follows Exempt-Exempt-Exempt (EEE) tax regime. As of now, an amount up to Rs. 1.5 lakh is exempted.
16. **Tenure of account:** This savings account remains active for a maximum period of 21 years from the date of opening of this account, after which the account stops to accrue any interest.
17. **Premature closure of account -** (1) In the event of death of the account holder, the account shall

be closed immediately on production of death certificate issued by the competent authority, and the balance at the credit of the account shall be paid along with interest till the month preceding the month of premature closure of the account to the guardian of the account holder.

(2) Where the Central Government is satisfied that operation or continuation of the account is causing undue hardship to the account holder, it may, by order, for reasons to be recorded in writing, allow pre-mature closure of the account only in cases of extreme compassionate grounds such as medical support in life threatening diseases, death, etc.

PRADHAN MANTRI JEEVAN JYOTI BIMA YOJANA (PMJJBY)

Background

Government of India backed Life Insurance Scheme for the benefit of weaker sections of the society. PMJJBY is an Insurance Scheme offering life insurance cover for death due to any reason. It would be a one year cover, renewable from year to year Hon'ble Prime Minister launched PMJJBY schemes nationally in Kolkata on 9th May, 2015.

Scope: All individual account holders of participating banks in the age group of 18 to 50 years will be entitled to join. In case of multiple bank accounts held by an individual in one or different banks, the person would be eligible to join the scheme through one bank account only. Aadhar would be the primary KYC for the bank account.

Enrolment period: The cover period is from 1st June to 31st May, subscribers are required to enroll and give their auto-debit consent by 31st May every year. Those joining subsequently would be able to do so with payment of full annual premium for prospective coverage.

For subscribers enrolling for the first time on or after 1st June 2016, insurance cover shall not be available for death (other than due to accident) occurring during the first 45 days from the date of enrolment into the scheme (lien period) and in case of death (other than due to accident) during lien period, no claim would be admissible.

Individuals is free to exit the scheme at any point and may re-join the scheme in future. The exclusion of insurance benefits during the lien period shall also apply to subscribers who exit the scheme during or after the first year and rejoin on any date on or after 1st June 2016.

In future years, new entrants into the eligible category or currently eligible individuals who did not join earlier or discontinued their subscription shall be able to join while the scheme is continuing subject to the 45 days lien period described above.

Benefits: Rs.2 lakh is payable on member's death due to any cause.

Premium: Rs.330/- per annum per member. The premium will be deducted from the account holder's bank account through 'auto debit' facility in one instalment, as per the option given, on or before 31stMay of each annual coverage period under the scheme. Delayed enrolment for prospective cover after 31stMay will be possible with full payment of annual premium.

Eligibility Conditions:

Individual bank account holders of the participating banks aged between 18 years (completed) and 50 years (age nearer birthday) who give their consent to join / enable auto-debit, as per the above modality, will be enrolled into the scheme.

Termination of assurance: The assurance on the life of the member shall terminate on any of the following events and no benefit will become payable there under:

1) On attaining age 55 years subject to annual renewal up to that date (entry, however, will not be possible beyond the age of 50 years).
2) Closure of account with the Bank or insufficiency of balance to keep the insurance in force.
3) In case a member is covered under PMJJBY with LIC of India / other company through more than one account and premium is received by LIC / other company inadvertently, insurance cover will be restricted to Rs. 2 Lakh and the premium paid for duplicate insurance(s) shall be liable to be forfeited.
4) If the insurance cover is ceased due to any technical reasons such as insufficient balance on due date or due to any administrative issues, the same can be reinstated on receipt of full annual premium, subject however to the cover being treated as fresh and the 45 days lien clause being applicable.
5) Participating Banks shall remit the premium to insurance companies in case of regular enrolment on or before 30th of June every year and in other cases in the same month when received.

Administration: The scheme, subject to the above, will be administered by the LIC P&GS Units / other insurance company setups. The data flow process and data proforma will be informed separately.

It will be the responsibility of the participating bank to recover the appropriate annual premium in one instalment, as per the option, from the account holders on or before the due date through 'auto-debit' process. Members may also give one-time mandate for auto-debit every year till the scheme is in force.

The acknowledgement slip may be made into an acknowledgement slip-cum-certificate of insurance.

PRADHAN MANTRI SURAKSHA BIMA YOJANA (PMSBY)

Background

PMSBY provides personal accident cover as a part of providing Social Security cover to the weaker section population through Public Sector General Insurance Companies (PSGICs) and other General Insurance companies willing to offer the product on similar terms with necessary approvals and tie up with Banks for this purpose.

The scheme will be a one-year cover, renewable from year to year, Accident Insurance Scheme offering

accidental death and disability cover for death or disability on account of an accident.

Scope: All savings bank account holders in the age 18 to 70 years in participating banks will be entitled to join.

In case of multiple saving bank accounts held by an individual in one or different banks, the person would be eligible to join the scheme through one savings bank account only. Aadhar would be the primary KYC for the bank account.

Enrollment Period: The cover shall be for the one-year period stretching from 1st June to 31st May for which option to join / pay by auto-debit from the designated savings bank account on the prescribed forms will be required to be given by 31st May of every year.

Individuals is free to exit the scheme at any point and may re-join the scheme in future years through the above modality.

Benefits

		Sum Insured
A	Death	Rs. 2 Lakh
B	Total and irrecoverable loss of both eyes or loss of use of both hands or feet or loss of sight of one eye and loss of use of hand or foot	Rs. 2 Lakh
C	Total and irrecoverable loss of sight of one eye or loss of use of one hand or foot	Rs. 1 Lakh

Premium: Rs.12/- per annum per member. The premium will be deducted from the account holder's savings bank account through 'auto debit' facility in one installment on or before 1stJune of each annual coverage period under the scheme.

Eligibility Conditions: The savings bank account holders of the participating banks aged between 18 years (completed) and 70 years (age nearer birthday) who give their consent to join / enable auto-debit, as per the above modality, will be enrolled into the scheme.

Termination of cover: The accident cover for the member shall terminate on any of the following events and no benefit will be payable there under:

1) On attaining age 70 years (age nearest birth day).
2) Closure of account with the Bank or insufficiency of balance to keep the insurance in force.
3) In case a member is covered through more than one account and premium is received by the Insurance Company inadvertently, insurance cover will be restricted to one only and the premium shall be liable to be forfeited.
4) If the insurance cover is ceased due to any technical reasons such as insufficient balance on due date or due to any administrative issues, the same can be reinstated on receipt of full annual premium, subject to conditions that may be laid down. During this period, the risk cover will be suspended, and reinstatement of risk cover will be at the sole discretion of Insurance Company.
5) Participating banks will deduct the premium amount in the same month when the auto debit option is given, preferably in May of every year, and remit the amount due to the Insurance Company in that month itself.

Administration

The scheme, subject to the above, will be administered as per the standard procedure stipulated by the Insurance Company. The data flow process and data proforma will be provided separately. It will be the responsibility of the participating bank to recover the appropriate annual premium from the account holders within the prescribed period through 'auto-debit' process. Enrollment form / Auto-debit authorization in the prescribed proforma shall be obtained and retained by the participating bank. In case of claim, the insurance company may seek submission of the same. Insurance Company reserves the right to call for these documents at any point of time.

The acknowledgement slip may be made into an acknowledgement slip-cum-certificate of insurance.

ATAL PENSION YOJANA (APY)

Background

The scheme is for Indian citizen workers in unorganized sector. It was launched in 2015. The scheme is administered by the Pension Fund Regulatory and Development Authority (PFRDA) under the National Pension Scheme (NPS). Subscribers would receive a fixed minimum of Rs. 1000 or Rs. 2,000 or Rs. 3,000 or Rs. 5000 per month at the age of 60 years depending on their contribution.

Benefit: Fixed pension for the subscribers between Rs. 1000 to Rs. 5000, if he joins and contributes between the age of 18 years and 40 years.

Eligibility

Atal Pension Yojana (APY) is open to all bank account holders. The Central Government would also co-contribute 50% of the total contribution or Rs. 1000 per annum, whichever is lower, to each eligible subscriber account, for a period of 5 years.

The Government co-contribution is payable to eligible PRANs by PFRDA after receiving the confirmation from Central Record Keeping Agency at such periodicity as may be decided by PFRDA.

Age of joining and contribution period

The minimum age of joining APY is 18 years and maximum age is 40 years. The age of exit and start of pension would be 60 years. Therefore, minimum period of contribution by the subscriber under APY would be 20 years or more.

Focus of APY: Mainly targeted at unorganised sector workers.

Enrolment and Subscriber Payment

All bank account holders under the eligible category may join APY with auto debit facility to accounts, leading to

reduction in contribution collection charges. The subscribers should keep the required balance in their savings bank accounts on the stipulated due dates to avoid any late payment penalty.

Enrolment agencies

All Points of Presence (Service Providers) and Aggregators under Swavalamban Scheme would enroll subscribers through architecture of National Pension System. The banks, as POP or aggregators, may employ BCs/Existing non - banking aggregators, micro insurance agents, and mutual fund agents as enablers for operational activities. The banks may share the incentives received by them from PFRDA/Government, as deemed appropriate.

Operational Framework

It is Government of India Scheme, which is administered by the Pension Fund Regulatory and Development Authority. The Institutional Architecture of NPS would be utilised to enroll subscribers under APY. The offer document of APY including the account opening form would be formulated by PFRDA.

Funding of APY

Government would provide

(i) fixed pension guarantee for the subscribers;

(ii) would co-contribute 50% of the total contribution or Rs. 1000 per annum, whichever is lower, to eligible subscribers; and

(iii) would also reimburse the promotional and development activities including incentive to the contribution collection agencies to encourage people to join the APY.

Penalty for default

Under APY, the individual subscribers shall have an option to make the contribution monthly. Banks are required to collect additional amount for delayed payments, such amount will vary from minimum Rs. 1 per month to Rs. 10/- per month as shown below:

- Rs. 1 per month for contribution up to Rs. 100 per month.
- Rs. 2 per month for contribution up to Rs. 101 to Rs. 500 per month.
- Rs. 5 per month for contribution between Rs 501 to Rs.1000 per month.
- Rs. 10 per month for contribution beyond Rs 1001 per month.

The fixed amount of interest/penalty will remain as part of the pension corpus of the subscriber.

Discontinuation of payments of contribution amount shall lead to following:

- After 6 months account will be frozen.
- After 12 months account will be deactivated.
- After 24 months account will be closed.

Exit and pension payment

Upon completion of 60 years, the subscribers will submit the request to the associated bank for drawing the guaranteed monthly pension.

Exit before 60 years of age is not permitted, however, it is permitted only in exceptional circumstances, i.e., in the event of the death of beneficiary or terminal disease.

PRADHAN MANTRI VAYA VANDANA YOJANA (PMVVY)

Introduction

PMVVY is a pension scheme announced by Government of India, exclusively for the senior citizens aged 60 years and above which is available from 4th May 2017 to 31st March 2020.Offline / Online purchase can be through LIC of India.

The Union Cabinet chaired by Prime Minister Narendra Modi implemented some major changes under Pradhan Mantri Vaya Vandanan Yojana (PMVVY). They are as follows:

1. The investment limit has been increased to 15 lakhs under the Pradhan Mantri Vaya Vandana Yojana (PMVVY). The earlier limit was 7.5 lakhs.
2. The last date to apply for Pradhan Mantri Vaya Vandana Yojana (PMVVY) has been extended to 31st March 2020.
3. The limit on maximum investment has now revised to per senior citizen (and not per family). So now in a family if both husband and wife are senior citizen. Both can invest 15 lakhs each as purchase price (total 30 lakhs) and can enjoy bonus facility.

Benefits

1) **Pension Payment:** On survival of the Pensioner during the policy term of 10 years, pension in arrears (at the end of each period as per mode chosen) shall be payable.
2) **Death Benefit:** On death of the Pensioner during the policy term of 10 years, the Purchase Price shall be refunded to the beneficiary.
3) **Maturity Benefit:** On survival of the pensioner to the end of the policy term of 10 years, Purchase price along with final pension installment shall be payable.

Eligibility Conditions and Other Restrictions

a) Minimum Entry Age : 60 years (completed)

b) Maximum Entry Age : No limit

c) Policy Term : 10 years

d) Minimum Pension : Rs. 1,000 per month Rs. 3,000 per quarter Rs.6, 000 per half-year Rs.12,000 per year

e) Maximum Pension : Rs. 10,000 per month Rs. 30,000 per quarter Rs. 60,000 per half-year Rs. 1, 20,000 per year`

The maximum pension amount criteria in this plan is for per senior citizen.

Payment of Purchase Price:

The scheme can be purchased by payment of a lump sum Purchase Price. The pensioner has an option to choose either the amount of pension or the Purchase Price. The minimum and maximum Purchase Price under different modes of pension will be as under:

Mode of Pension	Minimum Purchase Price	Maximum Purchase Price
Yearly	Rs. 1,44,578	Rs. 14,45,783
Half-yearly	Rs. 1,47,601	Rs. 14,76,015
Quarterly	Rs. 1,49,068	Rs. 14,90,683
Monthly	Rs. 1,50,000	Rs. 15,00,000

The Purchase Price to be charged shall be rounded to nearest rupee.

Mode of pension payment

The modes of pension payment are monthly, quarterly, half-yearly & yearly. The pension payment shall be through NEFT or Aadhaar Enabled Payment System. The first instalment of pension shall be paid after 1 year, 6 months, 3 months or 1 month from the date of purchase of the same depending on the mode of pension payment i.e. yearly, half-yearly, quarterly or monthly respectively.

Sample Pension rates per Rs.1000 Purchase Price:

The pension rates for Rs.1000 Purchase Price for different modes of pension payments are as below:

Yearly : Rs. 83.00 p.a.

Half-yearly : Rs. 81.30 p.a.

Quarterly : Rs. 80.50 p.a.

Monthly : Rs. 80.00 p.a.

The pension instalment shall be rounded off to the nearest rupee. These rates are age independent.

Surrender Value

The scheme allows premature exit during the policy term under exceptional circumstances like the Pensioner requiring money for the treatment of any critical/terminal illness of self or spouse. The Surrender Value payable in such cases shall be 98% of Purchase Price.

Loan

Loan facility is available after completion of 3 policy years. The maximum loan that can be granted shall be

75% of the Purchase Price. The rate of interest to be charged for loan amount shall be determined at periodic intervals.

For the loan sanctioned till 30thApril 2018, the applicable interest rate is 10% p.a. payable half-yearly for the entire term of the loan. Loan interest will be recovered from pension amount payable under the policy. The Loan interest will accrue as per the frequency of pension payment under the policy and it will be due on the due date of pension. However, the loan outstanding shall be recovered from the claim proceeds at the time of exit.

Free Look period:

If a policyholder is not satisfied with the "Terms and Conditions" of the policy, he/she may return the policy to the Corporation within 15 days (30 days if this policy is purchased online) from the date of receipt of the policy stating the reason of objections. The amount to be refunded within free look period shall be the Purchase Price deposited by the policyholder after deducting the charges for Stamp duty and pension paid, if any.

Exclusion:

There shall be no exclusion on count of suicide and full Purchase Price shall be payable.

PRADHAN MANTRI FASAL BIMA YOJANA (PMFBY)

Introduction

The Government of India, in April 2016 had launched PMFBY after rolling back the earlier insurance schemes – National Agriculture Insurance Scheme (NAIS), Weather based Crop Insurance scheme and Modified National Agricultural Insurance Scheme (MNAIS). The scheme is implemented by Agriculture Insurance Company of India (AIC) and other empanelled private general insurance companies which are selected by the State Governments through bidding.

Objectives

i. Providing financial support to farmers suffering crop loss / damage arising out of unforeseen events.

ii. Stabilizing the income of farmers to ensure their continuance in farming.

iii. Encouraging farmers to adopt innovative and modern agricultural practices.

iv. Ensuring flow of credit to the agriculture sector which contributes to food security, crop diversification and enhancing growth and competitiveness of agriculture sector besides protecting farmers from production risks.

Coverage of Farmers:

1. All farmers including sharecroppers and tenant farmers growing the notified crops in the notified areas are eligible for coverage.
2. **Compulsory Component**

   All farmers availing Seasonal Agricultural Operations (SAO) loans from Financial Institutions (i.e. loanee farmers)for the notified crop(s) would be covered compulsorily.
3. **Voluntary Component**

   The Scheme would be optional for the non-loanee farmers.
4. Special efforts shall be made to ensure maximum coverage of SC/ ST/ Women farmers under the scheme.

Crops covered by PMFBY

a) Food crops (Cereals, Millets and Pulses)

b) Oilseeds

c) Annual Commercial / Annual Horticultural crops.

Main conditions of sum insured / coverage limit in PMFBY

i. Sum insured per hectare for both loanee and non loanee farmers is same and equal to the Scale of Finance as decided by the District Level Technical Committee

ii. Sum insured for individual farmer is equal to the Scale of Finance per hectare multiplied by area of the notified crop proposed by the farmer for insurance. Area under cultivation shall always be expressed in hectare.

iii. Sum insured for irrigated and un-irrigated areas may be separate.

Risk covered

1) Yield Losses (standing crops, on notified area basis). Comprehensive risk insurance is provided to cover yield losses due to non-preventable risks, such as Natural Fire and Lightning, Storm, Hailstorm, Cyclone, Typhoon, Tempest, Hurricane, Tornado. Risks due to Flood, Inundation and Landslide, Drought, Dry spells, Pests/ Diseases also will be covered.

2) In cases where majority of the insured farmers of a notified area, having intent to sow/plant and incurred expenditure for the purpose, are prevented from sowing/planting the insured crop due to adverse weather conditions, shall be eligible for indemnity claims up to a maximum of 25 per cent of the sum insured

3) In post-harvest losses, coverage will be available up to a maximum period of 14 days from harvesting for those crops which are kept in “cut & spread” condition to dry in the field.

4) For certain localized problems, Loss / damage resulting from occurrence of identified localized risks like hailstorm, landslide, and Inundation affecting isolated farms in the notified area would also be covered.

Premium rates and premium subsidy on PMFBY

1) For Kharif crops, the farmer’s part of premium is 2% of sum assured.

2) For Rabi crops, the farmer's part of premium is 1.5% of the sum assured.

3) For annual commercial and horticultural crops, the farmer's part of premium is 5%

The remaining part of premium is paid equally by the central and respective state governments. All funds for this scheme come from Krishi Kalyan Kosh.

The Government under this system has migrated from claim based insurance scheme to an upfront subsidy for premium based system. It is a demand driven scheme, therefore no targets are fixed.

Farmers' details are required to be entered by banks in the unified portal for crop insurance which is available at *www.agri-insurance.gov.in* in order to facilitate assessment of coverage of crops insured, premiums deducted, etc.

While restructuring the loans in areas affected by a natural calamity, banks shall also take into account the insurance proceeds, if any, receivable from the Insurance Company. The insurance proceeds shall be adjusted to the 'restructured accounts' in cases where fresh loan have been granted to the borrower. However, banks shall act with empathy and consider restructuring and granting fresh loans without waiting for the receipt of insurance claim in cases where there is reasonable certainty of receiving the claim.

Prime Minister's Employment Generation Programme (PMEGP)

This scheme was launched by Government of India to promote employment opportunities through launching of new Micro enterprises in India. The programme does not cover existing enterprises in the sector.

Background & Other details

PMEGP is an outcome of merger of two earlier schemes of Government of India namely Prime Minister's Rojgar Yojana (PMRY) and Rural Employment Generation Programme (REGP) with an objective of generating employment opportunities through establishment of new micro enterprises in rural as well as urban areas. This is a credit linked subsidy programme.

PMEGP is a central sector scheme administered by the Ministry of Micro, Small and Medium Enterprises. (MoMSME) and implemented by Khadi and Village Industries Commission (KVIC). Ministry of MSME is in Administrative control of the programme as a single nodal agency.

Other objectives of the PMEGP include

- bringing together widely dispersed traditional artisans/ rural and urban unemployed youth and give them self-employment opportunities to the extent possible, at their place.
- to help arrest migration of rural youth to urban areas by providing employment locally.
- to increase the wage earning capacity of artisans and contribute to increase in the growth rate of rural and urban employment.

At the State level, the Scheme will be implemented through State KVIC Directorates, State Khadi and Village Ind ustries Boards (KVIBs) and District Industries Centres (DICs) and banks. The Government subsidy under the Scheme will be routed by KVIC through the identified Banks (PSU Banks/RRBs/ SIDBI/Approved Private Sector Bank/Co-operative Banks) for eventual distribution to the beneficiaries / entrepreneurs in their Bank accounts.

Identification of beneficiaries, of area specific viable projects, and providing training in entrepreneurship development will be taken care by KVIC, KVIBs and DICs in conjunction with reputed NGOs,Self Help Groups

(SHGs)/ National Small Industries Corporation (NSIC) / Udyami Mitras empanelled, Panchayati Raj institutions and other relevant bodies including banks. Banks cannot directly sanction loan to an applicant as it has to be identified by a Task force at District level consisting of District Magistrate/ District Collector/KVIC/DIC/Banks. Defaulters of bank loans are not eligible to avail the loan. Quantum of Bank Finance, Subsidy conditions

- The Bank will sanction 90% of the project cost in case of General Category of beneficiary/ institution and 95% in case of special category of the beneficiary/institution disburse suitably for setting up of the project.
- Bank will finance Capital Expenditure in the form of Term Loan and Working Capital in the form of cash credit. Bank can also finance in the form of Composite Loan consisting of Capital Expenditure and Working Capital. Max The maximum cost of the project/unit admissible in manufacturing sector is Rs.25 lakhs and in the business/service sector, it is Rs.10 lakhs.
- Bank Credit will be ranging between 60-75% of the total project cost after deducting 15-35% of margin money (subsidy) and owner's contribution of 10% from beneficiaries belonging to general category and 5% from beneficiaries belonging to special categories.
- Banks will claim Margin Money (subsidy) on the basis of projections of Capital Expenditure in the project report and sanction thereof, Margin Money (subsidy) on the actual availment of Capital Expenditure and excess, if any, will be refunded to KVIC, immediately after the project is ready for commencement of production.
- Rate of interest and repayment schedule Normal rate of interest shall be charged. Repayment schedule may range between 3 to 7 years after an initial moratorium as may be prescribed by the concerned bank/financial institution.

Eligibility for Borrowers and other conditions

Individuals, should be above 18 years of age and have passed VIII Std. in case of project above Rs.10.00 lakhs in manufacturing and above Rs. 5.00 lakhs for Service Sector. Apart from individuals, Charitable Trusts, Institutions Registered under Societies Registration Act-1860, SHGs (including those belonging to BPL provided that they have not availed benefits under any other Scheme) and Production based Co-operative Societies are also eligible for applying under this scheme.

There is no income ceiling specified under the scheme. Only new projects including Village Industries projects except activities indicated in the negative list of Village Industries, will receive assistance under the PMEGP. Existing Units and the units that have already availed Government Subsidy under any other scheme of Government of India or State Government are not eligible.

Other conditions

Only one person from one family is eligible for obtaining financial assistance for setting up of projects under PMEGP. The definition of 'family' includes self and spouse.

Applicants, who have already undergone training of at least 2 weeks under Entrepreneurship Development Programme (EDP) / Skill Development Programme (SDP) / Entrepreneurship cum Skill Development Programme (ESDP) or Vocational Training (VT) will be allowed to submit applications directly to Banks.

Quantum of Bank Finance, Subsidy conditions

- The Maximum project cost for a manufacturing sector unit is pegged at Rs. 25 lacs and for service and

business oriented unit is pegged at Rs.10 lac. The Bank will sanction 90% of the project cost in case of General Category of beneficiary/ institution and 95% in case of special category of the beneficiary/ institution and disburse suitably for setting up of the project.

- Bank will finance Capital Expenditure in the form of Term Loan and Working Capital in the form of cash credit. Bank can also finance in the form of Composite Loan consisting of Capital Expenditure and Working Capital. Max
- Bank Credit will be ranging between 60-75% of the total project cost after deducting 15-35% of margin money (subsidy) and owner's contribution of 10% from beneficiaries belonging to general category and 5% from beneficiaries belonging to special categories.
- Banks will claim Margin Money (subsidy) on the basis of projections of Capital Expenditure in the project report and sanction thereof, Margin Money (subsidy) on the actual availment of Capital Expenditure and excess, if any, will be refunded to KVIC, immediately after the project is ready for commencement of production.
- Rate of interest and repayment schedule Normal rate of interest shall be charged. Repayment schedule may range between 3 to 7 years after an initial moratorium as may be prescribed by the concerned bank/financial institution.

Eligibility for subsidy

The Institutions/Production Co-operative Societies/Trusts specifically registered as such and SC/ ST/ OBC/ Women/ Physically Handicapped / Ex-Servicemen and Minority Institutions with necessary provisions in the bye-laws to that effect are eligible for Margin Money (subsidy) for the special categories. Institutions /Production Cooperative Societies/ Trusts not registered as special categories, will be eligible for Margin Money (Subsidy) for general category.

Institutions through which beneficiaries can avail the scheme

All Public Sector Banks. All Regional Rural Banks. Co-operative Banks, Private Sector Scheduled Commercial Banks approved by State Level Task Force Committee, Small Industries Development Bank of India (SIDBI).

Coverage of Village Industry

Any Village Industry including Coir based projects (except those mentioned in the negative list) located in the rural area which produces any goods or renders any service with or without the use of power and in which the fixed capital investment per head of a full time artisan or worker i.e. Capital Expenditure on workshop/ workshed, machinery and furniture divided by full time employment created by the project does not exceed Rs. 1 lakh in plain areas and Rs.1.50 lakh in hilly areas.

Negative List of Activities

The following list of activities will not be permitted under PMEGP for setting up of micro enterprises/ projects /units.

Any industry/business connected with Meat(slaughtered), i.e. processing, canning and/or serving items made of it as food, production/manufacturing or sale of intoxicant items like Beedi /Pan/ Cigar/ Cigarette etc., any Hotel or Dhaba or sales outlet serving liquor, preparation/producing tobacco as raw materials, tapping of toddy for sale.

Any industry/business connected with cultivation of crops/ plantation like Tea, Coffee, Rubber etc. sericulture (Cocoon rearing), Horticulture, Floriculture, Animal Husbandry like Pisciculture, Piggery, Poultry, Harvester machines etc.

Manufacturing of Polythene carry bags of less than 20 microns thickness and manufacture of carry bags or containers made of recycled plastic for storing, carrying, dispensing or packaging of food stuff and any other item which causes environmental problems.

Rural Area

For the purpose of this scheme Rural Area has been defined as (i) Any area classified as Village as per the revenue record of the State/Union Territory, irrespective of population. (ii) Any area even if classified as town where its population does not exceed 20,000 persons.

Industries such as processing of Pashmina Wool and such other products like hand spinning and hand weaving, taking advantage of Khadi Programme under the purview of Certification Rules and availing sales rebate.

Rural Transport (Except Auto Rickshaw in Andaman & Nicobar Islands, House Boat, Shikara & Tourist Boats in J&K and Cycle Rickshaw).

Operational modalities of the scheme

KVIC will place the margin money (subsidy) amount with the Banks involved in the implementation of the scheme in accordance with the targets allocated to the implementing Banks in the State/ District. DICs, in close coordination with Banks, will ensure that at least 50 % of the total margin money (subsidy) allocated to them will be utilized in setting up of projects in rural areas.

The Task Force, under will hold quarterly meeting with the Banks at district level to review the status of the project proposals.

If projects are rejected, shortcomings/reasons will be furnished by the concerned Banks to the implementing agencies concerned and the applicants concerned will be requested by KVIC/KVIBs / DICs to provide additional information/documents if required and concerned representatives of KVIC, KVIBs and DICs, will provide assistance to the applicants in this process.

Basis of sanction, Release of Credit/Subsidy by banks

Banks will take their own credit decision on the basis of viability of each project. No collateral security will be insisted upon by Banks in line with the guidelines of RBI for projects involving loan up to Rs. 5 lakh in respect of the projects cleared by the Task Force. However, they have to appraise projects both technically and economically after ensuring that each project fulfills inter alia the criteria of

(i) Industry

(ii) Per Capita Investment

(iii) Own Contribution

(iv) Rural Areas (projects sponsored by KVIC/ KVIBs/DICs) and

(v) Negative List.

First installment of the loan will be released to the beneficiary only after completion of Entrepreneurship Development Programme (EDP) training of at least 2 weeks specially designed for the purpose, to be organized by KVIC / KVIBs / DICs or the institutions. After the successful completion of EDP training arranged by the KVIC/KVIBs/State DICs, the beneficiary will deposit with the bank, the owner's contribution. Thereafter, the bank will release first installment of the Bank Finance to the beneficiary. If a beneficiary doesn't complete EDP training, projects sanctioned will be declared ineligible for Margin Money (subsidy) assistance.

Claim of subsidy by banks

After the release of Bank finance either partly or fully, Bank will submit Margin Money (subsidy) claim in the prescribed format to the designated Nodal Branch of the State/Region where KVIC has placed lump sum deposit of Margin Money (subsidy) in advance in the Savings Bank Account in the name of KVIC, for release

of Margin Money (subsidy). RRBs and SIDBI will follow respective guide lines issued to them in this regard. If a subsidy claim is rejected. Detailed grounds for rejections shall be maintained by KVIC/KVIBs/DICs.

Treatment of subsidy (Margin Money)

Once the Margin Money (subsidy) is released in favour of the applicant borrower, it should be kept in the Term Deposit Receipt of three years at branch level in the name of the beneficiary/Institution. No interest will be paid on the TDR and no interest will be charged on loan to the corresponding amount of TDR. Since "Margin Money" (subsidy) is to be provided in the form of subsidy (Grant), it will be credited to the Borrowers loan account after three years from the date of first disbursement to the borrower/institution, by the Bank. In case the Bank's advance goes "bad" before the three year period, due to reasons, beyond the control of the beneficiary, the Margin Money (subsidy) will be adjusted by the Bank to liquidate the loan liability of the borrower either in part or full. If any recovery is effected subsequently by the Bank from any source whatsoever, such recovery will be utilized by the Bank for liquidating their outstanding dues first. Any surplus will be remitted to KVIC. Banks have to scrupulously follow the guidelines issued by KVIC and other concerned authorities while implementing the scheme.

Monitoring Authority

Ministry of MSME. It will allocate target, sanction and release required funds to KVIC. Quarterly review meeting will be held in the Ministry on the performance of PMEGP.

DEENDAYAL ANTYODAYA YOJANA (DAY)

A. National Rural Livelihood Mission (NRLM)

DAY- NRLM	**DEENDAYAL ANTYODAYA YOJANA NATIONAL – RURAL LIVELIHOOD MISSION (NRLM)**

Background

The Ministry of Rural Development, Government of India launched a new programme known as National Rural Livelihoods Mission (NRLM) by restructuring and replacing the Swarnjayanti Gram Swarozgar Yojana (SGSY) scheme with effect from April 01, 2013. NRLM was renamed as DAY-NRLM (Deendayal Antyodaya Yojana - National Rural Livelihoods Mission) w.e.f. March 29, 2016.

Objectives behind NRLM

The principal objective behind NRLM is poverty reduction through building strong institutions of the poor, particularly women thereby enabling access to a range of financial services and livelihoods services. The Scheme provides a continuous hand-holding support to the institutions of poor such as Self Help Groups (SHGs)for a period of 5-7 years till they come out of poverty. The support from DAY-NRLM includes all round capacity building of the SHGs ensuring that the group functions effectively on all issues concerning their

members, financial management, providing them with initial fund support to address vulnerabilities and high cost indebtedness, formation and nurturing of SHG federations, making the federations evolve as strong support organizations, making livelihoods of the poor sustainable, formation and nurturing of livelihoods organizations, skill development of the rural youth to start their own enterprises or take up jobs in organized sector, enabling these institutions to access their entitlements from the key line departments, etc

Role of State Governments

The DAY-NRLM, enable States to formulate their own State specific poverty reduction action plans at State, district and block level. The States will implement these programmes through identified blocks and districts as intensive blocks and districts, whereas remaining will be non-intensive blocks and districts. The selections of intensive districts are done by the states based on the demographic vulnerabilities and will be rolled out in a phased manner over the next 7-8 years. Initially 250 such intensive blocks have been identified. Rest of all blocks in the country will become intensive blocks over time. SHG is an informal group and registration under any Societies Act, State cooperative Act or a partnership firm is not mandatory.

Beneficiaries

Women SHGs under DAY-NRLM consist of 10-20 persons (70% or more should be belonging to Below Poverty Line or urban poor segment). In case of special SHGs i.e. groups in the difficult areas, groups with disabled persons, and groups formed in remote tribal areas, this number may be a minimum of 5 persons. Only for groups to be formed with Persons with disabilities, and other special categories like elders, transgenders, DAY-NRLM will have both men and women in the self-help groups.

Financial Assistance to the SHGs & Conditions

DAY-NRLM would provide Revolving Fund (RF) support to SHGs in existence for a minimum period of 3 to 6 months and follow the norms of good SHGs, i.e. they follow 'Panchasutra' – regular meetings, regular savings, regular internal lending, regular recoveries and maintenance of proper books of accounts.

Only such SHGs that have not received any RF earlier will be provided with RF, as corpus, with a minimum of Rs.10,000 and up to a maximum of Rs.15,000 per SHG. The purpose of RF is to strengthen their institutional and financial management capacity and build a good credit history within the group. No Capital Subsidy will be sanctioned to any SHG from the date of implementation of DAY-NRLM.

Cluster Investment Fund (CIF) will be provided to the SHGs in the intensive blocks, routed through the Village level/ Cluster level Federations, to be maintained in perpetuity by the Federations. The CIF will be used, by the Federations, to advance loans to the SHGs and/or to undertake the common/collective socio-economic activities.

Extension of Interest subvention

DAY-NRLM has a provision for interest subvention, to cover the difference between the Lending Rate of the banks and 7%, on all credit from the banks/ financial institutions availed by women SHGs, for a maximum of Rs. 3,00,000 per SHG. This will be made in two ways:

(i) In 250 identified districts, banks will lend to the women SHGs @7% up to an aggregated loan amount of Rs. 3,00,000/-. The SHGs will also get additional interest subvention of 3% on prompt payment, reducing the effective rate of interest to 4%.

(ii) In the remaining districts also, all women SHGs under DAY-NRLM are eligible for interest subvention

to the extent of difference between the lending rates and 7% for the loan up to Rs. 3,00,000, subject to maximum of 5.5% for the year 2019-20 or as prescribed by the MoRD. This part of the scheme will be operationalized by SRLM.

Services offered by banks under NRLM

Opening of Savings accounts: Banks would commence their services with opening of accounts for all the Women SHGs including members with disability and the Federations of the SHGs as per KYC norms as applicable from time to time. The SHGs engaged in promoting of savings habits among their members would be eligible to open savings bank accounts. Banks have to maintain separate Savings and loan account for Self Help Groups. Banks also help to open savings account of Federations of SHGs at village, Gram Panchayat, Cluster or higher level, as savings account for 'Association of persons' after following applicable KYC norms from time to time. SHGs and SHG federations be guided to transact through their respective saving accounts on regular basis. To facilitate this, banks are advised to enable transactions in jointly operated savings account of SHGs and their federations at retail outlets managed by Business Correspondent Agents. RBI has issued detailed guideline in this regard.

Eligibility criteria for the SHGs to avail loans

- SHG should be
  - in active existence at least since the last 6 months as per the books of account of SHGs and not from the date of opening of S/B account.
  - practicing 'Panchasutras' i.e. Regular meetings; Regular savings; Regular inter-loaning; Timely repayment; and Up-to-date books of accounts;
  - Qualified as per grading norms fixed by NABARD. Grading can also be done by Federations of SHGs come to existence.
- Even defunct SHGs are also eligible for credit if they are revived and continue to be active for a minimum period of 3 months.

Loan amount:

SHGs are eligible for multiple doses of assistance under DAY-NRLM over a period of time. They can avail either Term Loan (TL) or a Cash Credit Limit (CCL) loan or both based on the need. In case of need, additional loan can be sanctioned even though the previous loan is outstanding.

Cash Credit Limit (CCL): The quantum of CCL and Term Loan (TL) limits that can be sanctioned to a SHG are as per table below. Under CCL, yearly drawing power can be enhanced annually based on the repayment performance of the SHG. The drawing power (DP) in case of CC account as well as TL quantum, calculations are as below

DP for CCL	Quantum	TL Dose
1st year	6 times of the existing corpus or minimum of Rs.1 lakh whichever is higher.	Ist Dose
2nd year	8 times of the corpus at the time review/ enhancement or minimum of Rs. 2 lakh, whichever is higher.	IInd Dose

3rd year	Minimum of Rs. 3 lakhs, based on the Micro credit plan prepared by the SHGs and appraised by the Federations /Support agency and the previous credit History.	III Dose
4th year onwards	Minimum of Rs. 5 lakhs based on the Micro credit plan prepared by SHG and appraised by the Federations /Support agency and the previous credit History.	IV Dose

Banks should take necessary measures to ensure that eligible SHG are provided with repeat loans. Banks are advised to work with DAY-NRLM to institutionalize a mechanism for online submission of loan application of SHGs for tracking and timely disposal of application.

Corpus = Revolving funds (if any, received by that SHG)+ Own savings+ Interest earned by SHG from on-lending to its members + Income from other sources+ Funds from other sources in case of promotion by other institutions /NGOs

Purpose of loan and repayment

The loan amount will be distributed among members based on the Micro Credit Plan (MCP) prepared by the SHGs. The loans may be used by members for meeting social needs, high cost debt swapping, construction or repair of house, construction of toilets and taking up sustainable livelihoods by the individual members within the SHGs or to finance any viable common activity started by the SHGs. In order to facilitate use of loans for augmenting livelihoods of SHG members, it is advised that at least 50% of loans above ₹ 2 lakhs and 75% of loans above ₹ 4 lakhs be used primarily for income generating productive purposes. MCP prepared by SHG would form the basis for determining the purpose and usage of loans.

Repayment schedule

- The First year/ first dose of loan will be repaid in 12-18 months in monthly/ quarterly instalments.
- The Second year/ Second dose of loan will be repaid in 18-24 months in monthly/ quarterly instalments.
- The Third year/ Third dose of loan will be repaid in 24-36 months in monthly/ quarterly instalments.
- The loan from Fourth year/ Fourth dose onwards has to be repaid between 3-6 years based on the cash flow in monthly/ quarterly installments.

Security and Margin

No collateral and no margin will be charged up to Rs. 10.00 lakhs limit to the SHGs. No lien should be marked against savings bank account of SHGs and no deposits should be insisted upon while sanctioning loans.

Dealing with Defaulters: Willful defaulters should not be financed under DAY-NRLM. In case willful defaulters are members of a group, they might be allowed to benefit from the thrift and credit activities of the group including the corpus built up with the assistance of Revolving Fund. But for accessing bank loan by SHG for financing economic activities by its members, the willful defaulters should not have the benefit of such bank loan until the outstanding loans are repaid. SHG may be financed excluding such defaulters while documenting the loan.

Banks are not to deny loan to entire SHG on the pretext that spouse or other family members of individual members of SHG being a defaulter with the bank. Further, non-willful defaulters should not be debarred from receiving the loan. In case default is due to genuine reasons, Banks may follow the norms suggested for restructuring the account with revised repayment schedule.

Credit Target Planning

Based on the potential Linked Plan/ State Focus paper prepared by NABARD, State Level Bankers Committee (SLBC) sub-committee on SHG Bank Linkage may arrive at District wise, block wise and branch wise credit plans. The sub- committee should consider the existing SHGs, New SHGs proposed, and number of SHGs eligible for fresh and repeat loans as suggested by the SRLMs to arrive at the credit targets for the states. The targets so decided should be approved in the SBLC and should be reviewed and monitored periodically for effective implementation. District Coordination Committee (DCCs) will communicate block-wise/cluster-wise targets to the bank Branches through the Controllers.

Post sanction follow-up

Bank/branch staff to go and attend the meetings of the SHGs and Federations to observe the operations of the SHGs and keep a track of the regularity in the SHGs meetings and performance.

Loan pass books or statement of accounts in regional languages to be issued to the SHGs which may contain all the details of the loans disbursed to them and the terms and conditions applicable to the loan sanctioned. The passbook should be updated with every transaction made by the SHGs. At the time of documentation and disbursement of loan, it is advisable to clearly explain the terms and conditions as part of financial literacy.

For the purpose of proper recovery personal contact, organization of joint recovery camps with District Authorities Mission Management Units (DPMUs) / DRDAs should be done. Banks should prepare a list of defaulting SHGs under DAY-NRLM every month and furnish the list in the SLBC, DCC meetings. This would ensure that DAY-NRLM staff at the district/ block level will assist the bankers in initiating the repayment.

Reporting

The bank branches are required to furnish the progress report and the delinquency report achieved under various activities of DAY-NRLM in the specified formats to Lead District Managers every month for onward submission to Special Steering Committee/sub-committee constituted by SLBC.

Banks have to forward a state-wise consolidated report on the progress made on DAY-NRLM to RBI/NABARD at quarterly intervals. The data may be submitted within a month from the end of the concerned quarter. Existing procedure of submitting Lead Bank Returns is also continued for these advances.

DEENDAYAL ANTYODAYA YOJANA (DAY)

B. National Urban Livelihood Mission (NULM)

DAY- NULM	**DEENDAYAL ANTYODAYA YOJANA NATIONAL -URBAN LIVELIHOOD MISSION (NULM)**

Background

The Government of India, Ministry of Housing and Urban Poverty Alleviation (MoHUPA), restructured the existing Swarna Jayanti Shahari Rozgar Yojana (SJSRY) and launched the National Urban Livelihoods Mission (NULM) in 2013. NULM has been under implementation w.e.f. September 24, 2013 in all district headquarters (irrespective of population) and all the cities with population of 1 lakh or more. With a view to improving the livelihood opportunities for the poor in urban areas including hawkers/street vendors, Ministry of Housing and Urban Poverty Alleviation (UPA Division), Government of India decided to enhance the scope of NULM in 2016. The Mission with enhanced scope was renamed as "Deendayal Antyodaya Yojana - National Urban Livelihoods Mission (DAY-NULM)".

Revision in the scope of NULM

The Self Employment Program (SEP) of DAY-NULM focuses on providing financial assistance through provision of interest subsidy on loans to support establishment of Individual & Group Enterprises and Self-Help Groups (SHGs) of urban poor. The erstwhile provision of capital subsidy for USEP (Urban Self Employment Program) and UWSP (Urban Women Self-Help Program) under SJSRY has been replaced by interest subsidy for loans to Individual enterprise (SEP-I), Group enterprise (SEP-G) and Self Help Groups (SEP-SHGs).

Introduction and Background - NULM

The Self Employment Programme (SEP) provides financial assistance to individuals/groups including street venders/hawkers of urban poor for setting up gainful self-employment ventures/ micro-enterprises, suited to their skills, training, aptitude and local conditions. The programme also supports Self Help Groups (SHGs) of urban poor to access easy credit from bank and avail interest subsidy on SHG loans. The programme will also focus on technology, marketing and other support services to the above beneficiaries engaged in micro enterprises for their livelihoods and will also facilitate issuance of credit cards for working capital requirement of the entrepreneurs. The underemployed and unemployed urban poor will be encouraged to set up small enterprises relating to manufacturing, service and small business for which there is considerable local demand. Local skills and local crafts should be particularly encouraged. Each ULB should develop a compendium of such activities/projects keeping in view skills available, marketability of products, costs, economic viability etc.

Special focus groups

The percentage of women beneficiaries under SEP shall not be less than 30%. SCs and STs must be benefited at least to the extent of the proportion of their strength in the city/town population of poor. A special provision of 3% reservation should be made for the differently-abled under this program. In view of the Prime Minister's 15-Point Program for the Welfare of Minorities, at least 15% of the physical and financial targets be earmarked for the minority communities.

Eligibility

Individuals of above 18 years, Groups of urban poor including Self-Help Groups. No minimum educational qualification is required for prospective beneficiaries. However where the identified activity for micro-enterprise development requires some special skills appropriate training must be provided to the beneficiaries before extending financial support.

Identification of beneficiaries

The Community Organizers (COs) and professionals from Urban Local Body (ULB) will identify the prospective

beneficiaries from among the urban poor. Also they may identify eligible borrowers from references made by SHGs, Area Level Federations, Banks (including cases identified by their Business Correspondents/ Business Facilitators). Due diligence will be undertaken as per the Bank's policy in this regard.

Application procedures

The application for individual and group enterprise loans will be sponsored by the Urban Local Body (ULB) which will be the sponsoring agency for the individual and group enterprise. The applicants seeking loan can submit an application to the concerned ULB officials on a plain paper with basic details viz: Name, Age, Contact details, Address, Aadhaar details (if any), amount of loan required, bank account number (if available), type of enterprise/ activity, category etc. The application can also be sent by mail /post to the ULB office. The ULB shall accept such intents throughout the year.

On receipt of applications from beneficiaries respective ULBs will enter the details in a register/or MIS if available and hence will generate a waiting list of beneficiaries. The ULB will issue an acknowledgement to the beneficiary with a unique registration number, which may be used as a reference number for tracking the status of application.

ULB will call the beneficiaries in order of the waiting list to complete requisite documentation including filling of Loan Application Form (LAF), activity details, identity proof, address proof, bank account details etc. The LAF will contain basic data in respect of economic status of the beneficiary and her/his family. To verify the identity of the beneficiary, her/his Aadhar number will also be brought on record. If beneficiary does not have Aadhar card, his/ her any other unique identification document like voters' card, driving license etc. will be taken and s/ he will be helped to obtain Aadhar card as soon as possible. This data will be such that it can be used to analyse impact of the benefits on her/his economic status at a later stage.

Task Force constituted at ULB level will scrutinize the applications based on experience, skills, viability of activity, scope of the activity etc. Thereafter, the Task Force will shortlist the applications and call for interview of the applicants before recommending or rejecting the application or call for additional information from the applicant, if required.

Procedure for Sanction of Loans by banks

The cases recommended by the task force will be forwarded by the ULB to the concerned banks for further processing. Such cases have to be processed by concerned banks within a time frame of 15 days. Any rejection of such cases by banks has to be only in exceptional circumstances. Banks will send a periodic report to the ULB on the status of the applications received.

Banks can also directly accept the loan applications of urban poor beneficiaries on the basis of relevant documents as per the guidelines of Prime Minister MUDRA Yojana (PMMY) or any other such scheme without the need of having prior sponsoring from ULB.

The banks can send details of such loans sanctioned by them to ULBs for confirmation of their eligibility for interest subsidy under DAY-NULM. The subsidy will be transferred directly to the loan account of DAY-NULM beneficiaries. This procedure will also be direct benefit transfer compliant.

Financial Assistance

- The financial assistance will be in the form of Interest subsidy on the bank loans.
- Interest subsidy, over and above 7% rate of interest will be available on a bank loan for setting up of individual or group enterprises. The difference between 7% p.a. and the rate of interest charged by the bank will be provided to banks under DAY-NULM.

- Interest subsidy will be given only in case of timely repayment of loan. Suitable certification from banks will be obtained in this regard.
- An additional 3% interest subvention will be provided to all Women Self Help Groups (WSHGs) who repay their loan in time.
- The Interest subsidy will be subject to timely repayment of the loan (as per the loan repayment schedule) and suitable certification obtained from banks by the ULB.
- The additional 3% interest subvention amount will be reimbursed to the eligible WSHGs. The banks should credit the amount of 3% interest subvention to the eligible WHSGs accounts and thereafter seek the reimbursement.

Training of beneficiaries

Employment through skills Training & Placement: Financial assistance should be extended only after the prospective beneficiary has acquired required skills for running the proposed micro-enterprise. Such training may not be necessary if the beneficiary has already undergone training from a known institution, registered NGO/Voluntary organization or trained under any government scheme provided requisite certificate is produced. In case the beneficiary has acquired requisite skills from family occupation such cases should be certified by the ULB before extending financial assistance.

Entrepreneurship Development Program (EDP): In addition to skill training of the beneficiaries, the ULB will also arrange to conduct Entrepreneurship Development Program for 3-7 days for individual and group entrepreneurs. EDP will cover basics of entrepreneurship development such as management of an enterprise, basic accounting, financial management, marketing, backward and forward linkages, legal procedures, costing and revenue etc. In addition to above topics the module should also include group dynamics, allocation of work, profit sharing mechanism etc. for group enterprises.

Follow-up entrepreneurial support to Individual and Group entrepreneurs: After financing to Individual and Group beneficiaries, the ULB will also arrange to conduct follow-up Entrepreneurship Development Programme (EDP) preferably once in six months for each beneficiary who has been given a loan. During the follow-up EDP, problems and issues faced by beneficiaries should also be discussed and solutions should be given.

Procedure for interest subsidy to Banks and settlement

Scheduled commercial banks (SCBs) which are on the Core Banking Solution (CBS) platform would be eligible for getting interest subvention under the scheme. After disbursement of loan to the beneficiaries, the concerned branch of the bank will send details of disbursed loan cases to ULB along with details of interest subsidy amount.

Procedure for settlement claims from Banks

Procedure I

The settlement of claims made by banks would be done on quarterly basis by the ULBs in specified format, however the submission of claims should be monthly. The ULB will check the data at their end and will release the interest subsidy amount (difference between 7% p.a. and prevailing rate of interest) to the banks. The claims should not be pending more than a quarter. In case the claims of the banks are not settled for a period of 6 months, SLBC is empowered to stop the scheme temporarily in selected cities subject to clearance of claims by such ULBs. In such eventualities, the claims settlement should prospectively be given to the Lead District Bank.

Procedure II

Procedure for Settlement of Claims where Nodal Agency for releasing interest subsidy is designated: All the Banks will consolidate data regarding interest subsidy from their branches and upload on the portal of Nodal Bank designated for this purpose. The nodal bank, after verification, will transfer the interest subsidy to the bank branches. The State/UT will deposit some funds in advance with the nodal bank, which will release funds to the bank branches as per guidelines of the DAY-NULM. Nodal bank will regularly render account of reimbursement to the SULM. This procedure will be followed in all three types of loans i.e. SEP (I), SEP (G) and SHG-Bank Linkage.

Individual Enterprises (SEP I)- Loan and Subsidy

An individual beneficiary desirous of setting up an individual micro-enterprise for self-employment can avail benefit of subsidized loan under this component from any bank. The norms are as follows:

Particulars	Norm
Age	The beneficiary should have attained the age of 18 Years at the time of applying for loan.
Project Cost	Maximum project cost for individual micro-enterprise is Rs. 2 lacs.
Collateral Guarantee on Bank Loan	No collateral required. Banks are instructed not to accept collateral security in the case of loans up to Rs. 10 lakhs extended to units in the MSE sector. Therefore, only the assets created would be hypothecated/ mortgaged/ pledged to banks for advancing loans.**
Repayment Period	Will be between 5 to 7 Years after initial moratorium of 6-18 months as per norms of the banks.
Margin Money	No margin for loan up to Rs. 50,000. For higher amount loans, preferably 5% as margin money and in no case be more than 10% of the project cost.
Type of Loan Facility	Term loan for Capital Expenditure. Cash credit for working capital or a mix of both as per borrower's requirements.

** Banks are required to cover the loan under Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) setup by Small Industries Development Bank (SIDBI) or any other appropriate guarantee fund for the purpose of availing guarantee cover.

Group Enterprises (SEP-G) - Loan & Subsidy

A Self Help Group (SHG) or members of an SHG constituted under DAY-NULM or a group of urban poor for self-employment can avail benefit of subsidized loans under this component from any bank. The norms/ specifications for group based micro-enterprise loans are as follows:

Particulars	Norms
Eligibility Criteria	Group enterprises should have minimum of 5 members with a minimum of 70% of the members from urban poor families. More than one person from the same family should not be included in the same group.

Age	All members of the group enterprise should have attained an age of 18 years at the time of applying for bank loan.
Project cost	Maximum unit Project Cost for a group finance for enterprise is Rs. 10,00,000 (Ten Lakhs).
Amount of loan	Loan can be extended as a single loan to the group functioning as one borrowing unit or each member of the group can be provided individual loans up to Rs.2 lakhs and an overall cap of Rs. 10 lakhs based on mutual trust and collateral substitute among the group. RBI guidelines/principals under 'Bhoomi Heen Kisan' dated 13th November, 2014" should be followed for group loans.
Type of loan	In the form of Term Loan for Capital Expenditure. For Working Capital, through Cash Credit Facility. Composite Loans for Capital Expenditure and Working Capital, as per Group's requirement.
Loan and Margin Money	The Project Cost minus the beneficiary contribution (Margin Money) would be made available as loan amount. No margin is applicable for loans up to Rs. 50,000/-.For loans above Rs. 50,000, margin of 5% is to be taken. In any case margin cannot be more than 10%.
Collateral Guarantee	No collateral/guarantee is required in the case of loans up to Rs. 10 lakhs. Only the assets created would be hypothecated/ mortgaged/ pledged to banks for advancing loans.**
Repayment	Repayment schedule would range between 5 to 7 Years after initial moratorium of 6-18 months as per the norms of the banks.

**The banks may cover these loans under Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or any other appropriate guarantee fund.

SHG-Bank Linkage – General Guidelines

Reserve Bank of India has issued detailed guidelines to banks on SHB- Bank linkage programme vide their circular dated July 01, 2016. A brief over view of the same is as under:

a. Opening of Savings Bank Account of Self Help Groups (whether registered or unregistered), which are engaged in promoting habit of savings among their members as a starting point.

b. Thereafter, the SHGs be sanctioned Savings Linked Loans (varying from a saving to loan ratio of 1:1 to 1:4) after due assessment or grading by banks.

c. In case of matured SHGs, loans may be given beyond the limit of four times the savings as per the discretion of the bank.

d. Under Social Mobilization & Institution Development (SM&ID) component of DAY-NULM, the ULB will do necessary groundwork to open bank accounts for SHGs and facilitating access to Revolving Fund (RF).

e. The banks will send the details of disbursed loan cases to the ULB along with the calculation details of the interest subsidy amount. The ULB will check the data at their end and will release the interest subsidy amount on quarterly basis to the banks as per procedure.

f. ULB through its field staff or Resource Organization (ROs) will facilitate filling of loan applications

for eligible SHGs to access credit from the banks. The ULB will be responsible to forward the Loan application of the SHGs to the concerned banks with requisite documentation.

g. ULB will forward the data on loan applications sent to various banks to State Urban Livelihood Mission (SULM) authorities on monthly basis.

h. The SULM will monitor and review the progress with banks on regular basis and co-ordinate with SLBC for interest subsidy/ subvention on SHG Loans in the state.

i. Identification, selection, formation and monitoring of SHGs who are to get interest subvention would be the responsibility of State/ ULBs and banks would not be liable for wrong identification of SHGs who get interest subvention.

j. SHGs can be sanctioned either Term loan or a Cash Credit Limit (CCL) loan or both based on their need. In case of need, additional loan can be sanctioned even though the previous loan is outstanding.

RBI guidelines for prompt repayment are as under:

a. **For Cash Credit Limit to SHGs**

- Outstanding balance should not have remained in excess of the sanctioned limit/drawing power continuously for more than 30 days.
- Regular credits and debits should be routed through the account.
- At least one customer induced credit during the month should be reflected in the account. Such credit during a month should be sufficient to cover the interest debited during the month.

b. **For Term Loan to SHGs**

A term loan account where all of the interest payments and/or instalments of principal were paid within 30 days of the due date during the entire tenure of the loans would be considered as an account having prompt payment.

The prompt payment guidelines will continue to be guided by RBI guidelines on the subject in future.

Issuance of credit card

At times micro enterprises do not enjoy uniform cash flows in all months. Seeking enhancement from banks consume time. In such situations borrowers/beneficiaries approach private lenders for meeting their expenses baring high interest costs. To mitigate this problem and support the micro-entrepreneurs to meet their working capital and miscellaneous credit needs, DAY-NULM will facilitate access to Credit Cards or MUDRA Card through banks.

Banks can issue to such borrowers General Credit Card or any suitable cards to help such enterprises. RBI had advised details of General Credit Card Scheme through circular RPCD.MSME & NFS.BC.No.61/06.02.31/2013-14 dated December 02, 2013.

Support for Technology, Marketing and other services

Micro entrepreneurs often need support in order to grow and sustain their businesses. Support needed may be for establishment, technology, marketing, and other services. Support services under this component are envisaged with a view to provide an encouraging environment for development of micro enterprises. The City Livelihoods Centers (CLCs) established under DAY-NULM will offer services to the micro-enterprises such as in establishment (licenses, certificates registration, legal services etc.), production, procurement, technology,

processing, marketing, sales, packaging, accounting etc. for long term sustainability. CLCs will also provide support in taking up feasibility/ assessment studies on market demand and market strategy for products and services of micro-enterprises.

Reporting

To monitor progress of the targets vis-a-vis achievement under DAY-NULM, Banks are to furnish cumulative progress reports on quarterly basis in specified formats to the Director, UPA at dupa-mhupa@nic.in as well as to RBI within one month by the end of the quarter to which they relate.

Differential Rate of Interest Scheme

Background

Government of India had formulated in March, 1972 a scheme for extending financial assistance at concessional rate of interest @ 4% to selected low income groups for productive endeavours initially by public sector banks and then by private sector banks also . The scheme known as Differential Rate of Interest Scheme (DRI) is now being implemented by all Scheduled Commercial Banks.

The salient features of the scheme are as given below:

Eligibility

The following persons are eligible to avail the loans –

a. Individuals whose family income does not exceed Rs. 18,000 p.a. in rural areas and Rs. 24,000 in Semi-urban and Urban areas.

b. Individuals whose land holdings does not exceed 1 acre irrigated land and 2.5 acres of unirrigated land.

c. No ceiling for SC/ST engaged in agriculture and allied activities.

d. Those who are engaged in Cottage and Rural industries.

e. Physically handicapped person pursuing gainful occupation.

f. Orphanages and Women's homes.

g. State Owned Corporations/cooperative societies including Corporation for SC's/ST's, Co-operative Societies, Large Sized Adivasi Multi-purpose Cooperative Societies for Tribal areas.

Purpose of loans

For productive vocations/activities, pursuing higher education by indigent students, Purchase of artificial limbs, hearing aids, wheel chair for physically handicapped etc.

Amount of loan

The maximum amount of loan is fixed at Rs. 15,000. For physically handicapped borrowers an additional amount of Rs. 5000 for purchase of artificial limbs/Braille typewriter. Housing loan up to Rs. 20,000 per beneficiary for SC/ST under Indira Awas Yojana.

Rate of interest

4% p.a.

Subsidy and Margin

No subsidy is granted, No margin requirement is specified.

Security

Hypothecation of Assets created out of bank loan. Banks are not to insist for any collateral security.

Repayment period

Maximum of 5 years with a grace period of 2 years depending upon activity and income generated.

Other conditions

a. Out of the loan disbursed 40% should be given to SC/St beneficiaries.

b. At least ⅔rd loans should be routed through Rural and Semi-urban branches.

c. The target for lending under the DRI scheme will continue to be 1 per cent of the previous years' total advances.

d. Loans given under the scheme are to be classified as Weaker Section Advances.

The Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)

Ministry of Social Justice and Empowerment	**THE SELF EMPLOYMENT SCHEME FOR REHABILITATION OF MANUAL SCAVENGERS (SRMS)**

Background

The National Scheme for Liberation and Rehabilitation of Scavengers (NSLRS) is being implemented by all Public Sector banks since 1993 with an objective to liberate all scavengers and their dependents from their existing hereditary and obnoxious occupation of manually removing night soil and filth and to provide for and engage them in alternative and dignified occupations within a period of five years. Government of India stopped funding the existing NSLRS since 2005-06 and approved the Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS) with an objective to rehabilitate the remaining scavengers and their dependents by March 2009. As the Government of India, Ministry of Social Justice & Empowerment has decided to continue the scheme beyond September 30, 2009, banks have been advised to complete implementation of the scheme up to December 31, 2009 and the spillover in inevitable cases up to March 31, 2010 with a provision for the coverage of spill-over of beneficiaries even thereafter, if required. As per the updated number, reported by States/UTs, after launch of the Scheme, 1.18 lakh manual scavengers and their dependents in 18 States/UTs were identified for implementation of the Scheme.

The Central Sector Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS) has been revised under the "Prohibition of Employment as Manual Scavengers and their Rehabilitation Act, 2013" effective from Nov., 2013.

Objective

The objective of the scheme is to assist the manual scavengers, identified during various surveys, for their rehabilitation in alternative occupations.

Eligibility

Manual Scavengers, as defined under the "Prohibition of Employment as Manual Scavengers and their Rehabilitation Act, 2013" and their dependents, irrespective of their income, are eligible for assistance under the Scheme.

Definition of Manual Scavenger and their dependents

"Manual Scavenger" means a person engaged or employed by an individual or a local authority or a public or private agency, for manually cleaning, carrying, disposing of, or otherwise handling in any manner, human excreta in an insanitary latrine or in an open drain or pit into which human excreta from insanitary latrines is disposed of, or on a railway track, before the excreta fully decomposes and the expression "manual scavenger" shall be interpreted accordingly. The dependent of manual scavengers is one who is a member of their family or is dependent on them. Each individual manual scavenger and his/her spouse or children who are of 18 years of age and above, who are not employed (other than manual scavengers) will be provided assistance. For the purpose of training, the age of the dependent to be eligible would be reduced by the duration of the training so that immediately after getting the training he/she can be provided other assistance immediately after attaining the age of 18 years.

Cash assistance

The identified manual scavengers, one from each family, would be eligible for receiving cash assistance of Rs. 40,000, immediately after identification. The beneficiary is allowed to withdraw the amount in monthly instalments of maximum of Rs. 7000.

Quantum of loan

Loan up to a maximum of Rs. 10 lacs will be admissible under the scheme and Rs. 15 lacs in case of sanitation related projects like Vaccum Loader, Suction Machine with Vehicle, Garbage Disposal Vehicle, Pay & Use Toilets etc. which are extremely relevant for the target group, with high success rate and income.

Rate of interest

For projects upto Rs. 25000/-	5% p.a. (4% p.a. for women Beneficiaries)
For projects above Rs. 25000/-	6% p.a.

Moratorium period

Moratorium period will be two years.

Repayment period

Repayment period will be five years (including moratorium period of two years) for projects upto Rs. 5 lacs and seven years (including moratorium period of two years) for projects above Rs. 5 lacs.

Subsequent loan

Beneficiaries will be allowed to avail second and subsequent loan from Banks, if required, without capital and interest subsidy7 and other grants under the Scheme.

Penalty

In case of diversion of funds by beneficiaries for their other needs, the Banks can initiate action as per their policy and rules in this regard. In case, it is found that the beneficiary has diverted the subsidy for any purpose, other than for which the assistance was provided then –

(i) He/she will be liable to repay the entire amount of subsidy immediately with a penal interest of 9% p.a., and

(ii) He/she will become ineligible for any assistance under the scheme, in future.

- Other assistance

Manual Scavengers are also eligible for –

- Credit linked back-end capital Subsidy

Range of project cost	Rate of subsidy
Upto Rs. 2 lacs	50% of the project cost
Rs. 2 lacs – Rs. 5 lacs	Rs. 1 lac + 33.3% of the project cost between Rs. 2- 5 lacs
Rs. 5 lacs – Rs.10 lacs	Rs. 2 lac + 25% of the project cost between Rs. 5 -10 lacs
Rs.10-15 lacs	Rs. 3.25 lacs

- Interest subsidy

  Where the rate of interest chargeable by the Banks on loans is higher than the rates prescribed in the Scheme, interest subsidy to the extent of the difference will be given to the Banks by the respective State Channelizing Agencies (SCAs). SCAs are required to pay this amount to Banks on monthly basis so that there is no case of charging of compound interest by Banks on the interest subsidy portion.

Operation of Subsidy amount by the Bank

1. Subsidy will be back ended.
2. Banks/Lending agencies would disburse the full project cost including subsidy to the beneficiaries as loan.
3. The subsidy admissible to the beneficiaries under SRMS should be kept in the Subsidy Reserve Fund Account beneficiary-wise, instead of in term deposit in the name of the beneficiary. Banks should apply no interest on the Subsidy Reserve Fund account. In view of this, for the purpose of charging interest on the loan, the subsidy amount should be excluded.
4. The repayment schedule of the loan would be drawn in such a way that the subsidy kept under Subsidy Reserve Fund Account would be sufficient for adjustment towards loan repayment equivalent to capital subsidy amount.

5. Banks/Lending agencies would issue loan passbooks to beneficiaries.

Training

Training is provided to the beneficiaries for acquiring new skills and entrepreneurship capabilities. Training can be provided by Govt. agencies/Institutes as well as by reputed specialized training agencies. Training is provided in selected industries/business activities which facilitates gainful employment of the trainees. Beneficiaries would be provided training for courses up to two years with stipend @ Rs. 3000 per month. The training will be given as per the level of education and aptitude of the beneficiary.

PRADHAN MANTRI AWAS YOJANA

A. Pradhan Mantri Awas Yojana (Urban)

Introduction

"Housing for All" Mission for urban area is being implemented during 2015-2022 and this Mission will provide central assistance to implementing agencies through States and UTs for providing houses to all eligible families/ beneficiaries by 2022. Pradhan Mantri Awas Yojana (Urban) [PMAY(U)] is being implemented as Centrally Sponsored Scheme (CSS) except for the component of credit linked subsidy which will be implemented as a Central Sector Scheme. Mission with all its components has become effective from the date 17.06.2015 and will be implemented up to 31.03.2022.

Eligibility condition for Beneficiaries

A beneficiary family will comprise husband, wife, unmarried sons and/or unmarried daughters. The beneficiary family should not own a 'pucca' house either in his/her name or in the name of any member of his/her family in any part of India to be eligible to receive central assistance under the Mission.

A beneficiary family will be eligible for availing only a single benefit under any of the existing options i.e. slum redevelopment with private partner, credit linked subsidy, direct subsidy to individual beneficiary and affordable housing in partnership, as detailed in PMAY (U) guidelines.

Coverage and Duration

All Statutory Towns as per Census 2011 and towns notified subsequently would be eligible for coverage under the Mission.

Role of Urban Local bodies

Urban Local Bodies should ensure that individual houses under credit linked interest subsidy should have provision for basic civic services like water, sanitation, sewerage, road, electricity etc.

The minimum size of houses constructed under the Mission under each component should conform to the standards provided in National Building Code (NBC). All houses built or expanded under the Mission should essentially have toilet facility.

The houses under the Mission should be designed and constructed to meet the requirements of structural safety against earthquake, flood, cyclone, landslides etc. conforming to the National Building Code and other relevant Bureau of Indian Standards (BIS) codes.

The houses constructed/acquired with central assistance under the Mission should be in the name of the female head of the household or in the joint name of the male head of the household and his wife, and only in cases when there is no adult female member in the family, the house can be in the name of male member of the household.

Scheme Details

The Mission, in order to expand institutional credit flow to the housing needs of urban poor Credit linked subsidy will be provided on home loans taken by eligible urban poor (EWS/LIG) for acquisition, construction of house.

Beneficiaries of Economically Weaker section (EWS) and Low Income Group (LIG) seeking housing loans from Banks, Housing Finance Companies and other such institutions would be eligible for an interest subsidy at the rate of 6.5 % for a tenure of 20 years or during tenure of loan whichever is lower. The Net Present Value (NPV) of the interest subsidy will be calculated at a discount rate of 9 %.

The credit linked subsidy will be available

- only for loan amounts upto Rs 6 lakhs;
- additional loans beyond Rs. 6 lakhs, if any, will be at nonsubsidized rate;
- interest subsidy will be credited upfront to the loan account of beneficiaries through lending institutions resulting in reduced effective housing loan and Equated Monthly Instalment (EMI).

Credit linked subsidy would be available for housing loans availed for new construction and addition of rooms, kitchen, toilet etc. to existing dwellings as incremental housing.

The carpet area of houses being constructed or enhanced under this component of the mission should be up to 30 square metres and 60 square metres for EWS and LIG, respectively in order to avail of this credit linked subsidy.

The beneficiary, at his/her discretion, can build a house of larger area but interest subvention would be limited to first Rs. 6 lakh only.

Nodal and Monitoring Agencies

Housing and Urban Development Corporation (HUDCO) and National Housing Bank (NHB) have been identified as Central Nodal Agencies (CNAs) to channelize this subsidy to the lending institutions and for monitoring the progress of this component. Ministry may notify other institutions as CNA in future.

CNAs will be responsible for ensuring proper implementation and monitoring of the scheme and will put in place appropriate mechanisms for the purpose.

CNAs will provide periodic monitoring inputs to the Ministry of Housing and Urban Poverty Alleviation through regular monthly and quarterly reports as per specified formats.

Primary Lending Institutions (PLIs) i.e. lenders can register only with one CNA by signing MOU.

Role of ULBs /Lenders

State/UTs/ULBs/PLIs shall link beneficiary identification to Aadhaar, Voter card, any other unique identification or a certificate of house ownership from Revenue Authority of Beneficiary's native district to avoid duplication of benefits from other schemes.

Preference among beneficiaries

Preference under the Scheme, subject to beneficiaries being from EWS/LIG segments, should be given to Manual Scavengers, Women (with overriding preference to widows), persons belonging to Scheduled Castes/ Scheduled Tribes/Other Backward Classes, Minorities, Persons with disabilities and Transgender.

Role of SLNA

State Level Nodal Agency (SLNA) identified by State/UT for implementing the Mission will facilitate the identified eligible beneficiaries in getting approvals and documents, etc. to avail of credit linked subsidy. For identification as an EWS or LIG beneficiary under the scheme, an individual loan applicant will submit self-certificate/affidavit as proof of income.

In case a borrower who has taken a housing loan and availed of interest subvention under the scheme but later on switches to another PLI for balance transfer, such beneficiary will not be eligible to claim the benefit of interest subvention again.

Beneficiaries can take advantage under one component only.

In order that beneficiaries do not take advantage of more than one component, PLIs should take NOCs quarterly from State/UT Governments or designated agency of State/UT Governments for the list of EWS beneficiaries being given benefits under credit linked subsidy.

For enabling this process, the beneficiaries should be linked to his/her Aadhaar/ Voter ID Card/Any other unique identification Number or a certificate of house ownership from Revenue Authority of Beneficiary's native district and State/UT Government or its designated agency should furnish the NOC within 15 days of receipt of such request.

Till 30.06.2017, or as directed by the Ministry of Housing and Urban Poverty Alleviation, instead of taking NOC from States/UTs, CNAs, on behalf of PLIs, would send list of beneficiaries under CLSS on fortnightly basis to concerned States/UTs. Concerned States / UTs will consider this list, while deciding beneficiaries under other three verticals of the Mission, so that no beneficiary is granted more than one benefit under the Mission.

Primary Lending Institutions, in the home loan applications, shall disclose transparently the Scheme eligibility and ascertain willingness and eligibility of applicants under CLSS for EWS/LIG.

Release of Central Assistance and Subsidies

An advance subsidy will be released to each CNA at the start of the scheme. Subsequent amounts of credit linked subsidy will be released to the CNAs after 70 % utilization of earlier amounts, on quarterly basis, and based on claims raised by CNAs, as per prescribed format. Based on the loan disbursed by a PLI to EWS and LIG beneficiaries, the CNA will release the subsidy amount to PLIs directly based on the claims submitted on the total loans disbursed. Subsidy will be released to the PLI by the CNA in maximum of four instalments. 0.1% of total fund disbursement by the CNAs to the PLIs will be paid to the CNAs for their administrative expenses.

Subsidy will be credited by the PLI to the borrower's account upfront by deducting it from the principal loan

amount of the borrower. The borrower will pay EMI as per lending rates on the remainder of the principal loan amount.

Processing Fee to Lenders

In lieu of the processing fee for housing loan for the borrower under the scheme, PLIs will be given a lump sum amount of Rs. 3,000/- (Rupees Three Thousand only) per sanctioned application. PLIs will not take any processing charge from the beneficiary for housing loans upto Rs. 6 lakh under the Scheme. For additional loan amounts beyond Rs. 6 lakh, PLIs can charge the normal processing fee.

Beneficiary can apply for a housing loan directly or through the ULB or the local agencies identified by the State/ ULBs for facilitating the applications from intended beneficiaries. In order to incentivize the designated staff of ULBs or NGOs a sum of Rs.250/- only per sanctioned application would be paid out of CLS Scheme funds payable through State Governments.

Administration and Implementation

The Programme will have a three-tier implementation structure. An inter-ministerial committee viz. Central Sanctioning and Monitoring Committee (CSMC) is constituted under the Chairpersonship of Secretary (HUPA) for implementation of the Mission, approvals there under and monitoring. A Committee of Secretary (HUPA) and Secretary (DFS) in Government of India is also constituted for monitoring the credit linked subsidy component of the Mission, giving targets to lenders etc. States/UTs are required to constitute an inter-departmental State Level Sanctioning & Monitoring Committee (SLSMC), headed by Chief Secretary, for approval of Action Plans and projects under various components of the Mission.

Each State/UT will identify a State Level Nodal Agency (SLNA) under the Mission wherein a State Level Mission Directorate will be set up for coordination of the scheme and reform-related activities. State may nominate a separate State Level Nodal Agency (SLNA) under the credit linked subsidy component of the Mission to identify, motivate and organize beneficiaries to seek housing loans.

A city level Mission for selected cities should be set up under the chairpersonship of the Mayor or Chairman of the ULB as the case may be.

Suitable grievance redressal system exits at State and City level to address the grievances in implementing the PMAY (U) Mission including CLSS for EWS/LIG from various stakeholders.

PRIME MINISTER AWAS YOJANA

B. Prime Minister Awas Yojana – Gramin

प्रधानमंत्री
आवास योजना

Background

Public housing programme in the country started with the rehabilitation of refugees immediately after independence and since then, it has been a major focus area of the Government as an instrument of poverty alleviation. Rural housing programme, as an independent programme , started with Indira Awaas Yojana (IAY) in January 1996. Although IAY addressed the housing needs in the rural areas, certain gaps were identified during the concurrent evaluations and the performance Audit by Comptroller and Auditor General (CAG) of India in 2014. These gaps, i.e. non-assessment of housing shortage, lack of transparency in selection of beneficiaries, low quality of the house and lack of technical supervision, lack of convergence, loans not availed by beneficiaries and weak the mechanism for monitoring was limiting the impact and outcomes of the programme. To address these gaps in the rural housing program and in view of Government's commitment to providing "Housing for All" by 2022, the scheme of IAY has been re-structured into Pradhan Mantri Awaas Yojana – Gramin (PMAY-G) w.e.f. 1st April 2016.

Aims and Objectives PMAY – G

PMAY-G aims at providing a 'pucca' house, with basic amenities, to all houseless householder and those households living in kutcha and dilapidated house, by 2022. The immediate the objective is to cover 1.00 crore household living in kutcha house/dilapidated house in three years from 2016-17 to 2018- 19.The minimum size of the house has been increased to 25 sq.mt (from20sq.mt) with a hygienic cooking space. The unit assistance has been increased from Rs. 70,000 to Rs. 1.20 lakh in plains and from Rs75,000 to Rs 1.30 lakh in hilly states, difficult areas and IAP district. The assistance for construction of toilet shall be leveraged through convergence with SBM-G, MGNREGS or any other dedicated source of funding.

Cost of assistance

The cost of unit assistance is to be shared between Central and State Government in the ratio 60:40 in plain areas and 90:10 for North Eastern and the Himalayan States.

Process of identification of beneficiaries

The selection of beneficiary under PMAY – G is done by using housing deprivation parameters in the Socio Economic and Caste Census (SECC), 2011 which is to be verified by the Gram Sabhas. Using the data households that are houseless and living in 0, 1 and 2 kutcha wall and kutcha roof houses can be segregated and targeted. The Permanent Wait List so generated also ensures that the states have the ready list of the household to be covered under the scheme in the coming years (through Annual Select Lists) leading to better planning of implementation. To address grievances in beneficiary selection, an appellate process has also been put in place.

Eligible Borrowers under PMAY - G Scheduled Tribes / Scheduled Castes

- Freed bonded labourers
- Minorities and non - SC/ST rural households in the BPL category
- Widows and next-of-kin to defence personnel/paramilitary forces killed in action (irrespective of their income criteria), ex-servicemen and retirement Scheme

Conditions for Loan

- The family applying for a loan under this scheme must include a husband, wife and child/children that are unmarried. The family must not own a pucca house

- The applicant and his family must fulfil the income criteria mandated by this scheme and has to belong to either the EWS (Economically Weaker Section), LIG (Lower Income Group), or BPL (Below Poverty Line) category
- The income of the applicant's family should be between Rs.3 lakh and Rs.6 lakh p.a.
- Any loan amount above Rs.6 lakh, the interest rate on the additional amount will be as per market rate

Applying for PMAY – G

The beneficiary can apply by making an application along with the following documents as applicable in their respective cases.

Ethnic group certificate/ other certificates indicating that the applicant belongs to such beneficiary group; Income proof, ID proof such as Aadhar card, PAN, Driving licence, Voter ID, etc.; Address proof; Income certificate, Salary certificate; 6 months bank account statement; IT returns (if applicable), An affidavit stating that neither the applicant nor his family members own a pucca house.

The government will select the beneficiaries of PMAY-G and the final list will be published. Any interested candidates can then approach the respective authorities and avail the benefits of PMAY-G. The beneficiaries can login to PMAY site and on the 'Stakeholder' bar they can search for Beneficiary name.

Excluded category of persons

The following candidates who apply for a loan are excluded:

Candidates that

- have a motorised two wheeler/three wheeler/four wheeler/refrigerator
- have fishing boat
- have a mechanised three wheeler/four wheeler agricultural equipment
- have Kisan Credit Card (KCC) with a limit greater or equal to Rs.50,000 Any household that has at least
- one member that is employed with the government
- one member earning more than Rs.10,000 a month
- pays income tax/professional tax/
- a landline phone connection.

Benefit under PMAY – G

Home loans obtained under PMAY – G are eligible for a 3% concession on interest rates on housing loans of up to Rs.2 lakh.

STAND-UP INDIA SCHEME (FOR FINANCING SC/ST AND/OR WOMEN ENTREPRENEURS)

Background

Women in India had always faced problems in many social, professional and entrepreneurial fronts. It is more so in the case of women of SC/ST category. In order to assist such women who have entrepreneurship qualities in them, Government of India, introduced "Stand Up India'. This scheme helps to promote entrepreneurship spirit among women, especially SC & ST category i.e. those sections of the population facing significant hurdles due to lack of advice/mentorship as well as inadequate and delayed credit.

The intention of the scheme to leverage the institutional credit structure to reach out to these SC/ST women in starting greenfield enterprises to empower them economically. It caters to both experienced and new (trainee) borrowers. The Stand-Up India scheme is based on recognition of the challenges faced by SC, ST and women entrepreneurs in setting up enterprises, obtaining loans and other support needed from time to time for succeeding in business. The scheme therefore hopes to create a climate of enabling system which facilitates and continue to extend support measures for doing business activities by such SC/ST women .

Stand-up India scheme in addition to providing financial support also incorporates hand-holding support to the potential borrowers. Thus it provides for convergence with Central/State Government schemes.

Objective

To facilitate bank loans between 10 lakh and 1 Crore to at least one Scheduled Caste (SC) or Scheduled Tribe (ST) borrower and at least one woman borrower per bank branch for setting up a greenfield (new activity) enterprise. This enterprise may belong to manufacturing, services or the trading sector. In case of other than individuals, i.e. enterprises, at least 51% of the shareholding and controlling stake of such enterprises should be held by either an SC/ST or Woman entrepreneur.

Eligibility

1. SC/ST and/or woman entrepreneurs, above 18 years of age.
2. The loan is available for only green field project, that is, to say a first time venture of the beneficiary in the manufacturing or services or trading sector.
3. In case of non-individuals such as other legal entities, 51% of the shareholding and controlling stake should be held by either SC/ST and/or Women Entrepreneur.
4. Borrower should not be a defaulter with any bank/financial institution.

Coverage and access to loans

The scheme is available to all branches of Scheduled Commercial Banks. The scheme, will be accessed in any of the three potential ways:

- Directly at the branch or
- Through SIDBI's Stand-Up India portal
- The Lead District Manager (LDM) - under the Lead Bank Scheme.

A potential borrower can register on the portal directly which can be accessed at home, at Common Service Centers (CSCs), through a bank branch (through the nodal officer for MUDRA at the branch) or through the LDM. or through an internet access point facility.

Approach and assistance to women borrowers

The borrowers are assessed based on the response to following parameters, for guidance handholding right from the initial stage.

1. Location of the borrower
2. Category – SC/ ST/ Woman
3. Nature of business planned
4. Availability of place to operate the business.
5. Assistance needed for preparing a project plan
6. Requirement of skills/training (technical and financial).
7. Details of present bank account.
8. Amount of own investment into the project
9. Whether help is needed to raise margin money
10. Any previous experience in business

Based on the response, the portal provides relevant feedback and helps in categorizing the visitor to the portal as a ready borrower or a trainee borrower.

Ready Borrower

1. In case the borrower who requires no guidance, then registration on the portal as itself starts the process of application for the loan at the selected bank. While registering an application number will be generated and information about the borrower shared with the bank concerned, the LDM (posted in each district) and the relevant linked office of NABARD/ SIDBI. The offices of SIDBI and NABARD shall be designated Stand-Up Connect Centres (SUCC). The loan application will now be generated and tracked through the portal.
2. Trainee Borrower (New borrower)

   Where the borrower requires need for handholding, then he borrower will be registered as a Trainee Borrower on the portal which will link the borrower to the LDM of the concerned district and the relevant office of SIDBI/ NABARD. This process can be done through internet at borrower's home, or at a CSC or through a bank branch by the officer dealing with MUDRA cases.

Support will be arranged by SIDBI (79 offices) and NABARD (503 offices) through Stand-Up India Connect Centers. The trainee will be given support as per request in one or more of the following ways:

a. Financial training – at the Financial Literacy Centers (FLCs)

b. Skilling – at skilling centers (Vocational Training Centers - VTPs/ Other Centers -OCs)

c. EDPs – at MSME DIs/ District Industries Centers (DICs)/ Rural Self Employment Training Institutes (RSETIs)

d. Factory/ work shed – DICs

e. Margin money – e.g. State SC Finance Corporation, Women's Development Corporation, State Khadi & Village Industries Board (KVIB), MSME-DIs etc.

f. For mentoring support – DICCI, Women Entrepreneur Associations, Trade bodies, Well established NGOs.

g. For utility connections – Offices of utility providers.

h. Detailed Project Reports – Project profiles available with SIDBI/ NABARD/ DICs

If an applicant requires any assistance even after the loan has been sanctioned, they may access the services of the Stand-Up Connect Centers.

Nature of Loan

Composite loans (which includes term loan and working capital) between 10 lakh and upto 100 lakh as per requirement.

Purpose of Loan

For setting up a new ventures/ enterprise in manufacturing, trading or services sector by SC/ST/Women entrepreneur.

Size of Loan

Loan size will be 75% of the project cost including term loan and working capital. If the borrower's margins exceed 25% then loan size will be accordingly be lessened.

Interest Rate

The minimum applicable rate of the bank for that rated category of borrower. Interest not to exceed (MCLR + 3%+ tenor premium according to individual bank's rate structure.

Security and Risk coverage

Besides primary security plus collateral security or guarantee of Credit Guarantee Fund Scheme for Stand-Up India Loans (CGFSIL) as decided by the banks.

Repayment

The loan is repayable in 7 years with a maximum moratorium period of 18 months.

Working Capital

Working capital upto Rs.10 lakhs will be by way of way of overdraft. Any working capital loan exceeding

Rs. 10 lacs will be through Cash Credit limit. Banks can also issue RuPay debit card for the convenience of the borrower.

Margin Money

As per scheme 25% margin money to be brought in by the borrower. This can be provided in convergence with eligible Central / State schemes. While such schemes can be drawn upon for availing admissible subsidies or for meeting margin money requirements, in all cases, the borrower shall be required to bring in minimum of 10% of the project cost as own contribution.

A list of Central / State wise subsidy/incentive schemes is provided on the SIDBI Portal. This can be used by borrowers to secure subsidies. New schemes will be added as they become available to this portal.

Monitoring/Review

Lead District Manager will monitor progress of various applicants through their quarterly meetings including rejection cases.

Role of Bank branches:

- Wherever requested by borrowers help such borrowers in accessing the portal. Process loan applications received online or in person as per bank's policy as well as in the light of the BCSBI Code of Commitment to SME borrower (i.e. for loan up to Rs.5 lakh within 2 weeks, between Rs.5 – Rs.25 lakh in 3 weeks, above Rs.25 lakh in 6 weeks, from the date of receipt of application complete in all respects). In case of rejection, reason to be made known to borrower in writing.
- If any compliant is received from borrower, grievance redressal at the bank level should be done in 15 days as committed by bank under BCSBI code. .
- Banks to have an independent monitoring arrangement for loan application, sanction etc.

Role of LDMs

- They will have the overall monitoring of Start-up India applications, progress of sanctions, easing of bottlenecks, liaise with banks, follow-up with controlling offices of banks regarding processing, sanctioning as per time frame specified under BCSBI code applicable to Micro and Small Enterprises.
- Take care to fulfill handholding support of borrowers, arrange DLCC meetings in the specified periodicity and monitor progress.
- Participate in quarterly events with stakeholders organized by NABARD.

Role of DLCC

- Will review progress under the scheme under the supervision of Collector periodically. Look after the grievance redressal aspects at district level.
- Help in resolving issues relating to public utility services and work space for potential borrowers.

RURAL SELF EMPLOYMENT TRAINING INSTITUTES (RSETI)

RSETIs – Rural Self Employment Training Institutes, are an initiative of Ministry of Rural Development (MoRD) to have dedicated infrastructure in each district of the country to impart training and skill up-gradation of rural BPL (Below Poverty Line) youth geared towards entrepreneurship development to mitigate the unemployment problem. RSETIs are managed by banks with active co-operation from Government of India and State Governments. The RSETI concept is based on RUDSETI (Rural Development and Self Employment Training Institute, a society established jointly by three agencies – Syndicate Bank, Canara Bank and Sri Manjunatheswara Trust, Karnataka). One RSETI is established in every district in the country. Concerned bank is the lead bank in the district takes responsibility for creating and managing it. Government of India will provide one-time grant assistance, up to a maximum of Rs. 1 crore for meeting the expenditure on construction of building and other infrastructure. After successful completion of the training, the candidates will be provided with credit linkage assistance by the banks to start their own entrepreneurial ventures.

The common minimum infrastructure of each RSETI will be - 2 / 3 classrooms with toilet facilities (separate for women and physically challenged friendly), two workshops, two dormitories with bath facilities, adequate physical infrastructure for training, administration, hostel, staff quarters etc.

Programmes Structure and Contents

Each RSETI should offer 30 to 40 skill development programmes in a financial year in various avenues. The programme duration can be from one week to six weeks and could be in following categories:

- Agricultural – Agriculture and allied activities like dairy, poultry, apiculture, horticulture, sericulture, mushroom cultivation, floriculture, fisheries etc.
- Product – Dress designing, Rexene articles, incense sticks manufacturing, football making, bag, bakery products, leaf cup making, recycled paper manufacturing etc.
- Process – Two wheeler repairs, radio / TV repairs, motor rewinding, electrical transformer repairs, irrigation pump-set repairs, tractor and power tiller repairs, cell phone repairs, beautification course, photography and videography, screen printing, domestic electrical appliances repair, computer hardware and DTP (Desktop publishing)
- General – Skill development for women
- Other – Related to sectors like leather, construction, hospitality and sectors depending on local requirements.

Programmes will be decided by these institutes based on the local resource situation and potential demand for products / services. A uniform standardized curriculum would be developed and circulated among the institutes.

RSETIs have two sets of training curriculums – (i) Basic orientation programme courses for Swarnajayanti Gram Swarojgar Yojana (SGSY) – (initiative launched by the Government of India to provide sustainable income to poorest of poor people living in rural and urban areas of the country), Self Help Groups ('SHG's) and (ii) Skill development programmes for micro enterprise and wage employment / placement. Soft skill programme shall be an integral part in all the training programmes.

Selection of Trainees and Batch size

70% of the trainees should be from the rural Below Poverty Line (BPL) category certified by the District Rural Development Agencies (DRDA) with proper weightage, as per SGSY guidelines will be given to SC/STs, minorities, physically challenged and women. Ideal size of batch will be 25 -30 candidates. Shramdan / Yoga, would become a common input in training module.

Certificates issued by an RSETI will be recognized by all banks for purposes of extending credit to the trainees.

Credit needs of trainees will appraised by RSETIs and will be conveyed to the bank branches. The trainees can avail bank loans under SGSY or any government sponsored programmes.

RSETI performance –FY 2017 -18 (as on 31.03.2018) No. of States covered – 32

No. of Banks involved – 31 Functional RSETIs – 586

Target candidates to be trained – 3,97,688 Candidates trained – 4,23,343

Candidates settled – 3,49,918 (wage employed – 29,394 / self employed – 3,20,524)

With self finance – 1,57,386 With Bank finance – 1,63,138

FINANCIAL INCLUSION

"Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost". (The Committee on Financial inclusion, Chairman, Dr. C. Rangrajan). As per the definitions of United Nations, financial inclusion, broadly defined, refers to a wide range of financial services at a reasonable cost. These include not only banking products bur also other financial services such as insurance and equity products. (The committee on Financial Sector Reforms, Chairman: Dr. Raghuram G. Rajan). The essence of Financial inclusion is to ensure delivery of financial services which include – bank accounts for savings and transactional purposes, low cost credit for productive, personal and other purposes, financial advisory services, insurance facilities (life and non-life) etc.

Why Financial Inclusion?

It broadens the resource base of the financial system by developing a culture of savings among large segment of rural population and plays its own role in the process of economic development. Further, by bringing low income groups within the perimeter of formal banking sector, financial inclusion protects their financial wealth and other resources in exigent circumstances. Financial inclusion also mitigates the exploitation of vulnerable sections by the usurious money lenders by facilitating easy access to formal credit. In short, financial inclusion provides an access to various services to rural population to improve their financial status.

RBI Policy initiatives

- Advised all banks to open Basic Saving Bank Deposit (BSBD) accounts with minimum common facilities such as no minimum balance, deposit and withdrawal of cash at bank branch and ATMs, receipt / credit of money through electronic payment channels, facility of providing ATM card.

- Relaxed and simplified KYC norms to facilitate easy opening of bank accounts, especially for small accounts with balances not exceeding Rs. 50,000/- and aggregate credits in the accounts not exceeding Rs. 1,00,000 a year. Further, banks are advised not to insist on introduction for opening bank accounts of customers. In addition, banks are allowed to use Aadhar Cards as a proof of both identity and address. (Supreme Court rules that the Centre and States should not insist on Aadhar cards for providing essential services, as large number of people are still not having Aadhar Cards. The matter is still being heard by Supreme Court.)
- Compulsory requirement of opening branches in un-banked villages, banks are directed to allocate at least 25% of the total number of branches to be opened during the year in un-banked (Tier 5 and Tier 6) rural centers.
- Opening of intermediate brick and mortar structure, for effective cash management, documentation, redressal of customer grievances and close supervision of Business Correspondents ('BC') operations. Banks have been advised to open intermediate structures between the present base branch and BC location. This branch could be in the form of a low cost simple brick and mortar structure consisting of minimum infrastructure such as core banking solution terminal linked to a pass book printer and a safe for cash retention for operating large customer transactions.

Financial Education, Financial Inclusion and Financial Stability are three elements of an integral strategy. While financial inclusion works from supply side of providing access to various financial services, financial education feeds the demand side by promoting awareness among the people regarding the needs and benefits of financial services offered by banks and other institutions. Going forward, these two strategies promote greater financial stability.

Important issues which need to be addressed:

- **Business Correspondents (BC):**
  - (i) BCs have to be adequately compensated so that they are sufficiently incentivized to promote financial inclusion as a viable business opportunity.
  - (ii) The usefulness of BC model is dependent on the kind of support provided by the bank branches.
  - (iii) Banks should initiate suitable training and skill development programmes for effective functioning of BCs.
- **Tailor Made Services:**
  - (i) Designing suitable innovative products to cater to the requirements of poor villagers at affordable rates in an absolute imperative.
  - (ii) To wean away villagers from borrowing from money lenders, bank should develop simplified credit disbursement procedures and also flexibility in their work processes.
- **Technology Applications:**
  - (i) Banks should enhance their ATM network in rural and un-banked areas to serve poor villagers. While doing so, adequate care should be taken regarding safety / security issues. (ii) To reduce the overall transaction costs associated with small ticket transactions in rural areas, domestic RuPay cards may be utilized.
  - (iii) Banks may explore the possibility of issuing multipurpose cards which could function as debit cards, KCC and GCC as per the requirements in rural areas.

(iv) There are a number of issues involving Technology Service Providers.

Other issues that need to be addressed for an effective financial inclusion are:

- For effective use of Basic Savings Bank Deposit accounts economic activity needs to be improved.
- Urban financial inclusion leaves vast scope for improvement. Migration from rural to urban centres is also accentuating the problem.
- Providing of easy and cheap remittance facilities to migrant population is an absolute imperative as migrants are not adequately covered.
- To deal with poor villagers, banks need to initiate training programmes to frontline staff and managers as well as BCs on the human side of the banking.
- To achieve meaningful financial inclusion, banks should give priority for small farmers as compared to large farmers while sanctioning credit.
- Banks should ensure scalability of their CBS platforms.
- Banks should promote Electronic Benefit Transfer (EBT) systems effectively for boosting their financial inclusion plans.
- Banks should initiate steps to increase the credit absorption capacity in rural areas by promoting employment and other opportunities.
- There is an imperative need to ramp up the number of rural branches by the private sector banks.
- For up-scaling financial inclusion, adequate infrastructure such as digital and physical connectivity, uninterrupted power supply are prerequisites.
- Financial inclusion efforts should necessarily be done in vernacular languages.
- All round efforts should be made to ensure that Post Offices play a greater and more active role as they are closest to the rural people compared to bank branches.
- SIDBI should go in to reasons for not getting access to formal sources of credit by majority of MSME units.
- Over 70% of total population resides in the rural areas of the country, however, insurance reaches less than 3% of the total population.
- Research into the products, practices and procedures of unorganized sectors an absolute imperative to identify and understand the same which the bottom of the pyramid populace finds so convenient and comfortable to deal with.

BUSINESS CORRESPONDENTS / BUSINESS FACILITATORS (BCBF MODEL)

As penetration of banking services among masses has still not reached the desired level, RBI had issued guidelines to Scheduled Commercial Banks including Regional Rural Banks (RRBs) and Local Area Banks (LABs) to engage Business Correspondents (BCs)/ Business Facilitators subject to compliance with following:

- Banks to formulate a policy for engaging BCs with the approval of their Board of Directors. Due diligence to be carried out on individuals / entities to be engaged as BCs prior to their engagement, covering aspects such as:

  (i) market standing

(ii) financial soundness

(iii) management and corporate governance

(iv) cash handling ability

(v) ability to implement technology solutions in rendering financial services.

- The banks are permitted to engage following individuals / entities as BCs:

  (i) Retired- bank employees, teachers, government employees, ex-servicemen; individual owners of kirana / medical / Fair Price shops, Individual public Call Office operators, agents of Small Savings schemes of GoI / Insurance companies, individual owners of Petrol Pumps, authorized functionaries of well run SHGs which are linked to banks, others.

  (ii) NGOs / MFIs set up under Societies / Trust Act or Sec.25 Companies Act

  (iii) Registered Co-operative societies

  (iv) Post Offices

  (v) Registered Companies with large and widespread retail outlets (excluding NBFCs)

- Appointing Non-deposit taking NBFCs (NBFCs-ND) as BCs, subject to the following conditions:

  (i) There is no comingling of bank funds and those of the NBFC-ND appointed as BC.

  (ii) There should be a specific contractual arrangement to ensure that all possible conflicts of interest are adequately taken care of.

  (iii) Ensure that the NBFC-ND does not adopt any restrictive practice such as offering savings or remittance functions only to its own customers and forced bundling of services offered by the NBFC-ND and the bank does not take place.

- A BC can be a BC for more than one bank. The banks will be fully responsible for the actions of the BCs and their retail outlets / sub agents.

- The scope of activities of BC may include (i) identification of borrowers (ii) collection and preliminary processing of loan applications including verification of primary information and submission of applications (iii) creating awareness about products, educating and advising on managing money and debt counseling (iv) promoting, nurturing and monitoring SHGs, Joint liability groups, credit groups (v) disbursement of small value credit (vi) post sanction monitoring and recovery (vii) sale of third party products (viii) small value remittances and other payment instruments.

- Banks to ensure

  (i) compliance with KYC and AML norms under BC model.

  (ii) the preservation and protection of the security and confidentiality of customer information in the custody or possession of BC.

  (iii) that the equipment and the technology used by the BC are of high standard.

- The banks are allowed pay reasonable commission / fee to the BC. The banks (not BCs) are permitted to collect reasonable service charges from the customers in a transparent manner.

- Bank's arrangement with BC should specify; (i) Limits on cash holding by intermediaries and limits on individual customer payments and receipts. (ii) Cash collected from the customer should be

acknowledged by issuing receipt on behalf of the bank (iii) All off-line transactions to be accounted by the end of the day (iv) All agreements / contracts with the customer shall clearly specify that the bank is responsible to the customer for acts of omission and commission of BC.

- The distance between the place of business of a retail outlet/sub-agent of BC and the base branch should ordinarily not exceed 30 kms. in rural, semi-urban and urban areas and 5 kms. in metropolitan centres.
- The banks should carry out a detailed review of the performance of various BCs engaged by them at least once in a year and monitor their activities.
- Banks should take all measures to protect the interest of the customers.

  The bank should constitute Grievance Redressal Machinery within the bank for redressing complaints about services rendered by the BCs and give wide publicity about it through electronic and print media.
- Financial literacy and customer education should form an important part of the business strategy and should form part of the commitment by banks adopting the BC model.

Financial Literacy is the ability to understand how money works; how someone makes, manages and invests it, and expands it to help others. Financial Literacy creates demand for financial products and services, thereby accelerating pace of financial inclusion as it enables the common man to understand the needs and benefits of the products and services offered by the banks. All segments of the society need financial literacy in one form or the other. However, considering that a large segment of our society is financially excluded, financial literacy programmes, at present, should primarily focus on the individuals who are vulnerable to persistent downward financial pressures due to lack of understanding in the matters relating to personal finance.

Financial Literacy Camps

- The objective of conduct of financial literacy camps is to facilitate financial inclusion through provision of two essentials – literacy and easy access. It should aim at imparting knowledge to enable financial planning, inculcate saving habits and improve the understanding of financial products leading to effective use of financial services by the common man. Financial literacy should help them plan ahead of time for their life cycle needs and deal with unexpected emergencies without resorting to debt. They should be able to proactively manage money and avoid debt traps. In order to ensure that the knowledge imparted through awareness results in inculcating banking habits, literacy inputs need to be synchronized with access to financial services so as to enable the common man to use the information effectively to gain control over financial matters. It should result in enhancement of their economic security aided by use of banking services.
- The banks as providers of financial services, have an inherent gain in the spread of financial inclusion and financial literacy, as it would help them capture the untapped business opportunities. Small customer is the key and banks should harness the business opportunities available at the bottom of the pyramid. Hence, banks must view the financial literacy efforts as their future investments. Banks must provide a bouquet of banking services comprising of a small overdraft facility, variable recurring deposit accounts, remittance facility to the account holders in order to make the accounts operative. People should be encouraged to make transactions in these accounts so that the cost of maintaining the accounts is recovered to make it a viable and profi table business of the banks. The provision of adequate credit is also important not only in the interest of the customer, but also for the banks as the reviewed the extant policy on ATMs and has decided to permit non-banks to set up, own and operate ATMs to accelerate the growth and penetration of ATMs in the country. Such ATMs will be in the nature of White Label ATM

(WLA) and would provide ATM services to customers of all banks. Non-bank entities proposing to set WLAs have to seek authorization from RBI.

Development of National Payment System: The payment system could be broadly divided into two segments

– Paper-based Payments and Electronic Payments.

Paper-based Payments – RBI introduced Magnetic Ink Character Recognition (MICR) technology for speeding up and bringing in efficiency in processing of cheques. Recent developments include launch of Speed Clearing (for local clearance of outstation cheques drawn on core-banking enabled branches of banks) and introduction of Cheque Truncation System ('CTS' - to restrict physical movement of cheques and enable use of images for payment processing).

Electronic Payments – the overall thrust is to reduce the use of paper for transactions and move towards electronic mode. Following are various electronic payment services available in the country:

Electronic Clearing Service (ECS)/ National ECS (NECS): ECS is an electronic mode of payment / receipt for transactions that are repetitive and periodic in nature. ECS is used by institutions for making bulk payment of amounts towards distribution dividend, interest, salary, pension etc. or for bulk collection of amounts towards telephone / electricity / water dues, cess / tax collections, loan installment repayments, periodic investments in mutual funds, insurance premium etc.

National Electronic Funds Transfer (NEFT): NEFT is a payment system facilitating one-to-one funds transfer. Under this, 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. Thus, this is an interbank fund transfer system.

Real Time Gross Settlement (RTGS) System: This Real Time Gross Settlement is a continuous (real-time) settlement of funds transfer individually on an order by order basis (without netting). 'Real Time' means the processing of instructions at the time they are received rather than at some later time. 'Gross Settlement' means the settlement of funds transfer instruction occurs individually (on an instruction by instruction basis).

Considering that the funds settlement takes place in the books of Reserve Bank of India, the payments are final and irrevocable.

Pre-paid Payment System: Pre-paid instruments are payment instruments that facilitate purchase of goods and services against the value stored on these instruments. The pre-paid instruments can be issued in the form of smart cards, magnetic strip cards, internet accounts, internet wallets, mobile accounts, mobile wallets, paper vouchers etc.

Point of Sale (POS) Terminals / Online Transactions: POS terminals enable customers to make payments for purchases of goods and services by means of credit / debit cards. To facilitate customer convenience the Bank has also permitted cash withdrawal using debit cards issued by the banks at POS terminals.

LESSON ROUND UP

– For the economic upliftment, poverty alleviation, creation of employment opportunities, elimination of social inequities of people of India, Government of India has launched several credit linked and social security based schemes such as Prime Ministers Employment Generation Programme (PMEGP), Deendayal Antyodaya Yojana (DAY) - National Rural Livelihood Mission (NRLM) & National Urban Livelihood Mission (MULM), Differential Rate of Interest Scheme, Scheme for Rehabilitation of Manual Scavengers (SRMS)

2013, Pradhan Mantri Jana DhanYojna (PMJDY), Micro Units Development and Refinance Agency (MUDRA) Bank Yojana, National Equity Fund, Pradhan Mantri Awas Yojana (Urban), Pradhan Mantri Awas Yojana – Gramin, Start-up India Scheme, Sukanya Samriddhi Account, Pradhan Mantri Jeevan Jyoti Bima Yojana. (PMJJBY), Pradhan Mantri Suraksha Bima Yojana (PMSBY), Atal Pension Yojana (APY), Pradhan Mantri Vaya Vandana Yojana. (PMVVY), Pradhan Mantri Fasal Bima Yojana. (PMFBY).

– PMJDY was launched on 28.08.2014, is a National Mission for Financial Inclusion to ensure access to banking / savings and deposit accounts, Remittance, Credit, Pension, Insurance in an affordable manner to those who were excluded from main stream banking. The scheme started off "Basic Banking Accounts" with overdraft facility of Rs. 5000 after 6 months and RuPay Debit card with inbuilt accident insurance cover of Rs. 1lakh and RuPay Kisan card.

– Under Prime Minister's Mudra Yojana (PMMY) has been formulated in the year 2015 to provide financial assistance to eligible entrepreneurs in the SME sector to obtain collateral free financial assistance from banks from Rs. 50,000 to Rs. 10 lakhs by MUDRA loans are provided for income generating small business activity in manufacturing, processing, and service sector or trading. The Project cost is decided based on business plan and the investment proposed. MUDRA loan is not for consumption/personal needs.

– Under National Equity Fund scheme, SIDBI provides equity assistance to Micro and Small Enterprises (MSE) entrepreneurs. Sanction of refinance in respect of term loan for the projects by SIDBI is a prerequisite The complete requirements of the projects in the form of equity assistance, the term loan and working capital will be provided by one agency viz. a nationalized bank or State Finance Corporation.

– Sukanya Samriddhi Account is Government of India backed savings scheme targeted at the parents of girl children. It is a Girl Child Prosperity Account. The scheme encourages parents to build a fund for the future education and marriage expenses for their female child. The scheme was launched in 2015.

– Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY) is a Government of India backed Life Insurance Scheme for the benefit of weaker sections of the society. Life cover of Rs. 2.00 lac is available at a yearly premium of Rs. 330 and is renewable every year. The scheme is available to people in the age group of 18 to 50 years, life cover up to age of 55.

– Pradhan Mantri Suraksha Bima Yojana (PMSBY) is another Government of India backed personal accident insurance cover at a nominal premium of Rs. 12 per year providing an insurance cover of Rs.2 lac in the event of death. Bank account holders between age of 18 and 70 in participating banks are eligible.

– Atal Pension Yojana covers people employed in the unorganized sectors in India who are denied of social security benefits. To offer a social security and safety net Atal Pension Yojna was launched in the year 2015 covering Indian citizen workers in unorganized sector. The scheme is administered by the Pension Fund Regulatory and Development Authority (PFRDA) under the National Pension Scheme (NPS). Subscribers would receive a fixed minimum of Rs. 1000 to Rs. 5000 per month at the age of 60 years depending on their contribution

– 'Pradhan Mantri Vaya Vandana Yojana (PMVVY)' provides social security during old age and to protect elderly persons aged 60 and above against a future fall in their interest income due to uncertain market conditions. The scheme enables old age income security for senior citizens through provision of assured pension/return linked to the subscription amount based on government guarantee to Life Insurance Corporation of India (LIC). PMVVY is available from 4th May 2017 to 31st March 2020 through LIC of India.

- The Government of India, in April 2016 had launched Prime Minister's Fasal Bima Yojana after rolling back the earlier insurance schemes – National Agriculture Insurance Scheme (NAIS), weather based crop insurance scheme and Modified National Agricultural Insurance Scheme (MNAIS). The main objectives of the scheme are providing financial support to farmers suffering crop loss / damage arising out of unforeseen events there by stabilizing the income of farmers to ensure their continuance in farming and protecting farmers from production risks.
- PMEGP is a central sector scheme administered by the Ministry of Micro, Small and Medium Enterprises the Scheme is being implemented by Khadi and Village Industries Commission (KVIC). At the State level, the Scheme will be implemented through State KVIC Directorates, State Khadi and Village Industries Boards (KVIBs) and District Industries Centres (DICs) and banks. The main objective is to generate employment opportunities in rural as well as urban areas of the country through setting up of new self-employment ventures/projects/micro enterprises by providing assistance in the form of subsidies to individuals, Charitable Trusts, Institutions Registered under Societies Registration Act-1860, Self Help Groups (including those belonging to BPL provided that they have not availed benefits under any other Scheme) and Production based Co-operative Societies.
- Under DAY NRLM the principal objective is poverty reduction through building strong institutions of the poor, particularly women thereby enabling access to a range of financial services and livelihoods services. The programme is a means to strengthen women's self-help groups, the primary building block of the DAY-NRLM community institutional design. The mission provides a continuous handholding support to the institutions of poor for a period of 5-7 years till they come out of poverty. DAYNRLM has a provision for interest subvention, to cover the difference between the Lending Rate of the banks and 7%, on all credit from the banks/ financial institutions availed by women SHGs, for a maximum of Rs. 3,00,000 per SHG.
- Under DAY NULM, Ministry of Housing and Urban Poverty Alleviation (MoHUPA) Government of India, restructured the existing Swarna Jayanti Shahari Rozgar Yojana (SJSRY) and launched the National Urban Livelihoods Mission (NULM) in 2013. It was renamed as DAY MULM in 2016. The Self Employment Program (SEP) of NULM focuses on providing financial assistance through provision of interest subsidy on loans to support establishment of Individual & Group Enterprises and Self- Help Groups (SHGs) of urban poor.
- Under, Differential Rate of Interest Scheme, a limited financial assistance is extended at concessional rate of interest @ 4% to selected low income groups for productive endeavours initially by public sector banks and then by private sector banks also. DRI scheme is now being implemented by all Scheduled Commercial Banks. A maximum amount of loan is given up to Rs. 15,000. For physically handicapped borrowers an additional amount of Rs. 5000 for purchase of artificial limbs/Braille typewriter. Housing loan up to Rs. 20,000 for SC/ST under Indira Awas Yojana for DRI scheme.
- SRMS started off as National Scheme for Liberation and Rehabilitation of Scavengers (NSLRS) is being implemented by all Public Sector banks since 1993 with an objective to liberate all scavengers from their age old profession and engage them in alternative and dignified occupations. Since 2005-06 the NSLRS was renamed as Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS) with an objective to rehabilitate the remaining scavengers and their dependents. The Scheme was further revised with the enactment of "Prohibition of Employment as Manual Scavengers and their "Rehabilitation Act, 2013"under this scheme. The beneficiaries are provided cash assistance as well as loans at concessional rates of interest.

- Under "Housing for all" vision of the Government of India Pradhan Mantri Awas Yojana (Urban) [PMAY(U)] is being implemented with effect from June 2015, as Centrally Sponsored Scheme (CSS) to provide housing needs of identified urban poor, economically weaker section and low income group etc., through Credit Linked Subsidy Scheme subject certain criteria specified in this regard.
- Under Pradhan Mantri Awas Yojana – Gramin scheme, housing needs of rural poor identified by local bodies, is provided through home loans which are eligible for a 3% concession on interest rates on housing loans of upto Rs.2 lakh.
- The Stand-up India Scheme was launched by the Government to promote entrepreneurship spirit among women, especially SC & ST category i.e. those sections of the population facing significant hurdles due to lack of advice/mentorship as well as inadequate and delayed credit. The scheme encourages green-field ventures by women including those belonging to SC/ST category by providing loans at concessional rates and various supports.

GLOSSARY

- PMEGP, KVIC, DICs, SHGs, Micro Enterprises, Village Industries, Subsidy, Margin Money, Entrepreneurship Development Programme, Skill Development Programme, Vocational Training, DAY- NRLM, NULM, SEP, ULBs., SLBCs, DCC,BLBC, DRI Scheme, SRMS, PMJDY, MUDRA, APY, PMVVY, NEF, PMJJBY, PMBBY, PMFBY, PMSBY, SEP – I, SEP – G, SEP – SHGs, DAY-NULM, ULB.

SELF-TEST QUESTIONS

1. Fill in the blanks.
   a. At the national level, the PMEGP Scheme is being implemented by .....
   b. ..... programme will be rolled out in a phased manner over the next 7-8 years.
   c. NULM focuses on providing financial assistance through provision of interest subsidy on loans to support establishment of ..... and ..... of urban poor.
   d. Under DRI the maximum amount of loan fixed is .....
   e. Identified manual scavengers, one from each family, would be eligible for receiving cash assistance of .....
   f. The slogan for PMJDY is .....
   g. The 3 categories under MUDRA scheme are ....., ..., ...
   h. Start-up India scheme provides loans for ..... enterprises started by SC/ST/ women entrepreneurs.
   i. APY stands for .....
   j. Under Beti Bachao, Beti Padhao scheme, the saving account opened is .....
   k. Under PMVVY for monthly pension of Rs. 1000 the purchase price is Rs. .....
   l. Minimum educational qualification for availing loan under NULM is .....
   m. Maximum amount that can be deposited per year under Sukanya Samriddhi account is .....

.....

2. Write True or False

   a. Under PMEGP Individuals, should be above 18 years of age and have passed VIII Std. in case of project above Rs.10.00 lakhs in manufacturing and above Rs. 5lakh for Service Sector.

   b. Under NRLM, Women SHGs will also get additional interest subvention of 3% on prompt payment, reducing the effective rate of interest to 4%.

   c. Under NULM, the percentage of women beneficiaries under SEP shall not be less than 30%.

   d. Under DRI scheme, individuals whose family income does not exceed Rs. 24,000 p.a. in rural areas and Rs. 18,000 in Semi-urban and Urban areas can be given a loan.

   e. Under SRMS loan up to a maximum of Rs. 10 lakh will be admissible under the scheme and Rs. 15 lakhs in case of sanitation related projects.

   f. If purchase price is Rs. 15 lakh under PMVVY, the medical exam is mandatory.

   g. Under PMFBY, for the commercial horticulture crops, premium is 5%.

   h. APY is available to all Indian Citizens between 18 to 60 years of age.

   i. MUDRA bank works under SIDBI

   j. Under PMJDY, overdraft facility of Rs.10,000 is available.

3. Answer the following question

   a. Explain the documents required in PMJDY scheme?

   b. Explain MUDRA Yojana in detail.

   c. What do you understand by MUDRA Card?

   d. Explain features of National Equity Fund.

   e. What do you understand by Sukanya Samriddhi Account Yojana?

   f. Explain Pradhan Mantri Jeevan Jyoti Bima Yojana in detail.

   g. Explain benefits and eligibility of Atal Pension Yojana.

   h. Explain benefits and eligibility of Pradhan Mantri Vaya Vandana Yojana.

   i. Which farmers are covered under PMFBY?

   j. Explain : SEP – I, SEP – G, SEP - SHGs

Lesson 11
Consumer Protection

LESSON OUTLINE

- Introduction Consumer Protection Act, 1986
- Establishment of Consumer Protection Council
- Operational Aspects of Consumer Protection Act
- Banking Ombudsman
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

To have an understanding of

- Consumer Protection.
- Bodies established for Consumer Protection.
- Procedures relating to filing complaints.
- Provisions of the COPRAAct.
- Decisions on cases.
- Banking Ombudsman.
- Operations of the Scheme.
- Grounds for complaint.
- Decision on cases.

INTRODUCTION AND BACKGROUND

Consumer Protection Act, 1986 ('COPRA') is an act of the Parliament of India enacted in 1986 to protect the interest of consumers in India. It makes provision for the establishment of consumer councils and other authorities for the settlement of consumers' disputes and for matters connected therewith. A comprehensive amendment has been passed on December 17, 2002 and implemented w.e.f. March 15, 2003. The new Consumer Protection Act, 2019 (No. 35 of 2019) had received the assent of the President of India on 9.8.2019 and salient provisions of the newly enacted legislation are discussed in this lesson.

This statute is regarded as the Magna Carta in the field of consumer protection for checking the unfair trade practices and 'defect in goods' and 'deficiencies in services' as far as India is concerned. It has significantly impacted how businesses approach consumer complaints and empowered consumers to great extent.

CONSTITUTION OF CONSUMER PROTECTION COUNCILS/ AUTHORITY/ REDRESSAL FORUM

Central Consumer Protection Council

(*1*) The Central Government shall, by notification, establish with effect from such date as it may specify in that notification, the Central Consumer Protection Council to be known as the Central Council.

(*2*) The Central Council shall be an advisory council and consist of the following members, namely:—

(*a*) the Minister-in-charge of the Department of Consumer Affairs in the Central Government, who shall be the Chairperson; and

(*b*) such number of other official or non-official members representing such interests as may be prescribed.

(3) The Central Council shall meet as and when necessary, but at least one meeting of the Council shall be held every year.

State Consumer Protection Council

(*1*) Every State Government shall, by notification, establish with effect from such date as it may specify in such notification, a State Consumer Protection Council for such State to be known as the State Council.

(*2*) The State Council shall be an advisory council and consist of the following members,namely:—

(*a*) the Minister-in-charge of Consumer Affairs in the State Government who shall be the Chairperson;

(*b*) such number of other official or non-official members representing such interests as may be prescribed;

(*c*) such number of other official or non-official members, not exceeding ten, as may be nominated by the Central Government.

(*3*) The State Council shall meet as and when necessary but not less than two meetingsshall be held every year.

(*4*) The State Council shall meet at such time and place as the Chairperson may think fit and shall observe such procedure in regard to the transaction of its business, as may be prescribed.

(5) The objects of every State Council shall be to render advice on promotion and protection of consumer rights under this Act within the State.

District Consumer Protection Council

(*1*) The State Government shall, by notification, establish for every District with effect from such date as it may specify in such notification, a District Consumer Protection Council to be known as the District Council.

(*2*) The District Council shall be an advisory council and consist of the following members, namely:—

(*a*) The Collector of the district (by whatever name called), who shall be the Chairperson; and

(*b*) Such number of other official and non-official members representing such interests as may be prescribed.

(*3*) The District Council shall meet as and when necessary but not less than two meetings shall be held every year.

(*4*) The District Council shall meet at such time and place within the district as the Chairperson may think fit and shall observe such procedure in regard to the transaction of its business as may be prescribed.

(*5*) The objects of every District Council shall be to render advice on promotion and protection of consumer rights under this Act within the district.

CENTRAL CONSUMER PROTECTION AUTHORITY

(*1*) The Central Government shall, by notification, establish with effect from such date as it may specify in that notification, a Central Consumer Protection Authority to be known as the Central Authority to regulate matters relating to violation of rights of consumers, unfair trade practices and false or misleading advertisements which are prejudicial to the interests of public and consumers and to promote, protect and enforce the rights of consumers as a class.

(*2*) The Central Authority shall consist of a Chief Commissioner and such number of other Commissioners as may be prescribed, to be appointed by the Central Government to exercise the powers and discharge the functions under this Act.

(*3*) The headquarters of the Central Authority shall be at such place in the National Capital Region of Delhi, and it shall have regional and other offices in any other place in India as the Central Government may decide.

(*4*) The Central Government may, by notification, make rules to provide for the qualifications for appointment, method of recruitment, procedure for appointment, term of office, salaries and allowances, resignation, removal and other terms and conditions of the service of the Chief Commissioner and Commissioners of the Central Authority.

(*5*) No act or proceeding of the Central Authority shall be invalid merely by reason of—

(*a*) any vacancy in, or any defect in the constitution of, the Central Authority; or

(*b*) any defect in the appointment of a person acting as the Chief Commissioner or as a Commissioner; or

(*c*) any irregularity in the procedure of the Central Authority not affecting the merits of the case.

(6) The Central Government shall provide the Central Authority such number of officers and other employees as it considers necessary for the efficient performance of its functions under this Act.

(7) The salaries and allowances payable to, and the other terms and conditions of service of, the officers and other employees of the Central Authority appointed under this Act shall be such as may be prescribed.

(*8*) The Central Authority may engage, in accordance with the procedure specified by regulations, such number of experts and professionals of integrity and ability, who have special knowledge and experience in the areas of consumer rights and welfare, consumer policy, law, medicine, food safety, health, engineering, product safety, commerce, economics, public affairs or administration, as it deems necessary to assist it in the discharge of its functions under this Act.

(*9*) The Central Authority shall regulate the procedure for transaction of its business and allocation of its business amongst the Chief Commissioner and Commissioners as may be specified by regulations.

(*10*) The Chief Commissioner shall have the powers of general superintendence, direction and control in respect of all administrative matters of the Central Authority:

(*11*) The Central Authority shall have an Investigation Wing headed by a Director-

General for the purpose of conducting inquiry or investigation under this Act as may be directed by the Central Authority.

(*12*) The Central Government may appoint a Director-General and such number of Additional Director-General, Director, Joint Director, Deputy Director and Assistant Director, from amongst persons who have experience in investigation and possess such qualifications, in such manner, as may be prescribed.

(*13*) Every Additional Director-General, Director, Joint Director, Deputy Director and Assistant Director shall exercise his powers, and discharge his functions, subject to the general control, supervision and direction of the Director-General.

(*14*) The Director-General may delegate all or any of his powers to the Additional Director-General or Director, Joint Director or Deputy Director or Assistant Director, as the case may be, while conducting inquiries or investigations under this Act.

(*15*) The inquiries or the investigations made by the Director- General shall be submitted to the Central Authority in such form, in such manner and within such time, as may be specified by regulations.

(*16*) The District Collector (by whatever name called) may, on a complaint or on a reference made to him by the Central Authority or the Commissioner of a regional office, inquire into or investigate complaints regarding violation of rights of consumers as a class, on matters relating to violations of consumer rights, unfair trade practices and false or misleading advertisements, within his jurisdiction and submit his report to the Central Authority or to the Commissioner of a regional office, as the case may be.

(*17*) A complaint relating to violation of consumer rights or unfair trade practices or false or misleading advertisements which are prejudicial to the interests of consumers as a class, may be forwarded either in writing or in electronic mode, to any one of the authorities, namely, the District Collector or the Commissioner of regional office or the Central Authority.

(*18*) The Central Authority shall—

(*a*) protect, promote and enforce the rights of consumers as a class, and prevent violation of consumers rights under this Act;

(*b*) prevent unfair trade practices and ensure that no person engages himself in unfair trade practices;

(*c*) ensure that no false or misleading advertisement is made of any goods or services which contravenes the provisions of this Act or the rules or regulations made there under;

(*d*) ensure that no person takes part in the publication of any advertisement which is false or misleading.

(*e*) inquire or cause an inquiry or investigation to be made into violations of consumer rights or unfair trade practices, either *suo motu* or on a complaint received or on the directions from the Central Government;

(*f*) file complaints before the District Commission, the State Commission or the National Commission, as the case may be, under this Act;

(*g*) intervene in any proceedings before the District Commission or the State Commission or the National Commission, as the case may be, in respect of any allegation of violation of consumer rights or unfair trade practices;

(*h*) review the matters relating to, and the factors inhibiting enjoyment of, consumer rights, including safeguards provided for the protection of consumers under any other law for the time being in force and recommend appropriate remedial measures for their effective implementation;

(*i*) recommend adoption of international covenants and best international practices on consumer rights to ensure effective enforcement of consumer rights;

(*j*) undertake and promote research in the field of consumer rights;

(*k*) spread and promote awareness on consumer rights;

(*l*) encourage non-Governmental organisations and other institutions working in the field of consumer rights to co-operate and work with consumer protection agencies;

(*m*) mandate the use of unique and universal goods identifiers in such goods, as may be necessary, to prevent unfair trade practices and to protect consumers' interest;

(*n*) issue safety notices to alert consumers against dangerous or hazardous or unsafe goods or services;

(*o*) advise the Ministries and Departments of the Central and State Governments on consumer welfare measures;

(*p*) issue necessary guidelines to prevent unfair trade practices and protect consumers' interest.

The Central Authority may, after receiving any information or complaint or directions from the Central Government or of its own motion, conduct or cause to be conducted a preliminary inquiry as to whether there exists a *prima facie* case of violation of consumer rights or any unfair trade practice or any false or misleading advertisement, by any person, which is prejudicial to the public interest or to the interests of consumers and if it is satisfied that there exists a *prima facie* case, it shall cause investigation to be made by the Director-General or by the District Collector.

Where, after preliminary inquiry, the Central Authority is of the opinion that the matter is to be dealt with by a Regulator established under any other law for the time being in force, it may refer such matter to the concerned Regulator along with its report. For the purposes of investigation ,the Central Authority, the Director General or the District Collector may call to produce any document or record in his possession.

Where the Central Authority is satisfied on the basis of investigation that there is sufficient evidence to show violation of consumer rights or unfair trade practice by a person, it may pass such order as may be necessary, including –

(*a*) recalling of goods or withdrawal of services which are dangerous, hazardous or unsafe;

(*b*) reimbursement of the prices of goods or services so recalled to purchasers of such goods or services; and

(*c*) discontinuation of practices which are unfair and prejudicial to consumers' interest:

Provided that the Central Authority shall give the person an opportunity of being heard before passing an order under this section.

Where the Central Authority is satisfied after investigation that any advertisement is false or misleading and is prejudicial to the interest of any consumer or is in contravention of consumer rights, it may, by order, issue directions to the concerned trader or manufacturer or endorser or advertiser or publisher, as the case may be, to discontinue such advertisement or to modify the same in such manner and within such time as may be specified in that order.

If the Central Authority is of the opinion that it is necessary to impose a penalty in respect of such false or misleading advertisement, by a manufacturer or an endorser, it may, by order, impose on manufacturer or endorser a penalty which may extend to ten lakh rupees.

Provided that the Central Authority may, for every subsequent contravention by a manufacturer or endorser, impose a penalty, which may extend to fifty lakh rupees.

Where the Central Authority deems it necessary, it may, by order, prohibit the endorser of a false or misleading advertisement from making endorsement of any product or service for a period which may extend to one year.

Provided that the Central Authority may, for every subsequent contravention, prohibit such endorser from making endorsement in respect of any product or service for a period which may extend to three years.

Where the Central Authority is satisfied after investigation that any person is found to publish, or is a party to the publication of, a misleading advertisement, it may impose on such person a penalty which may extend to ten lakh rupees.

No endorser shall be liable to a penalty if he has exercised due diligence to verify the veracity of the claims made in the advertisement regarding the product or service being endorsed by him. No person shall be liable to such penalty if he proves that he had published or arranged for the publication of such advertisement in the ordinary course of his business:

Provided that no such defence shall be available to such person if he had previous knowledge of the order passed by the Central Authority for withdrawal or modification of such advertisement.

While determining the penalty under this section, regard shall be had to the following, namely:—

(*a*) the population and the area impacted or affected by such offence;

(*b*) the frequency and duration of such offence;

(*c*) the vulnerability of the class of persons likely to be adversely affected by such offence; and

(*d*) the gross revenue from the sales effected by virtue of such offence.

The Central Authority shall give the person an opportunity of being heard before an order under this section is passed.

For the purpose of conducting an investigation under the Act , the Director-General or any other officer authorised by him in this behalf, or the District Collector, as the case may be, may, if he has any reason to

believe that any person has violated any consumer rights or committed unfair trade practice or causes any false or misleading advertisement to be made, shall,—

(*a*) enter at any reasonable time into any such premises and search for any document or record or article or any other form of evidence and seize such document, record, article or such evidence;

(*b*) make a note or an inventory of such record or article; or

(*c*) require any person to produce any record, register or other document or article.

(*2*) The provisions of the Code of Criminal Procedure, 1973, relating to search and seizure shall apply, as far as may be, for search and seizure under this Act.

Every document, record or article seized shall be returned to the person, from whom they were seized or who produced the same, within a period of twenty days of the date of such seizure or production, as the case may be, after copies thereof or extracts therefrom certified by that person, in such manner as may be prescribed, have been taken.

Where any article seized are subject to speedy or natural decay, the Director-General or such other officer may dispose of the article in such manner as may be prescribed.

Any person aggrieved by any order passed by the Central Authority under this Act may file an appeal to the National Commission within a period of thirty days from the date of receipt of such order.

The Central Government may, after due appropriation made by Parliament by law in this behalf, make to the Central Authority grants of such sums of money as that Government may think fit for being utilised for the purposes of this Act.

The Central Authority shall maintain proper accounts and other relevant records and prepare an annual statement of accounts in such form and manner as may be prescribed in consultation with the Comptroller and Auditor-General of India.

The accounts of the Central Authority shall be audited by the Comptroller and Auditor-General of India at such intervals as may be specified by him and any expenditure incurred in connection with such audit shall be payable by the Central Authority to the Comptroller and Auditor-General of India. The Comptroller and Auditor-General of India or any other person appointed by him in connection with the audit of the accounts of the Central Authority shall have the same rights, privileges and authority in connection with such audit as the Comptroller and Auditor-General of India generally has, in connection with the audit of the Government accounts and, in particular, shall have the right to demand the production of books, accounts, connected vouchers and other documents and papers and to inspect any of the offices of the Central Authority.

The accounts of the Central Authority as certified by the Comptroller and Auditor-General of India or any other person appointed by him in this behalf together with the audit report thereon shall be forwarded annually to the Central Government which shall cause the same to be laid before each House of Parliament.

The Central Authority shall prepare once in every year, in such form, manner and at such time as may be prescribed, an annual report giving full account of its activities during the previous year and such other reports and returns, as may be directed, and copies of such report and returns shall be forwarded to the Central Government.A copy of such annual report shall be laid, as soon as may be after it is received, before each House of Parliament.

District Consumer Disputes Redressal Commission

The State Government shall, by notification, establish a District Consumer Disputes Redressal Commission, to be known as the District Commission, in each district of the State.

Provided that the State Government may, if it deems fit, establish more than one District Commission in a district.

(*2*) Each District Commission shall consist of—

(*a*) a President; and

(*b*) not less than two and not more than such number of members as may be prescribed, in consultation with the Central Government

The Central Government may, by notification, make rules to provide for the qualifications, method of recruitment, procedure for appointment, term of office, resignation and removal of the President and members of the District Commission.

The State Government may, by notification, make rules to provide for salaries and allowances and other terms and conditions of service of the President, and members of the District Commission.

If, at any time, there is a vacancy in the office of the President or member of a District Commission, the State Government may, by notification, direct—

(*a*) any other District Commission specified in that notification to exercise the jurisdiction in respect of that district also; or

(*b*) the President or a member of any other District Commission specified in that notification to exercise the powers and discharge the functions of the President or member of that District Commission also.

The State Government shall provide the District Commission with such officers and other employees as may be required to assist the District Commission in the discharge of its functions. The officers and other employees of the District Commission shall discharge their functions under the general superintendence of the President of the District Commission. The salaries and allowances payable to, and the other terms and conditions of service of, the officers and other employees of the District Commission shall be such as may be prescribed.

The District Commission shall have jurisdiction to entertain complaints where the value of the goods or services paid as consideration does not exceed one crore rupees.

Provided that where the Central Government deems it necessary so to do, it may prescribe such other value, as it deems fit.

A complaint shall be instituted in a District Commission within the local limits of whose jurisdiction,—

(*a*) the opposite party or each of the opposite parties, where there are more than one, at the time of the institution of the complaint, ordinarily resides or carries on business or has a branch office or personally works for gain; or

(*b*) any of the opposite parties, where there are more than one, at the time of the institution of the complaint, actually and voluntarily resides, or carries on business or has a branch office, or personally works for gain, provided that in such case the permission of the District Commission is given; or

(*c*) the cause of action, wholly or in part, arises; or

(*d*) the complainant resides or personally works for gain.

The District Commission shall ordinarily function in the district headquarters and may perform its functions at such other place in the district, as the State overnment may, in consultation with the State Commission, notify in the Official Gazette from time to time. A complaint, in relation to any goods sold or delivered or agreed to be sold or delivered or any service provided or agreed to be provided, may be filed with a District Commission by—

(*a*) the consumer,

(*i*) to whom such goods are sold or delivered or agreed to be sold or delivered or such service is provided or agreed to be provided; or

(*ii*) who alleges unfair trade practice in respect of such goods or service;

(*b*) any recognised consumer association, whether the consumer to whom such goods are sold or delivered or agreed to be sold or delivered or such service is provided or agreed to be provided, or who alleges unfair trade practice in respect of such goods or service, is a member of such association or not;

(*c*) one or more consumers, where there are numerous consumers having the same interest, with the permission of the District Commission, on behalf of, or for the benefit of, all consumers so interested; or

(*d*) the Central Government, the Central Authority or the State Government, as the case may be.

Provided that the complaint under this sub-section may be filed electronically in such manner as may be prescribed.

Explanation.—For the purposes of this sub-section, "recognised consumer association" means any voluntary consumer association registered under any law for the time being in force.

Every complaint filed shall be accompanied with such fee and payable in such manner, including electronic form, as may be prescribed.

Every proceeding before the District Commission shall be conducted by the President of that Commission and at least one member thereof, sitting together:

Provided that where a member, for any reason, is unable to conduct a proceeding till it is completed, the President and the other member shall continue the proceeding from the stage at which it was last heard by the previous member.

On receipt of a complaint the District Commission may, by order, admit the complaint for being proceeded with or reject the same.

Provided that a complaint shall not be rejected unless an opportunity of being heard has been given to the complainant.

Provided further that the admissibility of the complaint shall ordinarily be decided within twenty-one days from the date on which the complaint was filed.

Where the District Commission does not decide the issue of admissibility of the complaint within the period so specified, it shall be deemed to have been admitted.

Where the parties agree for settlement by mediation and give their consent in writing, the District Commission shall, within five days of receipt of such consent, refer the matter for mediation. The District Commission shall, on admission of a complaint, or in respect of cases referred for mediation on failure of settlement by mediation, proceed with such complaint.

Where the complaint relates to any goods, the District Commission shall,—

(*a*) refer a copy of the admitted complaint, within twenty-one days from the date of its admission to the opposite party mentioned in the complaint directing him to give his version of the case within a period of thirty days or such extended period not exceeding fifteen days as may be granted by it.

(*b*) if the opposite party on receipt of a complaint referred to him under clause (*a*) denies or disputes the allegations contained in the complaint, or omits or fails to take any action to represent his case within the time given by the District Commission, proceed to settle the consumer dispute .

(*c*) if the complaint alleges a defect in the goods which cannot be determined without proper analysis or test of the goods, obtain a sample of the goods from the complainant, seal it and authenticate it in the manner as may be prescribed and refer the sample so sealed to the appropriate laboratory along with a direction that such laboratory to make an analysis or test, whichever may be necessary, with a view to finding out whether such goods suffer from any defect alleged in the complaint or from any other defect and to report its findings thereon to the District Commission within a period of forty-five days of the receipt of the reference or within such extended period as may be granted by it;

(*d*) before any sample of the goods is referred to any appropriate laboratory under clause (*c*), require the complainant to deposit to the credit of the Commission such fees as may be specified, for payment to the appropriate laboratory for carrying out the necessary analysis or test in relation to the goods in question;

(*e*) remit the amount deposited to its credit under clause (*d*) to the appropriate laboratory to enable it to carry out the analysis or test mentioned in clause (*c*) and on receipt of the report from the appropriate laboratory, it shall forward a copy of the report along with such remarks as it may feel appropriate to the opposite party;

(*f*) if any of the parties disputes the correctness of the findings of the appropriate laboratory, or disputes the correctness of the methods of analysis or test adopted by the appropriate laboratory, require the opposite party or the complainant to submit in writing his objections with regard to the report made by the appropriate laboratory;

(*g*) give a reasonable opportunity to the complainant as well as the opposite party of being heard as to the correctness or otherwise of the report made by the appropriate laboratory and also as to the objection made in relation thereto

If the foregoing procedures can not the adopted by the District Commission in case of the complaint admitted by it in relation to goods or if the complaint relates to any services, it shall —

(*a*) refer a copy of such complaint to the opposite party directing him to give his version of the case within a period of thirty days or such extended period not exceeding fifteen days as may be granted by the District Commission; and

(*b*) if the opposite party, on receipt of a copy of the complaint, referred to him under clause (*a*) denies or disputes the allegations contained in the complaint, or omits or fails to take any action to represent his case within the time given by the District Commission, it shall proceed to settle the consumer dispute

(*i*) on the basis of evidence brought to its notice by the complainant and the opposite party, if the opposite party denies or disputes the allegations contained in the complaint, or

(*ii*) *ex parte* on the basis of evidence brought to its notice by the complainant, where the opposite party omits or fails to take any action to represent his case within the time given by the Commission;

(*c*) decide the complaint on merits if the complainant fails to appear on the date of hearing.

The District Commission may, by order, require an electronic service provider to provide such information, documents or records, as may be specified in that order.

Every complaint shall be heard by the District Commission on the basis of affidavit and documentary evidence placed on record:

Provided that where an application is made for hearing or for examination of parties in person or through video conferencing, the District Commission may, on sufficient cause being shown, and after recording its reasons in writing, allow the same.

Every complaint shall be disposed of as expeditiously as possible and endeavour shall be made to decide the complaint within a period of three months from the date of receipt of notice by opposite party where the complaint does not require analysis or testing of commodities and within five months if it requires analysis or testing of commodities:

No adjournment shall ordinarily be granted by the District Commission unless sufficient cause is shown and the reasons for grant of adjournment have been recorded in writing by the Commission. The District Commission shall make such orders as to the costs occasioned by the adjournment as may be specified by regulations. In the event of a complaint being disposed of after the period so specified, the District Commission shall record in writing, the reasons for the same at the time of disposing of the said complaint.

Where during the pendency of any proceeding before the District Commission, if it appears necessary, it may pass such interim order as is just and proper in the facts and circumstances of the case and the District Commission shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 while trying a suit in respect of the following matters, namely:—

(*a*) the summoning and enforcing the attendance of any defendant or witness and examining the witness on oath;

(*b*) requiring the discovery and production of any document or other material object as evidence;

(*c*) receiving of evidence on affidavits;

(*d*) the requisitioning of the report of the concerned analysis or test from the appropriate laboratory or from any other relevant source;

(*e*) issuing of commissions for the examination of any witness, or document; and

(*f*) any other matter which may be prescribed by the Central Government.

In the event of death of a complainant who is a consumer or of the opposite party against whom the complaint has been filed, the provisions of Order XXII of the First Schedule to the Code of Civil Procedure, 1908 shall apply subject to the modification that every reference therein to the plaintiff and the defendant shall be construed as reference to a complainant or the opposite party, as the case may be.

Where the District Commission is satisfied that the goods complained against suffer from any of the defects specified in the complaint or that any of the allegations contained in the complaint about the services or any unfair trade practices, or claims for compensation under product liability are proved, it shall issue an order to the opposite party directing him to do one or more of the following, namely:—

(*a*) to remove the defect pointed out by the appropriate laboratory from the goods in question;

(*b*) to replace the goods with new goods of similar description which shall be free from any defect;

(*c*) to return to the complainant the price, or, as the case may be, the charges paid by the complainant

along with such interest on such price or charges as may be decided;

(*d*) to pay such amount as may be awarded by it as compensation to the consumer for any loss or injury suffered by the consumer due to the negligence of the opposite party:

Provided that the District Commission shall have the power to grant punitive damages in such circumstances as it deems fit;

(*e*) to pay such amount as may be awarded by it as compensation in a product liability action.

(*f*) to remove the defects in goods or deficiencies in the services in question;

(*g*) to discontinue the unfair trade practice or restrictive trade practice and not to repeat them;

(*h*) not to offer the hazardous or unsafe goods for sale;

(*i*) to withdraw the hazardous goods from being offered for sale;

(*j*) to cease manufacture of hazardous goods and to desist from offering services which are hazardous in nature;

(*k*) to pay such sum as may be determined by it, if it is of the opinion that loss or injury has been suffered by a large number of consumers who are not identifiable conveniently:

Provided that the minimum amount of sum so payable shall not be less than twenty-five per cent. of the value of such defective goods sold or service provided, as the case may be, to such consumers;

(*l*) to issue corrective advertisement to neutralise the effect of misleading advertisement at the cost of the opposite party responsible for issuing such misleading advertisement;

(*m*) to provide for adequate costs to parties; and

(*n*) to cease and desist from issuing any misleading advertisement.

In any proceeding conducted by the President and a member and if they differ on any point or points, they shall state the point or points on which they differ and refer the same to another member for hearing on such point or points and the opinion of the majority shall be the order of the District Commission:

Provided that the other member shall give his opinion on such point or points referred to him within a period of one month from the date of such reference. Every order made by the District Commission shall be signed by the President and the member who conducted the proceeding:

Provided that where the order is made as per majority opinion ,such order shall also be signed by the other member.

The District Commission shall have the power to review any of the order passed by it if there is an error apparent on the face of the record, either of its own motion or on an application made by any of the parties within thirty days of such order.

Any person aggrieved by an order made by the District Commission may prefer an appeal against such order to the State Commission on the grounds of facts or law within a period of forty-five days from the date of the order, in such form and manner, as may be prescribed:

Provided that the State Commission may entertain an appeal after the expiry of the said period of forty-five days, if it is satisfied that there was sufficient cause for not filing it within that period:

Provided further that no appeal by a person, who is required to pay any amount in terms of an order of the

District Commission, shall be entertained by the State Commission unless the appellant has deposited fifty per cent. of that amount in the manner as may be prescribed:

State Consumer Disputes Redressal Commission

The State Government shall, by notification, establish a State Consumer Disputes Redressal Commission, to be known as the State Commission, in the State.

The State Commission shall ordinarily function at the State capital and perform its functions at such other places as the State Government may in consultation with the State Commission notify in the Official Gazette:

Provided that the State Government may, by notification, establish regional benches of the State Commission, at such places, as it deems fit.

(*3*) Each State Commission shall consist of—

(*a*) a President; and

(*b*) not less than four or not more than such number of members as may be prescribed in consultation with the Central Government

The Central Government may, by notification, make rules to provide for the qualification for appointment, method of recruitment, procedure of appointment, term of office, resignation and removal of the President and members of the State Commission. The State Government may, by notification, make rules to provide for salaries and allowances and other terms and conditions of service of the President and members of the State Commission. The State Government shall determine the nature and categories of the officers and other employees required to assist the State Commission in the discharge of its functions and provide the Commission with such officers and other employees as it may think fit.

The officers and other employees of the State Commission shall discharge their functions under the general superintendence of the President.The salaries and allowances payable to and the other terms and conditions of service of, the officers and other employees of the State Commission shall be such as may be prescribed.

The State Commission shall have jurisdiction—

(*a*) to entertain—

(*i*) complaints where the value of the goods or services paid as consideration, exceeds rupees one crore, but does not exceed rupees ten crore:

Provided that where the Central Government deems it necessary so to do, it may prescribe such other value, as it deems fit;

(*ii*) complaints against unfair contracts, where the value of goods or services paid as consideration does not exceed ten crore rupees;

(*iii*) appeals against the orders of any District Commission within the State; and

(*b*) to call for the records and pass appropriate orders in any consumer dispute which is pending before or has been decided by any District Commission within the State, where it appears to the State Commission that such District Commission has exercised a jurisdiction not vested in it by law, or has failed to exercise a jurisdiction so vested or has acted in exercise of its jurisdiction illegally or with material irregularity.

The jurisdiction, powers and authority of the State Commission may be exercised by Benches thereof, and a Bench may be constituted by the President with one or more members as the President may deem fit:

Provided that the senior-most member shall preside over the Bench.

Where the members of a Bench differ in opinion on any point, the points shall be decided according to the opinion of the majority, if there is a majority, but if the members are equally divided, they shall state the point or points on which they differ, and make a reference to the President who shall either hear the point or points himself or refer the case for hearing on such point or points by one or more of the other members and such point or points shall be decided according to the opinion of the majority of the members who have heard the case, including those who first heard it:

Provided that the President or the other members, as the case may be, shall give opinion on the point or points so referred within a period of one month from the date of such reference.

A complaint shall be instituted in a State Commission within the limits of whose jurisdiction,—

(*a*) the opposite party or each of the opposite parties, where there are more than one, at the time of the institution of the complaint, ordinarily resides or carries on business or has a branch office or personally works for gain; or

(*b*) any of the opposite parties, where there are more than one, at the time of the institution of the complaint, actually and voluntarily resides, or carries on business or has a branch office or personally works for gain, provided in such case, the permission of the State Commission is given; or

(*c*) the cause of action, wholly or in part, arises; or

(*d*) the complainant resides or personally works for gain.

On the application of the complainant or of its own motion, the State Commission may, at any stage of the proceeding, transfer any complaint pending before a District Commission to another District Commission within the State if the interest of justice so requires.

The State Commission shall have the power to review any of the order passed by it if there is an error apparent on the face of the record, either of its own motion or on an application made by any of the parties within thirty days of such order.

Any person aggrieved by an order made by the State Commission prefer an appeal against such order to the National Commission within a period of thirty days from the date of the order in such form and manner as may be prescribed:

Provided that the National Commission shall not entertain the appeal after the expiry of the said period of thirty days unless it is satisfied that there was sufficient cause for not filing it within that period:

Provided further that no appeal by a person, who is required to pay any amount in terms of an order of the State Commission, shall be entertained by the National Commission unless the appellant has deposited fifty per cent. of that amount in the manner as may be prescribed. An appeal shall lie to the National Commission from any order passed in appeal by any State Commission, if the National Commission is satisfied that the case involves a substantial question of law.

In an appeal involving a question of law, the memorandum of appeal shall precisely state the substantial question of law involved in the appeal. Where the National Commission is satisfied that a substantial question of law is involved in any case, it shall formulate that question and hear the appeal on that question:

Provided that nothing shall be deemed to take away or abridge the power of the National Commission to hear, for reasons to be recorded in writing, the appeal on any other substantial question of law, if it is satisfied that the case involves such question of law. An appeal may lie to the National Commission from an order passed *ex parte* by the State Commission.

An appeal filed before the State Commission or the National Commission, as the case may be, shall be heard as expeditiously as possible and every endeavour shall be made to dispose of the appeal within a period of ninety days from the date of its admission:

Provided that no adjournment shall ordinarily be granted by the State Commission or the National Commission, as the case may be, unless sufficient cause is shown and the reasons for grant of adjournment have been recorded in writing by such Commission. The State Commission or the National Commission, as the case may be, shall make such orders as to the costs occasioned by the adjournment, as may be specified by regulations. In the event of an appeal being disposed of after the period so specified, the State Commission or the National Commission, as the case may be, shall record in writing the reasons for the same at the time of disposing of the said appeal.

National Consumer Disputes Redressal Commission

The Central Government shall, by notification, establish a National Consumer Disputes Redressal Commission, to be known as the National Commission.

The National Commission shall ordinarily function at the National Capital Region and perform its functions at such other places as the Central Government may in consultation with the National Commission notify in the Official Gazette.

Provided that the Central Government may, by notification, establish regional Benches of the National Commission, at such places, as it deems fit.

The National Commission shall consist of—

(*a*) a President; and

(*b*) not less than four and not more than such number of members as may be prescribed.

The Central Government may, by notification, make rules to provide for qualifications, appointment, term of office, salaries and allowances, resignation, removal and other terms and conditions of service of the President and members of the National Commission:

Provided that the President and members of the National Commission shall hold office for such term as specified in the rules made by the Central government but not exceeding five years from the date on which he enters upon his office and shall be eligible for re-appointment. No President or members shall hold office as such after he has attained such age as specified in the rules made by the Central Government which shall not exceed,—

(*a*) in the case of the President, the age of seventy years;

(*b*) in the case of any other member, the age of sixty-seven years.

Neither the salary and allowances nor the other terms and conditions of service of President and members of the National Commission shall be varied to his disadvantage after his appointment.

Mediation

The State Government shall establish, by notification, a consumer mediation cell to be attached to each of the District Commissions and the State Commissions of that State. The Central Government shall establish, by notification, a consumer mediation cell to be attached to the National Commission and each of the regional Benches. A consumer mediation cell shall consist of such persons as may be prescribed.

Every consumer mediation cell shall maintain—

(*a*) a list of empanelled mediators;

(*b*) a list of cases handled by the cell;

(*c*) record of proceeding; and

(*d*) any other information as may be specified by regulations.

Every consumer mediation cell shall submit a quarterly report to the District Commission, State Commission or the National Commission to which it is attached, in the manner specified by regulations.

For the purpose of mediation, the National Commission or the State Commission or the District Commission, as the case may be, shall prepare a panel of the mediators to be maintained by the consumer mediation cell attached to it, on the recommendation of a selection committee consisting of the President and a member of that Commission. The qualifications and experience required for empanelment as mediator, the procedure for empanelment, the manner of training empanelled mediators, the fee payable to empanelled mediator, the terms and conditions for empanelment, the code of conduct for empanelled mediators, the grounds on which, and the manner in which, empanelled mediators shall be removed or empanelment shall be cancelled and other matters relating thereto, shall be such as may be specified by regulations. The panel of mediators prepared shall be valid for a period of five years, and the empanelled mediators shall be eligible to be considered for re-empanelment for another term, subject to such conditions as may be specified by regulations. The District Commission, the State Commission or the National Commission shall,while nominating any person from the panel of mediators , consider his suitability for resolving the consumer dispute involved.

It shall be the duty of the mediator to disclose—

(*a*) any personal, professional or financial interest in the outcome of the consumer dispute;

(*b*) the circumstances which may give rise to a justifiable doubt as to his independence or impartiality; and

(*c*) such other facts as may be specified by regulations.

Where the District Commission or the State Commission or the National Commission, as the case may be, is satisfied, on the information furnished by the mediator or on the information received from any other person including parties to the complaint and after hearing the mediator, it shall replace such mediator by another mediator. The mediation shall be held in the consumer mediation cell attached to the District Commission, the State Commission or the National Commission, as the case may be. Where a consumer dispute is referred for mediation by the District Commission or the State Commission or the National Commission, as the case may be, the mediator nominated by such Commission shall have regard to the rights and obligations of the parties, the usages of trade, if any, the circumstances giving rise to the consumer dispute and such other relevant factors, as he may deem necessary and shall be guided by the principles of natural justice while carrying out mediation. The mediator so nominated shall conduct mediation within such time and in such manner as may be specified by regulations.

Pursuant to mediation, if an agreement is reached between the parties with respect to all of the issues involved in the consumer dispute or with respect to only some of the issues, the terms of such agreement shall be reduced to writing accordingly, and signed by the parties to such dispute or their authorised representatives.

The mediator shall prepare a settlement report of the settlement and forward the signed agreement along with such report to the concerned Commission. Where no agreement is reached between the parties within the specified time or the mediator is of the opinion that settlement is not possible, he shall prepare his report accordingly and submit the same to the concerned Commission.

The District Commission or the State Commission or the National Commission, as the case may be, shall, within seven days of the receipt of the settlement report, pass suitable order recording such settlement of consumer dispute and dispose of the matter accordingly. Where the consumer dispute is settled only in part, the District Commission or the State Commission or the National Commission, as the case may be, shall record settlement of the issues which have been so settled and continue to hear other issues involved in such consumer dispute. Where the consumer dispute could not be settled by mediation, the District Commission or the State Commission or the National Commission, as the case may be, shall continue to hear all the issues involved in such consumer dispute.

Product liability

Product liability shall apply to every claim for compensation under a product liability action by a complainant for any harm caused by a defective product manufactured by a product manufacturer or serviced by a product service provider or sold by a product seller. A product liability action may be brought by a complainant against a product manufacturer or a product service provider or a product seller, as the case may be, for any harm caused to him on account of a defective product.

A product manufacturer shall be liable in a product liability action, if—

(*a*) the product contains a manufacturing defect; or

(*b*) the product is defective in design; or

(*c*) there is a deviation from manufacturing specifications; or

(*d*) the product does not conform to the express warranty; or

(*e*) the product fails to contain adequate instructions of correct usage to prevent any harm or any warning regarding improper or incorrect usage.

The major definations are as under:

- A **Consumer** is a person who buys goods or hires services, for a price (consideration) for use and not for resale. Any user of such goods and services, with the permission of the buyer is also a consumer.

  But does not include a person who avails of such services for any commercial purposes. (for the purpose of this clause, 'commercial purpose' does not include use by a person of goods bought and used by him and services availed by him exclusively for the purpose of earning his livelihood by means of self-employment).

- All goods and services including banking, insurance, transport, processing etc. in private, public and cooperative sector are covered.

- A consumer individually or jointly, any voluntary consumer organization, central or state government can fi le a complaint. A complainant also means one or more consumers, where there are numerous consumers having the same interest. In case of death of a consumer, his legal heir or representative can fi le a complaint.

- "Complaint" means any allegation in writing made by a complainant that :

  i) An unfair trade practice or a restrictive trade practices has been adopted by any trader or a service provider.

  ii) the goods bought by him or agreed to be bought by him ; suffer from one or more defects.

iii) services hired / availed / agreed to be hired / availed; suffer from deficiency in any respect.

iv) a trader or service provider, as the case may be, has charged for the goods / services mentioned in the complaint a price in excess of the price – fixed by or under any law for the time being in force, displayed on the goods or any package containing such goods, displayed on the price list exhibited by him or under any law, agreed between the parties.

v) goods / services which are hazardous to life and safety when used or being offered for sale to the public.

- Limitation period is 2 years from the date of cause of action. A complaint may be entertained after the period the period specified if the complainant satisfies the District Forum, The State Commission or the National Commission, as the case may be , that he had sufficient cause for not filing the complaint with in such period:

  Provided that no such complaint shall be entertained unless the national Commission, the State Commission or the district Forum, as the case may be, records its reasons for condoning such delay.

- A simple written complaint in duplicate with name and address of complainant and opposite party, facts of the case, copies of supporting documents and relief sought should be covered. A consumer should obtain proper receipt / cash memo for purchase made and guarantee / warranty card duly stamped and signed by the seller where ever applicable.

- Relief includes removal of defect from goods, removal of deficiencies from services, replacement of new goods free from defect, refund of fee / charges / price, award of compensation for loss or injury suffered, discontinuation or non repetition of unfair and restrictive trade practices, prohibition of sale of goods of hazardous nature, providing for adequate cost to party.

- Penalty for non-compliance of orders include imprisonment for minimum one month and maximum three years or fine of minimum Rs. 2,000 and maximum Rs. 10,000 or both imprisonment and fine.

- Cost awarded against complaint is maximum of Rs. 10,000.00.

- Period for appeal is 30 days from the date of order.

Some complaints and decisions:

1. **The complaint** : Not provided with the withdrawal slip for the reason that the customer did not bring the pass-book.

   Decision: It was held that it is not deficiency of service on the part of the bank when the rules required that a pass-book is must for issue of withdrawal slip.

2. **The complaint**: Amount of Rs.1,85,000/- lying deposited in 3 FDs were claimed by the complainant in the capacity of beneficiary under registered will executed by the depositor. The bank directed the beneficiary to establish the authenticity of will before a competent court of law and to secure a succession certificate in order to make payment.

   Decision: No deficiency in service in asking the complainant to produce succession certificate for disbursement of amount of depositor who died leaving a will.

3. **The complaint**: A complaint was filed for increase in service charges levied by banks for collection of cheques, issue of demand drafts, processing of loans etc.

   Decision: Complaint dismissed as it does not fall within the provisions of COPRA, 1986.

4. **The complaint**: The salary cheques were not cleared by the service branch of the bank due to riots / disturbances in the city.

   Decision: It was held not amounting to deficiency of service on the part of the bank.

5. **The complaint:** The cheque book facility was refused to the appellant –customer on the ground that minimum balance in the account was not maintained at Rs. 250/- as required by the rules of the bank.

   Decision: There was no deficiency in service on the part of the bank in such refusal.

6. **The complaint**: A customer en-cashing cheque insisted on the payment of the amount of cheque only in the denomination of Rs. 100/- as a right and initially refused to accept payment in Rs. 50/- currency notes as offered by the cashier. Filed case against the Bank.

   Decision: No deficiency of service on the ground that the complainant had neither any legal right nor justification to refuse the payment in Rs. 50/- denominations the same being legal tender. The complaint was dismissed.

7. **The complaint**: The bank was alleged to have failed to issue bank guarantee despite sufficient security and the complainant suffered financial loss.

   Decision: Non-issuance of bank guarantee despite security deposit with the bank would amount to deficiency in service.

   The complainant would be entitled to interest on the security amount.

8. **The complaint**: A cheque drawn in favour of the bank itself without striking off the word bearer. Bank paid the cheque to unknown outsider considering it as bearer.

   Decision: Bank has clearly shown utter negligence in paying a huge amount Rs. 20,000/- to an unknown outsider and thus caused loss to the account holder. The customer is entitled to the loss and costs of the complaint.

9. It was held that dishonor of cheque of a customer on the ground of insufficiency of funds when the customer had sufficient balance will obviously amount to “faulty” and “imperfect” manner of performance of service.

   Decision: On the quantum of damages, it was found that there was a clear nexus between the default of the respondent bank and the denial of allotment of debentures to complainant and the bank is liable to compensate the loss.

10. **The complaint**: A complaint was filed by one of the account holders of the bank alleging that an amount of Rs. 95,000/- has been withdrawn from his account on the basis of a forged cheque. The said cheque was not from the cheque book issued to the account holder.

    Decision: The bank was guilty of deficiency of service in allowing withdrawal of amount on a forged cheque, which was not issued by the bank to the complainant.

11. **The complaint**: Dividend warrants were issued by respondent No.1 and were sought to be en-cashed by respondent No. 2, a Banker at Panjim. The appellant filed a complaint before the District Forum as the warrants were returned unpaid with the remarks, “no advice” despite a letter dispatched to them by Industrial Finance Branch of SBI, Chandigarh. Respondent no. 2 took the defense that they cannot honour dividend warrants unless they received intimation from local Head Office at Mumbai.

    Decision: The state commission however held that refusal to clear the dividend warrants was deficiency

in service as question arise in view of the letter from Industrial Finance Branch of SBI, Chandigarh. Respondent No. 2 and Respondent No. 1 were held to be jointly liable.

12. **The complaint**: In a case concerning the security at the banking premises, cash was snatched from the hands of the complainant at the gate of the respondent bank. The appellant alleges that the absence of security on the gate and the non-provision of steps like siren / alarm system etc. amounts to deficiency in service on the part of the respondent bank.

    Decision: The state commission held that the non-provision of security on the gate of the bank on the date of occurrence i.e. snatching of cash in bank premises cannot be held to be amounting to deficiency in service by the complainant.

13. **The complaint**: The bank charged, unilaterally without prior information or consent of the bank customer, for providing their services by supply of MICR cheque.

    Decision: Consumer Forum and State Commission held it as deficiency of service but National Commission held that it was related to pricing and therefore, not in jurisdiction of the Consumer For a to decide. The Supreme court held that the charges by the bank for issuance of MICR cheques, is not against the directives of RBI. The question of it, being unilateral or with the consent of each customer does not arise.

The Consumer Protection (e-Commerce) Rules, 2019

In the exercise of powers conferred by sub-section (zg)(1) of section 101 of the Consumer Protection Act,2019 (35 of 2019) the Central Government hereby makes the following rules, namely:-

1. Short Title & Commencement –

(1) These rules may be called the Consumer Protection (e-Commerce) Rules , 2019.

(2) They shall come into force on the date of their publication in the official Gazette.

2. Definitions. – (1) In these rules unless the context otherwise requires, -

a) **"Act"** means the Consumer Protection Act, 2019 (35 of 2019).

b) **"Consumer"** shall have the same meaning as provided under the Consumer Protection Act, 2019.

c) **"E-Commerce entity"** means a company incorporated under the Companies Act, 1956 or the Companies Act, 2013 or a foreign company covered under section 2 (42) of the Companies Act, 2013 or an office, branch or agency in India as provided in Section 2 (v) (iii) of FEMA 1999, owned or controlled by a person resident outside India and includes an electronic service provider or a partnership or proprietary firm, whether inventory or market place model or both and conducting the e-Commerce business;

   Provided that "e-Commerce Entity" does not include any entity or business notified otherwise by the Government for the said purpose from time to time.

d) **"Electronic Record"** means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche; (as per Information Technology Act);

e) **"Electronic Service Provider"** means a person who provides technologies or processes to enable a product seller to engage in advertising or selling of goods or services to a consumer and includes any online market place or online auction sites;

f) "**Goods"** means goods as defined in the Sale of Goods Act, 1930 .

g) **"Inventory based model of e-Commerce"** means an e-Commerce activity where inventory of goods and services is owned by e-Commerce entity and is sold to the consumers directly;

h) **"Information"** includes data, message, text, images, sound, voice, codes, computer programmes, software and databases or micro film or computer generated micro fiche; (as per Information Technology Act);

i) **"Market place model of e-Commerce"** means providing of an information technology platform by an e-Commerce entity on a digital & electronic network to act as a facilitator between buyer and seller;

j) **"Seller"** means product seller as defined in the Sale of Goods Act 1930 and includes a Service Provider;

k) **"Service"** means Service as defined in the Consumer Protection Act, 1986;

Note: Words and expressions used in these guidelines and not defined but defined in the Consumer Protection Act, 2019 shall have the meanings respectively assigned to them in the Act.

3. General Conditions for carrying out e-Commerce business.-- Every e-Commerce entity carrying out or intending to carry out e-Commerce business in India subsequent to the publication of this notification in the Gazette, shall, within 90 days, comply with the following set of conditions for the conduct of e-Commerce business:

i. It shall be a registered legal entity under the laws of India;

ii. It shall submit a self-declaration to this Department stating that it is in compliance with these Guidelines;

iii. The promoter or key management personnel should not have been convicted of any criminal offence punishable with imprisonment in last 5 years by any Court of competent jurisdiction;

iv. It shall comply with the provisions of Information Technology (Intermediaries Guidelines) Rules, 2011.

v. Payments for sale may be facilitated by the e-Commerce entity in conformity with the guidelines of the Reserve Bank of India.

vi. Details about the sellers supplying the goods and services, including identity of their business, legal name, principal geographic address, name of website, e-mail address, contact details, including clarification of their business identity, the products they sell, and how they can be contacted by customers shall be displayed in the web site.

4. Liabilities of E Commerce entity.—

(1) An E- commerce Entity shall not –

i. directly or indirectly influence the price of the goods or services and shall maintain a level playing field;

ii. adopt any trade practice which for the purpose of promoting the sale, use or supply of any goods or for the provision of any service, or composite supply, adopts any unfair methods or unfair or deceptive practice that may influence transactional decisions of consumers in relation to products and services;

iii. falsely represent themselves as consumers or post reviews about goods and services in their name; or misrepresent or exaggerate the quality or the features of goods and services.

(2) An e-Commerce Entity shall,--

i. display terms of contract between e-Commerce entity and the seller relating to return, refund, exchange,

warranty / guarantee, delivery / shipment, mode of payments, grievance redressal mechanism etc. to enable consumers to make informed decisions.

ii. ensure that the advertisements for marketing of goods or services are consistent with the actual characteristics, access and usage conditions of such of goods or services;

iii) mention safety and health care information of the goods and service advertised for sale;

iv) provide information on available payment methods; the security of those payment methods, how to use those methods; how to cancel regular payments under those methods; charge back options and any costs applicable to those payment methods;

vi) Ensure that personally identifiable information of customers are protected, and that such data collection and storage and use comply with provisions of the Information Technology (Amendment) Act, 2008.

vii) Accept return of goods if delivered late from the stated delivery schedule or delivery of defective, wrong or spurious products, and/or not of the characteristics/features as advertised;

viii) Effect all payments towards accepted refund requests of the customers within a period of maximum of 14 days.

ix) if the ecommerce entity is informed by the consumer or comes to know by itself or through another source about any counterfeit product being sold on its platform, and is satisfied after due diligence, it shall notify the seller and if the seller is unable to provide any evidence that the product is genuine, it shall take down the said listing and notify the consumers of the same

x) be held guilty of contributory or secondary liability if it makes an assurance vouching for the authenticity of the goods sold on its market place – or if it guarantees that goods are authentic.

5. Liabilities of Sellers.– Any seller selling or advertising his products or services through an e-Commerce platform shall, -

a) have prior written contract with the respective e-Commerce entity in order to undertake or solicit such sale or offer;

b) provide all information required to be provided either by law or by any other mandatory regime for disclosing contractual information and compliance with that regime will be treated as sufficient;

c) display single-figure total and break up price for the goods or service, that includes all compulsory charges such as delivery, postage, taxes and handling and conveyance charges;

d) comply with mandatory display requirements as per Legal Metrology (amendment) rules 2017 for pre-packaged commodities;

e) provide mandatory safety and health care warnings and shelf life that a consumer would get at any physical point of sale;

f) Provide fair and reasonable, delivery terms, or to directly reference the shipping policy.

g) Be responsible for any warranty/guarantee obligation of goods and services sold.

h) Be upfront about how exchange, returns and refund process works, and who bares the costs of return shipping.

6. Consumer grievance redress procedure. – Every e-Commerce entity shall,-

i) Publish on its website the name of the Grievance Officer and his contact details as well as mechanism by which users can notify their complaints about products and services availed through their web site.

ii) The Grievance Officer shall redress the complaints within one month from the date of receipt of complaint

iii) provide facility to consumers to register their complaints over phone, email or website and shall provide complaint number for tracking the complaint;

iv) Provide consumers with transparent and effective consumer protection that is not less than the level of protection offered in other forms of commerce;

v) Provide mechanism/system to converge with NCH in grievance redress process

THE BANKING OMBUDSMAN SCHEME 2006

Introduction and Background

The Banking Ombudsman, is a quasi judicial authority, was introduced under section 35A of the banking Regulation Act, 1949 by RBI with effect from 1995. It was revised in 2002. The Banking Ombudsman is an official authority to investigate the complaint from the customers and address the complaint and thereby bring the solution among the aggrieved parties. So the Banking Ombudsman plays the role of a mediator and serves the purpose of reconciliation.

The Scheme is introduced with the object of enabling resolution of complaints relating to certain services rendered by banks and to facilitate the satisfaction or settlement of such complaints.

1. Short Title, Commencement, Extent and Application

(1) This Scheme may be called the Banking Ombudsman Scheme, 2006.

(2) It shall come into force on such date as the Reserve Bank may specify.

(3) It shall extend to the whole of India.

(4) The Scheme shall apply to the business in India of a bank as defined under the Scheme.

2. Suspension of the Scheme

(1) The Reserve Bank, if it is satisfied that it is expedient so to do, may by order suspend for such period as may be specified in the order, the operation of all or any of the provisions of the Scheme, either generally or in relation to any specified bank.

(2) The Reserve Bank may, by order, extend from time to time, the period of any suspension ordered as aforesaid by such period, as it thinks fit.

3. Definitions

(1) 'award' means an award passed by the Banking Ombudsman in accordance with the Scheme.

(2) 'Appellate Authority' means the Deputy Governor in charge of the Department of the Reserve Bank implementing the Scheme

(3) 'authorised representative' means a person duly appointed and authorised by a complainant to act on his behalf and represent him in the proceedings under the Scheme before a Banking Ombudsman for consideration of his complaint.

(4) 'Banking Ombudsman' means any person appointed under Clause 4 of the Scheme.

(5) 'bank' means a 'banking company', a 'corresponding new bank', a 'Regional Rural Bank', 'State Bank of

India' a 'Subsidiary Bank' as defined in Section 5 of the Banking Regulation Act, 1949 (Act 10 of 1949), or a 'Primary Co-operative Bank' as defined in clause (c) of Section 56 of that Act and included in the Second Schedule of the Reserve Bank of India Act, 1934 (Act 2 of 1934), having a place of business in India, whether such bank is incorporated in India or outside India.

(6) 'complaint' means a representation in writing or through electronic means containing a grievance alleging deficiency in banking service as mentioned in clause 8 of the Scheme.

(7) 'Reserve Bank' means the Reserve Bank of India constituted by Section 3 of the Reserve Bank of India Act, 1934 (Act 2 of 1934).

(8) 'the scheme' means the Banking Ombudsman Scheme, 2006.

(9) 'secretariat' means the office constituted as per Sub-Clause (1) of Clause 6 of the Scheme.

(10) 'settlement' means an agreement reached by the parties either by conciliation or mediation under Clause 11 of the Scheme.

4. Appointment & Tenure

(1) The Reserve Bank may appoint one or more of its officers in the rank of Chief General Manager or General Manager to be known as Banking Ombudsmen to carry out the functions entrusted to them by or under the Scheme.

(2) The appointment of Banking Ombudsman under the above Clause may be made for a period not exceeding three years at a time.

5. Location of Office and Temporary Headquarters

(1) The office of the Banking Ombudsman shall be located at such places as may be specified by the Reserve Bank.

(2) In order to expedite disposal of complaints, the Banking Ombudsman may hold sittings at such places within his area of jurisdiction as may be considered necessary and proper by him in respect of a complaint or reference before him.

6. Secretariat

(1) The Reserve Bank shall depute such number of its officers or other staff to the office of the Banking Ombudsman as is considered necessary to function as the secretariat of the Banking Ombudsman.

(2) The cost of the Secretariat shall be borne by the Reserve Bank.

7. Powers and Jurisdiction

(1) The Reserve Bank shall specify the territorial limits to which the authority of each Banking Ombudsman appointed under Clause 4 of the Scheme shall extend.

(2) The Banking Ombudsman shall receive and consider complaints relating to the deficiencies in banking or other services fi led on the grounds mentioned in clause 8 irrespective of the pecuniary value of the deficiency in service complained and facilitate their satisfaction or settlement by agreement or through conciliation and mediation between the bank concerned and the aggrieved parties or by passing an Award as per the provisions of the Scheme.

(3) The Banking Ombudsman shall exercise general powers of superintendence and control over his Office and shall be responsible for the conduct of business there at.

(4) The Office of the Banking Ombudsman shall draw up an annual budget for itself in consultation with Reserve Bank and shall exercise the powers of expenditure within the approved budget on the lines of Reserve Bank of India Expenditure Rules, 2005.

(5) The Banking Ombudsman shall send to the Governor, Reserve Bank, a report, as on 30th June every year, containing a general review of the activities of his Office during the preceding financial year and shall furnish such other information as the Reserve Bank may direct and the Reserve Bank may, if it considers necessary in the public interest so to do, publish the report and the information received from the Banking Ombudsman in such consolidated form or otherwise as it deems fit.

8. Grounds of Complaint

(1) Any person may file a complaint with the Banking Ombudsman having jurisdiction on any one of the following grounds alleging deficiency in banking including internet banking or other services.

(a) non-payment or inordinate delay in the payment or collection of cheques, drafts, bills etc.;

(b) non-acceptance, without sufficient cause, of small denomination notes tendered for any purpose, and for charging of commission in respect thereof;

(c) non-acceptance, without sufficient cause, of coins tendered and for charging of commission in respect thereof;

(d) non-payment or delay in payment of inward remittances;

(e) failure to issue or delay in issue of drafts, pay orders or bankers' cheques;

(f) non-adherence to prescribed working hours;

(g) failure to provide or delay in providing a banking facility (other than loans and advances) promised in writing by a bank or its direct selling agents;

(h) delays, non-credit of proceeds to parties' accounts, non-payment of deposit or non-observance of the Reserve Bank directives, if any, applicable to rate of interest on deposits in any savings, current or other account maintained with a bank;

(i) complaints from Non-Resident Indians having accounts in India in relation to their remittances from abroad, deposits and other bank- related matters;

(j) refusal to open deposit accounts without any valid reason for refusal;

(k) levying of charges without adequate prior notice to the customer;

(l) non-adherence to the instructions of Reserve Bank on ATM /Debit Card and Prepaid Card operations in India by the bank or its subsidiaries on any of the following :

i. Account debited but cash not dispensed by ATMs

ii. Account debited more than once for one withdrawal in ATMs or for POS transaction

iii. Less/Excess amount of cash dispensed by ATMs

iv. Debit in account without use of the card or details of the card

v. Use of stolen/cloned cards

vi. Others

(m) non-adherence by the bank or its subsidiaries to the instructions of Reserve Bank on credit card operations on any of the following:

i. Unsolicited calls for Add-on Cards, insurance for cards etc.

ii. Charging of Annual Fees on Cards issued free for life

iii. Wrong Billing/Wrong Debits

iv. Threatening calls/ inappropriate approach of recovery by recovery agents including nonobservance of Reserve Bank guidelines on engagement of recovery agents

v. Wrong reporting of credit information to Credit Information Bureau vi. Delay or failure to review and correct the credit status on account of wrongly reported credit information to Credit Information Bureau;

(n) non-adherence to the instructions of Reserve Bank with regard to Mobile Banking / Electronic Banking service in India by the bank on any of the following:

i. delay or failure to effect online payment / Fund Transfer,

ii. unauthorized electronic payment / Fund Transfer;

(o) non-disbursement or delay in disbursement of pension (to the extent the grievance can be attributed to the action on the part of the bank concerned, but not with regard to its employees);

(p) refusal to accept or delay in accepting payment towards taxes, as required by Reserve Bank/ Government;

(q) refusal to issue or delay in issuing, or failure to service or delay in servicing or redemption of Government securities;

(r) forced closure of deposit accounts without due notice or without sufficient reason;

(s) refusal to close or delay in closing the accounts;

(t) non-adherence to the fair practices code as adopted by the bank;

(u) non-adherence to the provisions of the Code of Bank's Commitments to Customers issued by Banking Codes and Standards Board of India and as adopted by the bank ;

(v) non-observance of Reserve Bank guidelines on engagement of recovery agents by banks;

(w) non-adherence to Reserve Bank guidelines on para-banking activities like sale of insurance / mutual fund /other third party investment products by banks with regard to following :

i. improper, unsuitable sale of third party financial products

ii. non-transparency /lack of adequate transparency in sale

iii. non-disclosure of grievance redressal mechanism available

iv. delay or refusal to facilitate after sales service by banks; and

(x) any other matter relating to the violation of the directives issued by the Reserve Bank in relation to banking or other services.

(2) A complaint on any one of the following grounds alleging deficiency in banking service in respect of loans and advances may be fi led with the Banking Ombudsman having jurisdiction:

(a) non-observance of Reserve Bank Directives on interest rates;

(b) delays in sanction, disbursement or non-observance of prescribed time schedule for disposal of loan applications;

(c) non-acceptance of application for loans without furnishing valid reasons to the applicant; and

(d) non-adherence to the provisions of the fair practices code for lenders as adopted by the bank or Code of Bank's Commitment to Customers, as the case may be;

(e) non-observance of Reserve Bank guidelines on engagement of recovery agents by banks; and

(f) non-observance of any other direction or instruction of the Reserve Bank as may be specified by the Reserve Bank for this purpose from time to time.

(3) The Banking Ombudsman may also deal with such other matter as may be specified by the Reserve Bank from time to time in this behalf.

9. Procedure for Filing Complaint

(1) Any person who has a grievance against a bank on any one or more of the grounds mentioned in Clause 8 of the Scheme may, himself or through his authorised representative (other than an advocate), make a complaint to the Banking Ombudsman within whose jurisdiction the branch or office of the bank complained against is located. Provided that a complaint arising out of the operations of credit cards and other types of services with centralized operations, shall be filed before the Banking Ombudsman within whose territorial jurisdiction the billing address of the customer is located.

(2) (a) The complaint in writing shall be duly signed by the complainant or his authorized representative and shall be, as far as possible, in the form specified in Annexure 'A' or as near as thereto as circumstances admit, stating clearly:

i. the name and the address of the complainant,

ii. the name and address of the branch or office of the bank against which the complaint is made,

iii. the facts giving rise to the complaint,

iv. the nature and extent of the loss caused to the complainant, and v. the relief sought for.

(b) The complainant shall file along with the complaint, copies of the documents, if any, which he proposes to rely upon and a declaration that the complaint is maintainable under Sub-Clause (3) of this Clause.

(c) A complaint made through electronic means shall also be accepted by the Banking Ombudsman and a print out of such complaint shall be taken on the record of the Banking Ombudsman.

(d) The Banking Ombudsman shall also entertain complaints covered by this Scheme received by Central Government or Reserve Bank and forwarded to the Banking Ombudsman for disposal.

(3) No complaint to the Banking Ombudsman shall lie unless:-

(a) the complainant had, before making a complaint to the Banking Ombudsman, made a written representation to the bank and the bank had rejected the complaint or the complainant had not received any reply within a period of one month after the bank received his representation or the complainant is not satisfied with the reply given to him by the bank;

(b) the complaint is made not later than one year after the complainant has received the reply of the bank to his representation or, where no reply is received, not later than one year and one month after the date of the representation to the bank;

(c) the complaint is not in respect of the same cause of action which was settled or dealt with on

merits by the Banking Ombudsman in any previous proceedings whether or not received from the same complainant or along with one or more complainants or oneor more of the parties concerned with the cause of action ;

(d) the complaint does not pertain to the same cause of action, for which any proceedings before any court, tribunal or arbitrator or any other forum is pending or a decree or Award or order has been passed by any such court, tribunal, arbitrator or forum;

(e) the complaint is not frivolous or vexatious in nature; and

(f) the complaint is made before the expiry of the period of limitation prescribed under the Indian Limitation Act, 1963 for such claims.

10. Power to Call for Information

(1) For the purpose of carrying out his duties under this Scheme, a Banking Ombudsman may require the bank against whom the complaint is made or any other bank concerned with the complaint to provide any information or furnish certified copies of any document relating to the complaint which is or is alleged to be in its possession. Provided that in the event of the failure of a bank to comply with the requisition without sufficient cause, the Banking Ombudsman may, if he deems fi t, draw the inference that the information if provided or copies if furnished would be unfavourable to the bank.

(2) The Banking Ombudsman shall maintain confidentiality of any information or document that may come into his knowledge or possession in the course of discharging his duties and shall not disclose such information or document to any person except with the consent of the person furnishing such information or document. Provided that nothing in this Clause shall prevent the Banking Ombudsman from disclosing information or document furnished by a party in a complaint to the other party or parties to the extent considered by him to be reasonably required to comply with any legal requirement or the principles of natural justice and fair play in the proceedings.

11. Settlement of Complaint by Agreement

(1) As soon as it may be practicable to do, the Banking Ombudsman shall send a copy of the complaint to the branch or office of the bank named in the complaint, under advice to the nodal officer referred to in Sub-Clause (3) of Clause 15, and endeavour to promote a settlement of the complaint by agreement between the complainant and the bank through conciliation or mediation.

(2) For the purpose of promoting a settlement of the complaint, the Banking Ombudsman shall not be bound by any rules of evidence and may follow such procedure as he may consider just and proper, which shall, however, at the least, require the Banking Ombudsman to provide an opportunity to the complainant to furnish his/her submissions in writing along with documentary evidence within a time limit on the written submissions made by the bank. Provided, where the Banking Ombudsman is of the opinion that the documentary evidence furnished and written submissions by both the parties are not conclusive enough to arrive at a decision, he may call for a meeting of bank or the concerned subsidiary and the complainant together to promote an amicable resolution. Provided further that where such meeting is held and it results in a mutually acceptable resolution of the grievance, the proceedings of the meeting shall be documented and signed by the parties specifically stating that they are agreeable to the resolution and thereafter the Banking Ombudsman shall pass an order recording the fact of settlement annexing thereto the terms of the settlement.

(3) The Banking Ombudsman may deem the complaint as resolved, in any of the following circumstances:

a. Where the grievance raised by the complainant has been resolved by the bank or the concerned subsidiary of a bank with the intervention of the Banking Ombudsman; or

b. The complainant agrees, whether in writing or otherwise, to the manner and extent of resolution of the grievance provided by the Banking Ombudsman based on the conciliation and mediation efforts; or

c. In the opinion of the Banking Ombudsman, the bank has adhered to the banking norms and practices in vogue and the complainant has been informed to this effect through appropriate means and complainant's objections if any to the same are not received by Banking Ombudsman within the time frame provided.

(4) The proceedings before the Banking Ombudsman shall be summary in nature.

12. Award by the Banking Ombudsman

(1) If a complaint is not settled by agreement within a period of one month from the date of receipt of the complaint or such further period as the Banking Ombudsman may allow the parties, he may, after affording the parties a reasonable opportunity to present their case, pass an Award or reject the complaint.

(2) The Banking Ombudsman shall take into account the evidence placed before him by the parties, the principles of banking law and practice, directions, instructions and guidelines issued by the Reserve Bank from time to time and such other factors which in his opinion are relevant to the complaint. (3) The award shall state brief the reasons for passing the award.

(4) The Award passed under Sub-Clause (1) shall contain the direction/s, if any, to the bank for specific performance of its obligations and in addition to or otherwise, the amount, if any, to be paid by the bank to the complainant by way of compensation for any loss suffered by the complainant, arising directly out of the act or omission of the bank.

(5) Notwithstanding anything contained in Sub-Clause (4), the Banking Ombudsman shall not have the power to pass an Award directing payment of an amount towards compensation which is more than the actual loss suffered by the complainant as a direct consequence of the act of omission or commission of the bank, or two million rupees whichever is lower. The compensation that can be awarded by the Banking Ombudsman shall be exclusive of the amount involved in the dispute.

(6) The Banking Ombudsman may also award compensation in addition to the above but not exceeding rupees 0.1 million to the complainant, taking into account the loss of the complainant's time, expenses incurred by the complainant, harassment and mental agony suffered by the complainant.

(7) A copy of the Award shall be sent to the complainant and the bank.

(8) An award shall lapse and be of no effect unless the complainant furnishes to the bank concerned within a period of 30 days from the date of receipt of copy of the Award, a letter of acceptance of the Award in full and final settlement of his claim. Provided that no such acceptance may be furnished by the complainant if he has fi led an Appeal under Sub-Clause (1) of clause 14.

(9) The bank shall, unless it has preferred an appeal under Sub-Clause (1) of Clause 14, within one month from the date of receipt by it of the acceptance in writing of the Award by the complainant under Sub-Clause (8), comply with the Award and intimate compliance to the Banking Ombudsman.

13. Rejection of the Complaint

(1) The Banking Ombudsman may reject a complaint at any stage if it appears to him that the complaint made is:

(a) not on the grounds of complaint referred to in clause 8; or

(b) otherwise not in accordance with Sub-Clause (3) of clause 9; or

(c) beyond the pecuniary jurisdiction of Banking Ombudsman prescribed under clause 12(5) and 12 (6): or

(d) requiring consideration of elaborate documentary and oral evidence and the proceedings before the Banking Ombudsman are not appropriate for adjudication of such complaint; or

(e) without any sufficient cause; or

(f) that it is not pursued by the complainant with reasonable diligence; or g. in the opinion of the Banking Ombudsman there is no loss or damage or inconvenience caused to the complainant.

(2) The Banking Ombudsman, shall, if it appears at any stage of the proceedings that the complaint pertains to the same cause of action, for which any proceedings before any court, tribunal or arbitrator or any other forum is pending or a decree or Award or order has been passed by any such court, tribunal, arbitrator or forum, pass an order rejecting the complaint giving reasons thereof.

14. Appeal before the Appellate Authority

(1) Party to the complaint aggrieved by an Award under Clause 12 or rejection of a complaint for the reasons referred to in sub clauses (d) to (g) of Clause 13, may within 30 days of the date of receipt of communication of Award or rejection of complaint, prefer an appeal before the Appellate Authority;

Provided that in case of appeal by a bank, the period of thirty days for fi ling an appeal shall commence from the date on which the bank receives letter of acceptance of Award by complainant under Sub-Clause (8) of Clause 12; Provided that the Appellate Authority may, if he is satisfied that the applicant had sufficient cause for not making the appeal within time, allow a further period not exceeding 30 days;

Provided further that appeal may be filed by a bank only with the previous sanction of the Chairman or, in his absence, the Managing Director or the Executive Director or the Chief Executive Officer or any other officer of equal rank."

(2) The Appellate Authority shall, after giving the parties a reasonable opportunity of being heard (a) dismiss the appeal; or (b) allow the appeal and set aside the Award; or (c) remand the matter to the Banking Ombudsman for fresh disposal in accordance with such directions as the Appellate Authority may consider necessary or proper; or (d) modify the Award and pass such directions as may be necessary to give effect to the Award so modified; or (e) pass any other order as it may deem fit.

(3) The order of the Appellate Authority shall have the same effect as the Award passed by Banking Ombudsman under Clause 12 or the order rejecting the complaint under Clause 13, as the case may be.

15. Banks to Display Salient Features of the Scheme for Common Knowledge of Public

(1) The banks covered by the Scheme shall ensure that the purpose of the Scheme and the contact details of the Banking Ombudsman to whom the complaints are to be made by the aggrieved party are displayed prominently in all the offices and branches of the bank in such manner that a person visiting the office or branch has adequate information of the Scheme.

(2) The banks covered by the Scheme shall ensure that a copy of the Scheme is available with the designated officer of the bank for perusal in the office premises of the bank, if anyone, desires to do so and notice about the availability of the Scheme with such designated officer shall be displayed along with the notice under Sub-Clause (1) of this Clause and shall place a copy of the Scheme on their websites.

(3) The banks covered by the Scheme shall appoint Nodal Officers at their Regional/Zonal Offices and inform the respective Office of the Banking Ombudsman under whose jurisdiction the Regional/Zonal Office falls. The Nodal Officer so appointed shall be responsible for representing the bank and furnishing information to the Banking Ombudsman in respect of complaints fi led against the bank. Wherever more than one zone/region of a bank are falling within the jurisdiction of a Banking Ombudsman, one of the Nodal Officers shall be designated as the 'Principal Nodal Officer' for such zones or regions.

16. Removal of Difficulties

If any difficulty arises in giving effect to the provisions of this Scheme, the Reserve Bank may make such provisions not inconsistent with the Banking Regulation Act, 1949 or the Scheme, as it appears to it to be necessary or expedient for removing the difficulty.

17. Application of the Banking Ombudsman Schemes, 1995 and 2002

The adjudication of pending complaints and execution of the Awards already passed, before coming into force of the Banking Ombudsman Scheme, 2006, shall continue to be governed by the provisions of the respective Banking Ombudsman Schemes and instructions of the Reserve Bank issued there under.

Fee for filing complaints

Banking Ombudsman does not charge any fee for filing and resolving customer's complaints. If any loss is suffered by the complainant then complainant is limited to the amount arising directly out of the act or omission of the bank, with the ceiling of Rs. 20.00 lac.

Internal Ombudsman Scheme, 2018 for Scheduled Commercial Banks

Reserve Bank of India (RBI) had, in May 2015, advised all public-sector and select private and foreign banks to appoint Internal Ombudsman (IO) as an independent authority to review complaints that were partially or wholly rejected by the respective banks. The IO mechanism was set up with a view to strengthen the internal grievance redressal system of banks and to ensure that the complaints of the customers are redressed at the level of the bank itself by an authority placed at the highest level of bank's grievance redressal mechanism so as to minimize the need for the customers to approach other fora for redressal.

As a part of this customer-centric approach, to enhance the independence of the IO while simultaneously strengthening the monitoring system over functioning of the IO mechanism, RBI has reviewed the arrangement and issued revised directions under Section 35 A of the Banking Regulation Act, 1949 in the form of '*Internal Ombudsman Scheme, 2018*'. The Scheme covers, *inter-alia,* appointment / tenure, roles and responsibilities, procedural guidelines and oversight mechanism for the IO.

All Scheduled Commercial Banks in India having more than ten banking outlets (excluding Regional Rural Banks), are required to appoint IO in their banks. **The IO shall, *inter alia*, examine customer complaints which are in the nature of deficiency in service on the part of the bank, (including those on the grounds of complaints listed in Clause 8 of the Banking Ombudsman Scheme, 2006) that are partly or wholly rejected by the bank**. As the banks shall internally escalate all complaints, which are not fully redressed to

their respective IOs before conveying the final decision to the complainant, the customers of banks need not approach the IO directly. The implementation of *IO Scheme, 2018* will be monitored by the bank's internal audit mechanism apart from regulatory oversight by RBI.

Ombudsman Scheme for Digital Transactions, 2019

Digital transaction in the banking industry is increasing day by day. In order to deal specifically with complaints relating to digital transaction, the RBI has introduced a separate Ombudsman Scheme for digital transactions in January 2019. The salient features of the schemes are as under:

- The scheme may be called the Ombudsman Scheme for Digital transaction, 2019.

Grounds of Complaint

(1) Prepaid Payment Instruments: Non-adherence to the instructions of RBI by system Participants about Prepaid Payment Instruments on any of the following:

a) Failure in crediting merchant's account within reasonable time.

b) Failure to load funds within reasonable time in wallets / cards;

c) Unauthorised electronic fund transfer

d) Non-transfer / refusal to transfer / failure to transfer within reasonable time, the balance in the Prepaid Payment Instruments to the holder's 'own' bank account or back to source at the time of closure, expiry of validity period etc of the Prepaid Payment Instrument.

e) Failure to refund within reasonable time / refusal to refund in case of unsuccessful / returned / rejected / cancelled / transactions

f) Non-credit / delay in crediting the account of the Prepaid Payment Instrument holder as per the terms and conditions of the promotion offer(s) from time to time, if any

g) Non-adherence to any other instruction of the RBI on Prepaid Payment Instruments.

(2) Mobile / Electronic Fund Transfers: Non-adherence to the instructions of the RBI on Mobile / Electronic fund transfers by System Participants on any of the following

a) Failure to effect online payment /Fund transfer within reasonable time.

b) Unauthorized electronic fund transfer

c) Failure to act upon stop payment instructions within the time frame and under the circumstances notified to the customers within prescribed timeline.

d) Failure to reverse the amount debited from customer account in cases of failed payment transactions within prescribed timeline

e) Non-adherence to any other instruction of the RBI on mobile / Electronic fund transfers.

(3) Non-adherence to instructions of RBI / respective System Provider to System Participants, on payment instructions through Unified Payments Interface (UPI) / Bharat Bill Payment System (BBPS) / Bharat QR code / UPI QR Code on the following grounds:

a) Failure in crediting funds to the beneficiaries' account

b) Failure to return within reasonable time the payment to the originating member in case of failure to credit the funds to the beneficiary's account

c) Failure to / delay in refund of money back to account in case of transaction failure or decline transactions (failed transactions)

d) Non-adherence to any other instruction of the RBI on Payment transactions / through UPI / BBPS / Bharat QR code / UPI QR Code

(4) Non-reversal / failure to reverse within reasonable time, funds wrongly transferred to the beneficiary account due to lapse at the end of System Participant.

(5) Any other matter relating to the violation of the directives including fees / charges, if any , issued by RBI in relation to digital transactions.

The other formalities/procedures are similar to the Banking Ombudsman Scheme which is on operation and hence a separate mention has not been made about the same.

Some of the cases :

Case 1

A house in the name of B. Narayanama was given on lease to a bank in1982. Subsequently, the lady died. The Bank did not pay rent from June 1992 to February 1997. Bella Ramarao, the appellant approached the bank and the Bank immediately paid amount around Rs. 3 lac. Bella contended that the interest also should be paid for the period. The bank refused to pay the interest. The appellant approached the Banking Ombudsman.

But the complaint was rejected, holding no merit in the case as it was outside the scope of scheme. Bella approached the Andhra Pradesh High Court. The High Court rejected the appeal, finding that it was outside the jurisdiction of the banking ombudsman.

Case 2

The appellant had the cash credit facility from 1994 with respondent bank and also he had issued two cheques of which one was en-cashed and the other was dishonoured. Respondent bank averred that the appellant had overdrawn account. It was held that when there was credit in favour of the complainant, dishonour of the cheque issued by the complainant could not be said to be bona fide. Respondent bank was guilty of deficiency of service and appellant was held entitled for compensation.

Case 3

The respondent was an exporter. Under discounting agreement, he entrusted documents relating to export and bills of exchange with appellant bank to negotiate the same through a foreign bank. Respondent alleged that the bank had failed to collect money in foreign currency indicated in documents but instead collected in local currency, hence there was deficiency in service on the part of the appellant bank and hence a claim for damages was made.

In appeal the Ombudsman it was held that there was no deficiency of service on the part of the bank as appellant bank, acting for and behalf of the respondent, had negotiated the documents as provided under agreement. However the conversion of local currency in U.S. dollars became difficult on account of policy of Sudan Government. It was observed that all that was required to be done under terms of the agreement and under contract had been done by the two banks.

Case 4

The complainants had purchased a tractor after taking loan from the respondent bank. The respondent bank

did not remit the premium amount to the insurance company with which complainants have insured their tractor as a result of which a loss suffered when the tractor met with an accident could not be recovered from the insurance company.

The issue for consideration is whether non-payment of premium amount by the bank amounted to deficiency in service. It was held that when hire purchase agreement between the bank and buyer of vehicle with the help of bank loan did not contain a condition creating obligation on the part of the bank to remit premium for insurance policy, complainant buyer of vehicle could not hold bank guilty of deficiency in service.

Case 5

The complainant withdrew overdraft facility sanctioned to him by the bank only after availing facility to the extent of Rs. 1,20, 000/- the facility was availed by the complainant for business purpose. It was held that where complaint alleging banking service deficiency was found connected with commercial purpose, the consumer complaint would not be maintainable.

Case 6

The complainant had deposited amount for issue of pay order in favour of a particular fi rm. However, the said pay order was cancelled by the bank and was issued in favour of another party.

It was held that when the bank has acted in good faith in cancellation of bank pay order and issuance of fresh pay order in favour of another party on the request made by manager of the complainant firm, there would be no deficiency in service.

The Reserve Bank of India has introduced an Ombudsman Scheme for Digital Transactions, 2019 (the Scheme). It is an expeditious and cost-free apex level mechanism for resolution of complaints regarding digital transactions undertaken by customers of the System Participants as defined in the Scheme. The Scheme is being introduced under Section 18 Payment and Settlement Systems Act, 2007, with effect from January 31, 2019.

1. Who is the Ombudsman for Digital Transactions?

The Ombudsman for Digital Transactions is a senior official appointed by the Reserve Bank of India to redress customer complaints against System Participants as defined in the Scheme for deficiency in certain services covered under the grounds of complaint specified under Clause 8 of the Scheme.

2. How many Ombudsman for Digital Transactions have been appointed and where are they located?

As on date, 21 Ombudsman for Digital Transactions have been appointed with their offices located mostly in state capitals. The addresses and contact details of the offices of the Ombudsman for Digital Transactions is provided under Annex I of the Scheme.

3. Which are the Entities covered under the Scheme?

The Scheme has been made applicable to System Participants as defined in Clause 3 (11) of the Scheme.

4. What are the grounds of complaints?

As per Clause 8 of the Scheme, the Ombudsman for Digital Transactions shall receive and consider complaints on deficiency in services against System Participants defined in the Scheme on any of the following grounds:

4.(1) Prepaid Payment Instruments: Non-adherence to the instructions of Reserve Bank by System Participants about Prepaid Payment Instruments[1] on any of the following:

a. Failure in crediting merchant's account within reasonable time;

b. Failure to load funds within reasonable time in wallets / cards;

c. Unauthorized electronic fund transfer;

d. Non-Transfer / Refusal to transfer/ failure to transfer within reasonable time, the balance in the Prepaid Payment Instruments to the holder's 'own' bank account or back to source at the time of closure, expiry of validity period etc., of the Prepaid Payment Instrument;

e. Failure to refund within reasonable time / refusal to refund in case of unsuccessful / returned / rejected / cancelled / transactions;

f. Non-credit / delay in crediting the account of the Prepaid Payment Instrument holder as per the terms and conditions of the promotions offer(s) from time to time, if any;

g. Non-adherence to any other instruction of the Reserve Bank on Prepaid Payment Instruments.

4.(2) Mobile / Electronic Fund Transfers: Non-adherence to the instructions of the Reserve Bank on Mobile / Electronic fund transfers by System Participants on any of the following:

a. Failure to effect online payment / fund transfer within reasonable time;

b. Unauthorized electronic fund transfer;

c. Failure to act upon stop-payment instructions within the time frame and under the circumstances notified to the customers within prescribed timeline;

d. Failure to reverse the amount debited from customer account in cases of failed payment transactions within prescribed timeline;

e. Non-adherence to any other instruction of the Reserve Bank on Mobile/Electronic fund transfers.

4.(3) Non-adherence to instructions of Reserve Bank / respective System Provider to System Participants, on payment transactions through Unified Payments Interface (UPI) / Bharat Bill Payment System (BBPS) / Bharat QR Code / UPI QR Code on the following grounds:

a. Failure in crediting funds to the beneficiaries' account;

b. Failure to return within reasonable time the payment to the originating member in case of failure to credit the funds to the beneficiary's account;

c. Failure to / delay in refund of money back to account in case of transaction failure or declined transactions (i.e. failed transactions);

d. Non-adherence to any other instruction of the Reserve Bank on payment transactions / through Unified Payments Interface (UPI) / Bharat Bill Payment System (BBPS)/ Bharat QR Code / UPI QR Code.

4.(4) Non-reversal / failure to reverse within reasonable time, funds wrongly transferred to the beneficiary account due to lapse at the end of System Participant.

4.(5) Any other matter relating to the violation of the directives including on fees / charges, if any, issued by the Reserve Bank in relation to digital transactions.

NOTE: In respect of digital transactions done on third party platforms, it will be the responsibility of the Payment Service Provider to resolve customer disputes arising out of such transactions.

5. When can one file a complaint?

For redressal of grievance, the complainant must first approach the System Participant (as defined in the Scheme) concerned. If the System Participant does not reply within a period of one month after receipt of the complaint, or rejects the complaint, or if the complainant is not satisfied with the reply given, the complainant can file the complaint with the Ombudsman for Digital Transactions within whose jurisdiction the branch or office of the System Participant complained against, is located. For complaints arising out of services with centralized operations, the same shall be filed before the Ombudsman for Digital Transactions within whose territorial jurisdiction the billing / declared address of the customer is located.

6. When will one's complaint not be considered by the Ombudsman?

One's complaint will not be considered under the following circumstances:

a. If the System Participant against whom the complaint is registered, is not covered under the Scheme.

b. If one has not approached the System Participant concerned in the first instance for redressal of the grievance.

c. If the subject matter of the complaint is not pertaining to the grounds of complaint specified under Clause 8 of the Scheme.

d. If one has not made the complaint within one year from the date of receipt of reply from the System Participant; or if no reply is received, and the complaint to the Ombudsman is made after the lapse of more than one year and one month from the date of complaint to the System Participant. In exceptional circumstances as decided by the Ombudsman, a complaint made after the period mentioned above may be accepted by the Ombudsman, provided the complaint is made before the expiry of the period of limitation prescribed under the Indian Limitation Act, 1963 for such claims.

e. If the subject matter of the complaint is pending for disposal / has already been dealt with at any other forum like court of law, consumer court etc.

f. If the complaint is for the same subject matter that was settled through the office of the Ombudsman in any previous proceedings.

g. If the complaint is frivolous or vexatious.

h. The complaint falls under the disputes covered under Section 24 of the Payment and Settlement Systems Act, 2007.

i. The complaint pertains to dispute arising from a transaction between customers.

7. What is the procedure for filing the complaint before the Ombudsman?

One can file a complaint with the Ombudsman by writing on a plain paper and sending it to the concerned office of the Ombudsman by post/fax/hand delivery. One can also file it by email to the Ombudsman for Digital Transactions. (For contact details please click here) A complaint form along with the scheme is also available on RBI's website, though, it is not mandatory to use this format.

8. Where can one lodge his/her complaint?

One may lodge complaint with the Office of the Ombudsman for Digital Transactions within whose jurisdiction the branch or office of the System Participant complained against, is located (For jurisdiction of the Ombudsman please click here). For complaint arising out of services with centralized operations, complaints can be filed with the office of the Ombudsman for Digital Transactions within whose territorial jurisdiction the billing / declared address of the customer is located.

9. Can a complaint be filed through an authorized representative?

Yes. The complaint can be filed through an authorized representative of the complainant (other than an advocate).

10. Is there any cost involved in filing a complaint with the Office of the Ombudsman for Digital Transactions?

No. There is no charge or any fee for filing / resolving customers' complaints.

11. Is there any limit on the amount of compensation that the Ombudsman can sanction?

The compensation amount, if any, which can be awarded by the Ombudsman, for any loss suffered by the complainant, is limited to the amount arising directly out of the act or omission or commission of the System Participant, or two million rupees whichever is lower. The compensation shall be over and above the disputed amount.

12. Can compensation be claimed for mental agony and harassment?

The Ombudsman may award compensation not exceeding rupees 0.1 million to the complainant for mental agony and harassment. The Ombudsman, while giving the compensation, shall take into account the loss of time, expenses incurred by the complainant, harassment and mental anguish suffered by the complainant.

13. What are the details required in a complaint to the Ombudsman?

The complainant is required to give details such as,

a. The name and the address of the complainant

b. The name and address of the branch or office of the System Participant against whom the complaint is made;

c. The facts giving rise to the complaint, supported by documents, if any;

d. The nature and extent of the loss caused to the complainant;

e. The relief sought for; and

f. Declaration that the complaint is maintainable under Clause 9(3) of the Scheme.

14. What happens after a complaint is received by the Ombudsman?

The Ombudsman endeavours to promote settlement of the complaint through conciliation/ mediation by agreement between the complainant and the System Participant. If the terms of settlement (offered by the System Participant) are acceptable in full and final settlement of one's complaint, the Ombudsman will pass an order as per the terms of settlement which becomes binding on the System Participant and the complainant. If the System Participant is found to have adhered to the extant norms and practices in vogue and the complainant has been informed to this effect through appropriate means and complainant's objections, if any, are not received by the Ombudsman within the time frame provided, the Ombudsman may pass an order to close the complaint.

15. Can the Ombudsman reject a complaint at any stage?

Yes. As per Clause 13 of the Scheme, the Ombudsman may reject a complaint at any stage on the following grounds:

a. Complaint not on the grounds of complaint referred to in Clause 8; or

b. Not in accordance with Sub Clause (3) of Clause 9; or

c. The compensation claimed beyond the limit prescribed under Clause 12 (5) and 12 (6): or

d. Requiring consideration of elaborate documentary and oral evidence and the proceedings before the Ombudsman are not appropriate for adjudication of such complaint; or

e. Without any sufficient cause; or

f. Complaint not pursued by the complainant with reasonable diligence; or

g. In the opinion of the Ombudsman there is no loss or damage or inconvenience caused to the complainant.

16. What happens if the complaint is not settled by agreement?

If the Ombudsman is satisfied that there is indeed a deficiency of service on the part of the System Participant and the complaint is not settled by agreement within a specified period as allowed by the Ombudsman, he/she proceeds to pass an Award. Before passing an Award, the Ombudsman will provide reasonable opportunity to the complainant and the System Participant to present their case. It is upto the complainant to accept the Award in full and final settlement or reject it.

17. Is there any further recourse available if one rejects the Ombudsman's decision?

Yes, the Scheme provides the appellate mechanism for the complainant as well as the System Participant.

Any person aggrieved by an Award issued under Clause 12 or by the decision of the Ombudsman rejecting the complaint for the reasons specified in sub-clause (d) to (g) of Clause 13 of the Scheme, can approach the Appellate Authority.

The Appellate Authority is vested with a Deputy Governor-in-Charge of the department of the RBI implementing the Scheme. The address of the Appellate Authority is:

The Appellate Authority
Ombudsman Scheme for Digital Transactions
Consumer Education and Protection Department
Reserve Bank of India
First Floor, Amar Building, Fort, Mumbai 400 001.

The complainant also has the option to explore other recourse and/or remedies available as per the law.

18. Is there any time limit for filing an appeal?

One can file appeal against the Award or the decision of the Ombudsman rejecting the complaint, within 30 days of the date of receipt of communication of Award or rejection of the complaint. The Appellate Authority may, if satisfied that the applicant had sufficient cause for not making an appeal within prescribed time, may allow a further period not exceeding 30 days.

19. How does the Appellate Authority deal with the appeal?

The appellate authority may:

a. Dismiss the appeal; or,

b. Allow the appeal and set aside the Award; or,

c. Remand the matter to the Ombudsman for fresh disposal in accordance with such directions as the Appellate Authority may consider necessary or proper; or,

d. Modify the Award and pass such directions as may be necessary to give effect to the Award so modified; or,

e. Pass any other order as it may deem fit.

1 Semi-closed System PPIs: These PPIs are issued by banks (approved by RBI) and non-banks (authorized by RBI) for purchase of goods and services, including financial services, remittance facilities, etc., at a group of clearly identified merchant locations / establishments which have a specific contract with the issuer (or contract through a payment aggregator / payment gateway) to accept the PPIs as payment instruments. These instruments do not permit cash withdrawal, irrespective of whether they are issued by banks or non-banks.

LESSON ROUND UP

– Consumer Protection Bill, 1986 seeks to provide for better protection of the interests of consumers and for the purpose, to make provision for the establishment of Consumer councils and other authorities for the settlement of consumer disputes and for matter connected therewith. Bank customers are also covered under the definition of "Consumer" and can take recourse through COPRA in case of lack/ deficiencies in banking service extended to them. A customer can file a case within a period of 2 years from the date cause of action has arisen. A bank customer can file his grievance redressal case with Consumer redressal councils according to the monetary jurisdiction applicable. Consumer redressal councils have a three tier structure at District, State and National level having monetary jurisdiction of claims up to Rs. 20 lacs, Up to Rs. 100 lacs and above Rs. 100 lacs respectively. Supreme court has appeallate jurisdiction in the matter.

– Banking Ombudsman Scheme is an arrangement/scheme for resolving customer complaints against banks in an inexpensive way. This arrangement has been put in place as a consequence of Narasmiham Committee's recommendations in the year 1995. After amendment the scheme has come in to force from 2006. Under this scheme a bank customer one year time to complain to Banking Ombudsman after he/she has complained to the bank and waited for a month. If the bank has not resolved the complaint or if a customer is not satisfied with bank's stand or if the bank has not replied a customer can approach the Banking Ombudsman and as per the procedures of the scheme get his complaint resolved. The maximum compensation in a case that can be awarded by the Banking Ombudsman is the actual compensation awarded or Rs. 20 lacs whichever is lower. The decisions of the Banking Ombudsman can be appealed against with the Appellate authority by either the complainant or the bank subject to rules in this regard. Banks have also been advised to appoint an Internal Ombudsman to strengthen the internal grievance redressal system of banks and to ensure that the complaints of the customers are redressed at the level of the bank itself. In view of the rapid increase in digital banking transactions a separate Ombudsman Scheme for Digital transaction has also been introduced to resolve complaints emanating from Bank customers in this regard.

GLOSSARY

Consumer, District Forum, State Consumer Redressal Commission, National Consumer Redressal Commission, Consumer Councils, Appellate jurisdiction, Banking Ombudsman, Internal Ombudsman, Limitation period, Award, Appellate Authority, Pecuniary jurisdiction, deficiency of service, Settlement.

SELF TEST QUESTIONS

1. Fill in the blanks

   a. The different Consumer redressal for a under COPRA are__,

   __, and_____.

   b. The State Consumer Disputes Redressal Commission (SCDRC) takes up compensations cases of claims less than Rs.____lac but above Rs._____lac.

c. The Limitation period under COPRA is_____years from the date of cause of action.

d. Supreme Court has only__jurisdiction under COPRA.

e. A Banking Ombudsman is an official appointed by__.

f. The Banking Ombudsman is required to send to the_____a report, as on 30th June every year regarding his activities.

2. State True or False

a. A customer of a bank is also a consumer.

b. No filing fee is required to be paid for fi ling a case under COPRA.

c. National Redressal Commission deals with compensation matters only up to Rs. 100 lacs.

d. The limitation period for lodging a complaint with Banking Ombudsman is two years from the time a complaint is made to the bank.

e. For filing an appeal against a Banking Ombudsman's decision no permission is required.

f. The time period for resolving a matter by Banking Ombudsman is one month.

3. Answer the following questions

a. Describe the rational for the introduction of COPRA.

b. Describe the procedure of fi ling complaints with various redressal fora under COPRA.

c. Who is a Banking Ombudsman? Mention the circumstances under which complaints can be made.

d. Write brief about Appellate Authority in the Scheme of Banking Ombudsman.

FURTHER READING

1. The Consumer Protection Act, 1986 Bare Act, Government of India.
2. The Banking Ombudsman Scheme – RBI Circular & Annual Reports
3. Various decisions of Consumer Courts – Gist of Summaries published in internet

Lesson 12
Loans and Advances

LESSON OUTLINE

- Different Types of Borrowers
- Fund Based Credit Facilities
  - Cash Credit
  - Overdraft
  - Demand Loans
  - Term Loans
  - Bill Finance etc.
- Non Fund Based Credit Facilities
  - Bank Guarantees
  - Letter Of Credit (LC)
  - Factoring
  - Commercial Papers (CP)
  - Bills Purchase And Discount
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

To learn about :

- Basic Principles of lending
- Classification of borrowers
  - Retail borrowers
  - Corporate borrowers
- Different types of borrowers
  - Individuals
  - Firms
  - Joint stock companies
  - HUF
  - Societies/Associations/Clubs
  - Trusts
- Types of credit facilities granted by Banks
- Loan System for Delivery of Bank Credit
- Types of Non Fund Based Limits granted by banks
- Restriction on Lending by Banks

INTRODUCTION

Money provided by the bank to entities for fulfilling their short-term requirements is known as advances**.** Loan is a kind of debt while Advances are called facility granted to customers by banks. Loans can be secured or unsecured, whereas Advances are generally secured by assets or by guarantee from a surety. The major part of bank's income is earned from interest and discount on the funds so lent.

Banks lend money from deposits it receives from public. The business of lending carries certain inherent risks. Banks therefore follow some fundamental principles of lending to safeguard the interest of depositors.

BASIC PRINCIPLES OF LENDING

Following are some of the basic principles that banks follow while lending:

1) **Safety of funds:** It is the most important principle of lending because the money that banks lend comes from public, so the safety is the first concern. Bank must ensure that money is in safe hands and will come back as agreed with interest and without any default. Safety mainly comes from the character of the borrower, capacity of borrower to do the business and his stake involved in the business. Besides this, the nature of security offered by borrower to the bank is of utmost importance.

2) **Liquidity:** It is also as important as safety. This is because major portion of bank deposits is repayable on demand or at a short notice. Bank grants loans on the security of assets which are easily marketable without much loss of time and value.

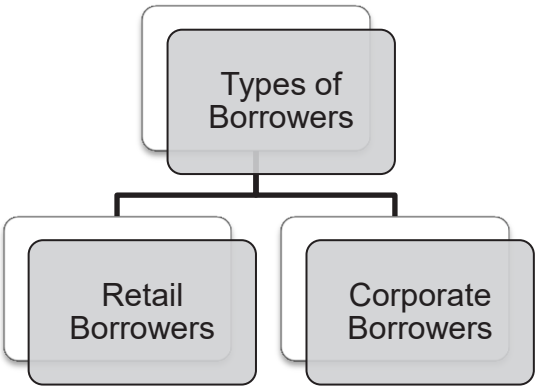
3) **Profitability:** It is important because banking is a business and any business survives and grows only on profits. Bank incurs expenses to maintain deposits such as interest, rent, stationary, infra structure etc. Such expenditure also must be recovered. The sound principle of lending is not to sacrifice safety or liquidity for the sake of higher profitability.

4) **Purpose:** Purpose of the loan should be productive. This ensures increase in sales and realization of sales proceeds generate additional income from which repayment of loan installment with interest is made. Banks also lend money for consumption purpose e.g. for purchasing consumer durables, where repayment comes from fixed income of the borrower. Loans are not advanced for speculative and unproductive purposes.

5) **Spread or Diversification:** Diversification avoids the risk of concentration. Banks lend money under different facilities like: term loan, cash credit, overdraft, bills, etc., for different purposes like business, housing, education, etc., to different industries like cement, pharmaceutical, agriculture, steel, IT, trade etc., in different geographical areas and so on to spread the risk. In short, banks should follow the principle of "Not putting all the eggs in one basket."

6) **Security:** Securities against which banks lend must be marketable, ascertainable, stable and transferable. Borrower should have clear and transferable title over the security given to the bank, so that if required can be effectively sold in the market by the bank.

DIFFERENT TYPES OF BORROWERS



There are different types of bank borrowers. They may be classified as individuals, partnership firms, companies – public as well as private, public sector undertakings, multinational companies etc. The financial and non-financial credit facilities required to the above customers are many. We can divide them into retail borrowers and corporate borrowers.

Retail Borrowers

The type of borrowers in retail segment may be identified as individuals, retail traders, Micro, Small and Medium enterprises (MSMEs), self-help groups, farmers, agricultural borrowers etc. The individuals borrow from banks for financial assistance in buying homes, vehicles, consumer items etc. Besides banks extend credit facilities to individuals under educational loans, consumer loans and personal loan schemes. Banks are issuing credit cards to their customers and public. The credit cards are issued in the form of revolving line of credit. The retail traders and self-help groups enjoy working capital facilities from banks. MSMEs get financial assistance from banks both for working capital and for purchase of machinery and equipment required for their business usages. Farmers avail crop loans, tractor loans and loans for allied activities.

Corporate Borrowers

Banks offer credit facility to corporate customers such as trading houses, multinational companies, exceptionally large domestic, industrial and business houses, public sector companies etc. Fund based and non- fund based facilities extended to corporate are term lending, short term finance, working capital finance, bill discounting, export credit, bank guarantee, letter of credit, collection of bills and documents etc. Besides, banks extend financial assistance like channel financing (extending working capital finance to dealers having business relationships with large companies), Vendor Finance (money lent to be used by the borrower to buy the vendor's products or property), Syndication (allows banks to pool their resources and share risks with other banks while handling large transactions like Project finance, Corporate term loans, working capital loans, acquisition finance etc.). Analysis of financial soundness of any business is generally based on the financial ratios and other accounting variables. The unhealthy position of financial statements directly leads to bankruptcy.

When a bank lends money, it enters into a contract with the borrower. To make that contract enforceable in the court of law, when the need arises, the contract must be a valid contract.

The essentials of valid contract are:

1. **Offer and acceptance:** It is an offer by one party and acceptance by other. Agreement is a primary criterion for making a contract.

2. **Mutual Consent:** Parties must agree upon the same thing, in the same sense and at the same time.
3. **Intention to create legal obligation:** Both the parties must have intention to go to court of law, if the other party fails to meet the promise/obligations.
4. **Free Consent:** Consent of parties must be free. It means there should not be force, undue influence, fraud or misrepresentation while obtaining consent.
5. **Parties must be Competent:** Every party to the contract must be major (completed 18 years of age), of sound mind (at the time of making a contract he can understand it and forming a rational judgment so as to its effect on his interest), and not disqualified by law to enter into a contract.
6. **Lawful object:** The object of the contract must be lawful. (not fraudulent, illegal, immoral or opposed to public policy)
7. **Lawful consideration:** Both the parties must get something lawful and real, in return for the promise made.
8. Not expressly declared as void.

Different Types of Borrowers for Lending In Banks

Banks lend money to following types of borrower :

1. **Individuals:** Individuals can apply for loan in single name or two or more individuals jointly can apply for bank loan. All applicants should individually be capable of entering into contract. In case of joint borrowers, the documents are to be executed jointly. On the death, insanity or insolvency of one of the joint borrowers, the survivor must pay the outstanding dues.

   Position of Individuals in Different Capacities:

   a) **Minors:** The minors, insane individuals and insolvents are incompetent and hence cannot apply for loan. Loan given to minor cannot be secured and recovered from a competent major person by obtaining his guarantee as here the original contract will be invalid so the subsequent contract (guarantee) cannot be enforceable.

   b) **Illiterate Person:** An illiterate person is one who cannot read or write. Especially he is an uneducated who cannot read. However, if he is otherwise competent he can enter into a valid contract. Since he cannot read and write he must be explained the contents of all the documents in language known to him and a separate declaration to that effect is to be kept on record. Instead of signature, an illiterate person will put his thump impression on all the documents in presence of bank officials.

   c) **Blind Person:** Blind person can be competent to contract. He can be different from an illiterate if he is educated, but banks will treat him like an illiterate when it comes to executing documents.

   d) **Married Woman:** A married woman has a legal entity separate from her husband. She can be adjudicated insolvent in respect of her own debts. Husband shall be liable for a loan raised by a married woman only if loan is granted with the consent of her husband who stands as a guarantor and when loan is availed for necessities of her life.

   e) **Pardanashin Woman:** A pardanashin lady is a woman who remains in complete seclusion and does not transact any business with people other than her family members. In a contract with her, a presumption of undue influence always exits, and she can avoid the contract where she complains of undue influence. The onus of proving absence of undue influence lies on other party.

2. **Firms:** In case of a proprietary firm, the proprietor is treated just like as individual except that he carries out business in the name of the firm instead of his individual name. In a partnership firm, liability of partners is unlimited, and the partners are jointly and severally liable for the debt of the firm. The firm is not a separate legal entity. Partners are principal, and they act as agent for each other. Maximum no. of partners in a firm can be 100. A joint stock company can be a partner in a partnership firm. It will be treated as one partner.

   Firm's bank account: On receipt of an application from one or more of the partners, a bank account in the name of the firm can be opened. A firm's bank account should be opened in the name of a firm and not in the name or names of the individual partner/partners.

   Liability of partner's in respect of firm's debt: The liability of the partners is unlimited, and every partner is liable to pay the debts of the firm to an unlimited extent. The liability of partners in different positions is as follows:

   (i) **If debts are due from the firm as well as from partners:** If the partners are personally indebted, the personal assets of the partners shall be applied first to meet the claims of their individual creditors. Out of the remainder, if any, claims of the firm's creditors will be met.

   (ii) **If the partners sign the loan documents in both of their capacity i.e. individual as well as jointly:** In this case the creditor can recover their debt simultaneously from the assets of the firm and the partners. The personal property of a partner may be attached even before judgement is delivered in a suit against the firm and its partners.

   (iii) In case of death of a partner:

   (a) **If the firm stands dissolved:** On receipt of intimation about the partner's death, the banker will close the firm's account immediately. This is necessary to decide the liability of deceased partner. If this is not done than rule in Clayton's case will apply.

   (b) **If the firm does not stand dissolved:** If it is reconstituted by the remaining partners, the banker should open a new account in the name of the reconstituted firm.

   In any case, the cheques issued by the deceased partner should not be honored by the banker without confirmation from the surviving partners.

   (iv) **Retirement of a partner:** On the retirement of a partner if bank account shows a debit balance, the banker must close the account immediately, to retain its right to claim money from the retiring partner. In absence of this, Rule in Clayton's case will apply. The liability for debts arising out of financial facility would continue in respect of retired partners till the date of notice. Their liability for future loans ceases immediately on serving such notice.

   (v) **Insolvency of a partner:** The insolvent partner ceases to be a partner from the date of declaration of his/her insolvency and he shall not be liable for any act of the firm thereafter. The insolvent partner does not remain competent to operate the firm's account. Banker should honor the cheques drawn by the insolvent partner before his adjudication only after getting confirmation from the solvent partners. Normally bankers must close the account and open a new account in the name of reconstituted firm to determine the liability of the insolvent partner. Otherwise the rule in Clayton's case will apply.

3. **Limited Liability Partnership (LLP)** is a legal entity separate from its partners. The liability of a partner is limited to his contribution. They are not liable for one another. Public disclosure is the critical feature of an LLP. An LLP must have at least two members. If one member chooses to leave the partnership, the LLP may have to be dissolved.

4. **Joint Stock Companies :** In case of Private Limited Company minimum members should be 2 and maximum can be 200. Minimum directors should be 2 and no ceiling as to maximum no of directors. In case of Public Limited Company minimum members should be 7 and no ceiling for maximum numbers. Minimum no. of directors should be 3 and no ceiling for maximum nos.

   – *Borrowing Powers of a Company* : Borrowing powers of the Board of Directors of a company are stated in Articles of Association (which deals with the indoor management), for loans other than short term loans. If powers are not stated, these are deemed to be equal to paid up capital plus free reserves of the company. This restriction does not apply to short-term loans and seasonal loans. Where the Board does not have adequate powers, shareholders can enhance these powers by passing a resolution.

   – The Board of Directors shall exercise the power to borrow money otherwise than on debentures only by means of resolutions passed at the meeting of the Board. The Board may, by a resolution delegate the power to borrow to any committee of directors, the managing director, secretaries and treasurer etc., and shall specify the total amount outstanding at any one time up to which money may be borrowed by the delegate.

   – *Borrowing by Board of Directors without Authorization* : If loan has been taken by Board without authority and used the sum for the benefits of the company, company cannot repudiate its liability to repay. In this regard it should be noted that any borrowings by the company may be ultra vires the directors but not ultra vires the company.

5. **Hindu Undivided Family (HUF) :** HUF is not governed by Indian Partnership Act. Senior most coparcener is a Karta. When the Karta expires or is declared as insolvent or becomes insane, the next senior coparcener becomes the Karta. He has powers to raise loan for family business and legal necessities of the family. His liability is unlimited. He can, without the consent of coparceners, create charge on the assets of family and execute documents. Banks obtain signatures of all major coparceners in their personal capacity, on all loan documents, to make them personally liable.

   Points to be considered by the banker:

   i. Though Karta has implied authority to take a loan, to execute necessary documents and to pledge the securities yet to be on safe side, the loan document should be executed by all the adult members of the family or with their consent by the head of the family.

   ii. Banker must check the purpose of the loan taken. Karta can take the loan and pledge the property of the family only for using the same in family business and not for speculation purposes.

   iii. The coparceners' liability in case of loans granted to HUF is limited to the extent of their interest in joint property. If the adult coparceners themselves contract along with Karta or ratify the contract entered by the Karta, then they become personally liable for the amount borrowed.

   iv. In case of minor as coparcener in HUF, then his guardians must sign the loan documents on his behalf. After attaining majority, he should also sign the documents to give his consent to the undertaking given by major coparceners.

6. **Societies, Clubs, Associations etc. :** These are non-profit making entities and represent group of people. These get legal status only after incorporation. Banks must ensure that the loan applied is consistent with objectives of the institution, loan amount is within the borrowing capacity and the managing committee has passed necessary resolution to that effect.

Points to be consider by the bankers:

(a) Ensure that the applicant society is an incorporated body under The Society Registration Act, 1860 as unregistered society cannot be sued.

(b) Obtain a copy of rules and by-laws of the society to know the powers and functions of the persons managing the affairs of the society.

(c) Obtain a copy of the resolution of the managing committee regarding appointing the bank concerned as the banker of the society, mentioning the name of the persons who are authorized to operate the bank account and giving other directions for the operations of the said account.

(d) Ascertain the borrowing powers of the society from its Charter of Memorandum, Note the purpose for which borrowings is permissible. Check the powers of members of the society to create charge over the assets of the society.

(e) If a person who is authorized to take loan on behalf of the society dies or resigns, the banker should stop the operations of the society's account till society nominates another person.

(f) If the person authorized to operate society's account also have his personal account in the same branch, banker must ensure that funds of the society are not credited to the personal account of the said office bearer.

7. **Trusts:** Trust can be private or public. Trustees do not have implied authority to borrow. Loans can be granted if it is for the trust. Trustee is authorized to borrow as per the trust deed.

FUND BASED CREDIT FACILITIES

Bank finance is tailor made to suit the needs of customers. The loans and advances wherein immediate flow of funds is made available to borrowers, are called funds-based facility. Banks earn interest income from this. In non- funds-based facilities like issuance of letter of guarantee, letter of credit etc., banks get fee income/ commission and there is no immediate outflow of funds from the bank.

1. Demand Loan: It is generally granted for short period from few days to several months. It has open ended repayment schedule or must be paid on demand by the lender. Normally there is no penalty for pre-payment. The purpose for which demand loan is sanctioned is generally purchase of raw material, paying of short term liabilities etc. The security can be stock, shares or other tangible assets, land building etc.

2. Term Loans: These are granted for specific period with fixed repayment schedule. The interest rates are fixed or floating. The tenure may range from one year to five years or even more. Generally, penalty is charged for pre-payment. These loans are sanctioned for procuring land and building, plant and machinery and other fixed assets to start or expand business. The security is charge on the asset for which or against which loan is sanctioned.

2.1 While funding a project, a banker generally takes into consideration the following aspects/factors:

1. **Land:**
   i. Land Sales Deeds(Land purchased agreement)
   ii. Legal Search Report
   iii. Location and accessibility
   iv. No Objection certificate from statutory bodies including local bodies for use of land
2. **Building:**
   i. Approved Building Plan
   ii. Building permission from the town planning commission
   iii. Architects detailed cost estimates
   iv. Type and nature of structure
3. **Plant and machinery:**
   i. Full detail and description of the plant & machinery, whether imported or indigenously available
   ii. Details of the technology and its suitability, the rate of obsolescence
   iii. The profile of the supplier
   iv. Post sales service support extended by the supplier
   v. Manufacturers catalogue
   vi. The profile and standing of the project management consultant
   vii. Any unique feature of the machinery, from the project angle to be clearly specified
   viii. Copy of the Performa invoices/quotations etc. for the plant and machinery are to be submitted in full
4. **Miscellaneous Fixed Assets:**

   Details and description of miscellaneous fixed assets, copy of invoices.
5. **Preliminary and Preoperative Expenses:**

   Complete break up and details.
6. **Working Capital Margin:**

   Source of working capital and its Working and calculation.

7. **Project implementation and draw down schedule:**

   The project implementation schedule with details and item wise break up and likely date of completion of the project. The draw down schedule of the project and timings of drawdown linked to the progress of the project.

8. **Assumptions underlying the projections and their basis:**

   The detailed assumptions underlying the projections and the basis of the same supported with conclusive evidence in respect of various cost factors and revenue projections assumed.

9. **Details of securities:**

   The prime, collateral securities, personnel guarantee offered etc.

10. **Technical/project Details:**

    a) Manpower details – requirement of Doctors, key managerial personnel, process of recruitment, availability and quality of the manpower/labour force, salary structure etc

    b) The infrastructure availability and its details

    c) Raw material– Consumption, Prices, duty element, price volatility, source and availability of supply etc.

    d) Utilities Details

       – Power –requirement, connected load (For calculation of power consumption), power sanction letter, standby arrangement etc.

       – Water – requirement, source of supply, suitability of water, chemical test report, storage arrangement etc.

       – Fuel and Oil and lubricants etc.

11. **Company Specific Information:**

    a) Copy of Memorandum of Association and Articles of Association, Certificate of Incorporation by Company Registrar.

    b) Copy of the project report.

    c) Extent of expenditure already incurred on the project with item wise breakup; the balance expenditure to be incurred

    d) The source of funds for the promoters' contribution and extent of funds already brought in with break up and details, and bank statements, suppliers receipts etc.

    e) Last three income tax returns and income tax returns of the company/group concerns and income tax assessment orders.

    f) Opinion letter (OPL) on the company/group accounts from the existing bankers.

    g) Shareholders agreement.

    h) Technical support agreement.

    i) SWOT (Strength, Weakness, Opportunities, Threats) analysis as perceived by the management

Banks have their own project parameters which are considered by them for long term funding. Few project parameters considered by banks for evaluation are given below:

Project Parameters

Parameter	Benchmark
Promoters' Contribution	Not less than 11% of the project cost
Debt Equity Ratio (DER)	2:1 up to 3:1
Fixed Asset Coverage Ratio(FACR)	Not less than 1.25
Repayment Period	Not exceeding 12 years excluding moratorium period
Debt Service Coverage Ratio(DSCR)	Not less than 1.50
Internal Rate Return (IRR)	4% and above from the estimated weighted average cost of funds

3. Overdraft (O/D Account): It means allowing the customer to draw cheques over and above credit balance in his account. Overdraft is normally allowed to Current Account customers and in exceptional cases Savings Bank account customers are also allowed to overdraw their account. High rate of interest is charged on daily debit balance of overdraft account. Generally, an overdraft facility is given by a bank on the basis of a written application and a promissory note signed by the customer.

Types of overdraft accounts:

(a) **Temporary or Clean overdraft:** Temporary overdrafts are allowed purely on personal credit of the party and it is for party to meet some urgent commitments on rare occasions. Allowing a customer to draw against his cheque sent in clearing also falls under this category.

(b) **Secured overdraft:** Secured overdraft is allowed up to a certain limit against some tangible security like bank deposits, LIC policy, National Savings Certificates, Shares and other similar assets. Secured overdraft is most popular with traders as it involves lesser operating cost, simple procedure of application and document formalities.

4. Cash Credit (CC account): It is short term finance to a borrower having a tenure up to one year which can be renewed for further period by the bank based on projected sales and satisfactory operation in the account during the period of finance. Cash Credit facility is extended in two forms – Open cash credit and Key cash credit (KCC). Open cash credit account is a running account just like a current account where the borrower can maintain debit balance in the account up to a sanctioned limit or drawing power whichever is lower. The cash credit facility is offered to a borrower normally either against pledge (Key Cash Credit) or hypothecation of stocks of raw materials, semi-finished goods and finished goods and book debts (Receivables).

In KCC, the borrower lodges the stock in his warehouse and the key of the warehouse will be handed over to the bank. The goods lodged in the warehouse is pledged to the bank and they are allowed to be removed by the borrower on remitting into his CC account the amount equivalent to value of the goods. The bank would release further funds to the borrower within the Drawing Power (DP) / sanctioned limit on borrower depositing (pledge) more stock in the warehouse. Therefore, such facility is called Key Cash Credit.

Cash credit limits are also sanctioned to a borrower against security of term deposits, LIC policies, NSCs or Gold jewels. This type of limit is offered mainly to traders who find it difficult to maintain stock register and submission of periodic stock statements. In case of manufacturing units this facility is required for purchase of raw materials, processing and converting them into finished goods. In case of traders, the limit is allowed for purchase of goods which they deal.

Maximum Permissible Bank Finance (MPBF) - Tandon Committee

A study group set up by the Reserve Bank of India in 1974 under the chairmanship of Mr. P.L. Tandon, popularly referred to as The Tandon Committee.

The committee has recommended the following:

1. Borrowers must observe a proper fund discipline. They should provide to the banker all the information regarding his operational plans well in advance. Accordingly, the banker must carry out a realistic credit appraisal of such plans.
2. The main function of the banker as a lender is to supplement the borrower's resources to carry on acceptable level of current assets. This has two implications:
   (i) Current assets must be reasonable and based on norms, and
   (ii) A part of funds requirement for carrying out current assets must be financed from long term funds.
3. The bank should know the end use of bank credit so that it is used only for purposes for which it was made available.
4. The bank should follow inventory and receivable norms and lending norms. It has suggested inventory and receivable norms for fifteen major industries. It has also suggested three lending norms which are as follows:
   (i) The borrower must contribute a minimum of 25% of working capital gap from long term funds.

   MPBF = 75% of [Current Assets Less Current Liabilities] i.e. 75% of Net Working Capital

   (ii) The borrower must contribute a minimum of 25% of the total current assets from long term funds.

   MPBF = [75% of Current Assets] Less Current Liabilities

   (iii) The borrower has to contribute the entire hard-core current assets and a minimum of 25% of the balance of the current assets from long term funds.

   MPBF = [75% of Soft Core Current Assets] Less Current Liabilities

Core current assets is permanent component of current assets which are required throughout the year for a company to run continuously and to stay viable.

RBI has withdrawn the prescription, with regard to assessment of working capital needs, based on the concept of Maximum Permissible Bank Finance, in April 1997. Banks are now free to evolve, with the approval of their Boards, methods for assessing the working capital requirements of borrowers, within the prudential guidelines and exposure norms prescribed.

MSE units having working capital limits of up to Rupees five crore from the banking system should be provided working capital finance computed on the basis of 20 percent of their projected annual turnover. The banks should adopt the simplified procedure in respect of all MSE units.

Example: From the following data, calculate the maximum permissible bank finance under the three methods suggested by the Tandon Committee:

Liabilities	Rs. in lacs	Current Assets	Rs. in lacs
Bank Borrowings	400	Raw Material	150
Creditors	150	Work in Progress	90
Other Current Liabilities	50	Finished Goods	190
		Receivables	160
		Other Current assets	110
Total	**600**	**Total**	**700**

The total Core Current Assets (CCA) are Rs. 280 lacs.

Solution:

The maximum permissible bank finance (MPBF) for the firm, under three methods may be ascertained as follow:

Method I	=	0.75 (CA- CL)
	=	0.75 (700-200)
	=	Rs. 375 lacs
Method II	=	0.75 (CA) – CL
	=	0.75(700) - 200
	=	Rs. 325 lacs
Method III	=	0.75 (CA-CCA) - CL
	=	0.75 (700-280) - 200
	=	Rs. 115 lacs

It is noted that the MPBF decreases gradually from the first method to second method and then to third method. As the firm has already availed the bank loan of Rs. 400 lacs, it is eligible to get finance of Rs. 375 lacs only under Method 1.

5. Bills Finance is a **short** term funding and is self-liquidating in nature. The bills can be classified as Demand Bills and Usance Bills. Demand Bills are payable on Demand. In Usance Bills, the seller gives certain period (Usance) to buyer to pay the bill. The bills are expressed to be payable after some time (30 days / 45 days / 90 days / one month / two months… etc.) from either the date of bill or from the sight of bill. Demand Bills are purchased, and Usance Bills are discounted by the banks. Banks negotiate these bills and seller gets credit against these bills immediately for the goods sold. The bank adjusts the money lent from the realization proceeds of the bill (called as self-liquidating advance).

Bills (Demand / Usance) can be clean or documentary (without or with document of title to the goods accompanying it respectively). The 'Document of Title to Goods' include Railway Receipt (RR), Motor Transport Receipt (MTR), Lorry Receipt (LR), Airway Bill or Bill of Lading. It depends on the mode of transportation used by the seller to send the goods to buyer. The documentary bills are drawn on DP term (documents to be delivered to the buyer against payment of the bill) or DA term (documents to be delivered to the buyer on accepting the bill). The terms

DA or DP depend on factors such as seller / buyer relationship, market conditions, nature of goods (perishable or not) etc. Advance against Usance documentary bill with DA term becomes 'Clean' after the document of title is delivered to the buyer. Therefore, while lending money to seller against Usance documentary Bill with DA term, banks take into consideration the credit worthiness of both the seller (drawer) and the buyer (drawee) of the bills and genuineness of underlying transactions / documents.

6. Packing Credit facility is sanctioned to the exporter to procure raw material and manufacture goods as required by the buyer, at pre-shipment stage. Bank secures this advance by creating hypothecation charge on the stock of goods and other current assets and debtors. The period for which a packing credit advance is given by a bank will depend upon the circumstances of the individual case, such as the time required for procuring, manufacturing or processing (where necessary) and shipping the relative goods / rendering of services. If pre-shipment advances are not adjusted by submission of export documents within 360 days from the date of advance, the advances will cease to qualify for prescribed rate of interest for export credit to the exporter ab initio.

7. Buyer's Credit is the credit the buyer (importer) avails from a bank in exporter's country under export credit scheme. The loan is drawn, and exporter is paid fully. Another way is, bank in exporter's country establishes a line of credit in favor of a bank in the importer's country. This bank in turn makes the credit available to the importer. This is mainly for import of capital goods. Banks are permitted to issue Letter of Comfort (LOC)/ Letter of Guarantee (LOG)/ Letter of Undertaking (LOU) in favour of overseas lenders/Bankers upto USD 50 million per transaction (USD 150 million for oil/gas refining & marketing, airline and shipping companies) for a period upto one year for import of all non capital goods permissible under Foreign Trade Policy and upto 3 years for import of capital goods subject to prudential guidelines issued by RBI from time to time.

8. Supplier's Credit is where the exporter supplier extends a credit to the buyer importer of capital goods. Some amount is paid initially and the balance payment in installments. The interest on the balance payment is as per the contract of agreement. The deferred payments are supported by the promissory notes or bill of exchange by the importer guaranteed by his banker. The exporter in tern raises loan from his banker under export credit scheme.

9. Leasing Finance: Lease is a contract between the owner of the asset (Lessor) and the user of the asset (Lessee). As per terms of lease agreement, the lessor pays money to the supplier who delivers asset to the lessee. The owner of the asset (lessor) transfers the right to another person to use the asset against, payment of fixed lease rents. Owner (lessor) and User (lessee) are the two parties of lease agreement. The lessor remains the owner of the asset and the possession of asset remains with lessee. Banks finance activities of leasing companies. Advance is sanctioned against fully paid new machinery / equipment by creating hypothecation charge on the same. The repayment is received from rentals of the machinery / equipment leased out. Lease rentals are decided in advance for the entire leased period. The accelerated lease rental means low in the beginning and gradually increasing later. In general, five years or the economic life of the asset, whichever is less is the maximum repayment period allowed.

10. Hire-Purchase finance takes place mostly in automobile sector. Here the ownership of the asset continues to remain with the Company till the agreement period ends. At the time of the termination of the agreement the hirer has options either to return the asset to company or purchase the asset upon the terms set out in the hire-purchase agreement. The assets in hire-purchase appears in the balance sheet of hirer, who also claims depreciation. The installment is partly treated as capital repayment and balance as interest expenditure. Only amount of interest is considered for tax purpose. Since hire-purchase finance takes place mostly in automobile sector, banks have started direct finance to transport operators as the advance under certain conditions is classified as priority sector advance.

RBI has permitted banks to undertake business of leasing and hire-purchase within a limit of 10% of their total advance.

11. Loan System for Delivery of Bank Credit: RBI has issued guidelines in Dec 2018 on enhancing credit discipline among the larger borrowers enjoying working capital facility from the banking system. In respect of borrowers having aggregate fund based working capital limit of Rs. 1500 million and above from the banking system, a minimum level of 'loan component' of 40 percent (to be increased to 60 % later on) shall be effective from April 1, 2019. Accordingly, for such borrowers, the outstanding 'loan component' (Working Capital Loan) must be equal to at least 40 percent of the sanctioned fund based working capital limit, including ad hoc limits and TODs. Hence, for such borrowers, drawings up to 40 percent of the total fund based working capital limits shall only be allowed from the 'loan component'. Drawings in excess of the minimum 'loan component' threshold may be allowed in the form of cash credit facility. The bifurcation of the working capital limit into loan and cash credit components shall be effected after excluding the export credit limits (pre-shipment and post-shipment) and bills limit for inland sales from the working capital limit. Investment by the bank in the commercial papers issued by the borrower shall form part of the loan component, provided the investment is sanctioned as part of the working capital limit. The amount and tenor of the loan component is fixed by banks in consultation with the borrowers, subject to the tenor being not less than seven days. Banks may decide to split the loan component into WCLs with different maturity periods as per the needs of the borrowers.

NON FUND BASED LIMITS

Non Fund Based facilities are those, which do not involve outflow of bank's funds at the time of sanction. Non fund based limits may turn into fund based facility on due date /occurrence of the specified event like devolvement of bills under LC, invocation of Bank Guarantee, etc.

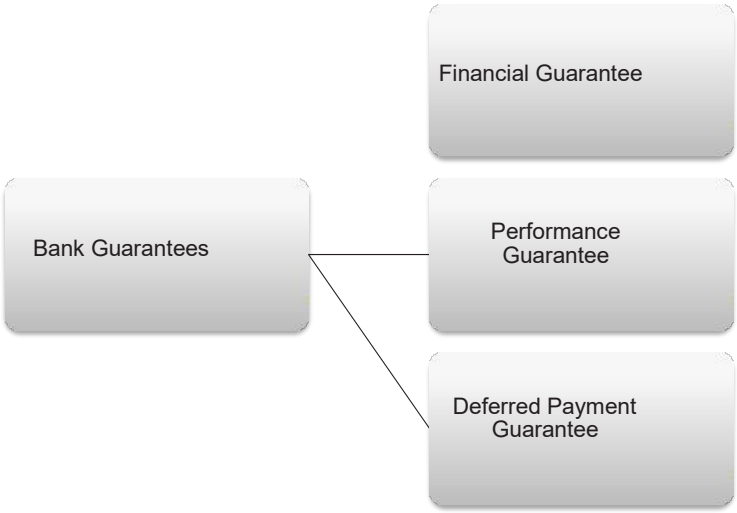
BANK GUARANTEES

It is a non-fund based facility required by the borrowers. Banks are often required to issue guarantees on behalf of their customers. A bank guarantee ensures that the liabilities of the debtor will be met in the event he fails to fulfill his contractual obligations. It is an agreement between three parties – the bank, the beneficiary and the applicant who seeks the guarantee from the bank. This agreement acts as an undertaking assuring the beneficiary that the bank would pay the specified amount, in the case of applicant's default in delivering the "financial" or "performance" obligation as mentioned in the guarantee.

While issuing guarantee bank should carefully note the following:

- The guarantee period is specific and clearly mentioned.
- The amount stated is specific.
- The purpose is clearly mentioned and is consistent with applicant's business.
- The grace period allowed to enforce guarantee rights is mentioned.
- The 'default' should by clearly mentioned.
- In a bank guarantee, the extent of monetary liability and the period of validity should be specific. For this reason the limitation clause is included.

Types of Bank Guarantees:



1. **Financial Guarantee** – Under this, bank guarantees that the applicant will meet the financial obligation and in case he fails, the bank as a guarantor is bound to pay (e.g. guarantees towards revenue dues, taxes, duties and for disputed liabilities for litigations pending at courts; credit enhancement; repayment of financial securities etc.).
2. **Performance Guarantee** – Under this, guarantee issued is for honouring a particular task and completion of the same in the prescribed / agreed upon manner as stated in the guarantee document. (e.g. bid bonds, retention money guarantee etc,).
3. **Deferred payment guarantee** – Here, the bank guarantees the payment of installments payable by the buyer of capital goods such as machinery, on term credit by the supplier.

Here normally 15 to 20% of the invoice price of the capital goods is paid by the borrower and the remaining amount along with the interest at the agreed rate is payable in installments spread over agreed period – 3 to 5 years or more. The seller draws usance bills which are accepted by the buyer and are either co-accepted by the banker or a guarantee is issued. Seller in turn can get these bills discounted from his banker. On due dates of the installments buyer's bank arranges the remittance of installments. Guarantee issuing bank creates charge on assets so purchased and also obtains counter-guarantee from the said applicant buyer.

Invocation of bank guarantee – Amount claimed should be paid to the beneficiary immediately if invocation is in accordance with the terms and conditions of the guarantee contract.

Expiry of guarantee – On the expiry of guarantee period the beneficiary should be intimated by letter with registered acknowledgement, indicating that the liability of the bank under the said guarantee stands discharge and the original guarantee be returned for cancellation. If no reply is received from the beneficiary in a reasonable time, the guarantee is treated as expired and cancelled.

Limitation period – Although the limitation clause is specified in the guarantee contract, the beneficiary can enforce his rights till the limitation period is alive. It is 30 years in case of Government and 3 years in other cases from the stipulated expiry date / invocation whichever is earlier.

RBI guidelines to banks for issuing guarantees on behalf of their customers:

- As a general rule, banks may provide only financial guarantees. However, scheduled banks may issue performance guarantees subject to exercising due caution in the matter.

- Guarantees should not be issued for periods exceeding ten years. Guarantees beyond ten years are allowed under a policy approved by the Boards of respective banks.
- Total volume of guarantee obligations outstanding at any time may not exceed 10% of the total owned resources of the bank comprising paid-up capital, reserves and deposits. Within the overall ceiling, proportion of unsecured guarantees outstanding at any time may be limited to an amount equivalent to 25% of the owned funds (paid up capital and reserves) of the bank or 25% of the total amount of guarantees, whichever is less.
- Banks should preferably issue secured guarantees. A secured guarantee means a guarantee made on security of assets (including cash margin), the market value of which will not at any time be less than the amount of the contingent liability on guarantee, or a guarantee fully covered by counter guarantee(s) of the Central or state governments, public sector financial institutions and / or insurance companies. Banks should generally provide deferred payment guarantees backed by adequate tangible securities or by counter guarantees of the Central or state governments, public sector financial institutions and / or insurance companies and other banks.
- Banks should avoid undue concentration of unsecured guarantee commitments to particular group of customers and / or traders.
- In case of deferred payment guarantees bank should ensure that the total credit facilities including the proposed deferred payment guarantees does not exceed the prescribed exposure ceilings.

The proposals for deferred payment guarantees should be examined having regard to profitability / cash flows of the project to ensure that sufficient surpluses are generated by the borrowing unit to meet the commitments, as a bank has to meet the liability at regular intervals, in respect of due instalments.

- The bank guarantee is a commitment made by the issuing bank to make payment to beneficiary. Failure on the part of the bank to honour the invocation claim legitimately made on it projects a distorted picture of its functioning.
- While co-accepting bills of customers, banks should ensure that they are out of genuine trade transactions and not accommodation bills. Before co-accepting bills, financial position and capacity of the parties to honour the bills, in the event of need should be assessed.
- Banks should adopt the Model Form of Bank Guarantee Bond and ensure that alterations/additions to the clauses whenever considered necessary are not one-sided and are made in agreement with the guaranteeing bank.

LETTER OF CREDIT (LC)

Letter of Credit ('LC'), also known as a documentary credit is a payment mechanism used specially in international trade. In an LC, buyer's bank undertakes to make payment to seller on production of documents stipulated in the document of LC. LC play an important role in the trade of a country, especially in its international trade. In most of the cases, the exporters (sellers) are personally not acquainted with the importers (buyers) in foreign countries. In such cases the exporters bear great risk, if they draw bills on importers, after having dispatched the goods as per their orders, because if the latter default in accepting the bills or making the payment, the exporter will suffer heavy losses. To avoid such risks, the exporters ask the importers to arrange a letter of credit from their banker in favour of themselves, on the basis of which goods may be exported to the foreign importers.

Uniform Customs and Practices for Documentary Credits - 600 (UCPDC-600) apply to any LC when its text expressly indicates that it is subject to these rules. The rules are binding to all parties unless expressly modified

or excluded. The Uniform Customs & Practice for Documentary Credits (UCP 600) is a set of rules agreed by the International Chamber of Commerce, which apply to finance institutions which issue Letters of Credit – financial instruments helping companies finance trade. Many banks and lenders are subject to this regulation, which aims to standardise international trade, reduce the risks of trading goods and services, and govern trade.

Parties to Letter of Credit (LC)

There are following four main parties to LC transaction:

1. Applicant or he is also called as Opener of LC. The bank opens LC on behalf of the applicant customer who is buyer / importer of goods.
2. Issuing bank is a bank which opens LC and undertakes to make payment to the beneficiary (seller/ exporter) on submission of document as per the terms of LC.
3. Beneficiary is the seller / exporter of goods in whose favour LC is opened.
4. Advising Bank is the bank through whom LC is advised to the beneficiary. Normally it is located in seller's location / country.

In addition to above four parties, following parties may also be involved in LC transaction.

- Confirming Bank is the bank which in addition to LC issuing bank, undertakes the responsibility of payment under LC. This is required since the LC issuing bank may not be known to the exporter and he therefore needs reputed bank from his country to add confirmation to the LC.
- Negotiating Bank negotiates the documents under LC.
- Paying Bank or Nominated Bank is the bank nominated or authorized by the LC issuing bank to make payment under LC. In practice, the paying bank presents the documents received by it either to issuing bank or Reimbursing Bank for payment and transfers the proceeds to the beneficiary's account.
- Reimbursing Bank is a bank with whom the LC issuing bank maintains foreign currency account (NOSTRO account). LC issuing bank authorizes the reimbursing bank to honor the LC reimbursement claim of negotiating bank.

Documents under LC

To receive payment, an exporter must present the documents required by LC. Typical types of documents in such contract include –

- Financial documents: Bill of Exchange, co –accepted draft.

  It is the basic document drawn by the beneficiary (exporter / seller) and has to be drawn as per the terms of the LC.

- Commercial documents – Invoice, packing list.

  It is addressed to the buyer (importer), signed by the seller (exporter) and contains details of sales like quantity, rate , specification and total amount.

- Shipping documents – bill of lading, airway bill, lorry/truck receipt, railway receipt etc.

  It is a document of title to the goods, proof that the exporter has dispatched the goods.

- Official documents – license, certificate of origin, inspection certificate, health certificate. These are the documents as specified in the LC document.

- Insurance documents – insurance policy or certificate but not a cover note.

The dispatched goods must be insured for the amount and the kind of risks as specified in LC document. The policy / certificate should be signed by the insurance company.

Types of LCs

1. Documentary LC and Clean LC: When the LC contains a clause that the payment is conditional on submission of document of title to goods such as bill of lading (evidence of dispatch of good), it is called Documentary LC. If no such clause is in the LC, it is called a clean LC.

2. Fixed Credit and Revolving Credit: Fixed credit is where LC specifies the amount up to which one or more bills can be drawn by the beneficiary within the specified time. The LC remains effective till the specified amount is exhausted within specified time.

In Revolving Credit, the LC opening bank does not specify the total amount up to which bills may be drawn, but mentions total amount up to which the bills may remain outstanding at a time. Thus after reaching that amount, as soon as the importer pays the bill, to that extent the limit gets reinstated. It is thus automatic and does not need renewal within the specified period of time.

3. Revocable and Irrevocable LC: In case of revocable LC, the opening bank reserves the right to cancel or modify the credit at any moment without prior notice to beneficiary. It therefore does not constitute a legally binding undertaking between the opening bank and the beneficiary. If, however, the negotiating bank makes payment to the beneficiary before receiving notice of cancellation or amendment, the opening bank has to honour the liability. Such a credit provides no real security to exporter but a mere intimation to draw bills under credit. As such exporter accepts such LC only from buyers of known integrity.

Irrevocable credit constitutes a definite undertaking of the issuing bank. Such a LC once established and advised cannot be cancelled or amended except with the consent of interested parties – beneficiary and negotiating bank.

If nothing is mentioned in LC, it is treated as irrevocable under UCPDC regulations.

4. Confirmed and Unconfirmed LCs: When the opening bank requests the advising bank in the exporter's country to add its confirmation to an irrevocable LC and the advising bank does so, the LC is "irrevocable and confirmed". The advising bank is then called as 'confirming bank' and its liability then becomes similar to the issuing bank. The confirmation cannot be cancelled or amended unless agreed by all the parties. A confirmed irrevocable LC provides absolute security to the beneficiary.

If the advising bank does not add its confirmation, the LC remains as unconfirmed. In such case there will be no such obligation on the advising bank.

5. 'With' and 'Without Recourse' Credit: In case of "with Recourse" bills, the banker as a holder of the bill, can recover the amount of the bill from the drawer, in case the drawee of the bill fails to pay it. In order to avoid such liability, the seller / exporter / drawer asks the importer / buyer to arrange credit "Without Recourse" to the drawer. In such a credit the issuing bank will have no recourse to the drawer (exporter) if the drawee (importer) fails to honour the bill. The liability of such a bill ends as soon as the bill is negotiated.

6. Transferable LCs: Ordinarily the beneficiary is authorized to draw bills of exchange under LC. But if the beneficiary is an intermediary in the transaction and the goods are actually to be supplied by someone else, the beneficiary may request the opener to arrange a transferable credit. Under transferable credit, the beneficiary can transfer the credit to one or more persons. But it can be done only if the credit is expressly designated

"transferable" by the issuing bank. The credit can be transferred only on the terms and conditions specified in the original credit. The second beneficiary, however, cannot transfer it further, but can transfer the unused portion back to the beneficiary.

7. Back to Back LC: When a beneficiary receives a non-transferable LC, he may request a bank to open a new LC in favour of some other person (may be local supplier), on the security of LC issued in his favour. Such LC is called Back to Back LC. The terms of such LC are identical except that the amount (price) may be lower and the validity earlier.

8. LC with Red Clause / Green Clause: LC with a clause printed in red ink, contains authority from the issuing bank to the advising / negotiating bank to grant advances (packing credit) to the beneficiary up to a specified amount at the responsibility of former. It is a short term advance recovered from the amount, payable by the negotiating bank to the beneficiary when it negotiates the documents under LC submitted by the beneficiary.

Green Clause is an extension of red clause LC allowing advances for storage of goods in warehouse in addition to packing credit.

9. Installment Credit: LC is issued for full value of goods but part-shipments of specific quantities of goods within nominated period are required. Credit is not available for missed shipment and shipments thereafter unless permitted in LC document.

Advantages of LCs to the Exporter (seller) and the Importer (buyer)

- Facilitates trade transactions between two parties who are not known to each other and located in two different countries.
- Beneficiary is assured of payment as long as it complies with the terms and conditions of LC.
- The credit risk is borne by the issuing bank and not the applicant (buyer).
- LC accelerates payment of receivables and helps beneficiary (seller) in minimizing collection time.
- The beneficiary's foreign exchange risk is eliminated with LC issued in the currency of seller's country.
- On the basis of LC the exporter may obtain advance from the bank for procuring and processing or manufacturing goods to be exported.
- Buyer is enabled to import goods.
- LC assures importer that bills drawn under LC will be honoured only when they are strictly in accordance with the conditions stipulated in LC document and the documents are duly submitted.

RBI guidelines for grant of LCs Facility

- For Commodities covered under Selective Credit Controls, there is no restriction for banks in opening LCs for import of essential items. However, banks are not permitted to open inland LCs, providing a clause therein which would enable other banks to discount Usance Bills under LCs.
- Before issuing LCs, banks should ensure that –
  - i) LCs are issued in security forms only.
  - ii) Large LCs are issued under two signatures, one of the signatory being from HO / Controlling office.
  - iii) LCs are not issued for amounts out of proportion to the borrower's genuine requirements, and are issued only after ensuring that the borrowers have made adequate arrangements for retiring the bills.

iv) Where LCs are for purchase of raw materials, borrowers do not maintain unduly high inventory of raw materials in relation to the norms/past trends.

v) In case of borrowers having banking arrangements on a consortium basis, the LCs are opened within the sanctioned limit on the basis of agreed share of each banks.

vi) If there is no formal consortium arrangements for financing the borrower, LCs should not be opened by the existing bank or new bank, without the knowledge of other banks.

vii) LCs for acquisition of capital goods should be opened only after banks have satisfied themselves about tying up of funds for meeting the relative liability by way of providing for long term funds or term loans.

viii) In no case working capital limits should be allowed to be utilized for retiring bills pertaining to acquisition of capital assets.

- The exposure ceilings and other restrictions prescribed for total credit exposure including non-fund based facility, advances to bank's directors, loans and advances to relatives of directors, unsecured guarantees etc., must be strictly observed.
- Unauthorized LCs are not to be issued.

FACTORING

Factoring is a financial transaction and a type of debtor finance in which a business (client) sells its accounts receivables (invoices) to a third party (called a factor) at a discount. It is the oldest form of business financing. For many companies it is the cash management tool of choice.

Factoring process

- The seller sells the goods to the buyer and raises the invoice on him.
- Invoices are then submitted to the factor for funding.
- Factor pays the seller, after deducting some discount on the invoice value. It pays around 75 to 80 percent of invoice value after deducting the discount.
- Factor then waits till the buyer to make the payment to him.
- On receiving the payment from buyer on due date, the factor pays remaining 20 to 25 percent of the amount to the client after deducting his fee.
- It can be with recourse factoring in which the loss due to non payment by the buyer is borne by the client or without recourse factoring if nonpayment risk is borne by the factor.
- Generally in India with recourse factoring is widely done.

Advantages of Factoring

- Since the factor performs the duty of collection of debtors, the client can focus on other areas of business.
- Credit risk of client is reduced, especially in without recourse factoring.
- Working capital is not locked-up, as factor immediately gives funds to the client.
- Reduces cost as the sales ledger and the recovery function is performed by the factor.

- Cash flow and the liquidity position in the business is improved.
- Business creditors can be paid timely or before time thus help in negotiating better discount terms from the suppliers.
- Reduces need for raising new capital in the business.

Disadvantages of Factoring

- Bad behaviour of factor with the debtors may affect the business relationship and the goodwill of the company.
- Factors often avoid risky debtors, so the responsibility of such debtors remains with the company.

RBI guidelines on provision of Factoring services by Banks

- Banks should adhere to the provisions of Factoring Regulation Act, 2011.
- Banks may formulate policy approved by their Boards. The policy may specifically address issues pertaining to the various risks associated with this activity and put in place suitable risk mitigation measures.
- Factoring services may be provided either with recourse or without recourse or on limited recourse basis.
- Proper and adequate control and reporting mechanisms should be put in place before such business is undertaken.
- Receivables acquired under factoring should not exceed 80% of the invoice value.
- Thorough credit appraisal of debtors should be done before entering into factoring arrangement.
- Invoices should represent genuine trade transactions.
- Under without recourse factoring, where the factor is underwriting the credit risk on the debtor, there should be clearly laid down board –approved limit.
- Factoring should be treated at par with loans and advances and accordingly extant prudential norms on loans and advances would be applicable to this activity.
- The facilities extended would be covered within the overall exposure ceiling.
- Interest charged will be subject to the guidelines on interest rates on advances and fees charged will be subject to the guidelines on reasonableness of bank charges.
- Credit information regarding overdue receivables should be furnished to the Credit Information Companies.
- The instructions / guidelines issued in respect of KYC / AML / CFT should be strictly adhered to.
- International factoring arrangements should be in compliance with FEMA guidelines.
- Engagement of Recovery Agents should be strictly as per the guidelines issued from time to time.
- Outsourcing of activities should adhere to the guidelines on “Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks.”
- To increase liquidity support for the MSME sector, RBI has told Bankers that factoring transactions on ‘with recourse’ basis shall be eligible for priority sector classification by banks, which are carrying out the business of factoring departmentally.

COMMERCIAL PAPERS (CP)

Commercial Paper (CP) is an unsecured money market instrument issued in form of a promissory note (negotiable instrument). It was introduced in 1990 with a view to enable highly rated corporate borrowers to meet their short-term funding requirements for their operations and to provide an additional instrument to investors.

Corporates, Primary Dealers (PDs) and All-India Financial Institutions ('FIs') are eligible to issue CP subject to –

- The tangible net worth of the company, as per the latest audited balance sheet , is not less than Rs. 4 crore.
- Company has been sanctioned working capital limit by bank/s or FIs.
- The borrowal account of the company is classified as a Standard Asset by the financing bank/s, FIs. All eligible participants shall obtain the credit rating for issuance of CP from credit rating agencies specified by RBI from time to time for the purpose. Minimum credit rating shall be A-2 (as prescribed by Securities Exchange Board of India) and issuer shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue (the maturity date of the CP should not go beyond the date up to which the rating of the issuer is valid). CP can be issued in denominations of Rs. 5 lakh or multiples thereof. The aggregate amount of CP from an issuer shall be within the limit as approved by its Board or the quantum indicated by the credit rating agency for the specified rating. CP will be issued at a discount to face value as may be determined by the issuer.

Only a schedule bank can act as an Issuing and Paying Agent ('IPA') and investors can be individuals, banking companies, other corporate bodies, Non-Resident Indians ('NRI's) and Foreign Institutional Investors (within the limits set for them by SEBI from time to time). No issuer shall have the issue of CP underwritten or co-accepted.

CPs can be issued either in form of a promissory note or in a dematerialized form. Banks, FIs and PDs can hold CP only in dematerialized form. Initially the investor in CP is required to pay only the discounted value of CP by means of a crossed account payee cheque to the account of the issuer through IPA. On maturity of CP, the holder of CP shall present the instrument for payment to the issuer through IPA if CP is held in physical form. If held in demat form, the holder will have to get it redeemed through the depository and receive payment through IPA.

Standardised procedures and documentation for CPs are prescribed in consultation with Fixed Income Money Market and Derivatives Association of India (FIMMDA) in consonance with international best practices. CP being a 'stand alone' product, it would not be obligatory in any manner on the part of banks and Financial Institutes to provide stand-by facility to the issuer. However they can provide credit enhancement by way of stand-by assistance/credit backstop facility etc. Non-banking entities including corporates can provide unconditional and irrevocable guarantee for credit enhancement for CP issue.

BILLS PURCHASE AND DISCOUNT

The bills of exchange are classified into Demand Bills and Usance Bills. A demand bill is one which is payable 'at sight' or 'on demand' or 'on presentation'. Usance bill is one where drawer (seller) allows certain period of time (Usance) say 30, 60 or 90 days to drawee (buyer) to make the payment. The bills can further be classified as Clean Bill or Documentary Bill. If drawer of a bill encloses document of title to the goods (Railway Receipt, Lorry Receipt, Motor Transport Receipt, Bill of Lading) it is documentary bill, and if no such document is enclosed, it is a clean bill.

In case of Purchase and Discount of bills, the banker credits the customer's account with the amount of the bill after deducting his charges (called discount). This facility extended against Demand bills is called Bills Purchased facility and facility extended against Usance bills is called Bills Discounting facility.

Advantages of Discounting of Bills

- *Safety of Bank's funds* : Though bank does not get charge over any tangible asset here, the security that the bill is negotiable legal instrument and if it is not paid by the drawee (buyer), bank can always recover by debiting drawer's (seller) account.
- *Certainty of payment* : As bill finance is of short term nature, bill maturing for payment on demand or after the usance is completed (which is maximum of 90 days), the advance is self-liquidating. Monitoring also becomes easy as when the bill of a particular party remains unpaid, further discounting bills of such party can be stopped.
- *Facility of refinance* : In case of need of funds, banks can rediscount the eligible bills with the Central Bank (RBI).
- *Stability in the value* : The value of the bill as security does not fluctuate. Amount advanced and amount payable are fixed.
- *Profitability* : Bank credits the amount of bill by recovering its interest (discount) from the amount of bill, hence the yield is more.

Banks have to take into consideration following points while sanctioning Bills facility:

- Clean bills are treated by banks as unsecured advance and hence sanctioned only to borrowers of high repute. Documentary bills are safer and advance against it is secured.
- Usance Documentary bills with DP term (documents against payment) are considered safer than DA term (documents against acceptance) as in latter case the goods are parted first and the payment is made by the buyer later.
- The purpose of the facility should be carefully verified.
- Adequate information about the parties on whom the bills are drawn by the borrower should be gathered from the market and their creditworthiness should be assessed.
- If borrower draws bills on number of parties, party wise limits within the overall limit should be sanctioned, depending on percentage of sales of each party in total sales.
- Ensure that bills are drawn out of genuine trade and commercial transactions and are not of accommodation nature.

Grant of Non Fund Based Limits (standalone basis):

Scheduled Commercial Banks are permitted by RBI to grant non-fund based facilities including Partial Credit Enhancement (PCE) to those customers, who do not avail any fund based facility from any bank in India, subject to the following conditions:

a) Banks shall formulate a comprehensive Board approved loan policy for grant of non-fund based facility to such borrowers.

b) Verification of Customer credentials: The banks shall ensure that the borrower has not availed any fund based facility from any bank operating in India. However, at the time of granting non-fund based

facilities, banks shall obtain declaration from the customer about the non- fund based credit facilities already enjoyed by them from other banks.

c) Credit Appraisal and due-diligence: Banks shall undertake the same level of credit appraisal as has been laid down for fund based facilities.

d) The instructions/ guidelines on Know Your Customer (KYC)/Anti- Money Laundering (AML)/ Combating of Financing of Terrorism (CFT) applicable to banks, issued by RBI from time to time, shall be adhered to in respect of all such credit facility.

e) Submission of Credit Information to CICs: Credit information relating to grant of such facility shall mandatorily be furnished to the Credit Information Companies (specifically authorized by RBI). Such reporting shall be subject to the guidelines under Credit Information Companies (Regulation) Act, 2005.

f) Exposure Norms: Banks shall adhere to the exposure norms as prescribed by RBI from time to time.

Traders who import goods and services from abroad, can now apply for credit facilities in the form of Letter of Credits, Bank Guarantees, all important financial instruments, required to transact overseas mostly, without availing vanilla bank loans

RESTRICTION ON LENDING

Under Banking Regulation Act, 1949, there are statutory restrictions on banks for lending. Brief of such restrictions is given below:

i) **Advances against bank's own shares**: In terms of Section 20(1) of the Banking Regulation Act, 1949, a bank cannot grant any loans and advances on the security of its own shares.

ii) **Advances to bank's Directors:** Section 20(1) of the Banking Regulation Act, 1949 lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.

iii) **Advances to Companies for Buy-back of their Securities:** As per provisions of the Companies Act, 2013, companies are permitted to purchase their own shares or other specified securities out of their free reserves/securities premium account or from the proceeds of any shares or other specified securities subject to compliance of statutory conditions. In view of the above, banks should not provide loans to companies for buy-back of shares/securities.

iv) **Granting loans and advances to relatives of Directors:** Without prior approval of the Board or without the knowledge of the Board, no loans and advances should be granted to relatives of the bank's Chairman/ Managing Director or other Directors, Directors (including Chairman/Managing Director) of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/ Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks.

v) **Restrictions on Grant of Financial Assistance to Industries Producing / Consuming Ozone Depleting Substances (ODS):** Banks should not extend finance for setting up of new units consuming/ producing the Ozone Depleting Substances (ODS). No financial assistance should be extended to small/medium scale units engaged in the manufacture of the aerosol units using chlorofluorocarbons (CFC) and no refinance would be extended to any project assisted in this sector.

vi) **Restrictions on Advances against Sensitive Commodities under Selective Credit Control (SCC):** With a view to prevent speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, Reserve Bank of India issues directives from time to time to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities.

vii) Banks and their subsidiaries should not undertake financing of 'Badla' transactions.

viii) Banks should not extend bridge loans against amounts receivable from Central/State Governments by way of subsidies, refunds, reimbursements, capital contributions, etc subject to certain exemptions like financing against receivables from Government by exporters (viz. Duty Draw Back and IPRS).

LESSON ROUND UP

- There is a sense of debt in loan, where as an advance is a facility being availed of by the borrower. However, like loans, advances are also repaid. Thus a credit facility repayable in installments over a period is termed as loan while a credit facility repayable within one year may be known as advances.
- Basic principles that banks must follow while lending are: safety of funds, liquidity, profitability, purpose, spread or diversification & security. There are two types of borrowers viz: Retail Borrowers &Corporate Borrowers. When bank lend money, it enters into a contract and all essentials of a valid contract must be present in the contract. Different types of credit facilities include demand loans, term loans, over draft and cash credit. While extending loans, banks have to follow directives of RBI regarding exposure norms and other such applicable norms in terms of credit policy guidelines. While extending working capital, banks follow the Tandon committee norms of MPBF. Banks also extend bills financing, packing credit; they also arrange Buyers credit, Suppliers credit, leasing and hire purchase. While lending money banks obtain security from the customer/borrower to safe guard itself as well as to fall back upon in case borrower defaults. The security is therefore examined properly using the MAST (Marketability, Ascertainability, Stability and Transferability) principle. Depending upon type of advance and the nature of security, appropriate charge like Lien, Hypothecation, Pledge, Assignment, Mortgage is created on the security.

GLOSSARY

- Principles of lending, Retail borrowers, Corporate borrowers, MAST, Cash Credit, overdraft, Term Lending, MPBF, 1st Method of lending, 2nd method of lending, Buyer's credit, Supplier's credit, Lease, Hire-purchase.

SELF-TEST QUESTIONS

1. Fill in the blanks
   a. MPBF under 1st method of lending is .....
   b. Borrower's contribution under 2nd method of lending is .....
   c. MAST is – M.....A.....S.....T.....
   d. In case of a Public Limited Co., minimum members should be ..... and maximum should be .....
   e. RBI has permitted banks to undertake business of leasing and hire-purchase within limit of ..... % of their .....
2. Write True or False
   a. The CIN number is 21 digits numerical number.
   b. Packing credit facility is sanctioned to the exporter.

c. In cash credit facility bank can effectively manage the funds.

d. HUF is governed by Indian Partnership Act.

e. In Public limited company there is no restriction on transfer of shares.

f. A bank can grant loans and advances against the security of its own shares

3. Write brief answers to following questions

a. What are the principles of lending?

b. What are the essentials of valid contract?

c. Distinguish between Lease finance and hire purchase.

d. What is packing credit?

e. Compare buyer's credit and supplier's credit.

f. Name the various types of institutional customers.

g. What are the precautions taken by the banker while giving loan to a society?

h. What do you understand by MPBF? Explain recommendations of Tandon Committee Report.

i. How many types of credit facilities are there? Explain all.

j. Distinguish between Bank Guarantee and Letter of Credit

k. What are the precautions to be taken by the banker while granting loans to HUF?

Further reading

1. Banking Law & Practice by P .N. Varshney
2. Principles of Practices of Banking – Indian Institute of Banking & Finance
3. The Indian Partnership Act 1932
4. The Companies Act , 2013
5. Articles on Banking – Shodganga

Lesson 13
Securities for Banker's Loan

LESSON OUTLINE

- Types of Securities
- Assignment
- Lien
- Set-off
- Hypothecation
- Pledge
- Mortgage
- Indemnities and Guarantees
- Book debts
- Corporate Securities
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Lending being essential function of banks to deploy the funds borrowed from depositors and also earn profits for survival and growth, it lends money to borrowers against various securities. While granting advances against these securities bank should examine these securities from the point of its ownership and marketability. Proper charge needs to be created so that in case of need the securities can be sold in the market to recover advanced money.

This chapter will enable the reader to learn about :

- What is a charge and types of charges.
- Types of securities.
- Care to be taken while handling different securities.
- RBI guideline while granting loans against various securities.

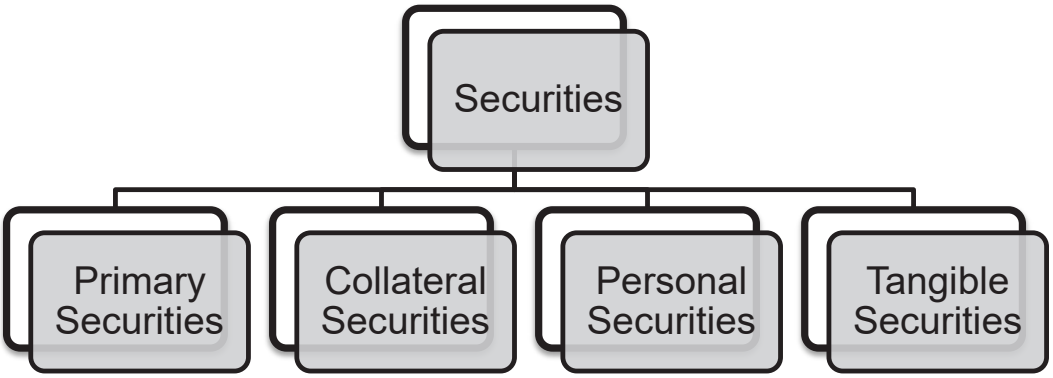
INTRODUCTION

Whenever banks advance loan generally securities are obtained. This is to safeguard advances extended by them in the event of a default by a borrower. Banks obtain movable and immovable properties as securities and create a charge on these securities so as to enforce their security interests later when a need arises. Creating a charge over a property depends upon the nature of property as well the nature of charge sought to be created. Keeping these aspects in mind, the chapter covers various aspects of securities accepted by banks as securities towards loans as well as different types of charges that are created thereon. This is an important aspect for any student of banking as one of the principal business of banking is lending. Several examples are also given for an easy understanding of concepts.

The contents are based on various acts such as The Indian Contract Act, The Transfer of Property Act, SARFESI Act, The Insurance Act, Sale of Goods Act etc and will be useful in practical understanding. The contents have been elaborated to offer rationale for various procedures adopted by banks. The contents are of Level 1 and 2 orientation enabling students to reinforce themselves with deeper understanding of various legalities involved in banking operations in general and more particularly in lending/Advances.

Securities for Banker's Loan

Banks sanction loans to borrowers against some security. These securities help bankers in case the borrower fails to repay the loan for one reason or other. Bankers in such cases sale / liquidate the securities and adjust the proceeds to outstanding loan balance including interest and other charges. As such selection of security, stipulating margin of safety, creating appropriate charge on the security etc. assume lot of importance in the process of lending.



Security can be Main (Principal / Primary) or Collateral (Secondary)

Main security is an asset against which or for the acquisition of which loan is sanctioned by the bank. For instance if bank sanctions loan to a borrower for purchase of machinery or sanctions loan to a borrower to meet his medical expenses and borrower offers his gold ornaments to the bank as security, then in both these cases the machinery and the gold ornaments are Main securities. However in first case the borrower in addition also offers his Fixed Deposit Receipt to bank as a security, then the FDR becomes collateral security. Thus the collateral is an additional security that borrower offers to the bank with the main security. Thus any security like house property, stock of raw materials, plant and equipment etc. can be main security or collateral security depending on whether bank gives loan for it / against it or it is additional security obtained by the bank, respectively.

Security can be Personal (Intangible) or Tangible

Personal security is the surety given by the borrower himself or other individual, firm, company by way of guarantee. This gives a bank a right to sue them in their personal capacity in case of need. Tangible security is in the form of plant, machinery, stock, land and building, etc., which is impersonal in nature.

Attributes of Good Security (MAST Principle)

- Marketability (Freely traded in the market and easily convertible in cash).
- Ascertainability (Value and location of security should be easily ascertainable).
- Stability (Value of security should not fluctuate widely).
- Transferability (Ownership of security should be legally transferable).

What is MARGIN and Why MARGIN is required?

When bank lends money to borrowers against securities, it stipulates certain percentage of the value of security (Market price or book value, whichever is less) as a contribution from the borrower, which is called a Margin. If borrower offers his machinery of Rs. 1,00,000.00 as security, bank generally lends Rs. 70,000.00 (70% of value of security) and asks borrower to bring Rs. 30,000.00 (30%) of his own contribution (margin). The percentage of margin varies depending on the nature of the security and risk profile of the borrower. Margin is necessary for following reasons:

1. Compulsion by regulatory authority. RBI makes it obligatory upon bankers to insist some minimum margin while lending.
2. Margin ensures involvement of borrower in the activity as his stake (own money) is in the asset purchased.
3. Margin acts as a buffer in deterioration in the quality and depreciation in the value of asset.
4. It also acts as a cushion against price fluctuations, non- payment of interest, charges debited to borrower's account and to some extent non-payment of loan installments.

The right of a lender (bank) to be paid from a debtor's (borrower) asset if the debt is not paid is called **Charge on asset**. Borrower creates charge on the securities offered to the bank for availing loan. This gives the bank, right to get payment out of the charged security, however the ownership of asset is not transferred to the creditor (bank).

When charge is created on Fixed Assets like plant and machinery, land and building etc. whose identity do not change during the period of loan is called **Fixed Charge.** Charge created on Current Assets like stocks, debtors which undergo changes (from raw material to work in process to finished goods to debtors) is called **Floating Charge.** It is an equitable charge on the assets of a going concern. The charge becomes fixed when the going concern ceases to be a going concern (winding up, appointment of receiver). This is called Crystallization of the charge. **Pari Passu** (is a Latin word which means "with an equal step" or "on equal footing"). **Charge** is created in favour of several creditors each having proportionate right on the asset on the basis of the ratio of their loans. This generally happens when several banks jointly finance a single borrower (consortium advance). In case of **Exclusive Charge** only one creditor has charge in his favour without intervention of any other creditor. When a charge is created on the assets already charged to another creditor, the second creditor has a charge which is called as **Second Charge**. The right of second charge holder is subject to first charge holder.

ASSIGNMENT

It is transfer of ownership of a property, or of benefits, interests, liabilities, rights under a contract (such as an insurance policy), by one party (the assignor) to another (assignee) by signing a document called deed of assignment. It is transfer of an actionable claim, which may be existing or in future, as a security for loan.

Legal assignment is an absolute transfer of actionable claim. It must be in writing. Signed by the assignor (in case of LIC policy, by the policy holder), and should be informed to the debtor (LIC). In **Equitable assignment** the possession of document representing actionable claim is handed over but no other formalities are observed. However debtor (LIC) has to be informed.

Assignment must be in writing and signed by the assignor or his legal representative and must be witnessed. To make the assignment valid, consideration is not must, however notice to the debtor and his acknowledgement is necessary to make debtor liable to assignee. A borrower can assign the book debts, money due from Government Departments, LIC policies to bank as security for an advance.

LIEN

Lien is defined in Indian Contract Act. It is a right of a creditor to retain the possession of goods and securities owned by the debtor, till the debts are fully paid off. However creditor does not get right to sell the securities. The lien can be **Particular lien** or **General lien**. In case of particular lien only those goods and securities in respect of which debts are incurred, can be retained by the creditor (if a wrist-watch is given to watch repairer for repairing, till the repairing charges are paid, the watch repairer has right to retain the wrist watch in his possession). He cannot sell the watch for the recovery of service charges or also cannot retain any other security of the debtor for these repairing charges. In case of general lien, for the general balance due, the creditor can retain the goods and securities of the debtor. Banks in India enjoy not only right of general lien, they can even sell the goods and securities of the debtor in case of need to recover debts. Banker's lien is therefore called as an **Implied Pledge**. Since Limitation Act is not applicable to right of lien, banks can recover time barred debts also.

Conditions necessary for exercising right of lien:

1. Goods and securities (cheques, bills, shares, debentures etc.) must be owned by the debtor in his own name. Banks may sanction advance to a borrower against third party securities. Such securities cannot be subject matter of lien (except in the name of guarantor).
2. Securities must be received in the capacity of Banker. It means for securing loan and not for other purpose like safe custody, safe deposit vaults, specifically for selling, inadvertently left in the bank, bank handling the securities as trustee or agent etc.
3. Reasonable notice must be given before the sale of securities.
4. There should not be any contract inconsistent to the right of lien.

Sometimes borrower gives an undertaking to the banker as regards his assets that, the assets are free from any charge and without the permission of the bank, no charge will be created on it. This undertaking is called **Negative Lien**. This undertaking, however, has no legal standing and has moral value only.

SET-OFF

Set-off is total or partial merging of a claim of one person against another, in the counter claim of latter against former. For example, if A, in one transaction, owes Rs. 10,000/- to B and in another transaction B owes Rs. 15,000/- to A; then it is not necessary that these two transactions should be settled separately. A and B

can combine these two transactions, and B can pay Rs. 5,000/- to A. Thus they can set-off the mutual debts. In banker – customer relationship, bank through this process recovers borrower's dues from his deposit account. Since this right is statutorily available to bank, the time-barred debts can also be recovered through this right of set-off.

Conditions necessary for exercising right of set-off:

1. Mutual debts must be in same name and capacity. This means if Deposit Account is in the name of A jointly with B and loan is in the name of A, then set-off cannot be exercised. Similarly loan given to Mr. X cannot be recovered from the savings account of his minor son where Mr. X is guardian. Loan given to an individual Mr. Y cannot be recovered from the account of a partnership firm where Mr. Y is one of the partner. However, loan given to a partnership firm can be recovered from the deposit accounts of individual partners, since partners are jointly and severally (individually) liable for firms act.
2. Debts must be due and payable. This means, in case of term loan the installment which is due on 10th day of a month cannot be recovered before 10th.
3. In case the deposit account is in the nature of "Term Deposit", the right can still be exercised, for a lawful debt; however only on maturity of the deposit account.
4. Set-off can be exercised in case of guarantor's account after money is demanded from him.

APPROPRIATION

Appropriation is a right of a debtor. When borrower having more than one debts to the bank, makes payment with an instructions to apply the same to a particular debt, then if the bank accepts this payment, must apply it as per the instructions of the borrower. Instructions can be expressed or implied. Banks need not accept the payment made by the borrower with a condition but if accepts then it cannot ignore the condition (instruction).

When borrower fails to give instruction where the amount is to be applied and even the circumstances also do not indicate to which debt the payment is to be applied then the creditor can apply the payment to any lawful debt which is due and payable.

If neither the debtor nor the creditor exercise right of appropriation then the payment will be applied to discharge the debt in order of time, that is in chronological order (first debit entry will be cleared by first credit entry).

The Rule in case of Clayton's Case is applicable to running accounts like cash credit and overdrafts where the borrower deposits as well as withdraws money from the account continuously. Here the rule states that the debit entry will be set-off by the credit entry by chronological order (first debit by subsequent first credit). In order to crystallize the liability of a deceased, insane, insolvent or retired partner in cash credit / overdraft accounts of partnership firms, banks stop operations in such accounts and allow further operations in fresh account. Similar steps are taken when loan accounts are secured by the guarantee and the guarantor is deceased, becomes insane or insolvent or guarantee is revoked by the guarantor. If the operations in the same account are continued, the subsequent credits will reduce the liability of such partner / guarantor.

PLEDGE

Pledge is defined in Indian Contract Act. It is bailment of goods as security for payment of a debt or performance of promise. The person who delivers goods (borrower) is Pledger or Pawnor and the person to whom the goods are delivered (bank) is Pledgee or Pawnee. The owner of the goods, the joint owner with the consent of other

owner(s), the agent of the owner can pledge the goods. Here the possession of goods is with the creditor (bank) and ownership remains with the debtor (borrower). The possession can be actual or constructive (by handing over the key of godown where the goods are stored, acknowledgement from the warehouseman, handing over document of title to the goods like railway receipt, bill of lading). The possession is till the repayment of loan. The creditor(bank) has to take proper care of the goods pledged. It is a legal charge and fixed one. The charge is not affected by law of limitation and does not require any registration. The creditor (bank) has right to sale the goods after giving notice.

HYPOTHECATION

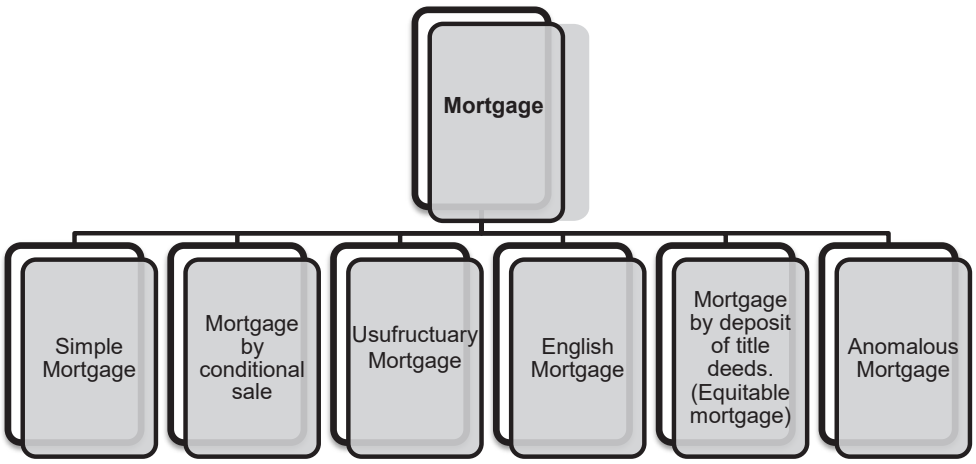
It is defined under SARFAESI Act as "Charge on movable property (stock, machinery, vehicle etc) in favour of secured creditor without delivery of possession of the assets. It is an equitable charge where the possession and the ownership of the assets remain with the borrower. The borrower is called Hypothecator and the bank (creditor) is called Hypothecatee. The right of sale is available to creditor only through a court. Under SARFAESI Act, sale is possible after possession. Creditor cannot take possession without the consent of borrower, however on getting possession, a creditor can sell the security as in case of pledge. Hypothecation is thus a charge against property for an amount of debt, where neither the ownership nor the possession, is passed to the creditor. The document (letter of hypothecation) signed by the borrower provides for an agreement, whereby the borrower agrees to give possession of goods when called upon to do so by the creditor. The charge is required to be registered with the Registrar of Companies (ROC) under section 77 of Companies Act, 2013 (earlier Under Section125 of Companies Act, 1956). Limitation period of 3 years is applicable under Limitation Act. It differs from Mortgage as mortgage relates to immovable properties.

MORTGAGE

It is defined in Transfer of Property Act as, transfer of interest in specific immovable property (land, benefits arising out of land, things attached and permanently fastened to earth) to secure an advanced loan, or an existing debt or a future debt or performance of an obligation. Once the amount due is paid to the lender, the interest in the property is restored back to the borrower. Lender gets right to recover the dues in case of default but does not become owner of the property. Mortgagor is the transferor of interest in the property and Mortgagee is the transferee. The principal money and the interest of which payment is secured is called the mortgage money and the instrument by which the transfer is affected is called the mortgage deed.

The mortgagor has right to redeem the document relating to mortgage property, where possession has been given, to get back the possession and where title has been transferred, to get retransferred, on liquidation of money borrowed. This right of redemption can be exercised before the decree for sale or foreclosure is passed by a court.

On default by the mortgagor, the mortgagee has right to obtain a decree from a court to the effect that the mortgagor be debarred for ever to redeem the mortgage. This is called right of foreclosure. The right of foreclosure describes a lender's ability to take possession of a property through a legal process called foreclosure. Lenders must abide by specific procedures in order for a foreclosure to be legal. The transfer of Property Act contemplates following six types of mortgages:



1. Simple Mortgage

- Court intervention required for mortgagee to sell the property.
- Rent and produce on the property, is not the right of mortgagee.
- Registration is compulsory.
- Mortgagor retains the possession of the property.
- Mortgagor is personally liable too.

2. Mortgage by conditional sale

- Mortgagor is not personally liable for repayment of money borrowed.
- Mortgagee by applying to court can get decree in his favor and can sue for foreclosure.
- Right of foreclosure is available for Mortgage by Conditional Sale only.

3. Usufructuary mortgage

- Mortgagee has legal possession of the property till the borrower repays the money borrowed, however sale is not allowed.
- Mortgagee has right to receive rent and benefits accruing from the property.
- Mortgagor is not liable personally.
- Law of limitation is not applicable.

3. English Mortgage

- Mortgagee gets absolute transfer of property on condition that the same will be retransferred if the debt is fully paid.
- Mortgagor personally liable to pay debt on a specified date.

4. Mortgage by deposit of title deeds (Equitable mortgage/ EMT)

- Property can be located anywhere but the deposit of title deeds has to be made at towns notified by State Government.

- The title deed deposited should be original. In case original title deed is lost or not in existence, a certified true copy by the sub-registrar can be deposited.
- The intention should be to secure debt.
- Registration with Registrar of Assurances is not required. In case of Company, registration of mortgage is required within 30 days.

5. Reverse Mortgage

It is a type of home loan for older homeowners that require no monthly mortgage payments. The amount of loan is determined on the basis of borrower's age, value of property, rate of interest and norms of lending institution. The purpose is to help Senior Citizens to convert their dwelling house property into liquid cash flows to meet their living expenses. Borrowers are still the owners of property and responsible for property taxes and home owner's insurance. Reverse mortgage allows elders to access the home equity they have built up in their homes now, and defer payment of loan until they die, sell or move out of the home. Because there are no required mortgage payments on a reverse mortgage, the interest is added to the loan balance each month. Over the loan's life, the homeowner's debt increases and home equity decreases. When the homeowner dies or moves, the proceeds from the home's sale go to the lender to repay the reverse mortgage's principal, interest, mortgage insurance and fees and balance amount to legal heirs.

Generally, no loan is given against ancestral property since it involves legal issues. Loan in joint names of owner and spouse can be given irrespective of title of property, however one person should be above 60 years and the other above 55 years. Generally, loan is given with a repayment period of 15 years.

6. Anomalous Mortgage

- Any mortgage other than one described above, falls in this category.

  The mortgagor can create subsequent mortgage(s) on the same property. The rule of priority is in the order of time they are created. Limitation period for filing suit for sale of mortgaged property is twelve years from the date mortgage debt becomes due. For filing a suit for foreclosure, limitation is thirty years from the date mortgage debt becomes due. Enforcement of mortgage is governed by the Code of Civil Procedure. Suit for sale of mortgage properties should be filed in the court, within whose jurisdiction the mortgaged property is situated.

INDEMNITIES AND GUARANTEES

Guarantees and Indemnities are a common way in which creditors protect themselves from the risk of debt default. Lenders will often seek a guarantee or indemnity if they have doubts about borrower's ability to fulfill his obligations under a loan agreement.

Contract of Guarantee and contract of Indemnity are defined in Indian Contract Act.

> "A contract of Guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default."
>
> "A contract of Indemnity is a contract by which one party promises to save other from loss caused to him by the conduct of promissor himself or by the conduct of any other person."

In a simple way it can be explained as under:

If A says to B, you lend money to C. If he doesn't pay, I will pay; is a guarantee. If A says to B, you lend money to C and I will see to it that you get your money back; is an Indemnity.

Contract of Guarantee has following three parties:

1. Guarantor, also called as Surety, who gives guarantee.
2. Creditor, the person to whom guarantee is given.
3. Principal Debtor, the person in respect of who's default the guarantee is given.

Thus there are three contracts involved. One between the debtor and the creditor, where the debtor agrees to pay the debts. Second between the creditor and guarantor, who agrees to pay in case the debtor makes default and third between the debtor and the guarantor, who accepts the request of debtor and gives guarantee to the creditor. Guarantee is thus a secondary contract, the primary being between the debtor and the creditor. As such if the primary contract is invalid the secondary contract is not enforceable in the court of law. Example – If loan is sanctioned to a minor, it becomes invalid contract as contract with a minor is void ab initio. Such loan cannot be recovered even if a third party guarantee is obtained at the time of lending. Guarantor's liability arises only after the default committed by the principal debtor.

Contract of Indemnity has following two parties:

1. Indemnifier, the person who makes promise of indemnity
2. Indemnified, the person with whom the promise is made.

The indemnified in a contract of indemnity is entitled to recover from his indemnifier, the damages, cost and sums when sued.

Salient features of contract of guarantee:

- The contract of guarantee can be either oral or written. Bankers however take a written guarantee to bind the surety by his words.
- Consideration: Anything done or any promise made by the Principal Debtor is sufficient consideration to surety for giving guarantee.
- Types of guarantees: A guarantee given for a particular transaction, undertaking or debt is a specific guarantee. This guarantee once given cannot be revoked. A guarantee which extends to a series of transactions is called continuing guarantee. This guarantee can be revoked (called back) by the surety by giving notice to the creditor, but only for future transactions.
- Invalid guarantee: Guarantee obtained by misrepresentation or concealment of the facts makes the guarantee invalid.
- Nature and extent of guarantor's liability: The liability of the surety is secondary and arises only after the principal debtor making default. If at the time of making a contract, surety sets a limit of his liability then he is liable only to that extent. In the absence of such contract, the liability of guarantor is co-extensive with the principal debtor.

Rights of guarantor:

- Right of subrogation: The surety is entitled to the benefit of every security of the debtor which was in the possession of the creditor at the time a contract of guarantee was signed. This right is not affected even if the surety was not aware about the securities of the debtor with the creditor. If the creditor loses or parts with such security, without the consent of the surety, the surety is discharged from his liability to the extent of value of the security so lost or parted with.
- Right to be indemnified by the principal debtor: There is implied promise by the principal debtor to

indemnify the surety. The surety has the right to recover from the principal debtor the amounts which he has rightfully paid under the contract.

- Right to revoke continuing guarantee: The surety has the right to revoke at any time a continuing guarantee by giving a notice of such revocation to the creditor. The surety however remains liable in respect of the transactions which have already taken place.

Liability of the guarantor:

- **The extent of liability** : The liability of the surety is to the same extent to which the principal debtor is liable to the creditor, provided the surety does not restrict his liability in the contact of guarantee. If the liability of principal debtor increases the liability of surety also increases to the same extent but cannot exceed that of principal debtor. The surety however can undertake fixed liability (lesser than the principal debtor) by specifying in the contract of guarantee. The extent of guarantee may be limited in either of the following ways –
  1. Surety may guarantee only part of the entire debt.
  2. Surety may guarantee full debt but specify the amount up to which he makes himself liable to the creditor.
- **The time liability arises** : The liability of surety arises on the principal debtor making default. The liability of the surety does not arise unless the liability of the principal debtor is determined. It is not necessary that the creditor should exhaust all his remedies against the principal debtor before proceeding against the surety for recovery.
- **Liability of co-sureties** : The co-sureties are liable to contribute equal amounts towards the liability of the debtor, provided – there is no agreement to the contrary and they are co-sureties for the same amount of debt. It is immaterial whether the contract of guarantee was the same or separate between each one of them and the creditor and whether they knew about the guarantee given by the other person or not. The contribution of each co-surety shall be equal and not proportionate. The actual amount of such contribution shall, however, not exceed the amount for which the guarantee is given by any one of them. If the creditor releases one of the co-sureties, other sureties are not discharged and the surety so released is also not discharged from his responsibilities to other sureties.

Obligations of Creditor towards surety

- The creditor must not change the original terms of the contract between himself and the principal debtor without taking consent of the surety(ies). Any variance, made without the surety's consent, in the terms of the contract between the principal debtor and the creditor, discharges the surety as to transactions subsequent to the variance.
- The creditor should not release or discharge the principal debtor. The surety is discharged from his obligation if there is a contract between the creditor and the principal debtor, by which the principal debtor is released or if there is any act or omission on the part of the creditor, the legal consequence of which is the discharge of the principal debtor.
- The creditor should not give any indulgence to the debtor. If the creditor enters into a contract whereby he makes a composition with or he agrees not to sue principal debtor or to extend the time of repayment of debt, the surety will be discharged from his liability unless the surety gives consent to such contract.
- The creditor should not do any act which is inconsistent with the right of the surety and should not omit to do any act which is required of him.

- As soon as the liability of the surety arises, the creditor is entitled to demand payment from him. The banker is also entitled to exercise his right of lien on the securities of the surety in his possession on arising liability of the surety.
- If the surety becomes insolvent, the creditor is entitled to recover the dues from the estate of the insolvent party after determining the surety's liability by recalling the debt from the principal debtor and in case of his default.

Guarantee is not a contract of '*uberrimae fidie' (utmost good faith):* A contract of guarantee does not require full disclosure of all material facts by the principal debtor or the creditor to the surety before the contract is entered into. Fraud on the part of principal debtor is not enough to set aside the contract, unless the surety can show that the creditor knew of the fraud and was a party to it. When a guarantee is given to a banker, there is no obligation on the banker to inform the intending surety of matters affecting the credit of the debtor or any circumstances connected with the transaction.

BOOK DEBTS

Book debts mean the amount that the customers of business owe to the business. Thus the trade receivables (debtors and bills receivable) are the book debts of the business. Debtors are the customers (persons or companies) who purchase goods or services from the business and pay money for the same later. Sometimes businesses after selling goods or services to customers, draw bill, which are accepted by them and amount is paid by them on due dates. These are called Bills receivables. Both are current assets of the business and are financed by the banks. It is a short term finance and is called working capital finance. Banks finance debtors which are not exceeding 90 days of age.

CORPORATE SECURITIES (SHARES / DEBENTURES / BONDS)

Securities issued by joint stock companies broadly fall into two categories:

1. Ownership securities – equity shares and preference shares and
2. Creditor ship securities – debentures.

Preference shares of a company are those shares which carry certain preference rights for their holders over those of equity shareholders. Preference shares carry prescribed rate of dividend, which company will have to pay before any dividend can be distributed to the equity shareholders. Preference shares can be cumulative or non-cumulative. In case of cumulative preference shares, if company is unable to pay the prescribed dividend during any year (s), the same will be payable out of profits of the company in future years. This right is not available to non-cumulative preference shareholders. Preference shares may be redeemable or non-redeemable. Redeemable shares are paid after specified period.

Debentures are generally secured by mortgage of immovable property of the company. The owners of such debentures are the secured creditors of the company. Unsecured debenture holders do not posses any such charge over the assets of company. Debentures are generally redeemable after specified time. Interest payable on debentures is at half yearly rest with an option of either cumulative or non-cumulative basis. Debentures can be fully or partly convertible. 'Debentures with Right Attached' gives holder, a right to subscribe to the shares of the company against cash payment (at a low premium) at a future date.

Bonds are issued by corporations, municipalities or governments to raise money for funding their projects. The bond issuer pays interest to the bond holder at regular intervals at specified rate called coupon rate. The bond amount is paid on maturity. The zero coupon bonds are issued at discount and on maturity paid at face value. Convertible bonds give option to investors to convert bond into equity at fixed conversion price.

RBI guidelines on Loans and Advances against Shares, debentures and Bonds.

- Advances may be granted to individuals against these securities held by them.
- The purpose of advance may be to meet contingencies and personal needs or for subscribing to new or right issues of shares/debentures/bonds or for purchase in the secondary market.
- Limit of advance should not exceed Rs. 10.00 lakhs per individual where securities are held in physical form and Rs. 20.00 lakhs per individual if securities are held in dematerialized form.
- Margin should be minimum 50% of the market value of equity shares / convertible debentures held on physical form, and minimum 25% if in dematerialized form. The margins for advances against preference shares, non-convertible debentures and bonds can be decided by individual banks.
- Each bank to formulate its loan policy with the approval of their Board of Directors.
- Share and stock brokers may be provided need based overdraft facility / line of credit after careful assessment of need. The ceiling of Rs. 10.00 and 20.00 lakhs will not be applicable in their cases.
- Share and stock brokers registered with SEBI and who comply with prescribed capital adequacy norms are only eligible for loans.
- While granting advances against shares held in joint names to joint holders or third party beneficiaries, banks should be circumspect and ensure that the objective of the regulation is not defeated by granting loans to other joint holders or third party beneficiaries to circumvent the above limits placed on loans against shares and other securities.
- Banks may grant advances to individuals for subscribing to IPOs. Loans/advances to any individual from banking system against security of shares, convertible debentures, convertible bonds, units of equity oriented mutual funds and PSU bonds should not exceed the limit Rs.10.00laks for subscribing to IPO. The corporate should not be extended credit by banks for investment in other companies' IPOs. Similarly banks should not provide finance to NBFCs for further lending to individuals for IPOs.
- Banks may extend finance to employees for purchasing shares of their own companies under Employee Stock Option Plan (ESOP) / reserved by way of employees' quota under IPO to the extent of 90% of the purchase price of the share or Rs. 20.00 lakhs whichever is less. Bank employees can not avail loan to purchase shares of their own bank under ESOP/IPOs or from secondary market.
- While advancing against Units of Mutual Funds, bank should ensure that – units are listed on Stock Exchange, units have completed minimum lock-in-period, amount of advance is linked to NAV/ repurchase price or market value, whichever is less and the advance is purpose oriented. The units issued by Mutual Funds relating to tax saving equity plans are not to be treated as approved securities for the purpose of considering loans / advances since they are not traded / listed in the stock exchanges.
- Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchange. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.
- Advances against primary security of shares/ debentures / bonds should be kept separate and not combined with other advances.
- No advances against partly paid shares to be granted.

CERSAI

A Central Registry has come into effect from 31 st March 2011. Government of India has made it compulsory that Equitable mortgages created by way of deposit of title deeds are registered with the Central Registry. As per provision of SARFAESI Act, a company has been formed named 'Central Registry of Securitisation Asset Reconstruction and Security Interest of India'(CERSAI) with 51% paid up capital held by Central Government and the remaining 49% of the paid up capital shared amongst the top 10 PSBs and National Housing Bank. CERSAI has been established as a company under section 8 of the Companies Act, 2013 by the Government of India. The object of the company is to maintain and operate a Registration System for the purpose of registration of transactions of securitisation, asset reconstruction of financial assets and creation of security interest over property, as contemplated under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act). CERSAI is providing the platform for filing registrations of transactions of securitisation, asset reconstruction and security interest by the banks and financial institutions.

CERSAI is a risk mitigation tool for the Banks / Housing Finance companies, FIs and public at large to prevent multiple financing against the same property. Any bank, financial institution or an individual can access the registration platform of CERSAI for a certain fee. By registering themselves with CERSAI, the lenders can pull up the information on an asset or property to validate that whether any previous security interest has been created by a different lender ((banks, financial institutions etc.) in the past. Usually, this is done before the sanction of a loan to a borrower.

Agricultural property is excluded from the purview of SARFAESI Act. Hence bank need not register with Central Registry mortgage/security interest created on agricultural land.

The Government of India has subsequently issued a Gazette Notification dated January 22, 2016 for filing of the following types of security interest on the CERSAI portal:

a. Particulars of creation, modification or satisfaction of security interest in immovable property by mortgage other than mortgage by deposit of title deeds.

b. Particulars of creation, modification or satisfaction of security interest in hypothecation of plant and machinery, stocks, debts including book debts or receivables, whether existing or future.

c. Particulars of creation, modification or satisfaction of security interest in intangible assets, being know how, patent, copyright, trademark, licence, franchise or any other business or commercial right of similar nature.

d. Particulars of creation, modification or satisfaction of security interest in any 'under construction' residential or commercial or a part thereof by an agreement or instrument other than mortgage.

In order to proceed under SARFAESI Act, it is now mandatory to register charge under CERSAI. After registration of security interest with Central Registry, Banks will have priority over all other debts, revenues, taxes, cesses and other rates payable to the central government or state government or local authority. Satisfaction of SI (Security Interest) has to be done on the CERSAI portal when all the loans on the asset have been repaid.

CHARGE CREATION

Charge creation is required to be registered when charge created on by way of Hypothecation of stocks, book debts, mortgage of immovable properties, ship, goodwill, uncalled share capital of the company. Charge registration is not required in case of Pledge of goods or securities or against Fixed Deposits. As per section 125 of Companies Act, Charges created on a company's assets (except pledge) have to be registered with Registrar

of Companies within 30 days of creation of the charge. When charge in favour of two banks is registered, priority of charge is in favour of bank, in whose favour it is created first i.e. date of documents.

LESSON ROUND UP

- Securities help a banker to recover the amount of advances, in case of borrowers' default. Securities can be principal or collateral one. Main security is the asset against which advances were given. Collateral security is an additional security that borrower offers to the bank with the main security. A good security has the attributes of MAST. Margin is a contribution from borrower which is insisted by a bank when advances are given. Margins enable involvement from borrower, acts as fall back if loans turn bad, acts as a cushion against fluctuations in the value of security. Banks create types of different types of 'charge' over securities given by a borrower to enforce their rights. Some of the charges which banks create are Assignment, Lien, Pledge, Hypothecation, Mortgage. Banks also obtain Guarantees and Indemnities from borrowers to safe guard themselves against defaults in certain cases.
- **Assignment** is transfer of an actionable claim, which may be existing or in future, as a security for loan. **Lien** a right of a creditor to retain the possession of goods and securities owned by the debtor, till the debts are fully paid off. However creditor does not get right to sell the securities. The lien can be **Particular lien** or **General lien**. Banks in India enjoy not only right of general lien, they can even sell the goods and securities of the debtor in case of need to recover debts. **Set-off** is total or partial merging of a claim of one person against another, in the counter claim of latter against former. This right is statutorily available to banks. **Appropriation** is a right of a debtor/ borrower. A borrower having more than one debt to the bank, makes payment with an instructions to apply the same to a particular debt his instruction has to be followed. When borrower fails to give instruction, right is of creditor the apply the payment to any lawful debt which is due and payable. If neither the debtor nor the creditor exercise right of appropriation then the payment will be applied to discharge the debt in chronological order.
- **Pledge** is Bailment of goods as security for payment of a debt or performance of promise. **Hypothecation** is a **c**harge on movable property (stock, machinery, vehicle etc) in favour of secured creditor without delivery of possession of the assets. It is an equitable charge where the possession and the ownership of the assets remain with the borrower. **Mortgage** is a transfer of interest in specific immovable property (land, benefits arising out of land, things attached and permanently fastened to earth) to secure an advanced loan, or an existing debt or a future debt or performance of an obligation. Transfer of Property Act contemplates six types of mortgages. **Guarantees** and **Indemnities** are a common way in which creditors protect themselves from the risk of debt default. **Contract of Guarantee** is a contract to perform the promise or discharge the liability of a third person in case of his default. A **Contract of Indemnity** is a contract by which one party promises to save other from loss caused to him by the conduct of promissor himself or by the conduct of any other person.

GLOSSARY

- Securities, Charging, Lien, General Lien, Particular Lien, Negative Lien, Right of Set-off, Appropriation, Assignment, Actionable claim, Pledge, Hypothecation, Mortgage, Simple Mortgage, English Mortgage, Mortgage by Conditional Sale, Usufructuary Mortgage, Mortgage by Deposit of Title Deeds, Anomalous Mortgage, Reverse Mortgage, Guarantees, Indemnities, Letter of Credit, Factoring, Commercial Paper, Purchase of Bills, Discounting of Bills, Documents of title to goods, Book Debts, Corporate Securities, CERSAI, Charge creation.

SELF TEST QUESTION

1. Write True or False
   a. The disadvantage of Factoring is that money remains blocked with factor and is not available for business.
   b. Bankers Lien is called as an Implied pledge because it gives right to the bank to sell the securities.
   c. Charge created on land, building, plant and machinery is Floating charge.
   d. Right of appropriation is that of a Creditor.
   e. Commercial Paper (CP) is a short term money market instrument issued as secured demand promissory note.
2. Fill in the blanks:
   a. In Hypothecation the possession of goods is with ..... where as in Pledge it is with .....
   b. Liability of a guarantor is ..... while that of indemnifier is .....
   c. In MAST principle:

      M ..... A ..... S ..... T .....
   d. Charge created by banks while giving loan against the security of Life Insurance policy is .....
   e. ..... is a risk mitigation tool for the Banks / Housing Finance companies, FIs and public at large to prevent multiple financing against the same property.
3. Answer the following questions.
   a. What are the various types of Mortgages?
   b. Compare Pledge and Hypothecation.
   c. What are the conditions necessary to exercise right of set-off?

For further reading

1. The Indian Contract Act.
2. Law of Sale of Goods Act.
3. The Transfer of Properties Act
4. The SARFESI Act
5. The Insurance Act
6. RBI Master Circulars on Credit/Money Market Instruments
7. Circulars of IBA

Lesson 14
Documentation

LESSON OUTLINE

- Types of Documents
- Procedure
- Stamping
- Securitisation
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Documentation is important area in Lending portfolio as properly executed documents help banks to recover money from the borrowers and their assets through courts. The document obtained should be in the proper custody of the bank's officials and they should be kept alive as they have limited period of life.

This chapter will enable the reader to learn about:

- What is document and Documentation.
- Why documentation.
- The Process – Selection, stamping and execution.
- Limitation Period.
- Securitization.

DOCUMENT AND PURPOSES OF DOCUMENTS

One of the important areas in Bank credit, is documentation. The purpose of a bank taking documents is multifold. Documents help banks to identify:

- The borrower and the capacity in which money is borrowed (Individual, partnership firm, company, trustee etc);
- Type of security (land, building, plant, machinery, stock, debtors, Life Insurance Policy etc.) ;
- The charge created on it (Pledge, hypothecation, mortgage, assignment etc.) and
- To count the limitation period, as the documents have expiry date and also
- Present in a court of law the evidence for the recovery of money from the defaulting borrower.

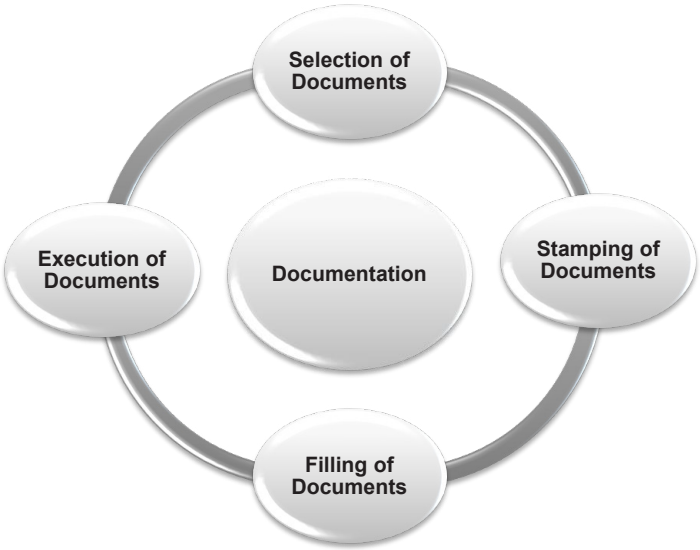
As per the General Clauses Act, the word **document** means "any matter written, expressed or described upon any substance by means of letters, figures or marks or by more than one of these means, which is intended to be used for the purpose of recording that matter" and as per Indian Stamp Act, "document include everything by which any right or liability is or proposed to be recorded". It means not only the contents printed on legal papers in legal language and stamped as per the Stamp Act constitute documents but even the account opening forms, the letters of correspondence between the customer and the bank are documents as they also can help in establishing written evidences of transactions.

Documentation includes execution of documents properly selected, appropriately stamped by concerned person(s). Execution means signing a document after having read and understood it. It is not necessary for a bank to explain each and every document to the executants; however, if specifically asked by the executants, then the bank should give correct information and should not misguide or hide any information. Documents requiring witnessing / attestation, if not witnessed or attested are not considered documents and cannot be enforceable in the court of law. Similar will be the effect in case, where the documents after execution require registration, but are not registered and documents requiring stamping are either unstamped or under stamped. Each executant must put date and place below the signature.

The execution of documents depend on capacity in which money is borrowed.

Borrower	Signatories
Individual	Himself / Herself or his / her Agent
Joint Borrower	All of them jointly or their respective Agents
Proprietorship firm	Proprietor or Agent
Partnership Firm	All the partners
HUF	The Karta. All the major coparceners if they are to be made personally liable.
Joint stock company	Persons authorized as per the resolution passed by the Board
Trust / Society / Club	Persons authorized as per the resolution

Procedure of Documentation



SELECTION OF DOCUMENTS

Documents required depend on what is the type of facility (e,g. security may be debtors but facility can be cash credit, bill discounting/purchases) , who is the borrower (individual – whether singly or jointly, partnership firm, HUF, joint stock company etc), what is the charge to be created (security may be stock but charge to be created can be hypothecation or pledge). Documents also depend on additional terms and conditions, if any, stipulated in the letter of sanction. Generally banks have printed forms of documents approved by their legal department. It should therefore be ensured that appropriate sets of documents are selected for the facility sanctioned to the borrower.

STAMPING OF DOCUMENTS

Stamp duty paid is revenue for the government – state or central.

Documents attracting stamp duty, should be stamped before or at the time of execution (not later), by paying appropriate amount of stamp duty. There are documents like Demand Promissory Note, Share Transfer Form, Insurance Policy etc. where the stamp duty is decided by the Central Government, hence it is same throughout the country. Documents like Letter of Hypothecation, Pledge, Guarantee etc., the stamp duty is decided by the State Government, hence it may differ from state to state. There are certain transactions where the stamp duty is not fixed but is ad-valorem that means depends on the value of the transaction represented in the document.

Bank documents are affixed with Non-judicial stamps. The stamp paper should bear the date prior to its execution and also should be less than six months old. Other stamps in use are:

- Judicial - used for filing of suits and postal stamps.
- Non-judicial stamps (are of three types)
  - **Adhesive stamps** such as revenue stamp, share transfer stamp, notary stamp etc,
  - **Special Adhesive stamps** which are affixed on letter of guarantee, agreements of pledge, hypothecation etc. and
  - **Embossed stamps** which are impressed on non-judicial papers used in place of special adhesive stamps.

Documents if unstamped or under stamped at the time of execution are not documents and are not accepted in the court. However before submitting in the court they can be brought in to order by paying penalty, which is ten times the deficit and then putting the deficit amount of stamps on the document, e.g. a document where stamp duty payable is Rs. 100.00 but is affixed with stamps of Rs. 60.00 (deficit of Rs. 40.00) , then after paying penalty of Rs.400.00 (ten times deficit), the deficit amount of Rs. 40.00 will be affixed on document (Total amount Rs.440.00) to bring it in order.

FILLING OF DOCUMENTS

Although banks have printed documents, it is necessary to fill the blanks and also to be completed with alterations, overwriting, cutting etc., if any, with proper authentication. It is to be ensured that the documents are completed in all respects and no blank places are left. One person in one sitting should complete the documents in the same ink and same handwriting. Otherwise it may give impression that the documents were blank at the time of execution. Subsequent filling of documents without the consent of executants makes the document invalid.

EXECUTION OF DOCUMENTS

Documents must be executed in the presence of bank officials. Each and every page of the document should be signed by each and every executant. The signatures on the documents must agree with the signatures on the loan application form. All alterations, insertions, deletions, additions must be authenticated under full signature of the executant. If a single document is signed by more than one executants on different dates and at different places, each executant on the last page of each document must put the date and place below the signature.

If the executant does not understand the language of the document, a separate declaration from him, in the language known to him must be taken stating that the contents of documents are explained to him and he has signed the document after having understood the same. The declaration letter should be witnessed by another person and the same should be attached to the document.

If the person who executes the documents is **illiterate,** he/she will affix the thumb impression instead of signature. The bank official in whose presence such documents are executed should give separate declaration that the contents of the documents are explained to the executant in language known to him and thumb impression is affixed after having understood the same. The declaration has to be witnessed by third person and the same should be attached to the document.

Such declaration should be obtained by the lawyer or the notary, in case the executant is a **blind person** and the same should be attached to the document.

If an executant has signed with left hand the fact be noted below the signature.

If documents are executed by a **partnership firm,** where minor is admitted for the benefits of partnership firm, such minor should not sign the documents. When such minor becomes major and if opts to be a partner, a separate declaration from him to be obtained to make him liable for the firm's dues. He then becomes liable for the firm's acts right from the date of his admission to the benefits of the firm. Minor is not liable for the losses of the firm. When minor becomes major or becomes aware of the fact that he has been admitted to the benefits of the firm – whichever date is later – from that day within 6 months he can repudiate the liability as a partner by giving public notice. In case of partnership firm the documents should be signed by all the partners (irrespective of operating instructions in current account), in their representative (under the rubber stamp) as well as personal capacity.

In case of **HUF** only the Karta should sign the documents and not the coparceners. However, if the bank

wants to make the coparceners personally liable then all the major coparceners of HUF should also sign the documents.

In case of a **company**, only those officials who are authorized to sign documents as per the resolution of the Board, should sign the documents. Bank should obtain a copy of resolution and place on record. Company's common seal has to be affixed on documents as per the resolution and the provisions in company's Article of Association. Documents without company's common seal are not considered as documents.

Every company creating a charge on its assets, within or outside India, must register it within 30 days of its creation, with **Registrar of Companies (ROC)**. If a charge is registered, a person acquiring such assets shall be deemed to have notice of charge from date of registration. If charge is not registered and a certificate of registration is not issued by ROC, charge created by a company shall not be taken into account by the liquidator or any other creditor.

It is the duty of a company to file the details with the Registrar. In case a company fails, the creditor may apply to the Registrar within prescribed period. ROC, within 14 days, after giving notice to company, allow such registration.

A company shall give intimation to ROC of the **satisfaction** in full, of any charge registered, within a period of 30 days from the date of such satisfaction.

When a charge is registered, the **priority of charge** will be determined by the date of execution of documents (creation) and not the date of registration. . For example ,documents are dated June 5, 2018 with bank A (creation of charge) and the charge is registered on June 25, 2018 (within the stipulated time of 30 days). Whereas on the same assets Bank B has documents dated June 7, 2018 and the charge registered on June 22, 2018. Here although bank B has registration done on 22nd June 2018, earlier than Bank A, who has done registration on 25th June, still Bank A will have priority as the creation of charge is earlier (and of course registration is done in stipulated time period).

Following Charges are required to register under Companies Act, 2013

- -Charge for the purpose of securing debentures
- -Charge on uncalled capital of the company
- -Charge on any immovable property and interest thereon
- -Charge on company's book debts
- -Charge on any movable property (except pledge)
- -Charge on the undertaking
- -Charge on any calls made but not paid
- -Charge on goodwill, patent or license under patent, trade mark, copy right or any license under copy right

The prescribed details for creation and modification to be filed in form CHG -1 (other than debentures) & CHG – 9 (for debentures) and satisfaction of the charge should be filed using CHG-4. A duly certified copy of each document evidencing any creation, modification, satisfaction should be filed with the forms.

In case of **Co-operative Societies**, documents should be executed by the office bearers as per the resolution passed in the general body meeting. Bank should have certified up-to-date true copy of Bye-laws on record and adhere strictly to the procedure / provisions in it as regards credit limit.

Clubs / Institutions / Schools must be incorporated otherwise they are not legal entities and do not have contracting powers. If they are incorporated, their borrowing powers and procedure is mentioned in their Bye-laws. Execution of documents should be as per the resolution passed.

When documents are signed in different states by different parties, then the procedure is – the document will be stamped as per the stamp duty applicable in the state where it is first signed. Then if the document travels to a state where stamp duty payable is more, then the difference will be paid first and then the second person will sign. If the document travels to a state where stamp duty payable is less then there is no need to pay any stamp duty. Any document other than bill of exchange and promissory note, executed out of India, and subsequently brought to India, will have to be stamped again by the first holder within 3 months from the arrival in India.

When documents are executed by Power of Attorney (PA) holders instead of principals, a notice should be sent to principal, intimating him about the same and the acknowledgement should be obtained. Such acknowledgement and the certified copy of PA should be kept on record.

REGISTRATION OF LOAN DOCUMENTS

The purpose of registration of a document is to give notice to public that such a document is executed and also to ensure that anyone who would like to deal with the property should have complete knowledge of all the transactions affecting the title to the asset / property. It can also help in preventing frauds and forgeries.

The documents are to be registered at the office of Registrar of Assurances under whose jurisdiction the property falls (and not where the documents are executed). The lime limit for registration is four months from the execution of document.

Witnessing of documents

It is the attestation of documents by two or more persons who must see the executants signing or putting the

thumb impression, as the case may be, on the documents. Witnessing persons should be third party / should not be the party to the transaction. Documents which require witnessing, if not witnessed, will not be considered as duly executed documents.

The documents which need witnessing are :

- All types of deeds – mortgage, sale, guarantee.
- Power of attorney
- Assignment of LIC on the policy itself.

Documents in the form of agreements (hypothecation, pledge, guarantee), lien, set-off, etc. need not be witnessed.

Limitation Act

The documents taken by banks for a credit facility, do not have perpetual life. The provisions of Limitation Act apply to them. The act prescribes the period of limitation for different types of documents. Limitation period is the time limit within which the parties to a legal agreement, can take action in a court of law to enforce their legal rights. A suit cannot be filed for recovery on the strength of a time barred document. Hence, if the documents are time barred, the bank's right of legal remedy is lost. There are certain rights like lien, set-off, selling the securities which are pledged where remedy through court is not required. As such there is no limitation period for these rights.

Extension of Limitation period

A limitation period can be extended in following ways-

- **Acknowledgement of Debt**

  It is an acceptance of liability by the party liable by Letter of Acknowledgement of Debt (LAD), balance confirmation letter or even ordinary letter. If can be in form of signing of a balance sheet by authorized person. It has to be before expiry of limitation period.

- **Part payment**

  If a debtor makes a part payment before expiry of limitation period, himself or if it is made by his authorized agent, a fresh limitation period starts from the date of such payment. The pay-in-slip has to be filled in by the debtor himself or signed by him or his agent. It cannot be signed by any other person including employee of the debtor.

- **Obtaining fresh set of documents**

  When the bank obtains the fresh set of documents before expiry of the original documents, fresh period of limitation starts from the date of execution of the fresh documents. A time barred debt can be revived under section 25(3) of Indian Contract Act only by fresh promise in writing and signed by the borrower or his authorized agent. A promissory note / fresh documents executed for the old or a barred debt will give rise to a fresh cause of action and a fresh limitation period will start from the date of such documents.

Some important points to be noted as regards the Limitation Act

- The limitation period cannot be altered (shortened / extended) by mutual consent.
- While computing the limitation period, the document executed date is considered. .It means a Demand

Promissory Note (which has limitation period 3 years from the date of execution) executed on 1st June 2018 will have limitation period up to 1st July 2021.

- If the court is closed on the day when limitation period expires, suit can be filed on the next working day of the court.
- The period of person's absence in India and also where a person is restrained by way of injunction from a court to enforce a legal remedy are excluded for computing the period.
- Most of the documents have limitation period of three years, and the banks therefore should maintain proper register to exercise control.
- When different people sign documents on different dates, the limitation period will start from the date, the last executant has signed.
- It was held by the Supreme Court in one of the cases that the limitation period against the guarantor will start from the day on which demand is made on the guarantor to pay the money.

Some limitation periods

Demand Loans	3 years from the date of loan
Demand promissory note	3 years from the date of execution / date of the document
Term Loan	3 years from the due date of each instalment
Cash Credit	3 years from the date of documents execution
Facility under charge of pledge	Limitation period not applicable.
Bill Discounted	3 years from the due date of the bill
Bill Purchased	3 years from the date of bill
Loan under mortgage	12 years from the
Recover of money lost in fraud	3 years from the date on which fraud is detected
Deposit Accounts	3 years from the date od demand
Execution of decree	12 years from the date of decree

SECURITIZATION

Prior to June 21st, 2002 when the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was enacted, banks and financial institutions had to enforce their security through courts for the recovery of their advances. The process was slow and time consuming. Moreover, hypothecation, the charge against which majority of advances is granted by banks, had no provision in any law. The SARFAESI Act takes care of these issues.

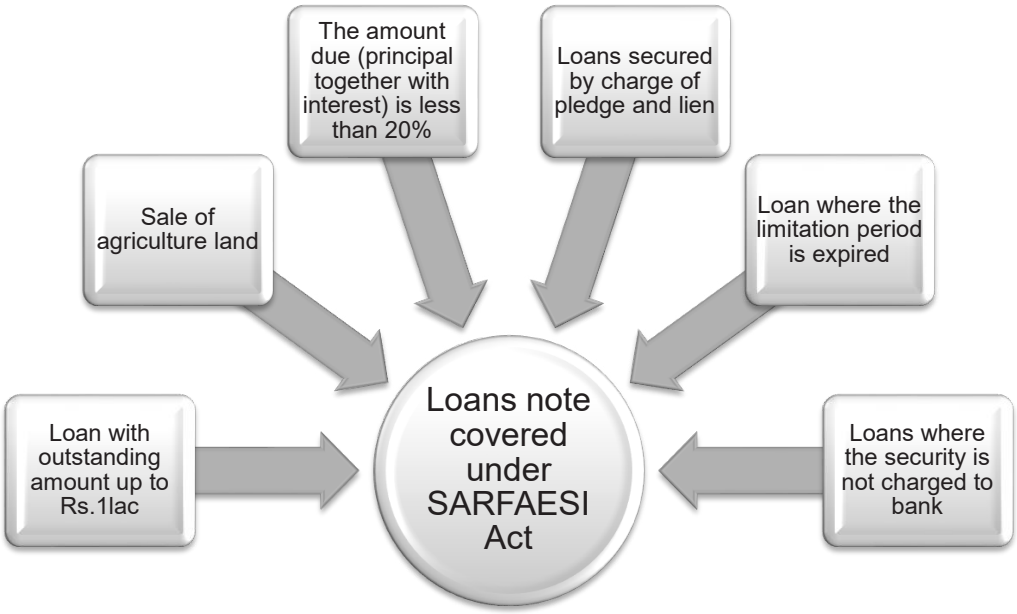
Securitization is the process of acquisition of Non Performing Asset (NPA) portfolio of a bank or a financial institution by Securitization or Reconstruction Company on mutually agreed terms and conditions as regards sale or transfer price, with or without recourses, transfer or sale etc. Bank gets price in the form of cash or debentures / bonds as mutually agreed upon. This process provides the banks and FIs a summary procedure for recovery of their secured dues which have been classified as NPA in their books, by setting up of Securitization and Reconstruction Company for taking over the defaulted loans.

Securitization or Reconstruction Company may be raising funds for acquisition from their own resources or from the Qualified Institutional Buyers by issuing security receipts representing undivided interest in the financial assets or otherwise. The security receipt is transferable in the market. SARFAESI Act, thus makes the secured NPA portfolio of a bank transferable.

The SARFAESI Act empowers the secured creditor (Bank / FI) as under, if the borrower and or guarantor defaults:

- To take possession, sell or lease the secured assets. (prior to this, a notice has to be served to the borrower / guarantor, to clear dues with in a time period of 60 days)
- Take over the management of the business or appoint a manager.
- Instruct any person at any time, who holds secured assets of the borrower and from whom any money is due or becoming due to the borrower; to pay such money to the bank (secured creditor).
- To initiate action in Debt Recovery Tribunal.

In case of consortium or multiple lending arrangement, if 60% of the secured creditors in value, agree to initiate recovery action, it will be binding on all secured creditors.



Important Provisions and terms in SARFAESI Act

- "**Asset reconstruction**" means acquisition by any securitization company or reconstruction company, of any right or interest of any bank / Financial Institution ('FI') in any financial assistance for the purpose of realization of such financial assistance.
- **"Bank"** includes all banks – Nationalized, RRBs, Co-operative etc. and any such banks which the Central Government may by notification, specify for the purpose of this Act, and also FIs.
- "**Borrower"** is any person who has been granted financial assistance by bank / FI, who has given guarantee or created any mortgage or pledge as security for the financial assistance granted by any bank / FI. It also includes a person who becomes borrower of a securitization company or reconstruction company consequent upon acquisition.

- "**Central Registry"** means the registration office set up by the Central Government for the purpose of registration of all the transactions of asset securitization, reconstruction and transactions of creation of security interests. The registration system operates on the priority of registration basis – person who registers first gets priority over the one who registers later.
- "**Default"** means non-payment of any principal debt or interest thereon or any other amount payable by a borrower to any secured creditor consequent upon which the account of the borrower is classified as non-performing asset in the books of secured creditor.
- "**Financial Assistance**" means any credit facility extended by bank or FI such as loan or advance granted, debentures or bonds subscribed, guarantee given, letter of credit established etc.
- " **Financial Asset**" means any debt or receivables including –
  a. Secured or unsecured claim to any debt or receivables.
  b. Any debt or receivables secured by mortgage or charge on immovable property.
  c. A mortgage, charge hypothecation, or pledge of movable property.
  d. Any right or interest in the security, whether full or part underlying such debt or receivables
  e. Any beneficial interest (existing, future, accruing, conditional or contingent) in the property, whether movable or immovable, or in such debt, receivables.
  f. Any financial assistance.
- "**Hypothecation**" means a charge in or upon any movable property, existing or future, created by the borrower in favour of a secured creditor without delivery of possession of the moveable property to such creditor, as a security for financial assistance and includes floating charge and crystallization of such charge into fixed charge on movable property.
- "**Non-performing Asset**" means an asset or account of a borrower, which has been classified by a bank or FI as sub-standard, doubtful or loss asset in accordance with the directives or guidelines relating to assets classifications issued by RBI
- "**Property**" means –
  a. Immovable property.
  b. Movable property.
  c. Debt or right to receive payment of money, whether secured or unsecured.
  d. Existing and future receivables.
  e. Intangible assets - know-how, patent, copyright, trade mark, license, franchise or any other business or commercial right of similar nature.
- "**Qualified Institutional Buyer"** (QIB) means a FI, insurance company, bank, state financial corporation, state industrial development corporation or a foreign industrial investor registered under SEBI Act.
- "**Reconstruction Company**" means a company formed and registered under Companies Act for the purpose of asset reconstruction.
- "**Securitization**" means acquisition of financial assets by any securitization / reconstruction company from any originator, whether by raising of funds by such company on its own or from QIB by issue of security receipts representing undivided interest in such financial assets or otherwise.

- "**Securitization Company**" means any company formed and registered under Companies Act for the purpose of securitization.
- "**Secured Asset**" means the property on which security interest is created.
- "**Secured Creditor**" means any bank or FI or any consortium or group of banks or FIs, including – debenture trustee appointed by any bank or FI or securitization company or reconstruction company.
- "**Secured Debt**" means a debt which is secured by any security interest.
- "**Security Interest**" means right, title and interest of any kind whatsoever upon property, created in favour of any secured creditor and includes any mortgage, charge, hypothecation, assignment.
- "**Security Receipt**" means a receipt or other security, issued by a securitization company or reconstruction company to any QIB pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization.

  Central Registry of Securitization Assets Reconstruction and Security Interest of India (CERSAI)

  CERSAI was established on march 31, 2011under Companies Act.

  Transaction to be registered are – securitization and asset reconstruction, all mortgages, securities hypothecated, security interest in intangible assets, security interest in under-construction buildings.

  The registration should be done with in 30 days of transaction. Permission of Central registrar is required if 30 days delay thereafter. For further delay the permission of Central Government is required.

  Banks can take possession of only those securities in respect of which the charge is registered with CERSAI. Banks will have priority of recovery over Govt. dues where charge is registered with CERSAI.

RBI guidelines on sale of NPAs

- At least once in a year – preferably in the beginning – banks shall identify and list internally specific financial assets identified for sale.
- Board should review, at a minimum, all assets classified as 'doubtful', above a threshold amount.
- The invitation for bids should preferably be publicly solicited using e-auction platform.
- Prospective buyers must be provided at least 2 weeks time for due diligence.
- Banks should have policy for valuation of assets. In case of exposure beyond Rs. 50.00 crore, banks shall obtain two external valuation reports.
- The discount rate used in the valuation exercise may be either cost of equity or average cost of funds or opportunity cost subject to a floor of the contracted interest rate plus penalty, if any.

Obligations of selling bank

- Any NPA asset in the books, is eligible for sale.
- Banks shall sell NPAs on without recourse basis.
- Only on receiving the entire sale consideration, the asset can be taken out of books.
- The selling bank can re-purchase the NPAs sold by it, only after specified period and only where SC/RC have successfully implemented the restructuring plan for the NPAs acquired.

Obligations of the purchasing bank

- Estimated cash flows should normally be realized in 3 years period.
- Can not sell purchased NPAs for minimum period of one year.
- First 90 days from the date of purchase the assets will be classified as standard assets. Thereafter it will be based on the recovery.
- The risk weight for the purpose of capital adequacy will be considered 100%

LESSON ROUND UP

– One of the important requirements of the lending banker is to hold valid legal documents. The process of execution of required documents in the proper form and according to law is known as documentation. Proper documentation helps in recovery of loans and advances. Banks have their own standard forms for promissory notes and other documents and no deviations are normally permitted. The borrowers are expected to execute these documents as required by the bank. Banks also do not generally give copies of these documents to the borrower which sometimes creates difficulty when these documents become subject matter of a legal dispute.

– Collateral security if properly obtained with all collateral documents as appropriate would assist the banks to protect the interests of the banks in case the borrower defaults. These securities supported by correct and valid documents would assist the banks in recovery process as well.

– Banks should be careful while accepting various securities and ensure such securities are properly charged (like lien, hypothecation, pledge, assignment, set off and mortgages) in favour of the banks.

SELF TEST QUESTIONS

1. Fill in the blanks:
   a. Every company creating a charge on its assets, must register it within ..... days of its creation, with .....
   b. Bank documents are affixed with .....stamps.
   c. For NPAs purchasing bank, the assets for first 90 days will be classified as .....
   d. Prospective buyers of NPAs. Must be provided minimum ..... for due diligence.
   e. Loan with outstanding amount up to ..... is not eligible under SARFAESI Act.
2. Write True or False:
   a. Registration is not required in case of a mortgage deed.
   b. Limitation period cannot be shortened or extended by mutual consent.
   c. Agreement of Hypothecation need not be witnessed.
   d. Charge on the Company's movable assets pledged to a bank, need not be registered.
   e. When a charge is registered, the priority of charge will be determined by the date of registration and not by the date of creation.
3. Answer the following questions.

a. List out the documents which require witnessing and documents which do not require witnessing.

b. List out the documents which require registration and documents which don't.

c. Which charges on the company's assets are required to be registered with ROC?

d. What are the different ways in which limitation period can be extended?

e. What is securitization?

Further reading

www.rbi.org.

Lesson 15
Calculation of Interest and Annuities

LESSON OUTLINE

- Calculation of Simple Interest
- Calculation of Compound Interest
- Equated Monthly Instalments
- Fixed Interest Rate
- Floating Interest Rate
- Calculation of Annuities
- Interest Calculation using Products/ Balances
- Amortisation of a Debt
- Concept of Sinking Funds
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Interest calculations are of vital importance in banking as banks deal with the same on a daily basis involving variety products such as deposits and loans. Though calculations are done through computers it is essential to know the principles and rationale behind calculations of the same for a banker. With this in view, inputs are given in this chapter. This chapter will enable a reader- .

- To understand the concepts of simple, compound interest.
- To understand the concepts of annuities and sinking funds.
- To know about mathematical calculations required for interest.
- To understand the calculations of equated monthly instalments.
- To understand the concept of annuities.
- To understand the concept and application of interest calculations based on products.
- To understand the concept of amortization.
- To understand the concept of sinking funds.

INTRODUCTION

Interest is payment from a borrower or deposit-taking financial institution to a lender or depositor of an amount above repayment of the principal sum (i.e., the amount borrowed), at a particular rate. It is distinct from a fee which the borrower may pay the lender or some third party. It is also distinct from dividend which is paid by a company to its shareholders (owners) from its profit or reserve, but not at a particular rate decided beforehand, rather on a pro rata basis as a share in the reward gained by risk taking entrepreneurs when the revenue earned exceeds the total costs

For example, a customer would usually pay interest to borrow from a bank, so they pay the bank an amount which is more than the amount they borrowed; or a customer may earn interest on their savings, and so they may withdraw more than they originally deposited. In the case of savings, the customer is the lender, and the bank plays the role of the borrower.

Interest differs from profit, in that interest is received by a lender, whereas profit is received by the owner of an asset, investment or enterprise. (Interest may be part or the whole of the profit on an investment, but the two concepts are distinct from each other from an accounting perspective.)

The rate of interest is equal to the interest amount paid or received over a particular period divided by the principal sum borrowed or lent (usually expressed as a percentage).

In economics, the rate of interest is the price of credit, and it plays the role of the cost of capital. In a free market economy, interest rates are subject to the law of supply and demand of the money supply, and one explanation of the tendency of interest rates to be generally greater than zero is the scarcity of loanable funds.

Interest income is always considered as the main pillar of any banking institution. As we all know, the definition of Banking is accepting deposits for the purpose of lending. Whenever a customer takes a loan from a bank, it charges him/ her certain interest at a predefined and specific rate. The actual meaning of interest is the rate at which a return is paid by the borrower to compensate the bank for a loss in value of money over period of time. The payment of the same is either at some time intervals or at the end of the loan period. The said interest is calculated based on the terms of the agreement between the borrower and the Bank. Many times, based on the borrower's needs and the type of the loan, the type of interest is ascertained.

Therefore the contents of this chapter covers concepts of interests such as simple interest, compound interest, Equated Monthly installment, fixed and floating interest rates, annuities, interest calculations based on products, concept of amortization and also about sinking funds.

The contents are of practical utility for a student and aimed to make him thorough with all concepts relating to interest rates. In that sense these contents are of Level 1 orientation enabling students to reinforce themselves with deeper operational knowledge. Though due to core banking adopted by banks calculation of interest is done by computers, it is imperative that a student learns the principles on which interest calculations are made so that these can be explained convincingly where necessary, apart from gaining mastery over the same.

Interest Rate

An **interest rate** is the amount of interest due per period, as a proportion of the amount lent, deposited or borrowed (called the principal sum). The total interest on an amount lent or borrowed depends on the principal sum, the interest rate, the compounding frequency, and the length of time over which it is lent, deposited or borrowed.

It is defined as the proportion of an amount loaned which a lender charges as interest to the borrower, normally

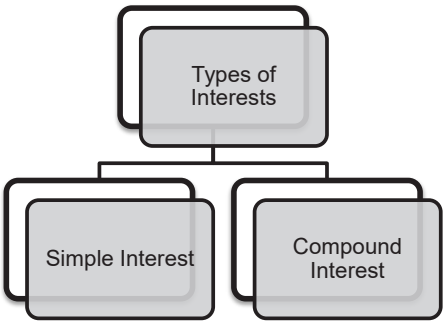
expressed as an annual percentage. It is the rate a bank or other lender charges to borrow its money, or the rate a bank pays its savers for keeping money in an account.

Annual interest rate is the rate over a period of one year. Other interest rates apply over different periods, such as a month or a day, but they are usually annualised. Interest rates vary according to:

- the government's directives to the central bank to accomplish the government's goals
- the currency of the principal sum lent or borrowed
- the term to maturity of the investment
- the perceived default probability of the borrower
- supply and demand in the market

Reasons for Interest Rate changes

- **Political short-term gain:** Lowering interest rates can give the economy a short-run boost. Under normal conditions, most economists think a cut in interest rates will only give a short term gain in economic activity that will soon be offset by inflation. The quick boost can influence elections. Most economists advocate independent central banks to limit the influence of politics on interest rates.
- **Deferred consumption:** When money is loaned the lender delays spending the money on consumption goods. Since according to time preference theory people prefer goods now to goods later, in a free market there will be a positive interest rate.
- **Inflationary expectations:** Most economies generally exhibit inflation, meaning a given amount of money buys fewer goods in the future than it will now. The borrower needs to compensate the lender for this.
- **Alternative investments:** The lender has a choice between using his money in different investments. If he chooses one, he forgoes the returns from all the others. Different investments effectively compete for funds.
- **Risks of investment:** There is always a risk that the borrower will go bankrupt, abscond, die, or otherwise default on the loan. This means that a lender generally charges a risk premium to ensure that, across his investments, he is compensated for those that fail.
- **Liquidity preference:** People prefer to have their resources available in a form that can immediately be exchanged, rather than a form that takes time to realize.
- **Taxes:** Because some of the gains from interest may be subject to taxes, the lender may insist on a higher rate to make up for this loss.
- **Banks:** Banks can tend to change the interest rate to either slow down or speed up economy growth. This involves either raising interest rates to slow the economy down, or lowering interest rates to promote economic growth.
- **Economy:** Interest rates can fluctuate according to the status of the economy. It will generally be found that if the economy is strong then the interest rates will be high, if the economy is weak the interest rates will be low.



CALCULATION OF SIMPLE INTEREST

Simple interest is a type of interest that is applied to the amount borrowed for the entire duration of the loan, without considering any other factors, such as past interest (paid or charged) or any other financial aspects. Simple interest is generally applied to short-term loans, usually one year or less. It is also called as 'Flat rate' as its the amount charged for each year at a fixed percentage for the amount borrowed.

Following is the formula for calculation of simple interest :

$$\text{Interest} = \frac{P \times R \times T}{100}$$

In above formula

Interest = Total interest charged for the given period P= Principal amount that was borrowed

R= Rate of interest specified

T= Time or duration of the loan in years

If Mr. A has borrowed Rs. 10000/- from ABC bank at 15% rate for one year, the interest the Bank would charge is

$$\text{Interest} = \frac{P \times R \times T}{100}$$

$$\text{Interest} = \frac{10000 \times 15 \times 1}{100}$$

Interest = 1500/-

Similarly using the above equation, we can get the value of other variations also.

Example 1

A sum of Rs. 30000 becomes Rs. 33000 at the end of 2 years when calculated at simple interest. The rate of interest would be-.

Simple interest = 33000 – 30000 = 3000 Time = 2 years.

$$\text{Interest} = \frac{P \times R \times T}{100}$$

R = 3000 * 100 / 30000 * 2

R = 5%.

Example. 2. At what rate percent per annum simple interest will a sum of money double itself in 6 years?

Solution:

Let P = x, then A = 2x

Also, S.I = A - P

= 2x - x

= x

T = 6 years

We know that S.I. = (P × R × T)/100

(x × R × 6)/100 = x

R = 100x/6x = 16.6 %

Example 3. A sum amounted to Rs 2520 at 10% p.a. for the period of 4 years. Find them sum.

Solution:

Let A = Rs. 2520

R = 10% p.a.

T = 4 years

P = ?

Let the principal be x

S.I = (x × 10 × 4)/100 = 2x/5

A = P + I

A = x + 2x/5

A = (5x + 2x)/5 = 7x/5 [But given that A = Rs. 2520]

7x/5 = 2520

7x = 2520 × 5

x = (2520 × 5)/7 = Rs. 1800

CALCULATION OF COMPOUND INTEREST

In simple interest calculation, the assumption is that the interest would be charged only once during the given period. In contrary to this, if the interest is charged more than once in the prescribed duration, the interest has to be re-invested. It is called as the compound interest. It is the addition of interest to the principal amount, or in other words, it is interest on interest. It is the result of reinvesting interest, rather than paying it out, so that interest in the next period is then earned on the principal sum plus previously accumulated interest.

Simple Interest	Compound Interest
It is calculated on the total principal amount for the total tenure.	It is calculated on the principal amount periodically (monthly, quarterly, half-yearly or annually).

The accumulated interest on the principal is not added to the calculation of interest for the next period.	The interest that you accumulate periodically is added to the calculation of interest for the next period.
The interest earned/paid will not increase even if the calculation is done periodically.	The interest earned or paid will increase if the frequency of interest generation or payment is more.
The accumulation of interest is slow.	The accumulation of interest is fast since you get interest on the growing interest amount as well.
Simple interest will not earn you enough for savings and investments but will benefit you if you take a loan.	Compound interest will earn you more in savings and investments but will be costlier on a loan.
It is not good for wealth creation.	It is good for wealth creation.
It is beneficial to the borrower but not to the lender. You will be paying less on a loan that is taken on simple interest.	It is beneficial to the lender but not to the borrower. You will be paying more on a loan that is taken on compound interest.
Simple interest is easy to calculate.	Compound interest is complicated to calculate.

Comparative analysis of Simple Interest and Compound Interest

The formula for compound interest is

$$A = P (1 + R)^n$$

Where

P = Principal Amount

R = Rate of interest (Annual) n = Number of year

A = Amount of money accumulated after n year including interest

Financial institutions vary in terms of their compounding rates - daily, monthly, yearly, etc. As a simple example, a savings account with Rs. 1000 principal and 10% interest per year (compounded yearly) would have a balance of Rs. 1100 at the end of the first year. By the end of the second year, the Rs. 1100 amount would have received 10% more, making Rs. 1210. And this will continue for the end of the tenure of the principal borrowed.

The formula for annual compound interest, including principal sum, is:

$$A = P (1 + r/n)^{(nt)}$$

Where:

A = the future value of the investment/loan, including interest

P = the principal investment amount (the initial deposit or loan amount) r = the annual interest rate (decimal)

n = the number of times that interest is compounded per year t = the number of years the money is invested or borrowed for

Note that this formula gives you the future value of an investment or loan, which is compound interest plus the principal. If we want to derive at the compound interest only, following formula is useful:

Total compounded interest = P (1 + r/n) (nt) – P

Example 4

1. If Mr. Darshan invests Rs. 20000/- into a Fixed Deposit, paying 10% annual interest the accumulation of the interest is quartrely, how much money will he get after 10 years?

Given information- P = 20000, r = 0.1, n = 4, t = 10

Solution: A = 20000 1 + 0.1/4 $^{4\,(10)}$

A = 20000 X 2.685063838

A= 53701.27

So Mr. Darshan will get Rs. 53701.27 after 10 years.

2. If Mr. Sudhakar wants have Rs. 25000 after 4 years, How much money he would need to deposit today at 8% annual interest compounded monthly?

Given information- P = ?, r = 0.8, n = 12, t = 4, A = 25000 25000 = P 1 + 0.08/12 $^{12\,(4)}$

25000 = P 1.375666

P = 18173.01

So Mr. Sudhakar should invest Rs. 18173.01.

Equated Monthly Instalments (EMI)

An equated monthly installment (EMI) is a fixed payment amount made by a borrower to the lender on a specified date each calendar month. Equated monthly installments are used to pay off interest and principal each month so that over a specified number of years, the loan is paid off in full. It consists of both, payment towards interest and payment towards principal. EMI is derived based on the amount borrowed, interest rate and the time for which the loan is taken.

The formula to calculate the EMI is

$$EMI = [P \times r \times (1+r)^n]/[(1+R)^n-1]$$

where P = loan amount or principal, r = interest rate per month [if the interest rate per annum is 9%, then the rate of interest will be 9/(12 x 100)], and n = the number of monthly installments.

Example 5

Loan amount = Rs. 10,00,000/-

Interest rate = (% rate) / 12 months = 11% / 12 months = 0.0091 Loan period (N)= 15 years = 180 months

$EMI = [P \times r \times (1+r)^n]/[(1+R)^n-1]$

$$EMI = \frac{(10,00,000 \times 0.0091) \times (1+0.0091)^{180}}{[(1+0.0091)^{180}]-1}$$

EMI = Rs. 11,365.96

As the interest calculation is on the reducing amount of the principal, the amount of EMI remains constant throughout the period.

Following table can illustrate the calculation and the appropriation of the interest and the principal amount. A

loan of Rs. 2,00,000 is taken at 10% interest rate for 18 months.

Date on which the EMI is paid	EMI	Interest Calculated @ 10%	Net amount after Interest adjusted towards principal	Principal outstanding
1/1/2018	12011.42	1666.67	10344.75	189655.25
1/2/2018	12011.42	1580.46	10430.96	179224.30
1/3/2018	12011.42	1493.54	10517.88	168706.41
1/4/2018	12011.42	1405.89	10605.53	158100.89
1/5/2018	12011.42	1317.51	10693.91	147406.98
1/6/2018	12011.42	1228.39	10783.02	136623.95
1/7/2018	12011.42	1138.53	10872.88	125751.07
1/8/2018	12011.42	1047.93	10963.49	114787.58
1/9/2018	12011.42	956.56	11054.85	103732.73
1/10/2018	12011.42	864.44	11146.98	92585.75
1/11/2018	12011.42	771.55	11239.87	81345.88
1/12/2018	12011.42	677.88	11333.53	70012.35
1/1/2019	12011.42	583.44	11427.98	58584.37
1/2/2019	12011.42	488.20	11523.21	47061.16
1/3/2019	12011.42	392.18	11619.24	35441.92
1/4/2019	12011.42	295.35	11716.07	23725.85
1/5/2019	12011.42	197.72	11813.70	11912.15
1/6/2019	12011.42	99.27	11912.15	0.00

FIXED INTEREST RATE

A fixed interest rate is an unchanging rate charged on a liability, such as a loan or mortgage. It might apply during the entire term of the loan or for just part of the term, but it remains the same throughout a set period. Mortgages can have multiple interest-rate options, including one that combines a fixed rate for some portion of the term and an adjustable rate for the balance. These are referred to as “hybrids.”

Salient points as regards fixed interest rate are as under :

- A fixed interest rate avoids the risk that a mortgage or loan payment can significantly increase over time.
- Fixed interest rates can be higher than variable rates.
- Borrowers are more likely to opt for fixed-rate loans during periods of low interest rates.
- Advantages and Disadvantages of Fixed Interest Rates
- Fixed rates are typically higher than adjustable rates. Loans with adjustable or variable rates usually offer lower introductory rates than fixed-rate loans, making these loans more appealing than fixed-rate loans when interest rates are high.
- Borrowers are more likely to opt for fixed interest rates during periods of low interest rates when locking in the rate is particularly beneficial. The opportunity cost is still much less than during periods of high interest rates if interest rates go lower.

FLOATING INTEREST RATE

As mentioned in the name, this rate is not fixed, it may change subject to the market conditions. That is to say the rate of interest which is tied to a bench mark rate. As and when the bench mark rate undergoes a change the rate of interest under floating rate will change. It is also called as variable rate. The bench mark rate should be made known by the bank to the depositor or borrower at the time of making the deposit or taking advances. Example of bench mark rates could be Repo rate or Bank rate or Marginal Cost of Lending Rate (MCLR). Let us see an example of floating rate linked to repo rate. If the floating rate quoted by the bank is = Repo rate + 100 basis point (i.e. 1%)

Lets us assume the repo rate for four quarters as : 1st Quarter = 5.50 %

2nd Quarter = 5.75%

3rd Quarter = 5.40%

4th Quarter = 5.90%

Then the corresponding interest rates will be 1st Quarter = 6.50%

2nd Quarter = 6.75% 3rd Quarter = 6.40% 4th Quarter = 6.90%

It can be seen from the above that floating rates can increase or decrease depending upon the movement of bench mark rate. It can be advantageous to the customer or it can be disadvantageous depending upon the bench mark rate movement. These days banks offer floating rate based deposits as well as loans such as housing loans/personal loans. This is subject to the conditions that there has to be complete transparency regarding the rate calculation from the bank side. Under the floating rate loan if the loan is being repaid by an EMI, the repayment tenure will be changed without disturbing the amount of EMI.

Annuities

An annuity is a financial product that provides certain cash flows at equal time intervals. Annuities are created by financial institutions, primarily life insurance companies, to provide regular income to a client.

An annuity is a reasonable alternative to some other investments as a source of income since it provides guaranteed income to an individual. However, annuities are less liquid than investments in securities because the initially deposited lump sum cannot be withdrawn without penalties.

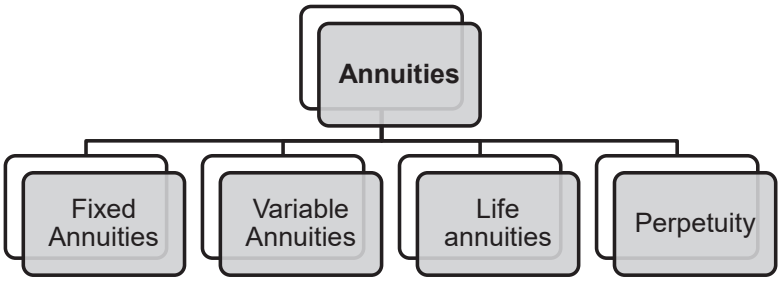
Upon the issuance of an annuity, an individual pays a lump sum to the issuer of the annuity (financial institution). Then, the issuer holds the amount for a certain period (called an accumulation period). After the accumulation period, the issuer must make fixed payments to the individual according to predetermined time intervals.

Annuities are primarily bought by individuals who want to receive stable retirement income.

Types of Annuities

There are several types of annuities that are classified according to frequency and types of payments. For example, the cash flows of annuities can be paid at different time intervals. The payments can be made weekly, biweekly, or monthly.

The primary types of annuities are:



1. Fixed annuities

Annuities that provide fixed payments. The payments are guaranteed, but the rate of return is usually minimal.

2. Variable annuities

Annuities that allow an individual to choose a selection of investments that will pay an income based on the performance of the selected investments. Variable annuities do not guarantee the amount of income, but the rate of return is generally higher relative to fixed annuities.

3. Life annuities

Life annuities provide fixed payments to their holders until his/her death.

4. Perpetuity

An annuity that provides perpetual cash flows with no end date. Examples of financial instruments that grant the perpetual cash flows to its holders are extremely rare.

Timing of payments

Payments of an annuity-immediate are made at the end of payment periods, so that interest accrues between the issue of the annuity and the first payment. Payments of an annuity-due are made at the beginning of payment periods, so a payment is made immediately on issue.

Contingency of payments

Annuities that provide payments that will be paid over a period known in advance are annuities certain or guaranteed annuities. Annuities paid only under certain circumstances are contingent annuities. A common example is a life annuity, which is paid over the remaining lifetime of the annuitant. Certain and life annuities are guaranteed to be paid for a number of years and then become contingent on the annuitant being alive.

Variability of payments

- **Fixed annuities** – These are annuities with fixed payments. If provided by an insurance company, the company guarantees a fixed return on the initial investment.
- **Variable annuities** –A variable annuity is a type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. As opposed to a fixed annuity that offers a guaranteed interest rate and a minimum payment at annuitization, variable annuities offer investors the opportunity to generate higher rates of returns by investing in equity and bond subaccounts. If a variable annuity is annuitized for income, the income payments can vary based on the performance of the subaccounts.
- **Equity-indexed annuities** – Annuities with payments linked to an index. Typically, the minimum

payment will be 0% and the maximum will be predetermined. The performance of an index determines whether the minimum, the maximum or something in between is credited to the customer.

Deferral of payments

An annuity which begins payments only after a period is a deferred annuity. An annuity which begins payments without a deferral period is an immediate annuity.

CALCULATION OF ANNUITIES

A series of fixed payments over a period of time or receipt of payments is known as Annuity. The fixed period can be monthly, quarterly, half-yearly (semi-annual), and yearly (annual).

Annuities can be classified broadly in to two types. Normal or ordinary annuity and annuity due.

Under ordinary annuities payments are received at the end of the period. The best example is fixed deposit interests received at the end of every quarter or interest payments received on bonds at the end of year.

Under annuities due, payments are received at the commencement of the period. Rental payments which are paid in advance to a land lord by a tenant.

Annuity calculations involve the concept of Present value and future value of money.

Present value of future receivables:

Example 6

If we have to determine the present value of future cash flows or payments we have to use the present value table for ordinary annuity. We can also use the mathematical formula. In other words we will arrive at the discounted value or the present value of every future cash flow. This can be mathematically done by using the following formula:

$$\text{PV of ordinary annuity} = \frac{C\,[(1+r)^n-1]}{r(1+r)^n}$$

Where C = Cash flow per period r = rate of interest

n = number of payments

Let us consider an example: You are receiving Rs. 10,000 every year as interest for the next 5 years and you are investing the same @ 5%

Then the PV of ordinary annuity = 10000 [(1+0.05)5 - 1) / 0.05(1.05)5]

= 10000(0.27628) / 0.063814)

= 10000 (4.32948)

= 43294.80

Example 7

For finding the future value of ordinary annuity the following formula can be used:

$$\text{FV of Ordinary Annuity} = C \quad \frac{(1 + r)n - 1}{\rho\ r(1+r)^n} \quad \text{Equation 2}$$

C = the cash flow per period r = the rate of interest

n= number of payments

Let us take the same example as cited in the above example under Present value of ordinary annuity.

where C = 10,000, r= 5% n = 5. Substituting the value in the above formula FV = 10000 [(1+0.05)5 - 1) / (0.05) 5]

FV = 10000 x 5.52563

= 55256.30

Example 8

For the purpose of calculating present value of an annuity due, we need to use the discounted formula for a period as payments are received in advance. It is very similar to the receiving rent in advance. For this purpose make use of the mathematical formula as given below:

$$\text{PV of Annuity Due} = C \frac{(1 + r)n - 1}{r\,(1 + r)n} \times (1 + r) \text{ -------- Equation 3}$$

Note: The notations C, r and n carry the same meaning and value as in Equation 1.

It can be noticed that equation 1 and 3 are more or less the same except for the modifying factor of (1+r). Talking the same values as mentioned in Example 1 if we substitute the same in Equation 3, the value works out to as follows:

Then the PV of due = 10000 [(1+0.05)5 - 1) / 0.05(1.05)5] x 1.05

= 10000(0.27628) / 0.063814) x 1.05

= 10000 (4.32948) x 1.05

= 45459. 56

The value in our Example 3 is greater than Example 1 as in example 3 payment or receipt occurs one period earlier compared to as in example 1.

CALCULATION OF FUTURE VALUE OF AN ANNUITY DUE

Under this calculation as payments are received in advance, (that is to say earlier when compared to ordinary annuity) they are held for a longer period than payment or receipts received at the end of the period. This is equal to receiving a payment on January 1 than receiving the same on December 31 of the same year. Under this circumstances we have to modify Equation 2 in Example 2 as under:

$$\text{FV of Ordinary Annuity} = C \frac{(1 + r)n - 1}{r} \times (1 + r) \text{ -------- Equation 4}$$

Substituting the values for C, r and n

FV Annuity Due = 10000 [(1+0.05)5 - 1) / 0.05]x (1.05)

= 10000 x 5.52563x1.05

= 55256.30 x 1.05

= 58019. 12

Thus it can be seen from examples 1,2,3 and 4 that there is a difference in monetary terms, between payments made in advance and when payments are made in arrears.

INTEREST CALCULATION USING PRODUCTS/BALANCES

While making interest calculation on various credit facilities banks adopt the following methods of charging interest rates.

1. Upfront (Front- end)
2. End of the period (Back end).

For example while discounting of bills such as Documentary Bills or Time bills banks charge interest rates for the period of the bill and only after deducting this amount along with other applicable charges such as postage, the balance amount is paid to the customer. This is known as upfront charging or front-end charging of interest.

Let us say the bill is for Rs. 1,85,000 of 3 months duration. Discount rate is 14% p.a and the postage is Rs. 150. Then amount of credit that will be passed on to the customer is as below:

Amount of the bill	=	1, 85,000
Less Discount	=	6475 [(185000X0.14)]/4)
Less Postage	=	150
Amount of credit to the customer	=	1,78,375

You will note that the bank will pass on the credit of Rs. 1,78, 375 only after deducting interest and postage of Rs. 6625. This is an example of upfront charging of interest.

End of the period charging of interest

On the contrary when a term loan is extended or cash credit extended, interest is charged at the end of the month or quarter as per the sanctioned terms. In the case of Cash Credit facility the daily outstanding, in the form of closing balance is taken in to account. The closing balance is multiplied by the number of days it was outstanding and products are arrived at. The product thus arrived is multiplied by the rate of interest specified for the account and divided by 365 days to arrive at the exact interest rate.

The following example will illustrate the concept of end of the period or back-end charging of interest rate.

Let us assume following debit balances remain outstanding in a CC account. The CC limit sanctioned is Rs.1,00,000 at an interest rate of 14% p.a. The interest is charged on monthly basis. Let us calculate products and interest for the entire month of July.

Limit: Rs. 1,00,000

Rate of Interest: 14% p.a.

Date (A)	Closing Balance (Dr) (B)	No. of days outstanding (C)	Products (B) x (C) = (D)
1. 7. 2018	20,000	6	120000
7.7.2018	35,000	3	105000
10.7.2018	45000	5	225000
15.7.2018	52000	6	312000
21.7. 2018	72000	7	504000
28.7.2018	44000	3	132000

31. 7.2018	39000	1	39000
1.8.2018	55000	**	**

Closing balance of 55000 falls in the month of August. Hence it will be taken in to account for the calculation of interest for August. Therefore, it will not be included in July products.

Calculation of interest:

The total of the product (D) above, works out to 14,37,000 Applicable interest rate is 14% p.a = 14/100 = 0.14
Interest would be = (1437000* 0.14) / 365

= Rs. 551.17

Interest applicable for the month of July = Rs. 551.17 and the same will be debited to the customer's account.

In the same manner interest for quarterly period may can also be calculated.

The above methodology is also applicable in the case of Savings Bank too. However the interest calculated for Savings Bank account will be credited to the account of the customer as it is a deposit account.

Amortisation of a Debt

The word amortisation means spread over a period. It means "to gradually write off the initial cost of (an asset) over a period". The term is also used in the context of " to reduce or pay off (a debt) with regular payments."

The concept of amortization can be understood by the following example:

Mr A has been granted a loan of Rs. 66,000 at an interest rate of 12% p.a. (i.e. 3% per quarter). The loan is to be amortised through a quarterly instalment payment of Rs. 5000 each. Work out an amortization schedule for this loan.

The amortization schedule is as follows:

Instalment Nr.	Instalment	Int Qrly 3% per quarter	Principal repaid	Principal Outstanding
1	5000.00	1980.00	3020.00	62980.00
2	5000.00	1889.40	3110.60	59869.40
3	5000.00	1796.07	3203.93	56665.47
4	5000.00	1699.95	3300.05	53365.42
5	5000.00	1600.95	3399.05	49966.37
6	5000.00	1498.98	3501.02	46465.35
7	5000.00	1393.95	3606.05	42859.30
8	5000.00	1285.77	3714.23	39145.07
9	5000.00	1174.35	3825.65	35319.42
10	5000.00	1059.57	3940.43	31378.99
11	5000.00	941.34	4058.66	27320.33
12	5000.00	819.60	4180.40	23139.93
13	5000.00	694.17	4305.83	18834.10
14	5000.00	565.02	4434.98	14399.12
15	5000.00	431.97	4568.03	9831.09
16	5000.00	294.93	4705.07	5126.02

17	5000.00	153.78	4846.22	279.80
18	288.20	8.40	279.80	0.00
Total repaid	85288.20	19288.20	66000.00	

CONCEPT OF SINKING FUNDS

A sinking fund is a means of repaying funds borrowed through a bond issue through periodic payments to a trustee who retires part of the issue by purchasing the bonds in the open market. Rather than the issuer repaying the entire principal of a bond issue on the maturity date, another company buys back a portion of the issue annually and usually at a fixed par value or at the current market value of the bonds, whichever is less.

Sinking fund is an amount of money that is accumulated in a systematic way of over a period of time to meet a future requirement or a contingency or cost of replacement of an asset. Since the amount of sinking fund needed is known in advance along with other parameters such as interest rate are known, it is easy to workout such a schedule. This is very similar to calculating the future value of annuity. Salient issue of the sinking fund are highlighted as follows

- A sinking fund is an account containing money set aside to pay off a debt or bond.
- Sinking funds may help pay off the debt at maturity or assist in buying back bonds on the open market.
- Callable bonds with sinking funds may be called back early removing future interest payments from the investor.
- Paying off debt early via a sinking fund saves a company interest expense and prevents the company from being put in financial difficulties in the future.

Advantages and Disadvantages of a Sinking Fund

A sinking fund improves a corporation's creditworthiness, letting the business pay investors a lower interest rate. Because of the interest savings, the corporation has more net income and cash flow for funding operations. Also, businesses may deduct interest payments given to lenders from their taxes, helping increase cash flow as well. Corporations may use the savings for covering sinking fund payments or other obligations. In addition, investors appreciate the added protection a sinking fund provides, making investors more likely to lend a company money. A business that is controlling its money is less likely to default on outstanding debt.

However, if interest rates decrease and bond prices increase, bonds may be called and investors may lose some of their interest payments, resulting in less long-term income. Also, investors may have to put their funds elsewhere at a lower interest rate, also missing out on potential long-term income.

The general formula for future value of annuity can be calculated by the formula is as below:

$$F = \frac{A\,[(1 + r)^n - 1]}{r}$$

Here F is the future value of annuity 'A' is amount borrowed, 'r' is the rate of interest, n is the number of years or period of loan. The following examples illustrate the concept of sinking fund:

1. A student borrows a sum of Rs. 1,00,000 per year at an interest rate of 6% for period of 5 years to complete a professional degree from a bank. How much money the student owes to the bank at the end of 5 years?

Substituting the values in the equation mentioned above

$$F= \frac{100000\ [\ (1+0.06)5 - 1]}{0.06}$$

= 100000 (0.34)/0.06

= 566666.67

The amount of money owed by the student will be Rs. 5,66,666.67.

2. A civil engineering company wish to buy a generator costing Rs. 700000 in 5 years. How much money the company should save annually if the rate of interest on its return is 10%.?

The value of F= 700000 n=5, r= 0.10. If we substitute the same in the equation

$$700000 = \frac{A\ [(1+0.10)^5 -1]}{0.10}$$

$$\text{Solving for A} = \frac{700000 * 0.10}{0.61}$$

A = 114754.10

The company has to save a sum of Rs. 114754.10 per annum.

3. A company expects drilling machine of value 80,000 will last for 10 years time with a salvage value of Rs. 8000. A new machine may cost Rs. 104000 at that point in time. The company wishes to set up a sinking fund with a return of 8%. What should be the annual savings by the company for contributing to the sinking fund?

Here in the problem n= 10 r=0.08 F= (104000 – 8000) = 96000

Substituting the value in equation and solving for A

$$96000 = \frac{A\ [\ (1+0.08)10 - 1]}{0.08}$$

$$A = \frac{96000 \text{ x } 0.08}{(2.16-1)}$$

A = 6620.68

The company should be contributing a sum of Rs. 6620.68 every year to the sinking fund in this case.

LESSON ROUND UP

– Charging of interest is an essential part of operational banking. It also forms the income streams for banks. Banks pay interest on certain products on simple interest basis and on other products they also pay interest on compound interest basis. They also charge interest on loan products on simple and compound interest basis as applicable in each case. Banks also use Equated Monthly Instalment payment option while fixing loan repayment by borrowers mostly on term loans. Due to financial innovation, banks also offer a choice of fixed or floating interest basis on certain products based on specific terms and conditions. Banks also use the concept of annuities in interest calculations for offering the same to customers. For borrowers of certain products like bill discounting banks collect interest on front end basis while on facilities lime cash credit banks levy interest on daily product basis on a backend basis. Loan repayments involving quarterly or half yearly or annual basis are based on the principle of amortization. The concept of sinking fund is used both by banks and customers for

estimation of annuity value of payment values over a period. A better understanding of these concepts will improve effectiveness while working in a bank or otherwise.

GLOSSARY

Simple Interest, Compound interest, Equated Monthly instalment, Fixed rate of interest, Floating rate of interest, Annuities, Present value of annuities, Future value of annuities, Amortization,

SELF TEST QUESTIONS

1. Fill in the blanks
   a. Simple interest is also known as .
   b. Compound interest is can be said to be interest on .
   c. EMI is a amount made by a borrower to the lender on a specified date each calendar month.
   d. Fixed interest rates does not get affected by .
   e. Floating interest rate is tied to .
   f. Annuities can be broadly classified i and
   g. Interest rates are charged by banks can be divided in to and methods.
   h. Amortization means
2. Write True or False
   a. Simple interest is generally applied to short-term loans, usually one year or less.
   b. Financial institutions levy compounding rates only on daily basis.
   c. An equated monthly instalment (EMI) is a variable payment amount made by a borrower to the lender on a specified date each calendar month.
   d. In general, fixed interest rate is higher than floating rate and does not get affected by market fluctuations.
   e. Repo rate or Bank rate or Marginal Cost of Lending Rate (MCLR) are examples of fixed interest rates.
   f. Under annuities due, payments are received at the commencement of the period.
3. Answer the following questions briefly.
   a. State the difference between simple interest rate and compound interest rate.
   b. Explain the concept of EMI and its effect on repayment of loans.
   c. State different types of annuities and briefly explain the same.
   d. What is amortization debt? How it is practically used in real life?
   e. Explain what is sinking funds with a few examples.

For further reading

1. Financial Management - Theory and Practice by Dr. Prasanna Chandra
2. Reading Materials from internet

Lesson 16
Calculation of YTM

LESSON OUTLINE

- Introduction to Risk Management
- Debt- Definition, Meaning & Salient Features
- Introduction to Bonds
- Terms associated with Bonds
- Cost of Debt Capital
- Bond value with semi-annual Interest
- Current Yield on Bond
- Calculation of Yield-to- Maturity of Bond
- Theorems for Bond Value
- Duration of Bond
- Properties of Duration
- Bond Price Volatility
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Banks are involved in investment activities on account of statutory obligation cast on them for maintaining SLR. Also banks derive a part of their income from investment/ trading activities in portfolios of securities such as Bonds, Debentures, Money market instruments etc. as permitted by RBI directives and other regulations. Therefore a basic exposure on securities is a must for a banker. In the light of this this chapter will enable a reader to learn in detail about

- Various debt instruments.
- Important terms involved in and their definitions.
- Bonds and their characteristics.
- Bond value determination.
- Yield and calculation.
- Concept of YTM and its calculation.
- Theorems of Bond valuation.
- Concept of duration and its computation.
- Interest rate elasticity.
- Bond volatility.

INTRODUCTION

One of the core functions of banks, apart from accepting deposits and lending is also investments. In bonds and securities etc. As a part of statutory compliance, banks have to invest in SLR securities which largely consist of a portfolio of bonds, other long term securities and money market securities. Income from securities also forms an important component of profits of a banking entity. Though every operating banker may not be involved in operational aspects of investments, an exposure to securities, enhances his understanding of the investible avenues. Also as several banks are involved in wealth management advisory work for clients, it is expected that an exposure to securities will enhance the personal effectiveness of such persons who are involved in such work.

Keeping this in view, this chapter focuses on securities which are dealt by banks as a matter of their routine investment/trading decisions.

Accordingly, this chapter covers debt, definitions of various terms involved, Bonds and their characteristics, calculation of bond values, calculation of yield, concept of YTM and its calculation, theorems of bond value, duration and its properties, aspects of bond volatility. Suitable mathematical examples are included wherever necessary to demonstrate the application of theoretical discussion for practical utility. The contents cater to Level 1 orientation. The topic and contents will expose students to equip themselves with the required knowledge base if and when an opportunity arises in future.

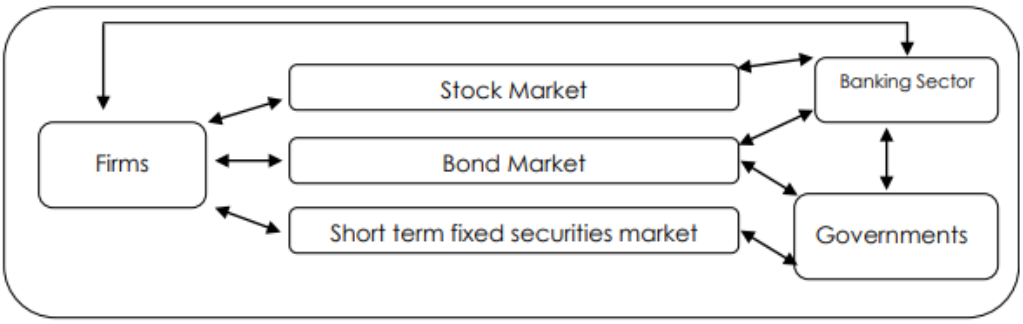
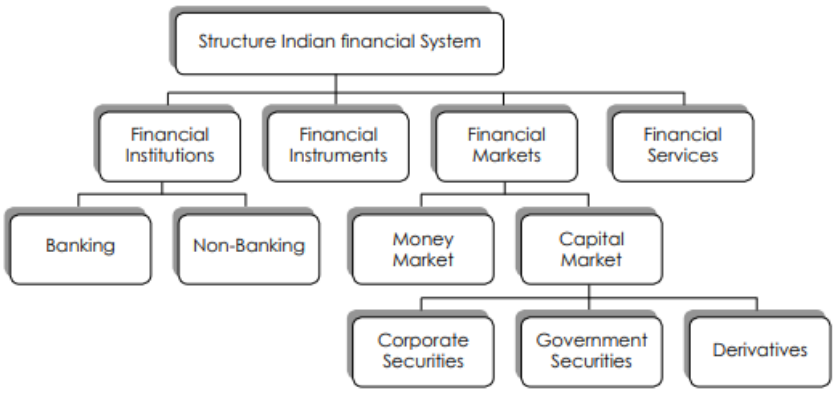


Figure: The Structure of financial system

Structure of Indian Financial System

The financial structure refers to the shape, constituents and their order in the financial system. The financial system consists of specialized and unspecialized financial institutions, organized and unorganized financial markets, financial instruments and services which facilitate transfer of funds. A financial system consists of financial institutions, financial markets, financial instruments and financial services which are all regulated by regulators like Ministry of Finance, t, RBI, SEBI, IRDA, Department of Economic Affairs, Department of Corporate Affairs, etc., which facilitate the process of smooth and efficient transfer of funds.



Structure of Indian Financial System

Classification of Financial Markets

There are different ways of classifying financial markets. One way of classifying the financial markets is by the type of financial claim into the debt market and the equity market. The debt market is the financial market for fixed claims like debt instruments. The equity market is the financial market for residual claims i.e. equity instruments. A second way of classifying the financial markets into money market and capital market is on the basis of maturity of claims.

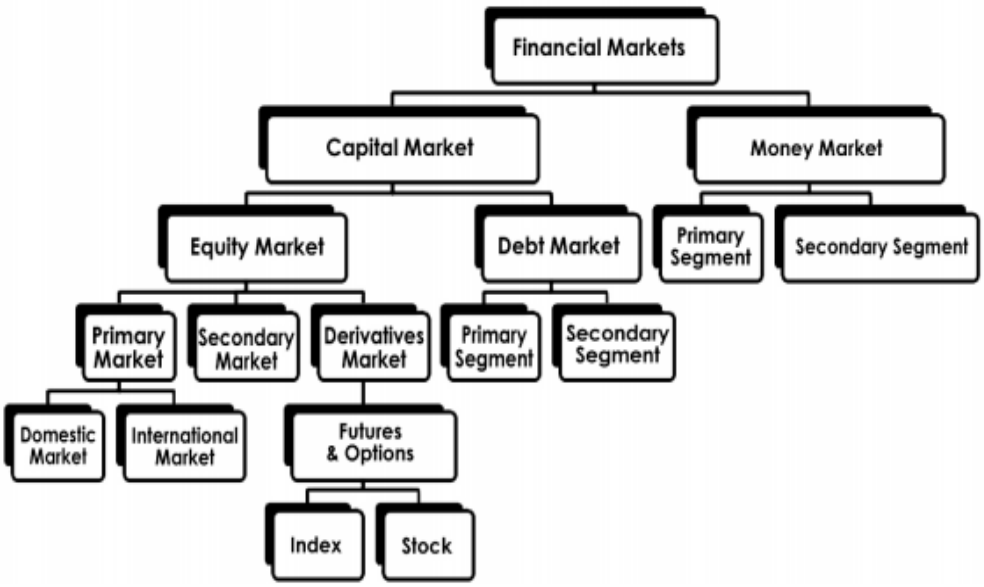


Table: Financial market classification

Criterion	Features	Examples
Products	Tradability, transferability, ownership, maturity, denomination, substance	Equity, debt instruments, derivatives
Services	Technical, advisory, information and knowledge-based, administrative	IT support, research and analysis, custody
Ways of trading	Physical, electronic, virtual	Over the counter, exchange, internet
Participants	Professionals, non-professionals, institutions, officials	Banks, central banks, non-bank financial companies, institutional investors, business firms, households
Origin	Domestic, cross-border, regional, international	National markets, regionally integrated markets, Euromarkets, domestic/foreign currency markets, onshore/offshore markets

Types of Financial Market Instruments:

Money Market

Money market is a very important segment of the Indian financial system. It is the market for dealing in monetary assets of short-term nature. Short-term funds up to one year and for financial assets that are close substitutes for money are dealt in the money market. It is not a physical location (like the stock market), but an activity that is conducted over the telephone. Money market instruments have the characteristics of liquidity (quick conversion into money), minimum transaction cost and no loss in value. Excess funds are deployed in the money market, which in turn is availed of to meet temporary shortages of cash and other obligations.

Money market provides access to providers (financial and other institutions and individuals) and users (comprising institutions and government and individuals) of short-term funds to fulfill their borrowings and investment requirements at an efficient market-clearing price. The rates struck between borrowers and lenders represent an array of money market rates. The interbank overnight money rate is referred to as the call rate. There are also a number of other rates such as yields on treasury bills of varied maturities, commercial paper rate and rates offered on certificates of deposit. Money market performs the crucial role of providing an equilibrating mechanism to even out short term liquidity and in the process, facilitating the conduct of monetary policy. Short-term surpluses and deficits are evened out. The money market is the major mechanism through which the Reserve Bank influences liquidity and the general level of interest rates. The Bank's interventions to influence liquidity serve as a signaling device for other segments of the financial system.

The Indian money market was segmented and highly regulated and lacked depth till the late eighties. A limited number of participants, regulation of entry and limited availability of instruments characterized it. The instruments were limited to call (overnight) and short notice (up to 14 days) money, inter-bank deposits and loans and commercial bills. Interest rates on market instruments were regulated. Sustained efforts for developing and deepening the money market were made only after the initiation of financial sector reforms in early nineties.

DEBT

Definition: A debt is an obligation to pay a sum of money borrowed, with interest on the same at a fixed interval or as agreed with a lender. Now-a-days Government, public sector companies or private corporate entities issue debt instruments in the form of Bonds and Debentures to raise capital. Such types of instruments are called debt securities. These debt securities are tradable in the debt markets.

When a legal entity issues a debt instrument in the form of a bond or a debenture, it amounts to borrowing money from the investors (who assume the position of lender).

As a part of the terms of the debt, the lenders have a right to receive interest at a stipulated rate or guaranteed rate from the legal entity during life of such debt instruments at fixed intervals. Another advantage for issuers of debt capital is the tax deduction available for coupon payments under the Income tax regulations, unlike equity capital where dividend payments are taxable. This feature results in lesser cost of capital in respect of debt instruments for the issuer of debt.

As an investment, bonds are riskier, but pay a higher interest rate, than money market funds, demand deposits or checkable deposits, but are safer than stocks, and usually less profitable, because they have no potential for growth.

Bonds are long-term debt or **funded debt**, issued by corporations, and governments and their agencies to finance operations or special projects. Corporations pay back interest and principal from earnings, whereas governments pay from taxes, or revenues from special projects. Unlike preferred stock, a corporation must pay interest on its bonds, and if the corporation goes bankrupt, bondholders are paid before stockholders.

Bonds are issued in the form of promissory note and therefore attract the provisions of Negotiable Instruments Act 1881. They are transferrable by endorsement and delivery without attracting stamp duty.

Though Bonds and debentures form part of debt instruments there are certain differences between them.

They are as follows:

Bonds	Debentures
1. Issued in the form of Promissory Notes.	1. They are in the form of acknowledgement of debt.
2. They can be transferred by endorsement and de- livery.	2. Transferability is not possible.
3. Carries higher stamp duty.	3.Carries lesser stamp duty
4. Normally are not convertible in to shares.	4. Options are available for conversion in to shares.

Broadly in India the following debt instruments are issued:

Sr. No.	Type of Security	Standard Features
1	Government of India securities	Medium to Long term dated securities issued by RBI on behalf of Government of India. Coupon payments are half yearly basis. (Semi-annual).
2	State Government Securities	Medium to Long term issued by RBI on behalf of State Governments. Coupon payments are half-yearly.
3	Government Guaranteed Bonds	Medium to Long term bonds issued by Government owned agencies and guaranteed by either Central/State government/s. Coupon payments are half-yearly.
4	Public Sector Undertaking bonds	Issued by either Central or State government owned enterprises for medium to long term periods. Coupon payments are half-yearly.
5	Private Corporate Debentures	Issued by rated private companies, for short and medium terms. Coupon payments can be annual or semi-annual or cumulative.
6	Money Market Instruments	Specific debt instruments like Treasury bills/CPs/CDs with a tenor of up to one year.

For example if Larsen & Toubro Company Limited issues a bond of Face value of Rs. 1,000 carrying an interest rate (also known as 'Coupon rate') 11% with a maturity of 8 years, the bond holder will get Rs.110 every year for the next 8 years and also at the end of 8 years he would get back his principal amount of Rs. 1000.

An issuer of bond has to make compulsory payment of coupon rate to the bond holders and also at the time of maturity it has to pay back the principal amount. If this is not so the bond holders can legally proceed against the company including filing a bankruptcy or winding up case. This makes it safe for the lenders though they may receive lesser coupon rate in comparison to other instruments. The advantage to the entity which raises the debt, is that it enjoys a lower cost of funds through debt capital.

In India generally bonds can be purchased by individuals, business firms and others. Bonds are which are issued by State and Central governments are secured by the guarantee of the concerned government. Private sector companies can also issue bonds either on secured or unsecured basis.

Bond is a negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the bond.

Bonds are the instruments of borrowing by governments and corporate. They promise a fixed rate of return, known as a coupon rate, till the date of maturity and the payback of the principal sum in a phased manner or at maturity.

There are two categories of bonds- those issued by government and those issued by firms (also known as debentures). From the perspective of risk, the bonds issued by the government are regarded as risk free, while those issued by firms are deemed to bear default risk.

Most of the debentures are issued on a secured basis against some fixed assets. There would be a charge created on these assets by the company in favour of the investors/ lenders/subscribers. In case the issuer is unable to repay the coupon and principal the assets which are charged can be sold and investors/lenders/ subscribers can get a compensation. Also in respect of debentures the rights of subscribers/lenders /investors rights are protected by way of appointment of a Trustee who would safe guard their interests. According to SEBI guidelines in respect of public issue of debentures it is mandatory to appoint a debenture trustee.

Risks involved in holding Government securities

Government securities are generally referred to as risk free instruments as sovereigns are not expected to default on their payments. However, as is the case with any financial instrument, there are risks associated with holding the Government securities. Hence, it is important to identify and understand such risks and take appropriate measures for mitigation of the same. The following are the major risks associated with holding Government securities.

(i) **Market risk** – Market risk arises out of adverse movement of prices of the securities that are held by an investor due to changes in interest rates. This will result in booking losses on marking to market or realizing a loss if the securities are sold at the adverse prices. Small investors, to some extent, can mitigate market risk by holding the bonds till maturity so that they can realize the yield at which the securities were actually bought.

(ii) **Reinvestment risk** – Cash flows on a Government security includes fixed coupon every half year and repayment of principal at maturity. These cash flows need to be reinvested whenever they are paid. Hence there is a risk that the investor may not be able to reinvest these proceeds at profitable rates due to changes in interest rate scenario.

(iii) **Liquidity risk** – Liquidity risk refers to the inability of an investor to liquidate (sell) his holdings due to non availability of buyers for the security, i.e., no trading activity in that particular security. Usually,

when a liquid bond of fixed maturity is bought, its tenor gets reduced due to time decay. For example, a 10 year security will become 8 year security after 2 years due to which it may become illiquid. Due to illiquidity, the investor may need to sell at adverse prices in case of urgent funds requirement. However, in such cases, eligible investors can participate in market repo and borrow the money against the collateral of the securities.

Characteristics of debt instruments :

1. **They are tradable**: Due to business practices debt securities can be traded in the secondary market. Hence they are liquid securities. However the liquidity may not be uniform for different classes of debt securities.
2. **Obligation to honour repayment of Principal** : At the time of maturity the issuer of debt security is obligated to repay the face value(also known as 'Par value which represents the original amount borrowed from lenders. The exception being Zero Coupon bond where the maturity value includes the face value and coupon amount.
3. **Maturity period or Tenor**: Every security that is issued carries a specific maturity date by which time the issuer has to repay. However in some cases, the face value is repaid on installment basis spread over the life of the debt security. These types of debt instruments are called "amortizing" securities where the repayments include principal and coupon (interest).
4. **Built-in flexibility possible**: These debt securities especially in the case of Bonds, the issuer can include flexibility of "Callable or Puttable" options. Under a 'Callable' option the issuer can repay or redeem the bond before its maturity date. Under 'Puttable' option the investors are given a right to seek redemption from the issuer before the bond matures.
5. **Periodic repayment of interest** : Due to various market developments interest rates can be offered on a fixed, compounded or floating basis depending upon the issuer. Floating rates are the rates of interest that is linked to a standard bench mark rates; therefore as and when the bench mark rates undergo changes the interest rate also would change. However the essential point is that interest payments have to be made by the issuer at periodical intervals. Generally all interest on debt securities are paid on half yearly or yearly basis.

Some of the special types of bonds issued in India include:

i. **Zero Coupon Bond** : In these bonds the issuer does not pay interest/coupon periodically. It is paid at maturity along with principal. Hence it is normally issued at a discount to face value. On maturity the principal returned with interest.

ii. **Convertible Bond**: Under specified terms by the issuer at the time of issue, the holder of such bond can convert the outstanding value of the bond in to equity of shares of the issuing company.

iii. **Municipal Bond**: These are issued by Municipalities in India, for meeting their funding requirements. Bengaluru Municipal Corporation was the first one to issue such a bond in India in 1997, followed subsequently by Ahmedabad. However Municipal Bond issues are not very active.

iv. **Asset Backed Securities**: These are issues by a borrower to raise finances on the basis of future receivables.

v. **Bearer Bonds**: It is an official certificate issued without recording the name of the holder. These are very risky because they can be either lost or stolen.

vi. **Registered Bonds**: It is a bond whose ownership is recorded by the issuer or by a transfer agent.

vii. **Term Bonds**: Most corporate bonds are term bonds, that is, they run for a specific term of years and then become due and payable.

viii. **Serial Bonds:** While issuing bonds some corporate arrange them in such a way that specific principal amounts become due on specified dates prior to maturity. They are termed as serial bonds.

ix. **Puttable Bonds:** A puttable bond grants the bondholder the right to sell the issue back to the issuer at par value on designated dates.

x. **Callable Bonds:** These bonds refer to the ability of the issuer to pay off a debt obligation prior to its maturity at the option of the issuer of debt.

xi. **Exchangeable Bonds:** It grants the bondholder the right to exchange the bonds for the common stock of a firm other than that of the issuer of the bond.

xii. **Fixed Rate Bonds:** These are bonds with a coupon or a stated rate of interest which remains constant throughout the life of the bond.

xiii. **High Yield Bonds:** They are bonds that are rated below investment grade by the credit rating agencies. They are also called junk bonds.

xiv. **Mortgage Bonds:** A bond that is secured through a lien against the property of the firm is known as mortgage bond.

xv. **Subordinated Bonds:** These bonds have a lower priority than secured debts, debentures and other bonds and the general creditors of the issuer in case of liquidation.

xvi. **Guaranteed Bonds:** It is an obligation guaranteed by another entity . or the parent company. Although these bonds are not risk-free, default risk is reduced since both companies would have to default.

xvii. **Perpetual Bonds:** These bonds are also called perpetuities. It has no maturity date.

xviii. **Global bonds:** Bonds that are designed so as to qualify for immediate trading in any domestic capital market and in the Euro market are called global bonds.

xix. **Easy Exit Bonds:** These are bonds which provide easy liquidity and exit route to investors by way of redemption or buy back facility where investors can get the benefit of ready encashment in case of need to withdraw before maturity.

xx. **Option Bonds:** These are cumulative and non-cumulative bonds where interest is payable on maturity or periodically. Redemption premium is also offered to attract investors. These were issued by institutions like IDBI, ICICI, etc.

xxi. **Double Option Bonds:** The face value of each bond is 5,000. The bond carries interest at 15% p.a. compounded half-yearly from the date of allotment. The bond has a maturity period of 10 years. Each bond has two parts in the form of two separate certificates, one for principal of 5,000 and other for interest (including redemption premium) of 16,500. Both these certificates are listed on all major stock exchanges. The Investor has the facility of selling either one or both parts at anytime he wishes so.

xxii. **Floating Rate Bonds:** Here, Interest rate is not fixed and is allowed to float depending upon the market conditions. This is an instrument used by the issuing Companies to hedge themselves against the volatility in the interest rates. Financial institutions like IDBI, ICICI, etc. have raised funds from these bonds.

xxiii. **Inflation Bonds:** Inflation Bonds are bonds in which interest rate is adjusted for inflation. Thus, the investor gets an interest free from the effects of inflation. For example, if the interest rate is 10% and the inflation is 2%, the investor will earn 12.20% [i.e. (1 + Interest Rate) X (1 + Inflation Rate) -1]. This is similar to Floating Rate Bonds, i.e. rate of return varies over a period of time.

TERMS ASSOCIATED WITH BONDS

The following terms are used when one deals with Bonds.

S. No.	Terminology	Meaning
1	Face Value	Also known as Par value. Normally it is stated on the face of the bond. It represents the principal amount borrowed by the issuer.
2	Coupon Rate	The interest rate on the debt security.
3	Yield	This represents the return on the bond, expressed as a percentage of the Face value (par) value.
4	Yield curve	It is a graphical representation of maturity value against yield to maturity.
5	Current yield	Represents the return on a debt security vis-à-vis it's current market price.
6	Yield to maturity	It represents the overall return on a debt security if it is retained till maturity with an assumption that all interest payments will be reinvested at the current yield on the security. It represents the total income one can receive on a debt security say a bond.
7	Maturity	The period of the debt security.
8	Term to Maturity	The remaining period of the debt security till maturity.
9	STRIPS	Separate Trading of Interest and Principal Securities.
10	Redemption value	The maturity value that a debt security holder (bond) may get. It may be at par value, at premium (higher than par value) or at a discount (less than par value)
11	Market price/value	The price at which a debt security is traded in the market. This may be less than redemption or par value as the case may be.

VALUATION OF BONDS

A bond or debenture is a contractual financial instrument which obligates its issuer to pay a given sum of money (face value) at a maturity date in future and a periodic interest payment at a fixed rate of interest (coupon rate).

Bond values are determined by 5 factors:

1. par value
2. coupon rate
3. prevailing interest rates
4. accrued interest
5. credit rating of the issuer

Bonds are issued by different organisations. The principal issuers of bonds in India are the central government, state government, public sector undertakings, private Sector undertakings and municipal bodies.

The value of a bond is equal to the present value of the cash flows expected from it. Valuation of bond requires

(i) An estimate of expected cash flows

(ii) An estimate of the required return

Assumptions:

(i) The coupon interest rate is fixed for the term of the bond.

(ii) The coupon payments are made annually and the next coupon payment is receivable exactly a year from now.

(iii) The bond will be redeemed at par on maturity.

COST OF DEBT CAPITAL

Bond Value

If an issuer is raising his capital through debt instruments, for efficient management of a business, the person managing the business should know how bonds or securities are valued so that they can maximize their earnings. The investors should also know how their securities can be valued so that they can make an informed decision. We will focus now as to how the value of a bond can be determined. This is the same as cost of capital.

For an investor, a bond carries in it a series of interest payments at the coupon rate till its maturity. At maturity the investor will also entitled to get back the principal sum invested. Therefore a bond is said to be a sum of interest payments plus the principal amount at maturity. This is known as intrinsic value. Therefore an intrinsic value of a bond is equal to the present value of its future benefits. This can be calculated by using a formula given below:

$$V = \sum_{t=1}^{n} \frac{In}{(1+r)^t} + \frac{MV}{(1+r)^n}$$

V = Value in Rupees n = Number of years

In = Interest or Coupon payment (In Rupees) r = Periodic required return

MV= Maturity value

t = The time period when the payment is received

If the interest payments are annual, we can make use of the Present Value tables for an annuity for arriving at the value of a bond.

Thus using the Present Value table **V= In x PVIFA (r,n) + MV x PVIF(r,n)**

Let us consider an example of comparing bond prices.

A bond of par value Rs. 1000 of 10 years maturity with a 10% coupon. Let us assume that the required coupon rate is 11%; what will be value of the bond?

V= 100 x PVIFA (11%,10 yr) + 1000 x PVIF (11%, 10 year)

= 100 x 5.889 + 1000 x 0.352

= 588.9 + 352

V = 940.9 (Rupees)

BOND VALUE WITH SEMI-ANNUAL INTEREST

As major part of the bond issuers make semi-annual (i.e. six monthly) coupon payments. This implies that to arrive at a valuation of a bond we need to modify the formula used above. The required modification would be in the following manner –

i. The annual interest payment (I) in the equation should be divided by 2

ii. The number of years to maturity is to be doubled (i.e. multiplied by 2) to get the total number of half yearly period.

iii. The periodic required return rate should be divided by 2.

The modified equation will be as follows:

$$V = \sum_{t=1}^{2n} \frac{In/2}{(1+r/2)^t} + \frac{MV}{(1+r/2)^{2n}}$$

V = Value in Rupees

2n = maturity period in number of half years

In/2 = Semi-annual Interest or Coupon payment (In Rupees) r/2 = periodic required return to a half year period

MV = Maturity value

t = the time period when the payment is received

Using the present value tables the value of the bond with semi-annual interest payments can be arrived at as under:

V= (In/2) x PVIFA (r/2, 2n) + MV x PVIF(r/2, 2n)

Let us consider an example in this regard. Consider a 10 year bond with a 12% coupon of par value 1000. Interest is payable semi-annual basis. If the required return is 14%, what will be the value of the bond?

In this case In/2= 120/2= 60;2n= 20; r/2 = 7%

V= 60 x (10.594) + 1000 (0.258) = 635.64 + 258 = Rs. 893.64

CURRENT YIELD ON BOND

Current yield on the bond represents the coupon rate related to market price of the bond which is traded in the market. The following example may illustrate this concept.

A 10 year bond of par value of Rs. 1000 with a coupon of 12% is traded in the market at Rs. 940. What is the current yield on the bond?

The Current yield = $\frac{120}{940}$ x100 = 12.76%

The current yield is a just estimate of yield only as it does not take in to account the capital gain or loss in purchasing and holding the bond till maturity.

CALCULATION OF YIELD-TO- MATURITY OF BOND

The yield to maturity is the total return that one can get if the instrument is held till maturity. It is also defined as the interest rate (also known as discount rate) that equals the present value of cash flow that equals the bonds current market value. It is also defined as a multiple period rate of return on a bond if the bond is held till maturity. The assumptions that underly are:

i. Issuer does not default the coupon payments

ii. All coupon payments are immediately reinvested at the promised yield till maturity. Mathematically Yield to maturity can be calculated as under :

$$P = \frac{AI}{(1+r)} + \frac{AI}{(1+r)^2} + \ldots \frac{AI}{(1+r)^n} + \frac{MV}{(1+r)^2}$$

Where P= Price of the Bond

AI = Annual Interest (in rupees) MV = Maturity value (in rupees) r = Interest rate

n = number of years left for maturity

YTM computation requires trial and error process. Let us understand this by an example.

A Rs. 1000 par value bond is carrying a coupon rate of 10% maturing after 10 years. The bond is selling at a price of Rs. 800. What is the YTM of the Bond?

The problem can be represented by the following equation

$$800 = \sum_{t=1} \frac{100}{(1+r)^t} + \frac{1000}{(1+r)^{10}}$$

The YTM will be the value of 'r' in the above equation.

In other words 800 = 100 (PVIFA r, 10 yrs) + 1000 (PVIF r, 10 yrs)

Let us try r= 14% , the RHS of the above equation can be represented & using the PV tables

= 100 (5.216) + 1000(0.270)

= 521.60 + 270.00

= 791.60

Since 791.60 is lesser than 800 we have to try a lower value for 'r'.

Let us take the value of r=13%

The equation becomes 800 = 100(PVIFA 13%, 10) + 1000 (PVIF 13%, 10)

The RHS of the equation = 100 (5.426) + 1000 (0.295)

= 542.60 + 295

= 837.60

From the above it is clear that the value of 'r' lies between 14% and 13%. We can use linear interpolation technique to find the exact value as under –

$$= 10 + (14-13) \times \frac{(837.60 - 800)}{(837.60 - 791.60)}$$

= 10.82 %

Therefore the YTM in this case is = 10.82%

Yield to Call of Bonds

Some bonds carry a call feature that entitles the issuer to call (buy back) the bond prior to the stated maturity

date in accordance with a call schedule. The basic property of a bond is that its price varies inversely with yield. If the required yield decreases, the present value of the cash flow increases; hence the price of the bond increases. Conversely, when the required yield increases, the present value of cash flow decreases. The higher the coupon rate, the smaller the percentage price change due to any given change in interest rate are positively related. The graph of the price-yield relationship for the bond has a convex shape.

The relationship between the coupon rate, the required yield and the price of bond is as follows:

Coupon Rate > Required Yield ⟷ Price > Par (Premium Bond)

Coupon Rate = Required Yield ⟷ Price = Par

Coupon Rate < Required Yield ⟷ Price > Par (Discount Bond)

Consider, a bond carrying a coupon rate of 14% issued 3 years ago for 1000 (its par value) by XYZ Co. The original maturity of bond was 10 years, so its residual maturity now is 7 years. The interest rate is fallen in the last 3 years and investors now expect a return of 10% from this bond. So the price of the bond now would be 1194.70 (based on the formula mentioned above).

THEOREMS FOR BOND VALUE

Based on the behavior of the bond market a set of theorems for bond valuation has been put forward by some authors. The same is as under :

1. When the required rate of return ('r') is equal to the coupon rate the value of the bond is equal to the par value.
2. When the required rate of return is greater than its coupon rate the value of the bond will be less than its par value.
3. When the required rate of return is less than the coupon rate the value of the bond will be greater than its par value.
4. When the required rate of return is greater than coupon rate the discount on the bond decreases as it approaches maturity.
5. When the required return is less than coupon rate the premium on the bond declines as it approaches maturity.
6. Bond price is inversely proportional to it's YTM.
7. The longer the term to maturity, for a given difference between YTM & Coupon rate, the greater will be the change in price with changes in price.
8. For an equal size increase or decrease in YTM, the bond price changes are not symmetrical. That is to say, in given maturity of a bond, the bond price change will be greater with a decrease in bond's YTM, than the change in bond price with an equal increase in bond's YTM.
9. Other things being the same, for a given change in YTM, the percentage of price change in respect of high coupon rate bond will be smaller than in case of bonds of low coupon rate.
10. A change in YTM affects the bonds with higher YTM in comparison to bonds with lower YTM.

A few examples of theorems stated above:

Example 1. For Theorem 4:

Face value of a bond of Rs. 1000 with a coupon of 10%. Years to maturity is say 6 years. The required return is 12% the value of the bond will be –

= 100 x PVIFA (12%, 6) + 1000 x PVIF (12%, 6)

= 100 X (4.111) + 1000 (0.507)

= 411.10 + 507

= 918.10

Let us find one year later what will be the price at the same required rate of return.

In this case the maturity period will be 5 years. Hence the computation will be as under:

= 100 x PVIFA (12%, 5) + 1000 X PVIF (12%, 5)

= 100 x (3.605) + 1000 x 0.567

= 360.5 + 567

= 927.5

Similarly we can find the value of the bond for r maturity periods of 4, 3, 2, 1 years as under :

For 4 years maturity

= 100 X PVIFA (12%, 4) + 1000 x PVIF (12%, 4)

= 100 X (3.037) + 1000 x (0.636)

= 303.70 + 636

= 939.70

For 3 years maturity

=100 x PVIFA (12%, 3) + 1000 x PVIF (12%, 3)

= 100 x (2.402) +1000 (0.712)

= 240.2 + 712

= 952.20

For 2 years maturity

= 100 x PVIFA (12%, 2) + 1000 x PVIF (12%, 2)

= 100 x (1.690) + 1000 x (0.797)

= 169.0 + 797

= 966

For 1 year maturity

= 100 X PVIFA (12%,1) + 1000 x PVIF (12%, 1)

= 100 x (0.893) + 1000 x(0.893)

= 89.30 + 893

= 982.30

Thus it can be seen that for a required rate of 12% the value of the bond increases as it moves towards maturity given in the table below:

Time to maturity (years)	Bond Value
6	918.10
5	927.50
4	939.70
3	952.20
2	966.00
1	982.30
0	1000.00

Example 2. For Theorem 7

Let us say a Bond A and Bond B, of face value of 1000 each with a coupon of 10%; let the years to maturity be 4 and 7 respectively. Let us through this example compute the market values of these two bonds to prove the theorem.

Market value of Bond A with YTM 10% = 100 x PVIFA (10%, 4) + 1000 x(PVIF 10%, 4)

= 100 x (3.170) + 1000 (0.683)

= 317 + 683

= 1000

Market Value of Bond B with YTM 10% = 100 X PVIFA (10%, 7) + 1000 xPVIF(10%, 7)

= 100 x (4.868) + 1000 (0.513)

= 486.80 + 513

= 999.80, say 1000

Let us calculate market value for a YTM of 11% of these bonds

Market Value of Bond 'A' with YTM 11% = 100 x PVIFA (11%, 4) + 1000x (PVIF 11%, 4)

= 100 x (3.102) + 1000 (0.659)

= 310.20 + 659

= 969.20

Market value of Bond B with YTM 11% = 100 x PVIFA(11%, 7) + 1000 x PVIF (11%, 7)

= 1000 x 4.712 + 1000 (0.482)

= 471.20 + 482

= 953.20

Let us look at the change in price due to change in YTM by 1% in case of Bond A = (1000 – 969.20) = 30.80/1000

= 3.08%

Let us consider the change in price due to change in YTM by 1% in case of Bond B = (1000- 953.20)= 46.80/1000= 4.68%

This proves that long term bonds are more price sensitive to interest rate changes compared to short term bonds.

Example 3. For Theorem 8

The theorem states that for an equal size increase and decrease in YTM, price changes of a bond are not symmetrical.

Let us consider a bond with Face value of 1000 with a coupon of 10%with maturity of 5 years. The market value

of this bond will be = 100 (3.790) + 1000 (0.621)

= 379 + 621

= 1000

Let us consider a 1% increase in the YTM, the market value will be = 100 x PVIFA (11%, 5) + 1000 PVIF(11%,5)

= 100 X 3.696 + 1000 x 0.593

= 369.60 + 593

= 962.60

The decrease in value is 3.74%.

Let us consider a 1% decrease in YTM, the market value will be = 100 x PVIFA (9%, 5) + 1000 PVIF(9%, 5)

= 100 x (3.890) + 1000 (0.650)

= 389+ 650

= 1039.

The increase in value is 3.9%

The decrease and increase in value is not symmetrical as per the calculation.

Example 4. For Theorem 10

The theorem states that a change in YTM affects the bonds with higher YTM in comparison to bonds with lower YTM.

We can understand the theorem with the help of the following example:

Bond X with a par value of Rs. 1000 with a coupon of 11% has a maturity period of 6 years. if the YTM is 9% the bond will have a market value of

= 110 X PVIFA (9%, 6) + 1000 (PVIF(9%, 6)

= 110 (4.486) + 1000 (0.596) = 493.46 + 596 = <u>1089.46</u>

Let us consider another Bond Y with similar properties with YTM of 18%, this will have a market value of

= 110 x PVIFA (18%, 6) + 1000 x PVIF(18%, 6)

= 110 (3.498) + 1000 (0.370) = 384.78 + 370 = <u>754.78</u>.

Let us increase the YTM of Bond X and Bond Y by 1/9th such that the revised YTM of Bond X will be 10% and that of Bond Y will be 20%. The market value of Bond X and Bond Y will change in to as given below:

Bond X = 110 (4.355) + 1000 (0.564) = 479.05 + 564 = <u>1043.05</u>

Bond Y = 110 (3.326) + 1000 (0.335) = 365.86 + 335 = 700. 86

We can notice that price decrease in respect of a bond with lower YTM is lesser than the decrease in the price of the bond with higher YTM.

DURATION OF BOND

When an investment is made in a bond, there could be risks in the form of

a. the reinvestment of annual interest

b. the capital gain or loss on sale of the bond at the maturity of the bond.

Under the scenario of rising interest rates there will be a gain on reinvestments and a loss on liquidation. However for a given bond, there will be a period of holding, in which the above mentioned risks will remain balanced that is to say if there is a loss in reinvestment, it will be off-set by a capital gain while liquidating the bond in the market. In other words the risk on account of interest rates, will be nil. Such a holding period is called "Duration".

Hence the term "duration" can be defined as a holding period of a bond at the end of which a bond holder will get his investment back.

How to calculate the duration period of a bond?

1. Arrive at the cash flows from holding the bond.
2. Determine the PV of these cash flows by discounting with the YTM rate.
3. Multiply the PVs by the respective number of years left before the PV is received.
4. Multiply the value arrived at 3 above, and divide by the present value.
5. Step 4 will give the duration.

Let us understand the concept of duration by an example.

Let us consider a Bond of par value 100 with a coupon of 12% with a maturity of 5 years. The expected YTM is 15%. Let us calculate the duration.

First let us determine the market value at YTM of 15%

Market value = 12(3.352) + 100 (0.497) = 89.92

The cash flow can be listed as under :

Year	Cash flow	PV factor @15%	Present value @15%	Proportion of Bond value	Proportion of Bond value X time years
1	12	0.87	10.440	0.116	0.116
2	12	0.756	9.072	0.101	0.202
3	12	0.658	7.896	0.088	0.264
4	12	0.572	6.864	0.076	0.304
5	112	0.497	55.664	0.619	3.095
			89.936		3.981

The duration of the bond is 3.981 years.

This concept was first introduced by Macaulay F. and this is also known as Macaulay duration.

VOLATILITY

Bond volatility is a term used to describe how much the value of a bond fluctuates over time. The less volatile the bond, the less risky the investment. More volatile bonds present more risk, but they also can present the higher reward possibility. Tracking volatility can give you insight into the potential risks and rewards of purchasing a bond.

Volatility of a bond price is related to its duration and yield.

The volatility of the Bond can be determined using the following formula:

$$\text{Volatility} = \frac{\text{Duration}}{(1 + \text{yield})} \quad \text{(This is also known as Modified Duration)}$$

Taking the above example the volatility of the bond can be worked out as under:

= 3.981/ (1+0.15)

= 3.981 /1.15

= 3.46.

This means that for a 1% increase or decrease in the required yield, will end up in 3.46 percent fall or rise in the price of the bond.

PROPERTIES OF DURATION

The following can be summarized as properties of duration.

a. Duration is always less than the term to maturity.

b. Only in the case of zero coupon the bond's duration will be equal to its term to maturity.

c. In respect of a perpetual bond the duration is equal to (1 + r)/r where r is equal to current yield of the bond.

d. If a coupon paying bond's maturity is longer, the greater will be the difference between its term to maturity and duration.

e. There is an inverse relation between duration and YTM.

f. In case of a bond with a larger coupon rate, its duration will be smaller.

g. Frequency of coupon rate and duration are inversely related; that is to say an increase in the frequency of coupon payments, there will be decrease in duration and vice versa.

h. Duration of a bond decreases as it approaches its maturity.

BOND PRICE VOLATILITY

Volatility often refers to the amount of uncertainty or risk related to the size of changes in a security's value. A higher volatility means that a security's value can potentially be spread out over a larger range of values. This means that the price of the security can change dramatically over a short time period in either direction. A lower volatility means that a security's value does not fluctuate dramatically, and tends to be more steady.

The sensitivity of the price of a bond in relation to change in interest rates is called 'bond volatility. Whenever there are changes in market yields, it causes the prices of the bonds change. For a given change in the price of a bond for a change in YTM, gives us the measure of interest rate risk of a bond. The interest rate risk of a bond is a function of its elasticity of the interest rate (denoted by 'IE').

Mathematically IE = $\frac{\text{\% change in the price of a bond in a period 't'}}{\text{\% change in YTM for a bond}}$

As bond prices and YTM are inversely related the IE is always a negative number.

Interest elasticity can also be stated as IE = $\frac{\text{Duration x YTM}}{\text{1+YTM}}$

It is also evident from the equation, any increase in duration will also increase the IE of the bond. Let us consider an example to understand the above.

Bond Y has a par value of 1000 with a coupon of 10% and period of maturity is 10 years. If the coupon rate is changed to 11%the market price of the bond will work out to

= 100 x $PVIFA_{(11\%,\ 10)}$ + 1000 x $PVIF_{(11\%,\ 10)}$

= 100 x (5.889) + 1000 x (0.352)

= 588.90 + 352

= 940.90

Price change is = (1000 - 940.90) 59.10 = 5.91%

IE = $-\frac{(59.10/1000) \times 100}{10\%^*}$ = - 5.91

*when the interest rates changes to 11 % from 10%, the percentage change works out 10% (i.e. $\frac{(1)}{10}$ x100 = 10%

The negative sign indicates that if the YTM is increased by 1 % the market price of the bond is reduces by 5.91%.

Additional worked out example

Bond X has a Face value of Rs. 1000 and a coupon rate of 12% paid annually, with a term to maturity of 4 years, is quoted in the market Rs. 840. Bond holder has to pay Income Tax of 30% and a capital gains tax of 15%. Calculate the following:

1. Current yield and Post tax yield of the bond.
2. Duration of the Bond.
3. Interest rate elasticity
4. Interest rate risk when the interest rate falls by 2%
5. Interest rate risk when the interest rate increases by 1% Data Given

Face Value :	Rs. 1000
Market Price :	Rs. 840
Coupon :	12%

Income Tax :	30%
Capital Gains Tax :	15%
Term to maturity :	4 years

Calculation :

1. Interest income (annual) = Rs. 120 (i.e. 12% on 1000)

   a. Post- Tax Income = Income – less tax = [120 – (30% of 120)] = 120- 36 = Rs. 84 Therefore the current yield of the bond (Post-tax) = 84/840 = 10%

   b. Bond redemption value after capital gains tax = [1000 – 15% of (1000-840)]

      = [1000- 24] = Rs. 976

   c. The post tax YTM is obtained by using the formula

      = $\frac{I(1-t)+(F-P)}{n}$ 0.4F + 0.6P

      Substituting the values I (1-t) = 84, F= 976 P=840 n=4 in the above equation

      $$= \frac{84 + (136/4)}{0.4 \times 976 + 0.6\,(840)} = \frac{84+34}{390.4+504} = \frac{118}{894.4} = 0.1319 \text{ or } 13.19\%$$

   Therefore the solution to question 1 is – Current yield on the bond = 10% & Post-tax yield (YTM) is 13.19%

2. For calculating the duration of the bond the following formula can also be used :

   $$= \frac{10\,(PVIFA_{(13,19\%,\,4)}\,(1+13.19)}{13.19} = \frac{(1-10) \times 4}{13.19} = 3.51 \text{ years}$$

   Since the calculations involve PVIFA for 13.19 the same has to be done through extra polation which will be cumbersome. Hence computerized calculations can be used.

   Therefore Duration of the bond is = 3.51 years.

3. Interest rate elasticity Duration x YTM

   = (1+YTM)

   $$= \frac{3.51 \times 0.1319}{(1+0.1319)} = 0.409019348 = 0.409$$

   Therefore interest rate elasticity will be 0.409.

4. The interest rate risk when the interest rate fall by 2% . This can be calculated by the following formula

   $$= \text{Interest rate elasticity} \times \frac{\text{Change in ytm\%}}{\text{YTM\%}}$$

   $$= 0.409 \times \frac{2/100}{13.19/100}$$

   $$= 0.409 \times \frac{0.02}{13.19}$$

   = 0.062019613

   = 0.062 %

In this case the % change will be positive as the price will increase against the fall in interest rate.

5. Percentage change in price when interest rate rises by 1%

   Using the formula as in question 4 above, the percentage change in price

   = 0. 409x (0.01/.1319)

   = 0.0310083397

   =0.031%

In this case since there is an interest rate rise the price of the bond will fall.

[Note: In all the examples involving Present Value calculations standard PV tables has been used.]

LESSON ROUND UP

- Debt is an obligation to pay a sum of money borrowed, with interest on the same at a fixed interval or as agreed with a lender. Nowadays Government, public sector companies or private corporate entities issue debt instruments such as Bonds and Debentures to raise capital. These are called debt securities. There are some differences exist between bonds and debentures. Government of India/ State Government securities, Government Guaranteed Bonds, Public Sector Undertaking bonds, Private Corporate Debentures, Money Market Instruments are examples of debt securities issued in India.
- An issuer of bond has to make compulsory payment of coupon rate to the bond holders and also at the time of maturity it has to pay back the principal amount. If this is not so the bond holders can legally proceed against the company including filing a bankruptcy or winding up case. This makes it safe for an investor. Some special type of bonds that are issued in India are - Zero Coupon Bond, Convertible Bond, Municipal Bond, Asset Backed Securities.
- Following are some of the important terms used in the context of bonds and their definitions are -
  - Yield - This represents the return on the bond. Expressed as a percentage of the Face value (par) value
  - Yield curve - It is a graphical representation of maturity value against yield to maturity.
- Current yield - Represents the return on a debt security vis-à-vis it's current market price. Yield to maturity - It represents the overall return on a debt security if it is retained till maturity with an assumption that all interest payments will be reinvested at the current yield on the security. It represents the total income one can receive on a debt security say a bond.
- A bond is said to be a sum of interest payments plus the principal amount at maturity. This is known as intrinsic value. If the interest payments are annual/semi-annual/, we can make use of the Present Value tables for an annuity for arriving at the value of a bond. The yield to maturity is the total return that one can get if the instrument is held till maturity. It is also defined as the interest rate (also known as discount rate) that equals the present value of cash flow that equals the bonds current market value. For arriving at values of Present values mathematical equations can be used .
- Based on the behaviour of the bond market a set of theorems for bond valuation has been put forward by some authors. The term "duration" in bond valuation is the holding period of a bond at the end of which a bond holder will get his investment back. Volatility of a bond price is related to its duration and yield. Some important properties of duration are –

a. Duration is always less than the term to maturity

b. There is an inverse relation between duration and YTM

c. Frequency of coupon rate and duration are inversely related d.

d. Duration of a bond decreases as it approaches its maturity.

– The sensitivity of the price of a bond in relation to change in interest rates is called 'bond volatility'. As bond prices and YTM are inversely related the IE is always a negative number.

GLOSSARY

Face Value, Coupon Rate, Yield, Yield curve, Current yield, Yield to Maturity, Maturity, Term to Maturity, Redemption value, Market price/value, Duration, Volatility, Interest rate Elasticity.

SELF TEST QUESTION

1. Fill in the blanks:

   i. In bonds, the issuer does not pay interest/coupon periodical interest.

   ii. are issued in the form of promissory note

   iii. Most of the are issued on a secured basis against some fixed assets.

   iv. An value of a bond is equal to the present value of its future benefits.

2. Write True or False:

   a. Advantage for issuers of debt capital is the tax deduction available for coupon payments under the Income tax regulations.

   b. Transferability is not possible in respect of debentures.

   c. According to SEBI guidelines in respect of public issue of debentures, it is mandatory to appoint a debenture trustee.

   d. Under 'Puttable' option the investors are given a right to seek redemption from the issuer before the bond matures.

   e. Floating rates are the rates of interest that is linked to a standard bench mark rates.

   f. Coupon rate is the interest rate on the debt security.

   g. Iintrinsic value of a bond is equal to the present value of its future benefits.

   h. Major part of the bond issuers make annual (i.e. six monthly) coupon payments.

   i. Current yield on the bond represents the coupon rate related to market price of the bond.

   j. The yield to maturity is the total return that one can get if the instrument is held till maturity.

   k. Bond price is inversely proportional to it's YTM.

3. Answer the following questions briefly:

   i. What are the differences between bonds and debentures? What are the different types of securities issued in India?

ii. What are the characteristics of debt instruments? Explain briefly.

iii. Define the following terms and give an example for the same:-

- Coupon Rate
- Yield
- Yield curve
- Current yield
- Yield to maturity
- Maturity
- Term to Maturity
- Duration

iv. A bond of par value Rs. 1000 of 10 years maturity with a 10% coupon. The required coupon rate is

12%; what will be value of the bond? [Given The $PVIFA_{(12\%,10yr)} = 5.650$ and $PVIF_{(12\%,10yr)} = 0.322$.]

v. Mention any five Theorems of Bond value.

vi. Explain what is duration. What are the properties of duration?

vii. What is Bond price volatility? Briefly explain the same.

For further reading

1. Financial Management – Theory and Practice – Dr. Prasanna Chandra – Tata McGraw Hill
2. Money Market Instruments – Reserve Bank of India website.
3. Securities Markets and Products- Indian Institute of Banking and Finance – Tax Mann Publication

Lesson 17
Introduction to Foreign Exchange

LESSON OUTLINE

- Fundamentals of Foreign Exchange
- Balance of Payment
- Capital & Current Account
- Definition of Foreign Exchange
- Foreign Exchange Management Act, 1999
- Methods of Settlement of Int.Trade
- Foreign Exchange Market
- Exchange Rate Mechanism
- Rates–Fixed/Floating/Spot/Forward/Cross
- Exchange Arithmetic
- Foreign Exchange Rates
- Forward Margin, Premium and Discount
- Calculation of Premium and Discount
- Cross Rate, Chain Rule
- Value Date
- Arbitrage
- Relevant Concepts
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

International Banking plays a pivotal role in the present day scenario of Liberalisation and globilisation. As Economic growth of the country not only lies on national production and productivity, but also more on international trade. Adverse Balance of Payment can be corrected only through large scale exports and minimized imports.

Settlement in International trade takes place through the Mechanism of Foreign Exchange.

Foreign Exchange is a vast area and out of it a small portion oriented towards syllabus is covered in this lesson and by reading this one will appreciate the knowledge that he has acquired as a result of this study. Also readers will develop interest for learning further in this area. It focused on

- The need for foreign exchange business
- Intricacies involved in Foreign Exchange
- Foreign Exchange Market
- Various Exchange Rates quoted by A.D.
- Foreign Exchange Arithmetic etc.

INTRODUCTION

The **Foreign Exchange Market** (**Forex**, **FX**, or **currency market**) is a form of exchange for the global decentralized trading of international currencies. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market determines the relative values of different currencies. The foreign exchange market assists international trade and investment by enabling currency conversion. For example, it permits a business in the United States to import goods from the European Union member states, especially Euro zone members, and pay Euros, even though its income is in United States dollars. It also supports direct speculation in the value of currencies, and the carry trade, speculation based on the interest rate differential between two currencies.

The foreign exchange market is unique because of the following characteristics:

- its huge trading volume representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except weekends, i.e., trading from 20:15 GMT on Sunday until 22:00 GMT Friday;
- the variety of factors that affect exchange rates;
- the low margins of relative profit compared with other markets of fixed income; and
- the use of leverage to enhance profit and loss margins and with respect to account size.

Sectors: The Foreign Exchange Market has the following major sectors:

(a) Spot Market,

(b) Forward and Futures Market, and

(c) Currency Options Market.

Functions of the Foreign Exchange Market

The foreign exchange market is merely a part of the money market in the financial centers is a place where foreign currencies are bought and sold. The buyers and sellers of claims on foreign money and the intermediaries together constitute a foreign exchange market. It is not restricted to any given country or a geographical area.

Thus, the foreign exchange market is the market for a national currency (foreign money) anywhere in the world, as the financial centers of the world are united in a single market.

The foreign exchange market performs the following important functions:

(i) to effect transfer of purchasing power between countries - transfer function;

(ii) to provide credit for foreign trade - credit function; and

(iii) to furnish facilities for hedging foreign exchange risks - hedging function.

(i) Transfer Function:

The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to accomplish transfers of purchasing power between two countries. This transfer of purchasing power is effected through a variety of credit instruments, such as telegraphic transfers, bank drafts and foreign bills.

In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous to domestic clearings.

(ii) Credit Function:

Another function of the foreign exchange market is to provide credit, both national and international so as to promote foreign trade. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months, till their maturity, is required.

(iii) Hedging Function:

A third function of the foreign exchange market is to hedge foreign exchange risks. In a free exchange market when exchange rates, i.e., the price of one currency in terms of another currency change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes exchange risk to a large extent if there are huge amounts of net claims or net liabilities which are to be met in foreign money.

Participants in Foreign Exchange Market

The following are the financial market participants :

1. **Commercial Companies**

   An important part of this market comes from the financial activities of companies seeking foreign exchange to pay for goods or services. Commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short term impact on market rates. Nevertheless, trade flows are an important factor in the long-term direction of a currency's exchange rate. Some multinational companies can have an unpredictable impact when very large positions are covered due to exposures that are not widely known by other market participants.

2. **Central Banks**

   National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies.

   They can use their often substantial foreign exchange reserves to stabilize the market. Nevertheless, the effectiveness of central bank "stabilizing speculation" is doubtful because central banks do not go bankrupt if they make large losses, like other traders would, and there is no convincing evidence that they do make a profit trading.

3. **Hedge Funds as Speculators**

   About 70% to 90%of the foreign exchange transactions are speculative. In other words, the person or institution that buys or sells the currency has no plan to actually take delivery of the currency in the end; rather, they are solely speculating on the movement of that particular currency. Hedge funds have gained a reputation for aggressive currency speculation since 1996. They control billions of dollars of equity and may borrow billions more, and thus may overwhelm intervention by central banks to support almost any currency, if the economic fundamentals are in the hedge funds' favor.

4. **Investment Management Firms**

   Investment management firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities. For example, an investment manager holding an international equity portfolio needs to purchase and sell several pairs of foreign currencies to pay for foreign securities purchases. Some investment management firms also have more speculative specialist currency overlay operations, which manage clients' currency exposures with the aim of generating profits as well as limiting risk. While the number of this type of specialist firms is quite small, many have a large value of assets under management and, hence, can generate large trades.

5. **Retail Foreign Exchange Traders**

   Individual Retail speculative traders constitute a growing segment of this market with the advent of retail foreign exchange platforms, both in size and importance. Currently, they participate indirectly through brokers or banks. There are two main types of retail FX brokers offering the opportunity for speculative currency trading: brokers and dealers or market makers. Brokers serve as an agent of the customer in the broader FX market, by seeking the best price in the market for a retail order and dealing on behalf of the retail customer. They charge a commission or mark-up in addition to the price obtained in the market. Dealers or market makers, by contrast, typically act as principal in the transaction versus the retail customer, and quote a price they are willing to deal at.

6. **Non-Bank Foreign Exchange Companies**

   Non-bank foreign exchange companies offer currency exchange and international payments to private individuals and companies. These are also known as foreign exchange brokers but are distinct in that they do not offer speculative trading but rather currency exchange with payments (i.e., there is usually a physical delivery of currency to a bank account). These companies' selling point is usually that they will offer better exchange rates or cheaper payments than the customer's bank. These companies differ from Money Transfer/Remittance Companies in that they generally offer higher-value services.

7. **Money Transfer/Remittance Companies and Bureaux De Change**

   Money transfer companies/remittance companies perform high-volume low-value transfers generally by economic migrants back to their home country. The four largest markets receiving foreign remittances are India, China, Mexico and the Philippines. The largest and best known provider is Western Union with 345,000 agents globally followed by UAE Exchange. Bureaux de change or currency transfer companies provide low value foreign exchange services for travelers. These are typically located at airports and stations or at tourist locations and allow physical notes to be exchanged from one currency to another. They access the foreign exchange markets via banks or non bank foreign exchange companies.

FUNDAMENTALS OF FOREIGN EXCHANGE

Foreign Trade: In the present day scenario, many countries in the world do trade with other countries. In other words International trade plays a pivotal role in the present day context. International trade refers to trade between countries. There is movement of goods and services between the countries due to enlargement of trade and commerce as self sufficiency is not attained by many countries though production and productivity has gone up on a large scale. A country producing some goods apart from selling in the domestic market try to sell them to another country. This may be due to surplus availability of goods for the domestic market and the deficit in the other country or otherwise the country which is in need of foreign exchange. Even if a country is efficient to produce goods and services still it will be advantageous to import goods from country/countries since it may be cheaper to import goods rather than manufacturing the goods in their own country. In this trade transaction one country is an exporter and the other country is an importer. Each country functions as a sovereign State with its own set of regulations and currency.

There are certain peculiar problems in the conduct of International Trade and Settlement of the transactions arising there from and they are as under:

1. Different countries have different monetary units.
2. Restrictions imposed by countries on export and import of goods.
3. Restrictions imposed by nations on payment.

Why foreign exchange transactions are regulated in India?

India being a developing nation, needed precious foreign exchange to pay for imports of oil, goods and services. In order to conserve foreign exchange, controls were introduced in India in 1939 itself. After independence, Government of India (GoI) first enacted Foreign Exchange Regulation Act, 1947 and regulated the usage of foreign exchange transactions through RBI. As the country's foreign exchange reserves reached a very low level, the then GoI, introduced a more stricter version of The Foreign Exchange Regulation Act, 1973 (FERA). Subsequently due to economic liberalization in 1991-92, FERA was amended and replaced with a liberal FEMA, from June 2000.

BALANCE OF PAYMENTS

Balance of payments is a record of value of all economic transactions i.e. record of flow of payments between residents of one country and the rest of the world In a specified period i.e. given time. Balance of Payments is a fundamental factor in determining the exchange rates as rate of exchange if determined by the forces of demand and supply. A change in the balance of payments of a country will affect the exchange rate of its currency.

Definition of Balance of Payments:

Balance of Payments is a systematic summary of the economic transactions of the country with the rest of the world during a specified period, normally a year.

Current Account and Capital Account : External receipts and payments of the countries are classified under two categories viz (i) Current Account & (ii) Capital Account.

Current Account is further classified as Visible and Invisible Trade. Visible Trade comprises of receipts and payments for the goods of exports and imports.

The invisible Trade comprises dividend payments etc.

Current Account transactions are those that are not capital account transactions and include the following:

Current Account Transactions

– Payment in connection with foreign trade, other current business, services and short-term banking and credit facilities in the ordinary course of business.

– Payments due as interest on loans and as net income from investments.

– Remittance for living expenses of parents, spouse and children residing abroad and

– Expenses in connection with foreign travel, education, medical care of parents, spouse and children.

Further current account transactions have been categorized as under:

a. **Prohibited category & Schedule I transactions**: Prohibited category includes transactions with Nepal and Bhutan or with their citizens and Schedule I transactions include remittance of earnings from lottery/racing etc., commission on exports under the Rupee State credit route or Exports against equity in a joint venture abroad etc.

b. **Schedule II transactions**: These transactions require Government approvals.

c. **Schedule III transactions**: These are transactions where Authorized Dealers can allow remittances up to the prescribed limits; beyond which, such remittances require Reserve Bank of India permission.

d. **Schedule IV transactions**: These include all other current account transactions for which Authorized Dealers are permitted allow remittances without monetary limits.

The difference between Exports and imports is called as trade balance. Surplus of exports over imports is called as Trade Surplus and excess of imports over exports is called Trade Deficit. For the purpose of calculating the trade balance normally exports are allowed on FOB basis and imports on CIF basis. Invisible trade surplus / deficit is also accounted for arriving at the Balance of Payment in Current Account. The current account is the difference between domestic savings and investments. If domestic savings exceed domestic investment there is surplus in current account. On the contrary if domestic savings are not sufficient for domestic investment it is called as deficit in current account.

Capital Account transactions are those which alter the assets or liabilities (including contingent liabilities) outside India of persons resident in India or Assets or liabilities in India of persons resident outside India and include:

Capital Account Transactions

– Investment in foreign securities.

– Raising foreign currency loans in India and abroad.

– Transfer of immovable property outside India.

– Issuing guarantees in favour of a resident outside India.

– Taking out an insurance policy from an insurance company outside India.

– Sale and purchase of forex derivatives in India and abroad and commodity derivative abroad by an Indian resident.

– Maintenance of foreign currency accounts in India and abroad by an Indian President.

– Export, import & holding currency/currency notes/loan and overdrafts/ borrowing from a person residing outside India.

– Loans and overdrafts to a person residing outside India and remittance outside India of capital assets of an Indian residents.

– Investment in issue of security by a body corporate or an entity in India and investment by way of contribution to the capital of a firm or a proprietorship concern or an association of persons in India.

– Acquisition and transfer of immovable property in India.

– Issuing of guarantee in favour of or on behalf an Indian resident .

– Deposits between an Indian resident and a person residing outside India.

– Maintenance of foreign currency accounts in India and remittance outside India of capital assets in India of a person residing outside India.

DEFINITION OF FOREIGN EXCHANGE

The term 'Foreign Exchange' has been defined by Preamble 2(n) to The Foreign Exchange Management Act, 1999 (FEMA) as, "foreign currency and includes :

(a) deposits, credits and balances payable in any foreign currency,

(b) drafts, travelers cheques, letters of credit or bills of exchange expressed or drawn in Indian currency but payable in any foreign currency; and

(c) drafts, travelers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency."

FEMA also defines the term foreign currency " means any currency other than Indian currency".

In simple words Foreign Exchange is the process of conversion of one currency into another currency. It is that section of economic science which deals with the means and methods by which rights to wealth in terms of another country's currency. It involves an investigation of the method by which the currency of one country is exchanged for that of another.

FOREIGN EXCHANGE MANAGEMENT ACT, 1999 (FEMA 1999)

The legal framework which deals with various aspects of foreign exchange management in India is Foreign Exchange Management Act (FEMA 1999).It was implemented from 1.6.2000. It has replaced the earlier law called as Foreign Exchange Regulation Act 1973.

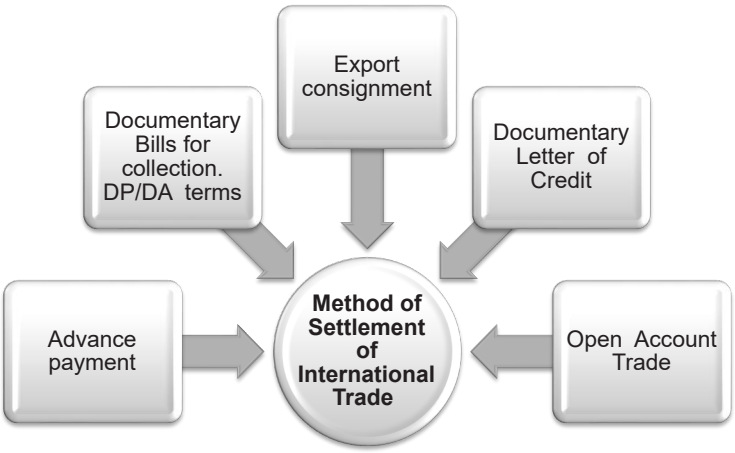
There are certain differences in the features of FERA and FEMA and they are as under:

Differences in the features of FERA and FEMA

Foreign Exchange Regulation Act, 1973	**Foreign Exchange Management Act, 1999**
– This Act mainly focused towards conserving foreign exchange and to prevent its misuse.	– Its focus is on development of foreign exchange market in India through facilitating external trade and payments towards it.
– There were restrictions with regard to transfer of funds.	– All current account transactions are free.
– Violation of FERA was a Criminal Office.	– Violation of FEMA is a Civil Offence.
– Offences under FERA is not compoundable.	– Offences under FEMA is compoundable.

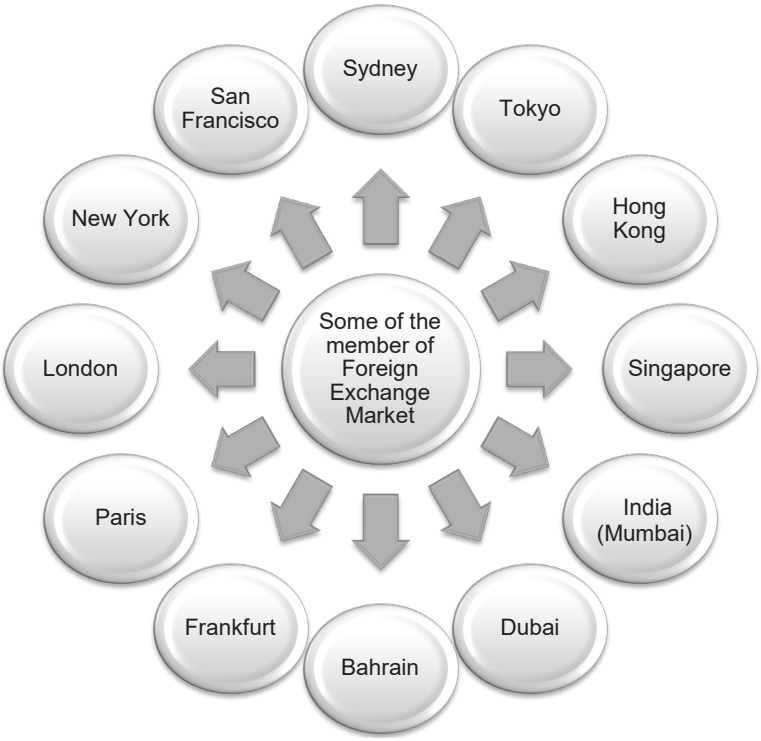
METHOD OF SETTLEMENT OF INTERNATIONAL TRADE

As seen already that the International trade involves both buying and selling of various commodities settlement takes place in different currencies. But the trade term of settlement is in any one of the following ways.



FOREIGN EXCHANGE MARKET

Foreign Exchange market can be defined as a market in which individuals, business firms and banks purchase and sell foreign currency. The term market mentioned here does neither mean any centralized meeting place nor any particular country. In other words it is described as an OTC (Over the Counter)market as there is no physical place where the participants meet to execute the deal as we see in the case of stock exchange. The foreign exchange market refers to communication system, viz., telephone, other satellite communication network, SWIFT through which participants remain in continuous contact with others. Foreign Exchange market for any currency such as US Dollar consists of all locations where US dollar is purchased and sold for other national currencies. These locations include Sydney, Tokyo, Hong Kong, Singapore, India (Mumbai), Dubai, Bahrain, Frankfurt, Paris, London, New York and San Francisco besides other locations. Trading among these locations is not subject to any formal requirements for participation.



The term foreign exchange market is used to refer to the wholesale segment of the market where dealings take place among the banks. The retail segment refers to the dealings take place between banks and their customers.

The leading foreign exchange market centres in India are Mumbai, Kolkatta, Delhi, Chennai etc. where bulk exchange dealings do take place. Additional centres have emerged as new centres such as Ahmedabad, Bangalore, Cochin, Goa etc. in view of policy of Reserve Bank of India to decentralize the exchange operations and to develop more broad based exchange market.

History of Foreign Exchange Market System

The foundation for a modern global forex market was said to have launched in the year 1850 in United States of America (US) when it had a few currency traders who exchanged various currencies on a rate determined by them privately. Also due to colonial rule of the British Empire which had its presence in large number of countries across the globe, British Pound Sterling remained as a common favourite of international dealings. However in 1880 many countries adopted Gold Standard as the basis for exchanging currencies. The Gold standard takes in to account "guarantees a fixed exchange rate of currency of another country that uses a gold standard (specie or bullion), regardless of what type of notes or coins are used as a means of exchange."

Thus Gold standard created means of exchange that had a "fixed external value in terms of gold that is independent of the inherent value of the means of exchange itself".

In simple terms Gold Standard depended upon value of Gold and the value of Gold held by a Government.

There were three different types of Gold Standards in vogue during the begining of 20th century. They are:

Gold Specie Standard: Under this system the monetary unit in circulation had certain amount of gold content and the value of the gold determined the value of the currency. The success of the system depended upon the government declaring the gold as medium for exchange for goods and services, government allowing free import or export of gold.

Gold Bullion Standard: Paper currency was circulated which was pegged against the gold stock held by the Government which agreed to sell gold bullion against demand in exchange at a fixed price for paper currency.

Gold Exchange Standard: Under this standard the Government guaranteed a fixed exchange rate pegged to a foreign currency that used gold standard (specie or bullion). The pegged currency was known as Reserve currency which can be convertible in to gold as it was with the case of bullion standard.

With the start of the first World War this standard was abandoned by many countries during the early 20th century. Also certain countries felt that larger amounts of gold were being transferred to other countries. In the aftermath of Great Depression, gold standard was banned in USA. Also the start of World War II created situations where monetary authorities printed more currencies without the stock of adequate gold. Also many countries faced economic problems such as high inflation, low growth which contributed to the decline in their currency value. The cumulative effect of these led to an introduction of a revised exchange rate system known as Bretton Woods System.

Bretton Woods System

During the World War II, economies of almost all countries were affected. This resulted in the disequilibrium of balance of payments. To set right the same, several countries devalued their currencies. This in turn resulted in the revaluation of the currency of another country. As this chain of activity continued to be followed by country after country to push their exports, there were wild fluctuations occurred frequently in the exchange rates resulting in breakdown of exchange rates. In the absence of a viable alternate system, international trade suffered.

Considering the seriousness of this development, Great Britain (GB) and United States of America (USA) took an initiative in this regard to create a free, stable and a multilateral monetary system which would bring in stabilization of foreign exchange rates and restore back international trade to a viable level for all parties concerned. Ultimately the proposal put forth by USA was accepted at a conference organized in Bretton Woods, in New Hampshire State, USA. This conference was held in July 1944 and was attended by Forty four countries including India (though under British rule then).

Apart from many developments, two significant developments that emerged out of Bretton Woods conference are:

- Establishment of International Monetary Fund ('IMF').
- International Bank for Reconstruction and Development ('IBRD') now popularly known as "World Bank".

We shall be discussing the effect of the former, as it has a direct relevance to the development of exchange rates and international foreign exchange markets. Under Articles of IMF an international exchange rate system known as "Bretton Woods System (BWS)" – a Monetary system - was evolved and introduced. This system was followed by member countries of IMF from the year 1946 to 1971.

The objects of the monetary system proposed by IMF in 1946 were :

- To establish an international monetary system with stable exchange rate system.
- To eliminate existing exchange controls.
- To bring in free convertibility of all currencies.

In addition to the above the following were the key outcomes of the agreement relating to the exchange rates:

(i) The Monetary system introduced by BWS required the member countries to fix a parity of their respective currencies vis-à-vis in terms of US Dollar (US$) or gold.

(ii) Member countries were required to maintain the fluctuation in their currency with in a band of ±1 per cent of their declared parity level vis a vis US$.

(iii) No change in parity would take place without the approval of IMF. This is to avoid unnecessary devaluation.

(iv) USA agreed to fix parity of its Dollar in terms of gold at US $ 35 per ounce of gold. and also committed to convert dollar balances held by monetary authorities of other countries freely in to gold at the fixed rate to maintain stability of dollar against gold.

(v) The Monetary authorities were obligated to intervene in the forex market if the parity levels exceeds ±1 per cent of their declared parity levels against US$.

(vi) If there were any fundamental problem faced by a member country in its Balance of payment position the declared parity can be changed with the permission of IMF.

As a result of these terms, the member countries were required to maintain foreign exchange reserves to effectively intervene in the foreign exchange market. If a member country was unable to intervene in the forex market due to lack of foreign exchange reserves they were permitted to approach IMF to draw from Special Drawing Rights (SDR) a facility of reserve asset created by IMF then. SDR can be exchanged for a currency of member a nation to the IMF.

Collapse of Bretton Woods System

As the U.S. economy prospered by leaps and bounds during 1950s and '60s, this resulted in huge deficits in balance of payment situation for the U.S. economy. The massive deficit resulted in the increase in supply of U.S. Dollars This situation became chronic during 1970 and 1971. The foreign exchange market participants felt

that at this juncture the gold reserves held by U.S. may not be sufficient to meet the market supply of circulating dollars, resulting in erosion of market confidence in the US$ for conversion at US$ 35 per ounce of gold. There was a virtual run on US$ forcing the U.S. on August 15,1971 to disengage from it's commitment of converting US$ in to gold made to the IMF in 1946. As a result most of the other members of IMF resorted to demand and supply based, market determined exchange rate (known as 'float') arrangement like Germany and Holland.

Smithsonian Agreement

As the Beretton Wood System collapsed, members of IMF wanted to have an alternative exchange rate system that effectively subserved the needs of the foreign exchange markets and participants. The consensus among the members of IMF was that the main reason for collapse of Bretton Wood System was the narrow band of parity adjustment of ±1 per cent of their declared parity levels against US$.

To arrive at a viable alternative, G-10 countries arranged a conference of IMF members in December 1971, and an agreement was reached under which the U.S. agreed for a devaluation of it's currency provided simultaneously Japan and Germany also devalued their currencies. This agreement was known as Smithsonian Agreement, in honour of the Institution where the conference was held.

Accordingly the USA devalued its US$ by 7.9 percent resulting in an effective increase in price at which Dollar can be converted to gold from US$ 35 per ounce to US$ 38. Simultaneously Germany and Japan and some other IMF members also revalued their currencies by 7 per cent. However some other members of IMF decided to continue to adhere to the floating rate system prevailing in their countries.

Under the Smithsonian agreement provided for a wider level of band of parity adjustment of ±2¼ per cent of their declared parity levels against US$ and for non- Dollar currencies a more wider band of ±4½ per cent against each other. However neither the U.S. government nor Federal Reserve encouraged the discipline. Under the circumstance prevailing then, "the dollar price in the gold free market continued to cause pressure on its official rate". In view of mounting pressures in the market though the U.S. devalued its currency by a further 10 per cent, its stubborn refusal to convert US$ in to gold, resulting in non-intervention of members of IMF in their markets. Japan and OEEC (Other European Economic Community) countries decided to settle for a float mechanism in their forex markets. Thus the fixed rate of exchange of foreign currencies came to an end.

Though many members of IMF adopted floating rate system of foreign exchange, the global oil crisis of 1973, resulted in high inflation and troubled balance of payment situation for many countries. To find a answer to the global exchange rate system, IMF organized a conference in Jamaica in the beginning of 1976. IMF tried the exchange values in terms of SDRs but the effective solution could not be found. Hence floating rate system stayed put and became stronger subsequently.

The European Monetary System and Development of Euro

In 1979 European Monetary System (EMS) was established to promote monetary stability of members of European Common Market otherwise known as European Community (EC). The objects of the EMS were -

(i) Stability of exchange rates of member states currencies.

(ii) To promote economic convergence of Europe by adopting common economic policies that brought stability to the currencies of member countries.

(iii) To develop economic and monetary union of European community through a common currency named EURO.

European Community members were signatories to the Smithsonian Agreement and agreed to maintain a fluctuation band of± 2¼ per cent of their declared parity levels against US$ while maintaining a fluctuation band of±4½ per cent of their declared parity levels among European currencies, which was later reduced to± 2¼ per cent. EMS had also established a European Currency Unit (ECU) which played an important role in EMS. ECU

was widely used for borrowing and lending and raising invoices in commercial trade. Though member countries of Europe had their own independent currencies, ECU was used as reference rate. During early 1990s Great Britain could not maintain the fluctuation band against other European currencies due to weakened economic fundamentals. Due to this In 1992 GB's Pound Sterling along with Italian Lira were forced out of Exchange Rate Mechanism of Europe. This forced EC authorities to fix the fluctuation band at ± 15 per cent levels.

Maastricht Treaty and introduction of Euro

In 1991 an agreement between European countries at Maastricht, in Netherland was arrived at to introduce a common currency named Euro by the year 1999 as well as establish an European Central Bank ('ECB'). The role of ECM was :

i. Issuing a common currency

ii. Conducting a monetary policies for European Union on behalf of central governing authorities

iii. Acting as a last resort all Central banks of member countries

iv. Managing the exchange rate for a common currency.

Accordingly Euro was introduced as a common currency in EC member countries except in Great Britain and in Denmark from January 1, 1999. As on date 19 countries out of 28 member countries of European Union use the Euro which according to the market sources, "is the second most traded currency in the foreign exchange market after the United States dollar".

The Euro is the second largest reserve currency as well as the second most traded currency in the world after the US$. As of August 2018, the estimated circulation of Euro was more than 1.2 trillion.

Market Size of Foreign Exchange market: According to Bank of International Settlement Triennial Central Bank Survey data, Trading in foreign exchange (FX) markets averaged $5.1 trillion per day in April 2016, FX and over-the-counter (OTC) derivatives markets. This is down from $5.4 trillion in April 2013. FX spot trading declined for the first time since 2001, even as activity in FX derivatives continued to increase. Trading in OTC interest rate derivatives averaged $2.7 trillion per day in April 2016, up from $2.3 trillion in April 2013. It was developed to facilitate settlement of debts arising out of international trade. The turnover in these markets in about 3 days is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London, followed by New York , Tokyo, Zurich, Frankfurt etc.

The business in foreign exchange markets in India have shown a steady increase as a consequence of increase in the volume of foreign trade of the country, improvement in the communication systems and greater access to the international exchange markets. Though the volume of business of foreign exchange market in India has increased which works out to US $ 5 billion per day cannot be compared with foreign exchange market of well developed countries. One of the reasons for our much less business is Rupee is not an internationally traded currency and is not in great demand. Some of the actively traded currencies in the foreign exchange market are US dollar, Sterling Pounds, Euro, Japanese Yen, Swiss Franc etc.

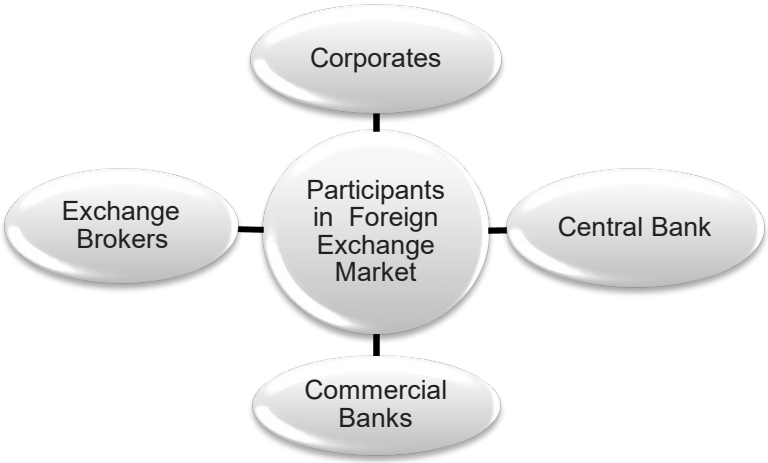
24 Hours Market: Foreign Exchange Market remains open 24 hours due to different time zones for different countries in the globe. At any point of time one market or the other remains open. Therefore it is stated that foreign exchange market is functioning throughout 24 hours of the day.

In India the market is open till the banks are open for their regular banking business. No transactions take place on Saturdays.

Efficiency : The participants keep abreast of current happenings by access to such services like Reuter, Telerate etc. Any significant developments in any market is almost instantaneously received by other markets and thus has a global impact. This makes the foreign exchange market very efficient as if they are functioning at one roof.

Currencies Traded : US Dollar is the common/main currency used to denominate international transactions though other currencies viz. Euro and Yen are gaining larger share and the share of US Dollar in the total turnover is shrinking.

Participants : The Participants in the Foreign Exchange Market comprises shown below in diagram.



Corporates: The business houses, multinational corporations, international investors may operate in the market to meet their genuine trade or investment requirements. The may also sell or buy currencies with a view to meet their requirements or speculate to the extent permitted by the Exchange Control Regulations. They operate through commercial banks by placing orders with them.

Central Bank : It may intervene in the market to influence the exchange rate and change it from that which would result only from private supplies and demands. The Central Bank may transact in the market on its own for the above purpose or it may do so on behalf of the Government when it sells or buys bonds and settles other transactions.

Reserve Bank of India is the Central Bank of our country. In India authorized dealers have recourse to Reserve Bank to sell /buy US dollars to the extent the latter is prepared to transact in the currency at the given point of time. Reserve Bank of India will not ordinarily buy/sell any other currency from/to authorized dealers. The contract can be entered into on any working day of the dealing room of Reserve Bank. Due to global practice, no transaction is entered into on Saturdays.

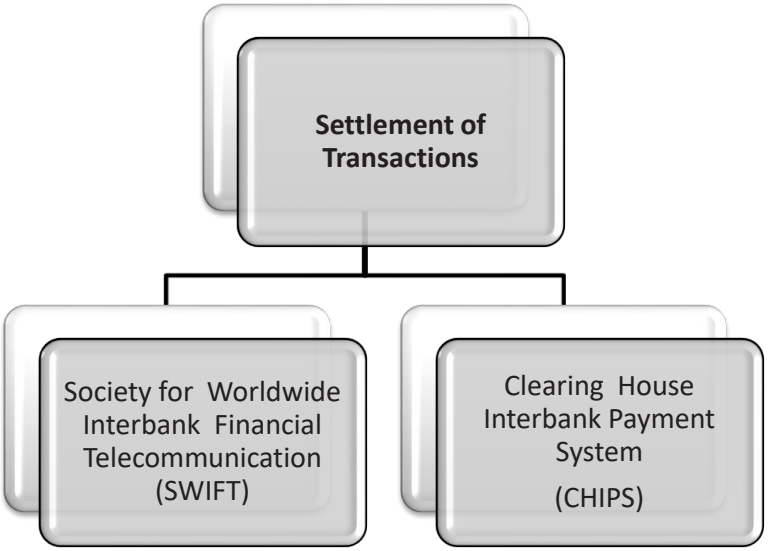
Normally Reserve Bank of India does not enter into the market in the ordinary course. Only when the exchange rates are moving in a detrimental way due to speculative forces it may intervene in the market either directly or through State Bank of India.

Commercial Banks : Commercial banks are the major players in the market. They buy and sell currencies for their customers. They do cover operations, purchase or sale of foreign currencies for future date based on sale or purchase of foreign currency on the present day. Such transactions constitute hardly 7% to 8% of the total transactions done by them. A major portion of the volume is accounted by trading in currencies to gain from exchange movements.

Exchange brokers : Exchange brokers facilitate deal between banks. In the absence of exchange brokers banks have to contact each other for quotes. If there are 150 banks at a centre , for obtaining the best quotes for a single currency a dealer may have to contact 149 banks. Exchange brokers ensure that most favourable quotation is obtained and at low cost in terms of time and money. The banks may leave with the brokers the limit up to which and the rate at which it wishes to buy or sell the foreign currency concerned. From the indents from various banks the brokers will be able to match the requirements of both.

Settlement of Transactions : Foreign Exchange markets make extensive use of the latest developments in

telecommunications for transmitting as well settling foreign exchange transactions. Banks use the exclusive network, SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.



SWIFT : SWIFT stands for Society for Worldwide Interbank Financial Telecommunication. It is owned by about 250 banks in Europe and North America and registered as a Society in Brussels, Belgium. It is a communication network for international financial market transactions linking effectively more than 25,000 financial institutions throughout the world, who have been allotted bank identifier code. Through Swift messages are transmitted from country to country via centrally interconnected operating centres located in Brussels Amsterdam and Culpeper, Virginia.

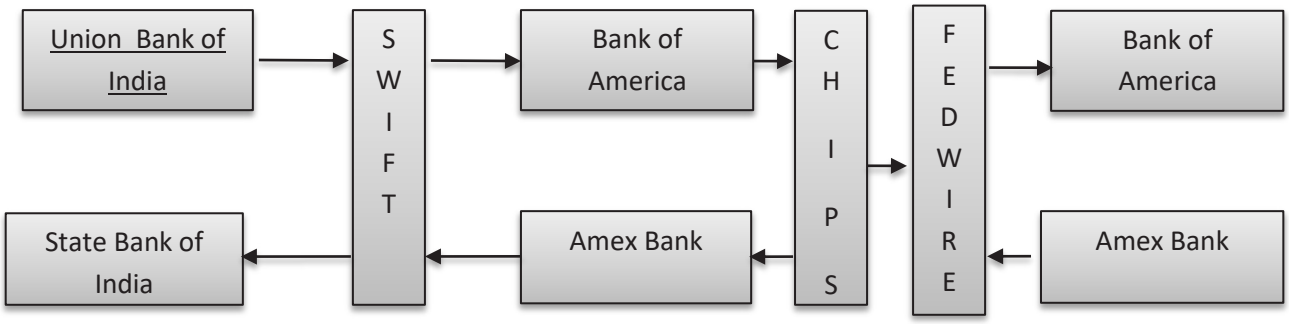
The member countries are connected to the Centres through Regional Processors in each Country. It has the following advantages :

- It is time tested reliable and accurate method of sending and receiving messages.
- Its structured format gives the information very clearly and as such it is widely used for various types of banking transactions.
- Access is available to a vast number of banks globally for launching new cross border initiatives. Message relay is instantaneous.

CHIPS : It stands for Clearing House Interbank Payment System. It is an electronic payment system owned by 12 private commercial banks constituting the New York clearing House Association. CHIPS begin its operation in 1971 and has grown to be the World's largest payment system. Foreign Exchange and Euro dollar transactions are settled through CHIPS. It provides the mechanism for settlement on daily basis.

The functioning of CHIPS arrangement is explained below with an hypothetical transaction. Union Bank of India , maintaining a dollar account with Bank of America, New York sells US $ 5 million to State Bank of India maintaining dollar account with Amex Bank.

How settlement for the transaction is explained below:



Foreign Exchange Rate Management

A foreign **exchange rate**, which is also called a forex rate or currency rate, represents the value of a specific currency compared to that of another country. For example, an interbank exchange rate of 91 Japanese yen (JPY, ¥) to the United States dollar (US$) means that ¥91 will be exchanged for each US$1 or that US$1 will be exchanged for each ¥91. Exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers where currency trading is continuous: 24 hours a day except weekends.

Currency rates are applicable only on currency pairs. The currency listed on the left is called the reference (or base) currency while the one listed to the right is the quote (or term) currency. Exchange rates are always written in the form of quotations. A quotation reflects the number of quote currencies that can be bought by using a single unit of reference currency.

Foreign Exchange Rates – Determinants

1. **Interest Rate Differentials:** Higher rate of interest for an investment in a particular currency can push up the demand for that currency, which will increase the exchange rate in favour of that currency.
2. **Inflation Rate Differentials:** Different countries' have differing inflation rates, and as a result, purchasing power of one currency may depreciate faster than currency of some other country. This contributes to movement in exchange rate.
3. **Government Policies:** Government may impose restriction on currency transactions. Through RBI, the Government, may also buy or sell currencies in huge quantity to adjust the prevailing exchange rates.
4. **Market Expectations:** Expectations on changes in Government, changes in taxation policies, foreign trade, inflation, etc. contribute to demand for foreign currencies, thereby affecting the exchange rates.
5. **Investment Opportunities:** Increase in investment opportunities in one country leads to influx of foreign currency funds to that country. Such huge inflow will amount to huge supply of that currency, thereby bringing down the exchange rate.
6. **Speculations:** Speculators and Treasury Managers influence movement in exchange rates by buying and selling foreign currencies with expectations of gains by exploiting market inefficiencies. The quantum of their operations affects the exchange rates.

EXCHANGE RATE MECHANISM

Introduction: An exchange rate is a simple arithmetical expression which gives value of one currency in terms of another. The exchange rate is therefore a bilateral rate expressing relative price of country's money. Exchange rates have developed over a period of time moving through different stages – controlled rates(fixed rates) managed rates and independently floating rates.

The exchange rate between currencies in a foreign exchange market is affected by number of factors. The extent to which these fluctuations are allowed is mainly dependant upon the monetary system adopted by the countries concerned.

When countries were under gold standard the value of currency of a country was fixed as the value of gold is of definite weight and fineness. The exchange rate between the currencies was determined on the relative value of gold content of currencies concerned.

e.g. If gold content of Indian rupee was 5grain of standard purity and that of US dollar 60 grains standard purity, the exchange rate between Indian Rupee and the US Dollar is as under.

1 Rupee = 5/60 = US $ 0.0833

1 US$ = 60/12 = Rs.12

(Note : This is not the present rate.)

This rate of exchange was known as the mint par of exchange because at the Indian mint one rupee would get 5 grains of gold and in the USA USD 0.0833 would get the same quantity of 5 grains of gold.

Exchange rates were stable under gold standard because any deviation in the exchange rate would be set right automatically by the movement of gold between the countries.

Exchange Rates:

Exchange rate can be expressed either in direct or indirect Rate. It can be spot rate or forward rate. It may be fixed or floating. In a forward exchange rate, interest factor is involved. Forward price can be either at premium or at discount depending upon whether the currency dealt with is appreciating or depreciating during the forward period. Forward Exchange Rate can be expressed as an outright price wherein the forward margin is loaded in the spot price.

Typically the quotation in the interbank market is a two way quotation. It means two prices are indicated one for purchase and the other for sale of foreign currency . In other words the market player quotes two prices one at which the banker is willing to buy and the other rate at which the banker is willing to sell the foreign currency.

Direct Quotation : Here foreign currency is fixed/constant and accordingly value of domestic currency varies. In other words in a foreign exchange quotation the foreign currency is the commodity which is being bought and sold and the exchange quotation which gives price for the foreign currency in terms of domestic currency is known as direct quotation. In direct quotation the rule is “ Buy Low and Sell High.”

US $ 1 = Rs. 67.2535/.2670

It is normally quoted as .2535/.2670

In the aforementioned example viz. US $ 1 = Rs. 67.2535/.2670 there is a gross profit of Rs. 0.0135 (Rs. 67.2670 - Rs. 67.2535. It means that the quoting bank is willing to buy dollars at Rs. 67.2535 and sell dollars at Rs.67.2670.

There are two types of quotations viz. direct quotation and indirect quotation

Indirect quotation : Here the quantity of domestic currency is fixed and accordingly value of foreign currency corresponding to domestic currency is given as a quote.

This is another way of quoting of value of currencies towards purchase or sale, e.g. Rs. 100 = US $ 1.4869/ 1.4900 (foreign currency was taken at Rs.67.2535/67.1140 = 1 US $)

In this case the quoting bank will receive US $ 1.4900 per Rs.100 while buying and gives US $ 1.4869 per Rs.100 while selling dollars. In other words the maxim here is “Buy High Sell Low.”

The buying rate is also known as the 'bid' rate and the selling rate is called as 'offer' rate. The difference between Bid and Offer is called 'Spread' representing the profit in the buying and selling transactions.

Spot and Forward Transactions:

The transactions in the interbank market may have place for settlement on the same day or Two days later or After a month.

The transaction where the exchange of currencies take place upto two days after the date of contract is known as the spot transaction, e.g. if a transaction taken place on Monday the delivery should take place on Wednesday. If Wednesday happens to be a holiday on the next working day i.e. Thursday.

The transaction in which the exchange of currencies takes place at a specified future date subsequent to the spot date is known as a forward transaction. The forward transaction can be for delivery at one month or two moths or three months etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract.

The market quotation for a currency consists of spot rate and forward margin.

The outright forward rate has to be calculated by loading the forward margin into the spot rate. e.g. US $ is quoted as under in the interbank market on 5th March

Spot	US $ 1 =	Rs. 67.4000/4200
Spot /April		.2000/.2100
Spot/ May		.3500/.3600

The following points are to be noted in interpreting the above quotation.

The first one is spot rate for dollars. The buying rate is Rs.67.4000 and the selling rate is 67.4200

The second and the third are forward margins for forward delivery during the months of April and May respectively. They are Rs. 0.20 and Rs.0.21

Under direct quotation the first rate is buying rate and the second rate is selling rate.

	Buying rate		**Selling rate**	
	April	**May**	**April**	**May**
Spot Rate	67.4000	67.4000	67.4200	67.4200
Add: Premium	0.2000	0.3500	0.2100	0.3600
Forward Rate	67.6000	67.7500	67.6300	67.7800

From the above calculation we arrive at the following outright rates

	Buying rate	**Selling rate**
Spot delivery	67.4000	67.4200
Forward delivery April	67.6000	67.6300
Forward delivery May	67.7500	67.7800

If the forward currency is at discount it would be indicated by quoting the forward margin in the descending order. Presume on 15th March the quotation for Pound Sterling in the interbank market is as follows:

Spot	GBP 1	93.4000/.4300

Spot/April		93.3800/.3600
Spot/May		93.5700/.5400

As the forward margin is in descending order (.3800/.3600) forward rate of sterling pounds is at discount. The outright forward rates are calculated by deducting the related discount from the spot rate. It is shown below:

	Buying rate		**Selling rate**	
	April	**May**	**April**	**May**
Spot Rate	93.4000	93.4000	93.4300	93.4300
Less : Discount	0.3800	0.5700	0.3600	0.5400
Forward Rate	93.0200	92.8300	93.0700	92.8900

From the above calculations the outright rates for Pound Sterling can be restated as under:

	Buying	Selling
Spot delivery GBP 1 =	93.4000	93.4300
Forward delivery April	93.0200	93.0700
Forward delivery May	93.8300	92.8900

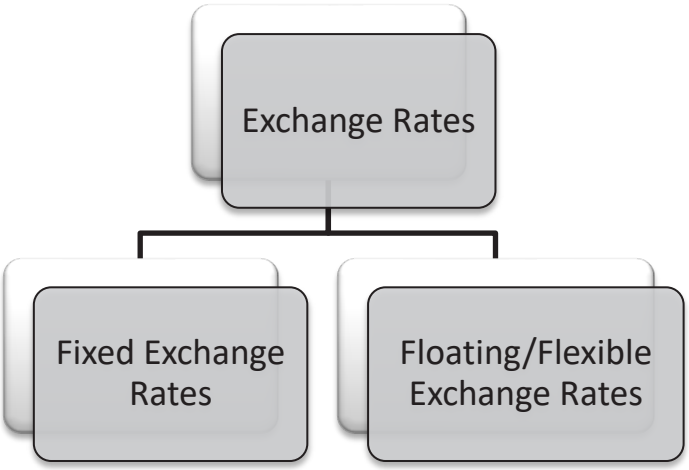
Forward margin in ascending order = Add Premium to spot rate

Forward margin in descending order = Deduct discount from spot rate

Foreign Exchange Dealers' Association of India (FEDAI) has issued guidelines on the quotation of merchant rates – spot and forward. In Indian forward market availability of option forward contract is a peculiar one.

Forward contracts which provide for utilization on a specific date are called as fixed forward contracts. The date of utilization is pre determined and it is a specific date. There is no option for delivery of utilization to either party other than the pre determined date.

EXCHANGE RATES



Fixed Exchange Rate

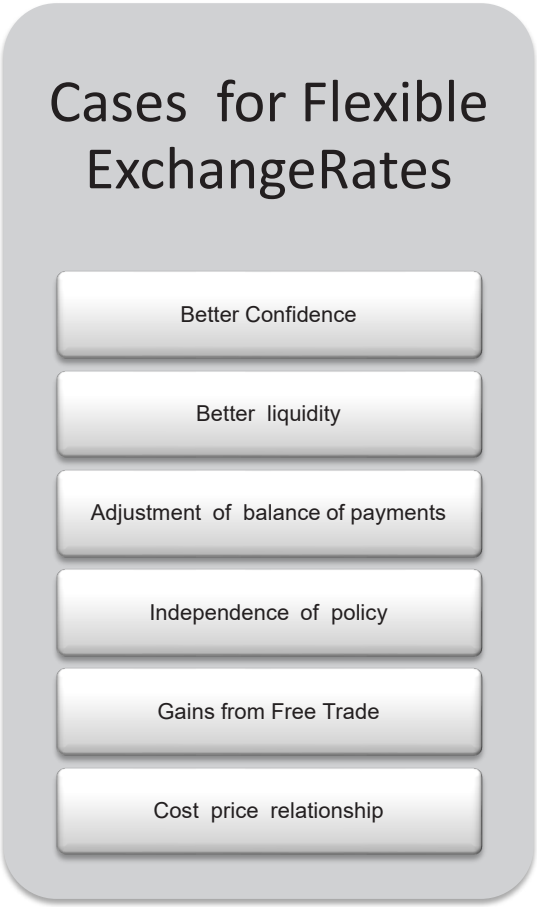
It refers to the system under the gold standard where the rate of exchange tends to stabilize around the mint par value. Any large variation of the rate of exchange from the mint par value would entail flow of gold into or from the country. This would have the effect of bringing the exchange rate back to the mint par value.

In the present day situation where gold standard no longer exists, fixed rates of exchange refer to maintenance of external value of the currency at a predetermined level. Whenever the exchange rate differs from this level it is corrected through official intervention, e.g., when International Monetary Fund (IMF) was formed every member country was required to declare the value of the currency in terms of gold and US Dollars (known as the par value). The actual market rates were allowed to fluctuate only within a narrow band of margin from the level. Though par value system was abolished with the second amendment to the articles of IMF in 1978 still the system of fixed rates continues in many countries in the form of pegging their currencies to a major currency.

Floating/Flexible Exchange Rates

Floating or flexible exchange rate refers to the system where the exchange rates are determined by the position/condition of demand and supply of foreign exchange in the market. Normally the exchange rates are free to fluctuate according to the demand and supply forces with no restrictions on buying and selling of foreign currencies in the exchange market.

Under floating exchange rates no par value is declared and the Central Bank does not intervene in the market. Any disparity in the balance of payments is adjusted through the changes in exchange rate that take place automatically in the market. As Central Bank does not intervene in the market there is no change in the exchange reserves of the country.

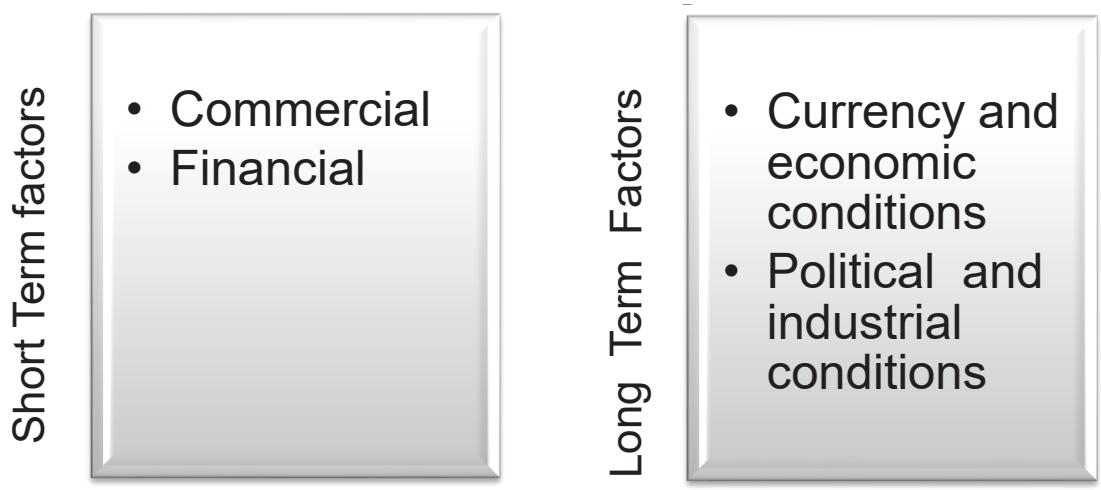


Factors affecting Exchange Rates :

So long as fixed exchange rate system was in vogue rates could not go beyond the respective lower and upper intervention points except when there was devaluation or revaluation of currency.

Whereas under Floating rate system, the exchange rates fluctuate on account of demand and supply of currency.

The principal factors affecting exchange rates are:



Long Term Periods

Purchasing power parity theory under a generalized system of clean floating exchange rates respond to inflation differentials. This is good theory for long term exchange movements.

Short Term Periods

Country's current account balances is a better indication of exchange rate trends. A surplus i.e. foreign exchange net inflows from export earnings pushes country's currency higher.

A nation's international competitiveness and with it the trend of its current account depends on different factors.

(i) Higher economic growth

(ii) Inflation will diminish export after certain future period and will increase imports.

EXCHANGE ARITHEMATIC

Example 1

Bank's export customer has presented a sight bill for US $ 1,00,000 for negotiation under a Letter of Credit providing for value date TT reimbursement.

The following is the additional information :

Indian agent is entitled to a commission of 0.5% as mentioned in the L/C.

Calculate Rupee amount to be credited to customer's current account taking into account the following:

Exchange margin is allowed at 0.15%

Exchange to be quoted as per FEDAI guidelines

Rupee amount is to be expressed to the Rupee.

Solution:

Bill amount is US $ 1,00,000

Exchange rate (spot)	= Rs. 67.150000
Less : Margin @ 0.15%	Rs. 0. 100725

	Rs.67. 049275
Rounded off to the multiples of 25	= Rs.67.0500
US $ 1,00,000 @ Rs. 67.0500	= Rs.67,05,000
Less: Commission to Indian Agent on the bill amount@0.5%	
= US $ 500 @ 67.0500	= Rs. 33,525

	= Rs.66,71,475

Amount to be credited to customer's a/c	= Rs. 66,71,475

Example 2

On 1.2.2018 the bank had purchased a demand bill for us $ 10,000 @ Rs. 66.10 and the exporter was paid in Rupee immediately. The bill when it was presented on 10th February 2018 at New York was not honoured. The advice of non payment was received and conveyed to the exporter on 13th February 2018. The Exporter requested that

1. Bill amount plus charges of Rs.250 be recovered from him.
2. 5% rebate be allowed to the overseas importer.
3. The bill be treated on collection basis and represented for payment.

On 3rd March 2018 the bank in New York faxed having conveyed the recovery of the amount and credited the proceeds less their charges US $ 20 with value date on 3rd March 2018.

Meanwhile the market has moved and the TT selling rate on 13th February 2018 was Rs. 66.25.

The TT buying rate on 3rd March 2018 was Rs. 66.05

Solution :

The repayment of the bill clearly means reversal of the deal and hence the bank has to sell ready dollars at the TT selling rate on the date of reversal of the transaction.

In this process we have to find out what would be the probable Rupee loss or profit to the customer.

On the 13th Feb 2018 the customer pays to the bank, the bill amount (overdue interest is ignored in our calculation and separately recovered). The following amount would be paid

Bill amount US $ 10,000

TT selling rate Rs. 66.25

Rupee amount payable by the customer	Rs.6,62,500
Add**:** Bill amount charges	250

Rs.6,62,750

On the export bill realized on 3rd March 2018, the dollar proceeds realized would be

Bill Amount US $	10,000
Less: 5% rebate	$ 500
Less: Bank charges	$ 20

	$ 9,480

The dollar amount at the TT buying rate of

US $ 9,480 X 66.05 = Rs.6,26,154

Gain or loss to the customer

Amount refunded by the customer on 13th February, 2018	= Rs. 6,62,750
Amount received by the customer on 3rd March, 2018	= Rs.6,26,154

Loss =	Rs. 36,596

Example 3

M/s XYZ corporation offered a sight bill to bank's Mumbai Fort Branch for US Dollar 2,50,000 on 01.01.2018 drawn under Letter of Credit established by Citi Bank, New York . Calculate what is the amount bank will credit exporter customer's account taking into account the following :

1. Inter bank US D 1 = Rs. 66.5000/5100
2. Transit period 10 days. Interest Rate 11%
3. Exchange Margin 0.15%

Solution:

Spot rate US D 1 =	Rs. 66.5000
Less : Margin 0.15%	Rs. 0.0997
	Rs. 66.4003
Rounded of to the multiples of 0.0025	Rs. 66.4000
US $ 2,50,000 @ 66.6000	Rs. 1,66,00,000.00
Less : Recover int at 11% for 10 days	Rs. 50027.40
Net payable	Rs. 1,65,50,972.60

Example 4

You sold Pound Sterling 2,00,000 in the interbank market at Pd Stg 1 = Rs.90.80 in cover of an inward TT reported by your branch in India. However it was detected that the transaction had been erroneously reported twice and you are therefore required to cancel your sale.

Assuming that Sterling Pounds was quoted in the local inter-bank market as under

Spot TT Pd. Sterling Rs.90.7075/7700

One month forward Rs.90.8000/8400

What will be the loss or gain to the bank bearing in mind that you are required to pay brokerage of Rs.2,000/- for original sale transaction, as well cancellation transaction.

Solution:

1. As This is a cancellation of sale we will have to buy from the market at interbank selling rate

   Pd Sterling 1 = 90.7700

   Pd Stg 2,00,000 @ 90.7700 = 1, 81,54,000

   Add: Brokerage 2,000

   = 1,81,56,000

2. Amount originally received for our sale

   Pd Stg 2,00,000 @ 90.80 = 1,81,60,000

   Less: Brokerage = 2,000

   = 1,81,58,000

   Profit = Rs. 2,000

Example 5

An importer-customer approached you on 1st Jan 2018 for sale to him

1. US Dollar 2,00,000 delivery on 31st March 2018
2. US Dollar 1,00,000 delivery on 30th April 2018

   Assumptions:

   Spot inter bank 66.5000/5100

Forward premia Jan		0.1350/0.1450
	Feb	0.3050/0.3150
	March	0.5500/0.5600
	April	0.7700/0.7800

Exchange margin 0.130%

Last two digit in multiples of 25

Calculate the rates to be quoted to the customers.

Solution:

Importer customer approached on 1.1.2018

US $ 2,00,000 delivery on 31.3.2018

Spot inter bank Rate Rs.66.5100 (being import sale txn)

Add: Premium upto 31.3.2018 + 5600

	Rs.67.0700
Add: Exchange margin 0.125%	0.0838

	Rs.67.1538

Rounded off to Rs.67.1550

2.US $ 1,00,000 delivery in April 2018

Spot inter bank rate	Rs.66.5100
Add: Premium upto 30.4.2018	+ Rs.00.7800

	Rs.67.2900
Add: Exchange margin @0.125%	0.0841

	Rs.67.3741

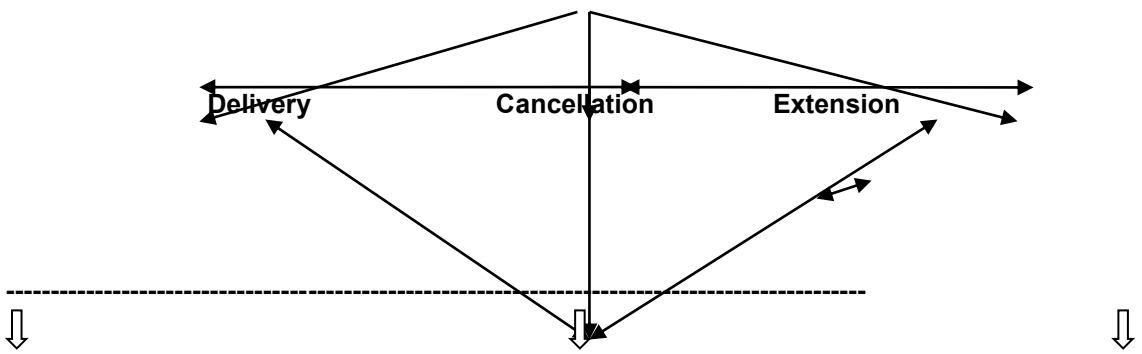
Rounded off to Rs. 67.3750

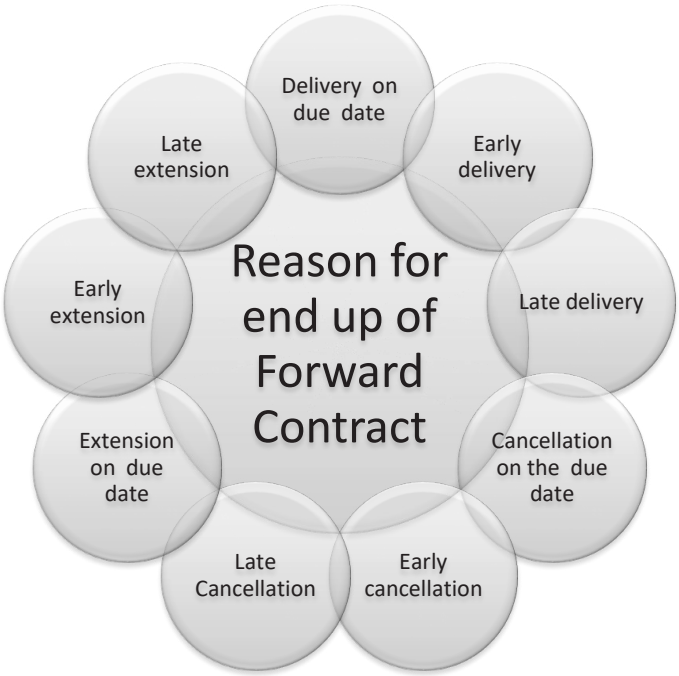
Execution of Forward Contract

In forward contact the time and the amount of foreign exchange to be delivered are pre-determined and the customer is bound by this agreement. So, theoretically, there should not be any variation and on the due date of the forward contract the customer will either deliver or take delivery of the fixed sum of foreign exchange as agreed upon. But in reality/practice often the delivery under a forward contract may take place either before or after the due date, or delivery of foreign exchange may not take place at all. In these cases the bank will generally agree for the same provided the customer agrees to bear the loss if any.

Now let us analyse the possibilities of the fate of a forward contract.

Forward contract





FORWARD EXCHANGE RATES

The transaction in which the exchange of currencies takes place at a specified future date subsequent to the spot date is known as a forward transaction. In other words as against delivery of funds on the same day or on the second working day from the date of transaction if it is on a specified future date the rate applied for such transaction is called Forward Rate Transaction .

The forward transaction can be for delivery at one month or two moths or three months etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract.

FORWARD MARGIN PREMIUM AND DISCOUNT

In a free market, the exchange rates would be based on the demand and supply system. A currency in excess supply would tend to become cheaper and a scarce one becomes costlier till balance between demand and supply struck.

Besides given the connection between exchange rates and funds cost in a totally free market the interest rates differentials for the two currencies would be reflected in the forward exchange rates.

The relationship between spot rate and forward rate of any two currencies depend firstly on the relative rates of interest obtainable on similar types of securities in the two Centre and secondly on the relationship between the demand for and the supply of forward currency in the markets.

Interest factor is the basic factor in arriving at the forward rate. If the rate of interest say in London for three months prime bank bills rate is 7% p.a. while the same can be purchased in Switzerland at a rate of interest of 8%p.a. there will be a flow of funds from London to Switzerland to take advantage of higher yield shown by Swiss bills. (assumption is that there is no exchange controls and hence movement of capital is allowed). The London investor has to buy Swiss Fr/Euro and the same is to be reconverted back to Sterling on maturity. This will lead to demand for Sterling in the forward.

The gain or loss will be adjusted in the forward rate of currencies.

The forward price of a currency against another can be worked out with the following factors:

1. Spot price of the currency
2. Interest rate differentials for the currencies
3. The term i.e. the future period for which the price is worked out.

An important point to be kept in mind is that the forward rate so worked out is not an indicator of the future trend of the currency.

Forward Margin - Premium

In a simple term it may said that the forward value of that currency(forward rate) is higher than the spot value (spot rate). A currency is said to be premium if its forward value is higher than the spot value.

The currency is said to be at premium if it commands more of the other currencies in the forward than in the spot. The actual outright forward rate is obtained by allowing the forward margin over the spot rate. It is arrived at by adding the forward margin to the spot to make it dearer.

Forward margin – Discount : If a currency is at discount it means that the forward value of that currency is lower than the spot value. A currency with a higher rate of interest is said to be at discount in the forward relative to the currency with lower rate of interest. iIf a currency commands less of the other currency in the forward than at the spot, it is said to be discount.

Factors determining forward Margin :

Rate of interest : The difference in the rate of interest prevailing at the home centre and the concerned foreign centre determines the forward margin. If the rate of interest at the foreign centre is higher than that prevailing at the home centre the forward margin would be at discount. Conversely, if the rate of interest at the foreign centre is lower than that at the home centre the forward margin would be at premium.

The spot rate for US dollar is Rs.66.000 The rate of interest in India is 8% and at New York it is 5% p.a. the bank has to quote 3 months selling rate to a customer. Assuming that the operation is for US Dollar 10,000 and the entire interest loss /gain is passed on to the customer. The forward rate can be calculated as under:

To meet the needs of the customer the bank may buy spot US dollars and deposit them in New York for 3 months so that it can deliver on due date the required dollars.

The calculation is as under:

Purchase $ & invest for 3 months	US $ 10,000	Borrow for dollar to pay at Rs.66/- Rs.66x10,000	Rs.6,60,000
Int earned at 5% for 3 months	US$ 125	Int payable 3 months@ 8%	Rs. 13,200
Receive after 3 months	US$ 10,125	Pay after 3 months	Rs.6,73,200

The bank should be able to get Rs. 6,73,200 against US $ 10,125. Therefore the rate quoted is :

6,73,200 /10,125 = Rs.66.48

Thus the forward premium is Re. 0.48

Demand and Supply : Forward margin is also determined by the demand for and the supply of foreign currency. If the demand for foreign currency is more than its supply forward rate would be at Premium and the rate would be at discount if the supply exceeds the demand.

Speculation about spot rates : Since the forward rates are based on spot rates any speculation about the movement of spot rates would influence forward rates also. If the exchange dealers anticipate the spot rate to appreciate, the forward rate would be quoted at premium and if they expect the spot rate to depreciate the forward rates would be quoted at a discount.

CALCULATION OF FORWARD PREMIUM/DISCOUNT

Example 6

Customer request his banker to book a forward sale contract for US$10,000 delivery after three months.

US $ are quoted in the local inter bank market as under:

Spot US $ 1 = Rs. 67.2400/.2500

One month forward premium	0.0850/0.0900
Two months forward premium	0.3650/0.3700
Three months forward premium	0. 6300/.6350

Additional information:

1. Exchange profit must be included in the rate quoted to the customer
2. Rate quoted should be nearest to the fourth decimal in multiples of 0.0025
3. Brokerage and other charges may be ignored.
4. Bank is entitled to exchange profit of 0.15% on the transaction.

Calculate the rate which will be quoted by you as a banker to your customer. What will be bank's profit?

Solution:

Inter bank spot selling rate	Rs. 67.2500
Add: Three months forward premium	Rs. 0.6350

	Rs. 67.8850
Add: Exchange profit 0.15%	.1018275

	Rs.67.9868275

Rounded off to Rs. 67.9875

Profit on the transaction

Rate quoted to the customer	Rs. 67.9875
US $ 10,000 @ 67.9875	= Rs.6,79,875
Less: US $ 10,000 @ 67.8850	= Rs.6,78,850
Profit	= Rs. 1,025

Example 7

On 1.3.2018 when a forward contract matured for execution bank was asked by an Importer customer to extend the validity of the forward sale contract for US $ 10,000 for a further period of three months.

Contracted Rate US $ 1 = 67.00

US $ quoted as on 1.3.2018

Spot	66.5000/ 66.6000
Premium April	0.2950/0.3000
Premium May	0.5550/0.5600
Premium June	0.7700/0.7750

Calculate the cost for your customer in respect of the extension of the forward contract. Rupee values to be rounded off to the nearest rupee.

Margin 0. 0.080% for buying rate

Margin 0.30% for selling rate

Solution:

This is an Extention of Forward Contract and it is a sale contract.

Step 1. Cancel the contract at TT buying rate on 1.3.2018

Spot US $ 1	= Rs.66.5000
Less: Margin 0.080%	0.0532

	=Rs.66.4468

Hence TT buying rate is Rs.66.4475 (rounded off)

US $ 10,000 @ Rs. 66.4475	= Rs. 6,64,475
US $ 10,000 @ Rs. 67.0000	= Rs. 6,70,000
Difference in favour of the bank	= Rs. 5,525

Step 2. New contract is to be booked at the appropriate forward rate, with premium for full month.

Three month extension from 01.03.2018 is upto 31.05.2018

Therefore premium for May is to be taken.

Three months forward rate is as under:

US $ 1	= Rs. 66.6000
Add: Premium for one month(May)	= Rs. 0.5600

	=Rs. 67.1600
Add: Margin 30%	=Rs. 0.2014

	= Rs.67.3614

Forward rate to be quoted to the customer is U S $ 1 = Rs. 67.3625

Example 8

Bank's importer customer requests that on 10th January book a forward exchange contract for Japanese Yen 2 Million delivery in March .

Assuming US $ dollar are quoted in Singapore Market against Japanese Yen as under:

Spot	US $ 1 = JPY 109.3000/.3110
1 month forward	100/90
2 month forward	200/190
3 months forward	300/290
4 months forward	400/390
5 month forward	500/490
6 month forward	600/590

and US $ in the local interbank market as

spot	US $ 1 = Rs. 66.1000/.1050
Spot /Feb	900/950
March	1200/1300
April	1900/2000
May	2500/2600
June	3200/3125
July	3725/3800

What rate will bank quote to its customer bearing in mind that bank is required to keep an exchange margin of 0.15% on TT selling and 0.20% on bills selling.

Solution:

Against Rupee, dollar is quoted at premium. Since this is a sale transaction late delivery will be taken. The forward rate to the customer will be based on spot/March selling rate in the interbank market

Dollar/Rupee spot selling rate	= Rs.66.1050
Add: Premium for March	= .1300

	= Rs.66.2350
Add: Exchange margin for TT selling at 0.15% on 66.2350	= 0.0993

Forward TT selling rate for dollar	= Rs.66.3343
Add: Exchange margin for bills selling Rate 0.20% on	0 .1326

Forward bills selling rate for dollar	Rs.66.4669

Against Yen. Dollar is quoted at discount. Since the buying rate is reckoned

for this leg of transaction , the latest delivery date of 31.3.2018 will be taken. This falls under third month from 10th Jan.

Dollar /Yen Spot buying rate	= JPY 109.3000
Less: Discount for 3 months	= JPY 0.0300

	= JPY 109.2700

Forward bill selling rate for Jap Yen

$$\frac{66.4669}{109.2700} \times 100 = \text{Rs. } 60.8281$$

Rounded off the rate quoted would be Rs. 60.8300 per 100 JPY.

Example 9

Bank's exporter customer requests bank on 4th May to book a forward contract of CAD 70,000 for delivery customer's option July.

Assuming the bank covers its purchase of Canadian dollars in Singapore Market and US $ – CA$ are quoted as under.

Spot	US$ 1 = CA$1.2820/2840
1 month	40/30
2 months	60/50
3 months	80/70

and the Rupee – US Dollar are quoted in the interbank market as under

Spot	US $ 1 = Rs. 67.2425/2525
Spot /June	1150/1250
July	2250/2350
August	3350/3450

What rate will you quote to your customer bearing in mind that an exchange margin of 0.10% has to be loaded in the exchange rate? What will be the rupee amount payable to the customer?

Solution:

Earliest delivery date will be taken i.e. 1st July as

US dollar/Rupee spot buying rate	Rs. 67.2425
Add: Premium for June	Rs. 0.1150

	Rs.67.3575
Less: Exchange margin at 0.10% on Rs.67.3575	Rs. 0.0673

Forward buying rate for US Dollar Rs.67.2902

US dollar is at discount against Canadian dollar. Since selling rate is reckoned earliest delivery date will be considered which is 1st July and falls between first and second month. Rounding off to the earlier month, the customer rate will be based on one month US dollar/Canadian dollar rate at Singapore Market.

US Dollar /Canadian dollar spot selling rate = CAD 1.2840

Less: Discount for one month = CAD 0.0030

= CAD 1.2810

Forward buying rate of for Canadian dollar

(67.2902 \ 1.2870) = Rs.52.5294

Rounded off, the rate quoted is Rs. 52.5300 per Canadian dollar

Rupee amount payable to the customer for CAD 70,000 is Rs. 36,77,100.

Example 10

An importer-customer of bank wishes to book a forward contract with you on 1st January for sale to him SGD 4,00,000 delivery on 28th February.

The spot rates on 1st Jan are USD/Rs.66.2425/2525 and USD/SGD 1.3258/.3268 and the swap points are

	USD/Rs.
Spot/Jan	0300/0400
Spot/Feb	1100/1300
/Mar	1900/2200
/April	2700/3100
/May	3500/4000

	USD/SGD
1ST month forward	48/49
2nd month forward	96/97
3rd month forward	138/140

Calculate the rates to be quoted to the customer keeping an exchange margin of Re. 0.05. Fineness of quotation as per FEDAI Rules.

Solution:

The customer requires the rate for fixed date delivery on 28th February. The rate quoted to him will be based on Spot/Feb rate of US dollar / Rupee and second month forward rate US Dollar/Singapore dollar.

US Dollar/Rupee spot selling rate = Rs. 66.2525

Add: Forward premium for delivery Feb = Rs. 0.1300

= Rs. 66.3825

Add : Exchange Margin + Rs. 0.0500

Forward Selling rate for US Dollar	= Rs. 66.4325

US Dollar /Singapore Dollar spot buying rate SGD	1.3258
Add : Forward premium for 2nd month SGD	0.0096

	SGD Rs 1. 3354

Forward selling rate (66.4325 /1.3354)	Rs. 49.74727
Rounded off the rate quoted is	Rs. 49.75

Example 11

Your customer requested you on 5th April to book a forward contract cover an export bill for Singapore Dollar 2,00,000 drawn on Singapore and payable 30 days after sight with an option to him over the month June.

The following rates prevail in the interbank market for US dollars

Spot	US $ 1 = Rs. 66.2425/2475
Spot / April	1650/1750
May	3150/3250
June	4650/4750
July	6150/6250
August	7650/7750
September	9150/9250

At Singapore market, Singapore dollar is quoted for

Spot	US $ 1 = SGD 1.3440/1.3514
1 month forward	75/85
2 months forward	120/130
3 months forward	160/170
4 months forward	200/210
5 monthly forward	240/250
6 monthly forward	280/290

Transit period is 25 days. Exchange margin required is 0.15%

What rate will you quote to your customer?

Solution:

US Dollar is at premium against Rupee. Earliest delivery under the forward contract is on 1st June. Usance period of 30 days and transit period of 25 days. Now upto 55 days making 25th July the due date of the bill. This will be rounded off to the lower month and the exchange rate to the customer will be based on Spot/June rate for US Dollar in the interbank market.

US Dollar/Rupee spot buying rate	= Rs. 66.2425
Add: Premium for June	+ Rs. 0.4650

	Rs.66.7075
Less: Exchange margin at 0.15% on Rs.66.7075	Rs. 0.1000

Forward buying rate for US dollar	Rs.66.6075

US Dollar is at premium against Singapore dollar. Selling rate is to be considered taking latest delivery of 30th June, the bill is expected to realize on 15th August which falls in the fifth month from April . The forward rate to the customer will be calculated based on 5 months forward US Dollar/Singapore dollar rate.

US dollar/Singapore dollar spot selling rate =	SGD 1.3514
Add: Premium for 5 months	= SGD 0.0250

	=SGD 1.3764

Forward buying rate for Singapore dollar	(66.6074 /1.3764)
	Rs.48.3925

The rate quoted to the customer is Rs. 48.3925 per Singapore Dollar.

***Example 12*:** On 18th April an Export customer seeks forward cover for Euro 100,000 with an option to him over July covering an export bill for 30 days usance

The interbank rates for US $ are as under

Spot	US $ 1 = Rs.67.2425/2500
Spot/April	500/600
May	1400/1500
June	2800/2900
July	4200/4300

Euro is quoted in Singapore Market as under:

Spot	Euro 1 = US$ 0.835988
1 month	20/21
2 months	40/41
3 months	60/61
4 months	80/81

Transit period is 25 days. The bank requires an exchange margin of 0.10% . Calculate the rate to be quoted to the customer.

Solution:

Dollar/rupee market spot buying rate	= Rs. 67.2425
Add: Premium for July	.2800

	= Rs.67.5225
Less: Exchange margin at 0.10% on 67.5225	0.0675

Forward bill buying rate	= Rs.67.4550

Euro is at premium at Singapore market. The notional due date falls in July. This may be rounded off to earlier month. Premium for 3 months will be taken.

Euro dollar market spot buying rate	= US D 1.1973
Add: 3 months premium	0.0060

Euro dollar forward bill buying rate = US D 1.2033

Euro dollar forward bill buying rate

(Rs. 67.4550 x 1.2033) = Rs. 81.1686015

Rounded off to the nearest multiple of 0.0025 the rate quoted would be Rs.81.1700 per Euro

Example 13

Bank's importer customer requests that on 10th January to book a forward exchange contract for Japanese Yen 2 Million delivery in March .

Assuming US $ are quoted in Singapore Market against Japanese Yen as under:

Spot	US $ 1 = JPY 109.3000/.3110
1 month forward	100/90
2 month forward	200/190
3 months forward	300/290
4 months forward	400/390
5 month forward	500/490
6 month forward	600/590

and US $ in the local interbank market as

spot	US $ 1 = Rs. 66.1000/.1050
Spot /Feb	900/950
March	1200/1300
April	1900/2000
May	2500/2600
June	3200/3125

July	3725/3800

What rate will bank quote to its customer bearing in mind that bank is required to keep an exchange margin of 0.15% on TT selling and 0.20% on bills selling.

Solution:

Against Rupee, dollar is quoted at premium. Since this is a sale transaction late delivery will be taken. The forward rate to the customer will be based on spot/March selling rate in the interbank market:

Dollar/Rupee spot selling rate	= Rs.66.1050
Add: Premium for March	= .1300

	= Rs.66.2350
Add: Exchange margin for TT selling at 0.15% on 66.2350	= 0.0993

Forward TT selling rate for dollar	= Rs.66.3343
Add: Exchange margin for bills selling	
Rate 0.20% on	0 .1326

Forward bills selling rate for dollar	Rs.66.4669

Against Yen. Dollar is quoted at discount. Since the buying rate is reckoned

for this leg of transaction , the latest delivery date of 31.3.2018 will be taken. This falls under third month from 10th Jan.

Dollar /Yen Spot buying rate	= JPY 109.3000
Less: Discount for 3 months	= JPY 0.0300
	= ---
	JPY 109.2700

Forward bill selling rate for Jap Yen

$$\frac{66.4669}{109.2700} \times 100 = \text{Rs. } 60.8281$$

Rounded off the rate quoted would be Rs. 60.8300 per 100 JPY

CROSS RATE

Cross rate is one wherein the national currency does not figure in the transaction. In other words in foreign exchange market where rates for some currencies are not available as they are not quoted and as such rate for such currencies are arrived at through another currency or currency pairs which is called as cross rate. This method of getting rates through another currency pair is known as cross rate mechanism.

It is a possible solution for calculation of rates for currency pairs which are not actively traded in the market in general.

Calculation of TT buying rates based on cross rates

TT buying rate		
Dollar/Rupee market spot buying rate	= Rs.	
Less Exchange Margin	(-) Rs.	
TT buying rate for dollar	= Rs.	..(1)
Dollar/Foreign Currency market spot selling rate	= FC	..(2)
T.T. buying rate for Foreign currency = (1)/(2) **Rounded off to nearest multiple of 0.0025**		

Calculation of bills buying rates based on cross rates.

Bills buying rate			
Dollar/Rupee market spot buying rate	= Rs.		
Add: Forward premium(for transit and usance period rounded off to lower month) Or Less: Forward discount (for transit and usance Periods: rounded off to Higher month)	Rs. (+) (-)		
Less: Exchange margin	(-)		
Bills buying rate for dollar	= Rs.		(1)
Foreign currency/dollar market for spot selling rate		= FC	
Add: Forward premium(for transit and usance period rounded off to lower month) Or Less: Forward discount (for transit and usance Periods: rounded off to Higher month)		 + – FC	
		=FC (2)	
Bills buying rate for Foreign currency = (1)/(2) **Rounded off to nearest multiple of 0.0025**			

Example 14. X bank issued a demand draft on Montreal for Canadian dollar for 20,000 at CAD 1 = 52.4140. However after a few days of purchase the purchaser of the draft requested X bank to cancel it and repay the rupee equivalent to him.

Assuming the Canadian dollars were quoted in the Singapore Foreign Exchange market as under:

US $ = cad 1.2830/.2852 and in the interbank market US Dollar 1 = 66.2525/2625. How much the customer will gain or lose on cancellation of the draft. Exchange margin on TT buying is 0.08%

Solution:

The bank cancels the demand draft at TT buying rate

US Dollar/Rupee market buying rate Rs.	= 66.2525
Less: Exchange margin at 0.08% on 66.2525	- 0.0530

	Rs. =66.1995
US $ /Canadian dollar market selling rate = CAD	1.2852
Canadian Dollar TT buying Rate (66.1995/1.2852	= Rs.51.5091
Rounded off the rate applicable is	= Rs.51.5100
Amount paid by the customer on purchase of DD for CAD 20,000 @ 52.4140	= Rs. 10,48,280
Amount received by the customer on cancellation Of DD for 20,000 @ 51.5100	= Rs. 10,30,200
Loss to the customer	= Rs. 18,,080

Your customer has requested you to purchase a 30 days sight bill for Euro

Assuming Rupee /US Dollar are quoted in the local interbank market as under:

Spot	= US $ 1 = Rs.67.2525/.2600
One month forward	1800/1850
Two months forward	3600/3650
Three months forward	5600/5650

And Euro currency is quoted in Singapore market US $ 1= Euro 0.84736/.8573

One month forward	55/65
Two months forward	110/120
Three months forward	160/170

What rate will you quote to your customer provided you required an exchange margin of 0.10% bearing in mind the following

1. Transit period for bill is 25 days
2. Rate of Int @ 10% p.a.
3. Commission on export bill is Rs.500
4. Also show the net amount payable to the customer Rupee amount is to be quoted nearest to the whole rupee.

Solution:

The usance of the bill and transit period comes to 55 days. In the dollar/Rupee leg. Forward dollar is at premium. In this case, since dollar buying rate is recokoned 55 days will be rounded off to lower period viz. one month

Dollar /rupee market spot buying rate	= Rs.67.2525
Add: premium for one month	+ Re. 0.1800

	= Rs.67.4325
Less: Exchange margin at 0.10% on Rs.67.4325	= Re. 0.0674

Bills buying rate for dollar	= Rs.67.4999
Dollar /Euro spot selling rate	= Euro 0.8573
Add: Premium for 2 months	+ 0.0120

	0.8693
Bills buying rate for Euro 67.4999/0.8693	= Rs.77.6485

Rounded off to the nearest mutiole of 0.0025. Therefore the rate quoted to the customer would be Rs.77.6500 per Euro.

CHAIN RULE

It is used in attaining a comparison or ratio between two quantities which are linked together through another or other quantities and consists of a series of equations, commencing with a statement of the problem in the form of a query and continuing the equation in the form of a chain in that each equation must start in terms of the same quantity as that which concluded the previous equation.

VALUE DATE

The term value date is used to define the date on which a payment of funds or any entry to an account becomes actually effective and are subjected to interest. In the case of payments on T T the value date is usually the same in both centres i.e. payment of the respective currency in each centre takes place on the same day. Here there is no gain or loss of interest accrues to either party. As against same date of settlement if there is a time lag between the receipts of funds at one centre and payment of funds at another centre compensation should be paid to the party which is out of funds. Normal mode of compensation is interest which should be recovered/ paid. This may be by adjusting the value date if acceptable to both the parties.

ARBITRAGE

Arbitrage means simultaneous buying and selling of a currency in two or more markets to take advantage of temporary difference in prices. This is explained here. If perfect conditions prevail in the market, the exchange rate for a currency should be the same in all Centres. For example, if US $ is quoted at Rs. 67.2525 in Mumbai the same rate is to be quoted in New York . But in reality as imperfect conditions are prevailing the rates in different centres are different. Thus in New York Indian Rupee in terms of US $ may be quoted at Rs. 67.3525. In such a case it would be advantageous for a bank in Mumbai to buy US $ locally and arrange to sell them in New York thereby make a profit .

Arbitrage consists of the purchase and sale of same currency in different centres viz. in three or four centres and involving several currencies also. Transaction conducted at two centres only is known as simple or direct arbitrage. If additional centres are involved, it is called as compound arbitrage. Such operations are to be carried out with minimum of delay if advantage is to be taken of temporary price difference and it requires a high degree of technical skill.

RELEVANT CONCEPTS /AREAS IN FOREIGN EXCHANGE

Authorised Dealers :

Authorised Dealers means persons who are authorized by Reserve Bank of India to deal with foreign exchange without any restriction. As per Sec 10(1) of FEMA 1999 RBI is empowered to authorize any person to deal in foreign exchange as an Authorised Dealer. They are issued licence to deal with foreign exchange . They are commercial banks. Normally banks which are having national presence are allowed to become Authorised Dealer. All commercial banks are not Authorised Dealers.

According to RBI, whether a transaction is a Current Account transaction or a Capital Account transaction, each of these transactions is to be carried out through a person authorized to deal in foreign exchange. In this regard Section 10 (1) of FEMA states as under : " The Reserve Bank may, on an application made to it in this behalf, authorize any person to be known as authorised person to deal in foreign exchange or in foreign securities, as an authorised dealer, money changer or off-shore banking unit or in any other manner as it deems fit".

Such authorization is conferred on these persons through a license. An AP may be Authorised Dealer belonging to Category I, II, or III or can be a Money Changer. The details are as under :

1.**Authorised Dealers Category I**: This category comprises of Commercial Banks, State Co-operative Banks and Urban Co-operative Banks. They are authorized to carry out all Current and Capital Account transactions as per RBI directions issued from time to time.

2. **Authorised Dealers Category II**: This category consists of Co-operative Banks, Regional Rural Banks, Full Fledged Money Changers and others. They are authorized to carry out specified non-trade related current account transactions and also all activities permitted to Full Fledged Money Changers from time to time.

3. **Authorized Dealers Category III:** This category consists of select Financial Institutions and other institutions who conduct transactions which are incidental to the foreign exchange activities incidental to their business under taken by them.

4. **Full Fledged Money Changers ('FFMC')**: This category consists of Department of Post (Post offices),certain Urban Co-operative Banks and others. They conduct the business of buying and selling foreign currencies.

Authorised Money Changers

Authorised Money Changers are those firms, organisations who are permitted by Reserve Bank of India to handle limited foreign exchange transaction viz. exchange of foreign currency notes, coins and travellers cheques in order to facilitate the tourists. Here again there are two types viz. Full fledged Money Changers and Restricted Money Changers.

Full fledged money changers are authorized to handle both purchase and sale of foreign currencies, coins and Travellers Cheques. Restricted Money Changers are only permitted to purchase foreign currency notes. They are functioning under the set of guidelines, Rules,& Regulations, directions, instructions of Reserve Bank of India.

Rules of the Foreign Exchange Dealers Association of India, (FEDAI)

Prior to the year 1939 financing of foreign trade and foreign exchange was looked after by foreign banks operating in India. These banks as a group were known as Exchange Bank's Association and members of this Association included foreign banks operating in the cities of Mumbai, Kolkatta, Delhi, Chennai and Amritsar. The terms and conditions for foreign exchange business were laid down by them. With the introduction of exchange control in India in 1939, rules and regulations of Exchange Banks were brought under RBI.

Subsequently, due to the growth of foreign trade of India, RBI permitted several scheduled commercial banks to

undertake foreign exchange business. To bring in uniformity in the conduct of foreign exchange business, it was considered desirable to form an Association of all Authorised Dealers as members. Accordingly an association known as Foreign Exchange Dealers Association of India ('FEDAI') was formed in 1958. Undertaking was given by each Authorised Dealer to RBI, to abide by the terms and conditions prescribed by FEDAI for transacting foreign exchange business in India.

FEDAI was registered as a Company under Section 25 of the erstwhile Companies Act 1956 and each of the Authorized Dealer as it's member. FEDAI is a self-regulatory body consisting of 104 Public Sector Banks, Foreign Banks, Private Sector Banks, Co-operative Banks and Financial Institutions. FEDAI being a non-profit organization, expenses are shared by all members on annual basis.

The main objective of FEDAI as stated in their Memorandum of Association "further the interests and regulate dealings of and between Authorised Dealers in foreign exchange inter-se and with public, forex brokers, the RBI and other bodies. FEDAI is also supported by Indian Banks Association (IBA) and Fixed Income and Money Markey Dealers Association of India (FIMMDA) and other bodies in holding various programmes for the benefit of foreign exchange market participants.

FEDAI plays a significant and multifarious roles in the conduct of foreign exchange market activities in India. These are as follows:-

1. Ensures a level playing field for foreign exchange market participants by formulating uniform rules and guidelines and harmonizes interests of all.
2. Associates with RBI in promoting the growth of India's external sector and also with various export promotion councils/chambers of commerce to provide a fillip to India's exports and imports.
3. Effectively presents India's views in international forum like International Chamber of Commerce, Paris in various revisions on the ground rules applicable to international trade financing arrangements like Documentary Credits, Collections etc.
4. Provides training to bank officers by conducting various workshops, special programmes, seminars to develop expertise in foreign exchange operations, improving processes and the quality of customer service.
5. Grants accreditation to foreign exchange market intermediaries such a brokers and electronic service providers. Also monitors foreign exchange brokers activities interbank foreign exchange market.
6. Offers guidance and information as well as various aspects of foreign exchange business to members.
7. Works with member banks industries key priorities, and concentrates on specific tasks and targets.
8. Contributes to the development of foreign exchange market in the areas of efficiency, depth and liquidity with greater market discipline.
9. Acts as a catalyst in promoting the best business practices leading to the efficient conduct of foreign exchange business, including development and maintenance of derivatives and associated documentation.
10. Play as a facilitator between it's members, RBI, Export Organizations, various Chambers of Commerce and other bodies as well as among it's members.

Apart from the above FEDAI holds Annual Conferences for the benefit of interaction among its members as well as with the regulator and discusses issues of concern.

FEDAI has been tasked with the responsibility of Administering the following benchmark rates for use by member banks:

1. Spot fixing rates

2. FCNR (B) base rates
3. Month end Revaluation rates
4. US Dollar/ Indian Rupee option volatility.

International Commercial Rules /International Standard Banking Practice

To promote global trade and commerce on the principles of free enterprise on a harmonious business and trade practices, it was necessary to standardize rules governing business policies, mechanics of trade and various other related aspects of international trade and businesses. With this objective a global organization known as International Chamber of Commerce (ICC) was founded in the year 1919 immediately after the cessation of World War I, in Paris, France. Till that time there was no uniform rules or systems that governed global commerce, trade, finance and investment. To fill this gap a few entrepreneurs joined together and founded ICC. In 1923 ICC established International Court of Arbitration to settle commercial disputes through arbitration.

There are three principal areas of activities carried out by ICC. They are setting rules, resolving disputes and "policy advocacy". Banking being an integral part of global commerce and trade is also one of the important areas of focus of ICC. Every year Trillions of dollars of global trade transactions are carried out through international banks from almost all continents. Therefore in order to ensure a harmonious and a smooth conduct of business with each other across countries, banks also need common rules and guidelines to avoid "confusion that comes along with national rules." Therefore, ICC, took upon itself the responsibility of formulating a set of rules.

The first of such rules was brought out in the year 1930 covering Documentary Credits in which banks are involved. The early 30s, was "a time of growing nationalism and protectionism" —and since then these rules have become a widely adopted and followed rules.

These rules facilitate the conduct of trade transactions amounting to over US$1 trillion annually. These rules are adjusted continuously to cater to the evolving needs of the international trade which are routed through banks. Presently the prevailing rule in use is Uniform Customs and Practice for Documentary Credits 600. (UCP 600).

UCP 600 a set of rules is extensively used in the area of Letters of Credit (otherwise known as Documentary Credits) issued on behalf of buyers/importers by banks as a part of trade finance. UCP supports banks and commercial buyers and sellers in more than 175 countries who are members of ICC. The first UCP document was introduced in the year 1933. Subsequently several revisions have been made over the years and the current version which is being in use is UCP 600, which was introduced in the year 1st July 2007. ICC has indicated that a revision of the same is under progress and is expected to be revised in the year 2020.

UCP 600 like other publications of ICC is not a law. These aim at uniform rules for voluntary adoption and implementation by commercial organizations including banks of member countries of ICC. UCP 600 has been designed by experts in banking and representatives of commercial organizations including corporate legal experts and not by any legislature and therefore free of any political, regional or locational bias. These rules voluntarily incorporated in documentary credits by insertion of an indication as under – "This credit is subject to the provisions of UCP 600". These rules are flexible and provide a stable base for review as well as judicial scrutiny.

The main object of UCP was establishing a uniformity of interpretation of rules and practice in documentary credits and due to this it's acceptance has been wide. Even non-members of ICC seem to informally follow the rules in international dealings with a ICC member country.

A detailed discussion on UCP 600 and its application at this juncture, is beyond the scope of the chapter.

International Standard Banking Practice for Examination of Documents under Documentary Credit

Consider the following example.

In one of the Letter of Credit ('LC') transactions relating to the export. the LC covered goods of " A 50,000 Kilogrammes of Cumin seeds ". The invoice submitted by the exporter stated "50 M. Tonnes of Cumin seeds". The importer's bank (LC Issuing Bank) rejected the documents stating that discrepancy in documents.

In another case the LC mentioned as "Invoices of Amanda Flowers International Private Limited. " whereas Invoice submitted by the exporter stated "Amanda Flowers Intl. Pvt. Ltd." The importer's bank rejected the documents stating that documents have discrepancy.

In both cases mentioned above, rejection of documents were on account of insignificant discrepancies though there are no material discrepancies. A LC appears very safe for contracting parties but cases such as above it fails to deliver the desired results. This also demonstrates that banks vary in their document-examination practices.

Therefore to bring in an uniformity of practices adopted for scrutiny of documents ICC brought out a publication titled as "International Standard Banking Practice for the Examination of Documents under Documentary Credits ("ISBP") bearing a publication bearing number 645, in the year 2002. Since then a revised publication ISBP 745 which was brought out in April 2013.

In a nutshell it can be stated that ISBP is a companion document to UCP 600 and both are to be read in conjunction with each other by bankers so as to effectively enhance standard international practice of document examinations.

In addition to the above, the following rules made by ICC help international trade and banks to conduct the transactions smoothly reducing much of the ambiguities. These are as follows:

International Commercial Terms ('INCO' Terms): These rules have become international standard reference terms for contracts of sale of goods. Developed first in the year 1936, these rules encompass trade terms used both domestically and internationally. The first publication of INCO Terms included the following six viz. Free Alongside Ship ('FAS'), Free on Board ('FOB'), Cost & Freight ('C&F'), Cost, Insurance and Freight ('CIF'), Ex-Ship and Ex-Quay. These terms define the duties and responsibilities of contracting parties in trade transactions.

Successive revisions to the existing terms have kept pace with developments over the years in modes of transport such as Air transport, carriage of goods like containers, couriers etc. The latest version, INCO Terms 2010 is in use and the same is expected to be revised in the year 2020.

Uniform Rules for Collection ('URC 522')

Due to the complexity of international trade and local practices a necessity was felt by a group of business men, under ICC in 1956 to bring forward a uniform rules for collection practices so that a common understanding prevails among buyers, sellers and the banks involved and thus was born Uniform Rules for Collection (URC).

Therefore URC can be defined as a set of international standards of collection process for bankers involved in the process. URC promotes a, "common understanding of terminology and expectations" between banks.

How does this mechanism work?

In international trade dealings, a seller of goods, forwards documents relating to the goods through his bank along with suitable instructions to the buyer's bank requesting buyers bank to present these documents to the buyer for obtaining payment of the trade deal. The buyer's bank should present the documents to the buyer strictly in terms of the conditions specified by the seller and instructs his bank to collect the proceeds of the same from buyers's bank, indicating the conditions.

The buyer's bank upon receipt of the documents from the seller's bank, presents the same to the buyer and is expected to follow the conditions of presentment as specified by the seller and obtains the payment from the buyer and remits the same to the seller through his bank. This process is known as Collection method in

Banking.

The buyer will obtain the possession of goods only after getting the documents from his bank against payment (if the bill specifies that "Documents against Payment") or against acceptance (if the bill specifies that "Documents against Acceptance". the payment of the same will be made at a specified date in future depending upon the terms agreed between buyer and seller).

In the absence of a Letter of Credit, documentary collection method is adopted in export transactions. Under the collection process banks play a role of a channel for the transactions sans guarantee of payment. Documentary collection method has some advantages for a buyer as well as a seller as indicated in the following table: -

For the seller	For the buyer
1. Even if the seller and buyer have an on- going relationship and the seller can avoid the risk of delivery of goods on 'open account' basis.	1. No need for providing advance payment, a guarantee or a Letter of Credit towards the payment to the buyer. Consequently costs of the transaction is less.
2. Collection arrangement assures a seller that documents will be released to the buyer only after payment or acceptance, as the case may be.	2. The buyer gets the flexibility of time in making payment if documents are under "Against Acceptance" as the buyer can sell the goods first and make payment to the seller later (but before the due date).
3. Most suitable method, if: • the seller has no doubt about the ability of the buyer to make the payment, • the political and economic situation in the buyer's country is stable, • there are no foreign exchange repatriation restrictions in the country of the buyer to that of the seller.	3. Convenient method, if • the buyer has no doubts about the sellers ability to ship the goods • the political and economic situation in seller's country is stable • there are no sanctions against selling goods to the buyer's country.

Additionally ICC has published the following, for ushering in uniformity of practices for banks and other parties involved internationally :-

- Uniform Rules for Demand Guarantees ('URDG')
- Uniform Rules for Forfaiting (URF 800)
- Uniform Rules for Bank Payment Obligations
- ICC Banking Commission Opinions

Dealing Room

The Dealing Room of a Bank is a place where foreign exchange transactions of the bank are put through in the interbank market, in parallel market or with customers. Therefore Dealing Room occupies an important place in the organization as a Profit Centre. This is because any business for that matter is run with the object of making profit so also banks. In the banking scenario the two areas where they make profit are Credit Management and Foreign Exchange Management. The said Foreign Exchange Management is done through Dealing Room which is called as Front Office. They put through transactions viz. purchase and sale of foreign currencies and all market related transactions through various quotes viz. direct, indirect, spot, forward, cross rates etc. At the end of the day foreign exchange transaction position is consolidated for the Bank as a whole and accordingly in the international market purchase and sale of foreign currencies take place.

LESSONS ROUND UP

The term Foreign Exchange denotes foreign currency and includes (a) deposits, credits and balances payable in any foreign currency, (b) drafts, travelers cheques, letters of credit or bills of exchange expressed or drawn in Indian currency but payable in any foreign currency, (c) drafts, travelers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency. Foreign exchange transactions are regulated in India through provisions of FEMA, Trade Control regulations, RBI directives, FEDAI regulations, International Commercial Rules, International Standard Banking Practice etc. Foreign Exchange transactions are classified in to two categories viz. Current Account and Capital Account transactions. **Capital Account transactions** are those which alter the assets or liabilities (including contingent liabilities) outside India of persons resident in India or Assets or liabilities in India of persons resident outside India. Other than capital account transactions form part of Current Account transactions. Any of these transactions are to be carried out through an Authorised Persons in India. Banks are designated as Authorised Dealers and are licensed to carry out foreign exchange transactions. While carrying out forex transactions banks are to follow international commercial rules like UCP 600, URC 522 etc.

Foreign Exchange market is a global set up where various currencies are traded. It can be said to be a Over-the-Counter market for purchase or sale or exchange of foreign exchange, subject to internationally accepted rules and conventions, by players therein. The international foreign exchange market system started with Gold Standard and after its collapse in 1920s shifted to Brettonwoods System in 1945. The Bretton Woods System continued till 1971 after which briefly switched over to Smithsonian Agreement. However consequent to the oil crisis in 1973 and its fall out on foreign exchange scenario free float of currencies gained prominence and has continued ever since. Parallel European Monetary System emerged in late 1970s which gave rise to European Currency Unit that gained prominence in dealings in European Monetary System. The Masstricht Treaty in 1991 signed by the Europen community members gave rise to a new common European currency “Euro” in 2000.Except Great Britain and Denmark all other members introduced Euro as a transaction currency in their countries as per Maastricht Treaty provisions. Historically Indian Rupee was linked Great Britain Pound Sterling. This continued till 1973 though for a brief intervening period between 1971 to 1975 it was linked to US$. However as British Sterling Pounds faced problems India delinked its Rupee from the same and has linked the same against a basket of currencies to work out an exchange rate against other currencies. From March 1, 1993 RBI has allowed the Rupee exchange to be quoted as per market determined rates.

International forex market is a 24 hours market. Variety of factors affect the market performance. In fact, every minute, depending upon the political, economic, financial, market and trader psychology the foreign exchange market reacts through the exchange rates. Major players in the international forex market include individual customers, banks, Central Banks, Speculators, Brokers, Multinational Corporations, Governments and Domestic companies.

Exchange Rate: The rate at which one currency is exchanged for another currency. Exchange rates can be quoted as Direct rate or indirect rate. In India Direct quote rates are in vogue since August 2, 1993. Rates are always quoted as a pair namely bid and offer rate. In direct quotes the first rate is the **Bid rate** (buying rate) and the second rate is the Offer rate (**Selling rate**). The difference between Bid and Offer is called ‘**Spread**’ representing the profit in the buying and selling transactions. A ‘**pip**’ is an abbrevation for Price Interest Point. A pip is the fourth decimal place in a currency pair.when currency pairs displayed is up to 4 decimal places. **Cross rate** is (a derived rate) a method through which if price of one currency is not available against the other, the exchange rate between them is obtained with the help of a common third currency. Buying rate and Selling rate can be arrived through cross rates. **Value date** is the actual date on which the exchange of currencies take place in full settlement of a foreign exchange transaction, irrespective of the date of the deal. Based on the value date concept, there are internationally accepted rules for value dates various transactions such as Cash, Spot, Tom and Forward. If the settlement for an exchange rate deal takes place beyond “Spot”

date, it is known as "Forwad Rate". A forward rate may be a quoted on a premium or a discount basis. When a currency is quoted costlier compared to the spot rate the currency is said to be at a premium. When a currency is quoted cheaper compared to the spot rate the currency is said to be at a discount.

Simultaneous buying and selling a fixed quantity of a foreign currency in different market simultaneously to take advantage of rate differences is known as Arbitrage transaction.

GLOSSARY

Foreign Exchange, FEMA, Trade Control Regulations, FEDAI, International Commercial Rules, INCO terms, UCP 600, URC 522, ISBP, Gold Standard, Bretton Woods Agreement, Smithsonian Agreement, Free float, Basket of currencies, European Monetary System, Euro Currency Unit, Maastricht Treaty, Euro, Foreign Exchange Rate, Direct quote, Indirect quote, Cross rate, Chain rule, Spread, Bid and Offer rate, Pips, Value date, Cash deal, Spot deal, Tom deal, Forward contracts, Premium, Discount, Forward differential, Arbitrage,

SELF TEST QUESTIONS

1. State whether the following statements are True or False
   a. International markets operate at different time zones.
   b. Authorised Money changers can handle all types of foreign exchange transaction.
   c. Rates not available in case the home currency is not quoted in the international market
   d. Dealing room function is a back office function and not opened in many banks.
2. Who are the participants of Foreign Exchange Market. Briefly discuss.
3. How exchange rates are determined in the foreign exchange market?
4. What are all the variation quotations being used in foreign exchange market?
5. Analyse Foreward Contract.
6. Write short note on factors affecting forward margin
7. What is meant by Forward margin - Premium and Discount?
8. Write short notes on : Arbitrate, Chain Rule, Cross Rate and value date.
9. What is meant by capital account and current account in International Trade.
10. Solve the following problem

    On 16.7.2017 your exporter customer requested you to book a forward contract for fixed delivery 2 months in respect of 30 days bill for Australian Dollar 50,000

    US Dollars were quoted in the interbank market a under:

Spot	US D 1 = 66.2525/3525
Spot/August	4200/4400
September	7700/7900
October	1.100/1.0800
Nov	1.400/1.4200

    At Singapore Market the Australian Dollars were quoted as follows:

Spot	US D 1 + 1.3319/3551
One month	110/100
Two months	200/190
Three months	300/290
Four months	390/380

Transit period is 25 days

Exchange margin is 0.10%

Calculate the rate to be quoted to the customer

11. Solve the problem

Your exporter customer request you to quote him a rate for purchase of a Singapore Dollar 2,00,000

Assuming US Dollar quoted in the inter bank market is as under

Spot	US $ 66.5500/5600
1 month forward	66.3500/3600
2 month forward	66.0500/0600
3 months forward	65.7600/7700

And Singapore dollar are quoted in Singapore market as under:

Spot	US $ 1= SGD 1.3422/3542
1 month	0.0040/0.0045
2 month	0.0060/0.0065
3 month	0.0080/0.0085

Transit period is 25 days

Exchange margin to be included in the rate is 0.10%

Interest to be recovered at 10%

What will be rate quoted to the customer? Also calculate the rupee amount payable to him and the interest to be recovered.

12. On 26 July an Exporter customer tendered for purchase of a bill payable 60 days from sight and drawn on New York for US $ 30,000. The dollar/Rupee rates in the inter bank exchange market were as under

Spot	US 4 1 = 67.0500/67.2500
Spot /August	1600/1500
Spot /September	2900/2800
Spot /October	4300/4200
Spot /November	5700/5600

Rate of Interest is 10% p.a.

Exchange margin of 0.10% to the loaded

Fineness as per FEDAI Rules.

Out of pocket expenses Rs. 500 to be recovered.

What will be the exchange rate to be quoted to the customer and the rupee amount payable to him?

Further Reading

www.rbi.org.in

www.incometaxindia.gov.in

Lesson 18
Non-Performing Assets

LESSON OUTLINE

- Definition: NPA
- Income Recognition
- Asset Classification
- Provisioning Norms
- CDR
- Business Correspondent and Business Facilitators
- Re-structuring
- One Time Settlement
- Sale to ARC
- Recovery Through DRT
- Enforcement of Security under SARFEASI
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Non-performing assets of the banking system in India has assumed lot of importance in view of its effect on the Banking system of India. Any one learning about banking in India should have a fair idea of the same. The contents of this chapter will help a reader to learn about :

- Income Recognition
- Asset Classification
- Provisioning Norms
- CDR

INTRODUCTION

Prior to the introduction of NPA norms in India in 1991-92, profits announced by banks were inflated and not real, as the interest debited in loan accounts where there was no possibility of its recovery was also included in the income; there was no provision made for the monies lent where the recovery of instalments were not forthcoming and no provision for the deterioration in the market value and realizable value of the security. The accounting practices followed amongst bankers were not uniform.

However in line with the international practices and as per the recommendations made by the Committee on the Financial System (Narasimham Committee-1) the RBI has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts. Over the years Prudential norms and Asset classification have assumed lot of importance and every student of banking is expected to be aware of the same.

The study of this chapter will enable the reader to understand the rational and the guidelines on classification of assets, income recognition and the provisioning norms as circulated to banks by the Reserve Bank of India. The policy of income recognition should be objective and based on record of recovery rather than any subjective considerations. The classification of assets of bank also has to be done objectively. The provisioning should be made on the basis of classification of assets based on the period for which the asset has remained nonperforming and the availability of the security and its realizable value.

Banks have to ensure that while granting loans and advances, realistic repayment schedules are fixed on the basis of cash flows of borrowers. This would facilitate prompt repayment by the borrowers and there by improve the record of recovery. Banks also undertake debt restructuring exercise for corporates for the benefit of all stake holders a knowledge of which will be useful. Banks also undertake financial inclusion on a large scale with the help of business correspondents and business facilitators with active use of technology for speedier, accurate and at affordable costs for helping rural poor. Mobile banking services are also being extended to customers as a part of digital banking initiatives. Banks are also involved in setting up of RSETIs for providing training and skill development in respect of rural below poverty line unemployed youth. A comprehensive exposure to these topics in this chapter will increase the awareness of a reader to the range of services provided by banks in this regard.

The contents are based principally on RBI Master Directions/Master circulars and will be useful in practical understanding of the concept of NPA, Income recognition, provisioning norms. The contents have been elaborated to the extent necessary to offer rationale for various norms adopted by banks in this regard. The contents are of Level 1 and 2 orientation enabling students to reinforce themselves with deeper operational knowledge on the topic.

Classification of Bank Advances on basis of Performance

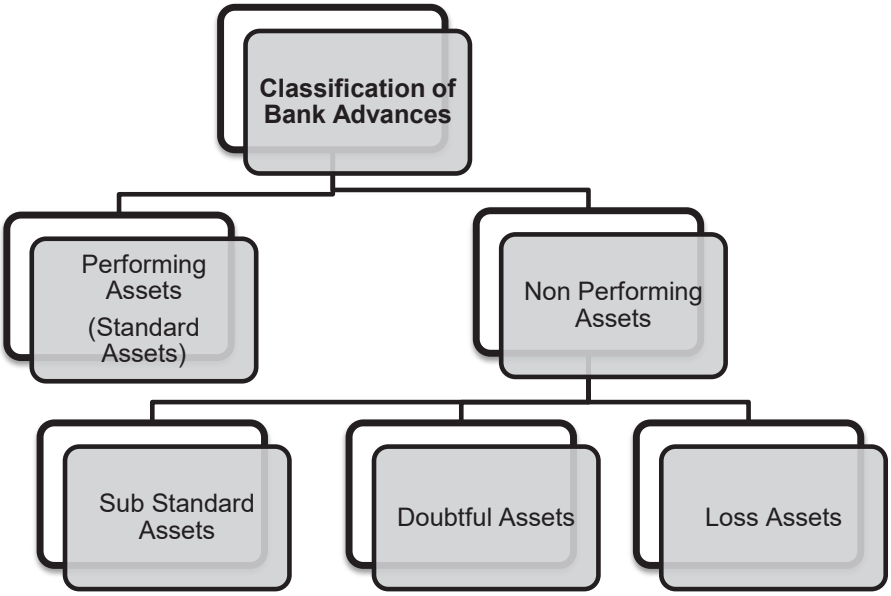
The Banks have to classify their advances into two broad groups:

1. Performing Assets

2. Non Performing Assets

Performing assets are also called as Standard Assets. The Non Performing Assets is again classified into three categories and they are (i) sub standard Assets (ii) doubtful assets & (iii) Loss Assets.

Classification of Bank Advances



Performing Assets

Standard Assets - Standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. The operations in the loan account is satisfactory in terms of timely repayment of principal and interest, availability of security, no adverse features in the operations of the accounts etc.

NON-PERFORMING ASSET (NPA)

An asset, including a leased asset, when stops generating income for the bank, it becomes Non-performing. A loan or an advance is non-performing asset (NPA) where:

(i) interest and /or installment of principal remain overdue for a period of more than 90 days in case of a term loan. In case of interest payments, banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

(ii) the account remains "out of order" in case of CC/OD (cash credit/ overdraft). An account should be treated as "out of order", if the outstanding balance remains continuously in excess of the sanctioned limit / drawing power for 90 days. In case where the outstanding balance in the principal operating account is less than the sanctioned limit / drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as "out of order."

If the cash credit facility or ad hoc limit sanctioned remains unreviewed or unrenewed for 180 days from the due date or sanctioned date respectively.

(iii) the bill (purchased / discounted) remains overdue for more than 90 days.

(iv) the amount of liquidity facility remains outstanding for more than 90 days, in respect of securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006.

(v) In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of derivative contract, if remain unpaid for a period of 90 days from the specific due date for payment.

(vi) Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

(vii) in case of Credit Cards, if minimum amount due, mentioned in monthly credit card statement, is not paid fully within 90 days from the payment due date.

(viii) In case of Agriculture loans if instalment or the interest remains outstanding beyond due date for two crop seasons (crop maturing within one year) and one crop season (for crops maturing after one year) In other agricultural loans the norm is 90 days.

(ix) advances against term deposits, NSCs eligible for surrender, Indira Vikas Patras and Life policies need not be treated as NPAs if adequate margin is available in the account. Advances against gold ornaments, government securities and other securities are not allowed this exemption.

(x) In case of consortium advances the classification can be different for different banks as it is based on the record of recovery with the individual member bank.

(xi) On Account of GST implementation, standard MSME loan accounts up to Rs. 25 crores as on 31.08.2017 will be classified as standard, if payment due as on 1.9.2017 falling due up to 31.12 2018, not paid up t 180 days. 90 days norm to be apply from 1st January 2019.

(xii) the availability of security or net worth of borrower / guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise.

Income Recognition

- Income from NPA is not recognized on accrual basis but is booked as income only when it is actually received. The bank should not charge and take to income account interest on any NPA. This will apply to Government guaranteed accounts also.
- Interest on advances against Term Deposits, National Savings Certficates (NSC), Indira Vikas Patra (IVP), Kisan Vikas Patra (KVP) and Life insurance policies may be taken to income account on due date, provided adequate margin is available in the accounts.
- Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognized on an accrual basis over the period of time covered by the negotiated or rescheduled extension of credit.
- If any advance, including bills purchased or discounted, become NPA, the entire interest accrued and credited to income account in the past periods, should be reversed, if the same is not realized. This will apply to government guaranteed accounts also.
- In respect of NPAs, fees, commissions, and other income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if uncollected.
- The finance charge component of finance income on the leased assets which has accrued and was credited to income account before the asset became non performing, and remaining unrealized should be reversed or provided for in the current accounting period.
- Interest realized on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.
- On an account turning in to NPA, the bank should stop further application of interest. However may continue to record such accrued interest in a Memorandum account in their books.

INCOME RECOGNITION NORM

Interest income in respect of restructured accounts classified as 'standard assets' may be recognized on accrual

basis and that in respect of the restructured accounts classified as 'non-performing assets' shall be recognized on cash basis.

In the case of additional finance in accounts where the pre-restructuring facilities were classified as NPA, the interest income shall be recognised only on cash basis except when the restructuring is accompanied by a change in ownership.

ASSET CLASSIFICATION

• Banks are required to classify NPAs into three categories, based on the period for which the asset has remained non performing – (i) Substandard Asset, the asset which has remained NPA for a period less than or equal to 12 months. (ii) Doubtful Asset, the asset which has remained in substandard category for a period of 12 months. (iii) Loss Asset, the asset where loss has been identified by the bank or internal or external auditors or the RBI inspectors but the amount has not been written off wholly. Classification of assets should be done taking into account the degree of well defined credit weaknesses and the extent of dependence on collateral security for realization of dues.

Upgradation of accounts to the category of Standard Assets:

- When the borrower makes payment of entire due amount in a NPA account, from the date of such payment the account will be classified as standard asset.
- All restructured advances can be classified as Standard asset after satisfactory performance during a period of one year from the commencement of the first payment of interest or principal.

A standard Asset which remained as irregular or out of order or overdue up to a period of 90 days will be treated as Special Mention Account (SMA) in three categories as given below :

SMA Sub Categories	Basis for classification - Principal or interest payment or any other amount wholly or partly overdue between
SMA-1	01-30 days
SMA-2	31-60 days
SMA-3	61-90 days

Lenders shall report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC) on all borrower entities having aggregate exposure of Rs 50 million and above with them. The CRILC-Main Report will now be required to be submitted on a monthly basis effective April 1, 2018. In addition, the lenders shall report to CRILC, all borrower entities in default (with aggregate exposure of Rs 50 million and above), on a weekly basis, at the close of business on every Friday, or the preceding working day if Friday happens to be a holiday. The first such weekly report shall be submitted for the week ending February 23, 2018.

Illustration: A Term Loan disbursed on April 15, 2014 where the first installment was due on June 15, 2014. The borrower did not pay the installment. Then –

From	To	Asset classification
15.04.2014	15.06.2014	Standard
16.06.2014	15.09.2014	Overdue (Special Mention Account 0, 1, 2)
16.09.2014	15.09.2015	Sub-standard
16.09.2015	15.09.2016	Doubtful – category 1
16.09.2016	15.06.2018	Doubtful – category 2

16.09.2018	Further …..	Doubtful – category 3

The classification of assets as NPA should be based on the record of recovery. Bank should not classify an advance as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements, non-renewal of the limits on the due date etc.

- If arrears of interest and principal are paid by the borrower in case of loan accounts classified as NPAs, the account should no longer be treated as NPA and may be classified as 'standard'.
- The asset classification of borrowal accounts where a solitary or few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity.
- Asset classification should be borrower-wise and not facility-wise.
- Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks.
- Accounts where there is erosion in the value of security / fraud committed by borrowers, the asset should be straightaway classified as doubtful (if realizable value of security is less than 50%) or loss (if realizable value of security assessed is less than 10%) asset.
- Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and Life insurance policies need not be treated as NPAs. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.
- In case of bank finance given for industrial projects or for agricultural plantations etc. where moratorium is available for payment of interest, payment of interest becomes 'due' only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.
- The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPA is not for the purpose of recognition of income. Advances sanctioned against State Government guarantees should be classified as NPA in the normal course, if the guarantee is invoked and remains in default for more than 180 days.

Conversion of Principal into Debt / Equity and Unpaid Interest into ‹Funded Interest Term Loan› (FITL), Debt or Equity Instruments.

The FITL / debt / equity instruments created by conversion of part of principal / unpaid interest, as the case may be, will be placed in the same asset classification category in which the restructured advance has been classified.

These instruments shall be valued as per usual valuation norms and marked to market. Equity instruments, whether classified as standard or NPA, shall be valued at market value, if quoted, or else at break-up value (without considering the revaluation reserve, if any) as ascertained from the company's balance sheet as on March 31st of the immediate preceding financial year. In case balance sheet as on March 31st of the immediate preceding financial year is not available, the entire portfolio of equity shares of the company held by the bank shall be valued at Rs.1. Depreciation on these instruments shall not be offset against the appreciation in any other securities held under the AFS category.

The unrealised income represented by FITL / Debt or equity instrument can only be recognised in the profit and loss account as under:

a. FITL/debt instruments: only on sale or redemption, as the case may be;

b. Unquoted equity/ quoted equity (where classified as NPA): only on sale;

c. Quoted equity (where classified as standard): market value of the equity as on the date of upgradation, not exceeding the amount of unrealised income converted to such equity. Subsequent changes to value of the equity will be dealt as per the extant prudential norms on investment portfolio of banks.

Change in Ownership

In case of change in ownership of the borrowing entities, credit facilities of the concerned borrowing entities may be continued/upgraded as 'standard' after the change in ownership is implemented, either under the IBC or under this framework. If the change in ownership is implemented under this framework, then the classification as 'standard, shall be subject to the following conditions:

i. Banks shall conduct necessary due diligence in this regard and clearly establish that the acquirer is not a person disqualified in terms of Section 29A of the Insolvency and Bankruptcy Code, 2016.

ii. The new promoter shall have acquired at least 26 per cent of the paid up equity capital of the borrower entity and shall be the single largest shareholder of the borrower entity.

iii. The new promoter shall be in 'control' of the borrower entity as per the definition of 'control' in the Companies Act 2013 / regulations issued by the Securities and Exchange Board of India/any other applicable regulations / accounting standards as the case may be.

iv. The conditions for implementation of RP as per Section I-C of the covering circular are complied with. For such accounts to continue to be classified as standard, all the outstanding loans/credit facilities of the borrowing entity need to demonstrate satisfactory performance during the specified period. If the account fails to perform satisfactorily at any point of time during the specified period, the credit facilities shall be immediately downgraded as non-performing assets (NPAs) i.e., 'sub-standard'. Any future upgrade for such accounts shall be contingent on implementation of a fresh RP (either under IBC, wherever mandatory filings are applicable or initiated voluntarily by the lenders, or outside IBC) and demonstration of satisfactory performance thereafter. Further, the quantum of provisions held by the bank against the said account as on the date of change in ownership of the borrowing entities can be reversed only after satisfactory performance during the specified period.

PROVISIONING NORMS

From the time when a loan account becomes NPA and till the time of recovery of dues banks are required to make provisions RBI has prescribed following percentage of provisions:

Farm Credit within Agriculture, MSE and Individual home loans up to Rs. 75 lac (Standard Assets)	0.25%
Residential housing (Standard Assets)	0.75%
Commercial Real Estate (Standard assets)	1.00%
Sub-standard Unsecured (infrastructure) 20%	0.40%
Other standard loans	2%
Home Loans at Teaser rate Sub-standard Secured	15%
Sub-standard Unsecured	25%
Sub-standard Unsecured (infrastructure)	20%

Non-reporting to Central Repository for Information of Large Credit. (CRILC)	
Secured sub-standard up to 6 months	15%
Above 6 months up to 12 months	25%
Unsecured sub-standard up to 6 months	25%
Unsecured sub-standard above 6 months to 12 months	40%
Doubtful up to 12 months (secured portion) (Doubtful 1)	25%
Doubtful up to 12 months (Unsecured portion)	100%
Doubtful – more than 12 months up to 3 years (Secured portion) (Doubtful2)	40%
Doubtful – more than 12 months up to 3 years (Unsecured portion)	100%
Doubtful – more than 3 years (secured / unsecured) (Doubtful 3)	100%
Non-reporting to CRILC	
Secured doubtful -2	40%
Secured doubtful -3	100%
Loss Assets	100%

● Floating provisions – some banks make a “floating provision” over and above the specific provisions made in respect of accounts identified as NPAs. The floating provisions, wherever available, could be set-off against provisions required to be made as per above stated provisioning guidelines. Considering that higher loan loss provisioning adds to the overall financial strength of the banks and the stability of the financial sector, banks are urged to voluntarily set apart provisions much above the minimum prudential levels as a desirable practice.

Banks should adopt an accounting principle and exercise the right of appropriation of recoveries – towards principal and interest – in a uniform and consistent manner,

Treatment of NPA provisions:

● Additional provisions for NPAs at higher than prescribed rates – such higher rates are to be in the policy of the bank, approved by the board. The policy should be applied consistently from year to year. This provision amount can be netted off from the gross NPAs to arrive at net NPAs

● Excess provision on sale of Standard Assets / NPAs – If sale proceeds of a standard asset are more than its book value the excess provision can be credited to profit and loss account. Excess provision in case of sale of NPA asset can be credited to Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets

Floating provisions – Cannot be netted from Gross NPA to arrive at net NPAs but can be a part of Tier II capital subject to overall ceiling of 1.25% of Total Risk Weighted Assets.

● Provisioning Coverage Ratio (PCR) – PCR of 70% of gross NPAs was prescribed, as a macro prudential measure by RBI, with a view to augmenting provisioning buffer in a counter-cyclical manner when the banks were making good profits. Banks are advised that – (i) the PCR of 70% may be with reference to the gross NPA position in banks as on September 2010, (ii) the surplus of the provision under PCR vis-à-vis as required as per prudential norms should be segregated into an account styled as “countercyclical provisioning buffer”, (iii) this buffer will be allowed to be used by banks for making specific provisions for NPAs during periods of system wide downturn, with the prior approval of RBI.

Provision Coverage Ratio (PCR)

It is calculated as under as per RBI formula

$$\frac{\textbf{Specific provisions for NPAs held / required + Provisions for diminution in fair value of the restructured accounts classified as NPAs + + Technical write-off}}{\textbf{(Gross NPAs + Technical/Prudential Write-off)}} \textbf{ X 100}$$

Gross NPAs = The principal dues of NPAs plus Funded Interest Term Loan (FITL) where the corresponding contra credit is parked in sundries account (interest capitalization – Restructured accounts), in respect of NPA accounts.

NET NPA = Gross NPA – (Balance in interest suspense account + DICGC / ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held)

CORPORATE DEBT RESTRUCTURING (CDR)

Corporate Debt Restructuring is mechanism to restructure in a transparent way the borrowings of sticky borrowal accounts of viable corporate entities outside the formal forums such as Board for Industrial and Financial Reconstruction, Debt Recovery Tribunals, and Courts so as to benefit all stake holders in the entity and was introduced in India as a result of recommendations of a Vepa Kamesam Committee and Mrs. Shyamala Gopinath Committees. The guidelines evolved by RBI on the basis of these recommendations are fine amended by RBI from time to time due to continuous developments in the banking scenario.

The Main features of CDR (Corporate Debt Restructuring) mechanism:

- The framework will aim at preserving viable corporate that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly, timely and coordinated restructuring program.
- CDR system in the country will have a three tier structure:
  - CDR standing Forum
  - CDR Empowered Group
  - CDR Cell

CDR Standing Forum would be the representative general body of all financial institutions and banks participating in CDR system. It will be a self-empowered body, which will lay down policies and guidelines, and monitor the progress of corporate debt restructuring. The Forum will provide an official platform for both the creditors and borrowers to amicably and collectively evolve policies and guidelines for working out debt restructuring plans in the interest of all concerned. The RBI will not be a member of the Forum and Core Group. Its role will be confined to providing broad guidelines. The Forum shall meet at least once every six months and would review and monitor the progress of corporate debt restructuring system. A CDR Core Group will be carved out of the Forum to assist the Forum in taking decisions relating to policy. The CDR Core Group would lay down the policies and guidelines to be followed by the CDR Empowered Group and CDR Cell for debt restructuring.

The individual cases of corporate debt restructuring shall be decided by CDR Empowered Group. In order to make the CDR Empowered Group effective and broad based and operate efficiently and smoothly, it would have to be ensured that participating institutions / banks approve a panel of senior officers to represent them in the CDR Empowered Group. There should be a general authorization by the respective Boards of the participating institutions / banks in favour of their representatives on the CDR Empowered Group, authorizing them to take decisions on behalf of their organization, regarding restructuring of debts of individual corporate. The Group will consider the preliminary report of all cases of requests of restructuring, submitted to it by the CDR Cell. After the Group decides that restructuring of the company is prima-facie feasible and the enterprise is potentially viable in terms of the policies and guidelines evolved by the Forum, the detailed restructuring package will be worked out by the CDR Cell in conjunction with the Lead Institution. The Group shall decide on the acceptable

viability benchmark levels on the following illustrative parameters, which may be applied on a case-by-case basis, based on the merits of each case - ROCE (Return on Capital Employed), DSCR (Debt Service Coverage Ratio), Gap between the Internal Rate of Return (IRR) and the Cost of Fund (CoF), Extent of sacrifice. The decisions of the Group shall be final. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and / or liquidation or winding up of the company, collectively or individually.

The Forum and the Group will be assisted by CDR Cell in all their functions. The Cell will make the initial scrutiny of the proposals received from the borrowers / creditors, by calling the proposed rehabilitation plan and other information within one month. The Cell will prepare the restructuring plan in terms of the general policies and guidelines approved by Forum and place for consideration of Group within 30 days for decision.

Other features:

- The CDR mechanism will cover only multiple banking accounts / syndication /consortium accounts of corporate borrowers with outstanding fund-based and non-fund based exposure of Rs. 10 crores and above by banks and institutions.
- Category 1 CDR system will be applicable only to accounts classified as ‘standard’ and ‘sub-standard’.
- The accounts where recovery suits have been fi led by the creditors against company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under CDR system is taken by at least 75% of the creditors (by value) and 60% of creditors (by numbers).
- Cases involving frauds or diversion of funds with malafide intent are not covered.
- Reference to CDR System could be triggered by :
  - (i) any or more of the creditor who have minimum 20% share in either working capital or term finance or
  - (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) .
- CDR is a non-statutory mechanism which is a voluntary system based on Debtor – Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The DCA and ICA will provide the legal basis to CDR mechanism.
- In order to improve effectiveness of the CDR mechanism a clause may be incorporated in loan agreements involving consortium / syndicate accounts where by all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.
- One of the most important elements of Debtor – Creditor Agreement would be ‘stand still’ agreement binding for 90 days or 180 days by both sides. Under this clause, both the debtor and creditor(s) shall agree to a legally binding ‘stand still’ whereby both the parties commit themselves not to take recourse to any other legal action during the ‘stand still’ period. This clause will be applicable only to any civil action and will not cover any criminal action.
- During the pendency of the case with CDR System, the usual asset classification norms would continue to apply.
- Additional finance, if any, is to be provided by all creditors of a ‘standard’ and ‘substandard’ account irrespective of whether they are working capital or term loan creditors, on pro rata basis. The additional finance may be treated as ‘standard asset’, up to a period of one year after the first interest / principal payment, whichever is earlier, falls due under the approved restructuring package.
- The lenders who wish to exit from the package would have the option to sell their existing share

to either the existing lenders or fresh lenders, at an appropriate rate, mutually decided between the existing lender and taking over lender. One Time Settlement (OTS) can also be considered as a part of the restructuring package.

- The Group should decide on the issue regarding convertibility (into equity) option as a part of restructuring exercise.
- CDR 2 (Category 2 CDR System) was introduced for cases where the accounts have been classified as 'doubtful' in the books of creditors, and if minimum of 75% of creditors (by value) and 60% creditors (by number) satisfy themselves of the viability of the account and consent for such restructuring on two conditions – (i) the existing loans will only be restructured and it would be up to the promoter to firm up additional financial arrangement with new or existing creditors individually. (ii) all other norms of the CDR system will continue to apply to this category also.
- Restructuring of corporate debts under CDR system could take place in stages –
  - (i) before commencement of commercial production,
  - (ii) after commencement of commercial production but before the asset has been classified as 'substandard',
  - (iii) after commencement of commercial production and the asset has been classified as 'substandard' or 'doubtful'.

A special Note

The Reserve Bank of India has issued various instructions aimed at resolution of stressed assets in the economy, including introduction of certain specific schemes at different points of time (It also includes CDR mechanism discussed above). However In view of the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC), the RBI had decided to substitute the then existing guidelines with a harmonised and simplified generic framework for resolution of stressed assets vide circular No. RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18 February 12, 2018.

A summary of the simplified generic framework as this circular is as follows:

Revised Framework

A. Early identification and reporting of stress

- Lenders shall identify incipient stress in loan accounts, immediately on default[2], by classifying stressed assets as special mention accounts (SMA) as per the following categories:

SMA Sub-categories	Basis for classification – Principal or interest payment or any other amount wholly or partly overdue between
SMA 0	01-30 days
SMA 1	31-60 days
SMA 2	61-90 days

- Lenders to report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC) on all borrower entities having aggregate exposure of Rs.50 million and above with them. The CRILC-Main Report will now be required to be submitted on a monthly basis effective April 1, 2018. In addition, the lenders shall report to CRILC, all borrower entities in default (with aggregate exposure of Rs. 50 million and above), on a weekly basis, at the close of business on every Friday, or the preceding working day if Friday happens to be a holiday.

- Implementation of Resolution Plan
- All lenders should have in place Board-approved policies for resolution of stressed assets under this framework, including the timelines for resolution. As soon as there is a default in the borrower entity's account with any lender, all lenders − singly or jointly − shall initiate steps to cure the default. The resolution plan (RP) may involve any actions / plans / reorganization including, but not limited to, regularisation of the account by payment of all over dues by the borrower entity, sale of the exposures to other entities / investors, change in ownership, or restructuring[4]. The RP shall be clearly documented by all the lenders (even if there is no change in any terms and conditions).
- Implementation Conditions for RP
- A RP in respect of borrower entities to whom the lenders continue to have credit exposure, shall be deemed to be 'implemented' only if the following conditions are met:
    a. the borrower entity is no longer in default with any of the lenders;
    b. if the resolution involves restructuring; then
        i. all related documentation, including execution of necessary agreements between lenders and borrower / creation of security charge / perfection of securities are completed by all lenders; and
        ii. the new capital structure and/or changes in the terms of conditions of the existing loans get duly reflected in the books of all the lenders and the borrower.

Additionally, RPs involving restructuring / change in ownership in respect of 'large' accounts (i.e., accounts where the aggregate exposure of lenders is Rs. 1 billion and above), shall require independent credit evaluation (ICE) of the residual debt[5] by credit rating agencies (CRAs) specifically authorised by the Reserve Bank for this purpose. While accounts with aggregate exposure of Rs. 5 billion and above shall require two such ICEs, others shall require one ICE. Only such RPs which receive a credit opinion of RP4 or better for the residual debt from one or two CRAs, as the case may be, shall be considered for implementation. Further, ICEs shall be subject to the following:

a. The CRAs shall be directly engaged by the lenders and the payment of fee for such assignments shall be made by the lenders.
b. If lenders obtain ICE from more than the required number of CRAs, all such ICE opinions shall be RP4 or better for the RP to be considered for implementation.
c. The above requirement of ICE shall be applicable to restructuring of all large accounts implemented from the date of this circular, even if the restructuring is carried out before the 'reference date' stipulated in paragraph below.

Timelines for Large Accounts to be Referred under IBC

- In respect of accounts with aggregate exposure of the lenders at Rs.20 billion and above, on or after March 1, 2018 ('reference date'), including accounts where resolution may have been initiated under any of the existing schemes as well as accounts classified as restructured standard assets which are currently in respective specified periods (as per the previous guidelines), RP shall be implemented as per the following timelines:
    (i) If in default as on the reference date, then 180 days from the reference date.
    (ii) If in default after the reference date, then 180 days from the date of first such default.
- If a RP in respect of such large accounts is not implemented as per the timelines specified in paragraphs , lenders shall file insolvency application, singly or jointly, under the Insolvency and Bankruptcy Code

2016 (IBC) within 15 days from the expiry of the said timeline.

- In respect of such large accounts, where a RP involving restructuring/change in ownership is implemented within the 180-day period, the account should not be in default at any point of time during the 'specified period', failing which the lenders shall file an insolvency application, singly or jointly, under the IBC within 15 days from the date of such default.
- 'Specified period' means the period from the date of implementation of RP up to the date by which at least 20 percent of the outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is repaid.
- Provided that the specified period cannot end before one year from the commencement of the first payment of interest or principal (whichever is later) on the credit facility with longest period of moratorium under the terms of RP.
- Any default in payment after the expiry of the specified period shall be reckoned as a fresh default for the purpose of this framework.
- For other accounts with aggregate exposure of the lenders below Rs. 20 billion and, at or above Rs. 1 billion, the Reserve Bank intends to announce, over a two-year period, reference dates for implementing the RP to ensure calibrated, time-bound resolution of all such accounts in default.
- It is, however, clarified that the said transition arrangement shall not be available for borrower entities in respect of which specific instructions have already been issued by the Reserve Bank to the banks for reference under IBC. Lenders shall continue to pursue such cases as per the earlier instructions.

Prudential Norms

- The revised prudential norms applicable to any restructuring, whether under the IBC framework or outside the IBC, are contained in Anexure 1 of Cir: No. RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18 February 12, 2018. The provisioning in respect of exposure to borrower entities against whom insolvency applications are filed under the IBC shall be as per their asset classification in terms of the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning, as amended from time to time.

Supervisory Review

- Any failure on the part of lenders in meeting the prescribed timelines or any actions by lenders with an intent to conceal the actual status of accounts or evergreen the stressed accounts, will be subjected to stringent supervisory / enforcement actions as deemed appropriate by the Reserve Bank, including, but not limited to, higher provisioning on such accounts and monetary penalties.

Disclosure

- Banks are to make appropriate disclosures in their financial statements, under 'Notes on Accounts', relating to resolution plans implemented as per detailed guidelines issued/ will be issued from time to time.

Exceptions

- Restructuring in respect of projects under implementation involving deferment of date of commencement of commercial operations (DCCO), will continue to be covered under the guidelines contained at paragraph 4.2.15 of the Master Circular of RBI dated July 1, 2015 on 'Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances'.
- Withdrawal of extant instructions

The extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as an institutional mechanism for resolution of stressed accounts also stands discontinued. All accounts, including such accounts where any of the schemes have been invoked but not yet implemented, shall be governed by the revised framework.

However certain provisions of this circular was challenged by borrowers in Supreme Court. In pursuance of that case on April 3, 2019 the Hon'ble Supreme Court has held the circular of RBI as 'ultra vires' of its powers. Further developments in this regard are awaited.

Restructuring of Advances of MSME

Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances (Circular No. RBI/2018-19/100 DBR.NO.BP.Bc.18/21.04.048/2018-19, January 1, 2019)

1. A one-time restructuring of existing loans to MSMEs classified as 'standard' without downgrade in the assest classification is permitted subject to:
    i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed Rs. 250 million as on January1, 2019
    ii. The borrower's account is in default but is a 'standard asset' as on January 2019 and continues to be classified as a 'standard asset' till the date of implementation of restructuring.
    iii. The borrowing entity is GST – registered on the date of implementation of the restructuring. Where the entity is exempted from GST-registration, that the eligibility for restructuring without GST-registration, should be determined on the basis of exemption limit obtaining as on January 1, 2019 as per clarification issued by RBI.
    iv. The restructuring of the borrower account is implemented on or before March 31, 2020. A restructuring would be treated as implemented if –
        a. All related documentation are completed and
        b. The new capital structure and /or changes in the terms and conditions of the existing loans get duly reflected in the books of all lenders and the borrower.
    v. A provision of 5% in addition to the provisions already held, has to be made in respect of accounts restructured under these instructions. Banks will, however have the option of reversing such provisions at the end of the specified period (a period of one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium) subject to the account demonstrating satisfactory performance (no payment of interest and /or principal shall remain overdue for a period of more than 30 days) during the specified period.
    vi. Post-restructuring, NPA classification of these accounts shall be as per the extant IRAC norms
    vii. Banks and NBFCs have to make appropriate disclosures in their financial statement, under 'Notes on Accounts', regarding Number of accounts restructured and amount in million
    viii. All other instructions applicable to restructuring of loans to MSME borrowers shall continue to be applicable.
2. Banks and NBFCs who wish to adopt this scheme have to put in place a Board approved policy on restructuring of MSME advances under these instructions. The policy has to include include framework

for viability assessment of the stressed accounts and regular monitoring of the restructured accounts.

3. Accounts classified as NPA can be restructured; however, the extant asset classification norms governing restructuring of NPAs will continue to apply.
4. Barring the above one-time exception, any MSME account which is restructured must be downgraded to NPA upon restructuring and will slip into progressively lower asset classification and higher provisioning requirements as per extant IRAC norms. Such an account may be considered for upgradation to 'standard' only if it demonstrates satisfactory performance during the specified period.

Restructuring:

When a Lender gives concession to the borrower, for economic or legal reasons relating to the borrower's financial difficulty it is called Restructuring. It normally involves:

- Modification of terms of the advances / securities, including alteration of repayment period / repayable amount / the amount of instalments / rate of interest.
- Sanction of additional credit facility.
- roll over of credit facility
- enhancement of existing credit limit
- compromise settlement.

Prudential Norms:

- Standard account will be downgraded as sub-standard with immediate effect. Theses accounts can be upgraded when all outstanding loans show satisfactory performance during the specified period. If not, the account shall immediately on such default be reclassified s per the repayment schedule that existed before the restructuring.
- Accounts shall attract provisioning as per the asset classification category.
- Additional finance approved under Resolution Plan (RP) may be treated as standard asset during specified period (period from date of implementation of RP to date by which at least 20% of the outstanding principal debt as per the RP and interest capitalization sanctioned as part of the restructuring, if any, is repaid) if the restructured asset fails to perform satisfactorily during the specified period or does not qualify for upgradation at the end of the specified period, the additional advance shall be placed in same asset classification category as the restructured debt.
- Interest income for restructured accounts classified as standard assets may be recognised on accrual basis and that for restructured accounts classified as non-performing assets shall be recognised on cash basis.
- 'Funded Interest Term Loan' / Debt / Equity instruments will be placed in the same asset classification category in which restructured loan has been classified. These instruments shall be valued as per usual valuation norms and marked to market.
- Change in Ownership of borrowing entity – after implementation of change in ownership, credit facilities may be continued / upgraded as "standard 'subject to

    1. Banks shall conduct necessary due diligence
    2. the new promoter shall have acquired at least 26% of the paid-up equity capital of the borrower entity and shall be the single largest shareholder of the borrower entity.

3. the new promoter shall be in 'control' of borrower entity as per definition of 'control' in the Companies Act

- Sale and leaseback transaction of the assets of a borrower or other transactions of similar nature will be treated as an event of restructuring for the purpose of asset classification and provisioning in the books of banks with regards to the residual debt of the seller as well as the debt of the buyer if - 1. The seller is in financial difficulty. 2 – more than 50% of the revenues of the buyer from the specific asset is dependent on the cash flow from the seller and 3 – minimum 25% of the loans availed by the buyer for the purchase of the specific asset is funded by the lenders who already have a credit exposure to the seller.

One Time Settlement (OTS):

It is a type of compromise settlement executed by the banks in order to recover NPAs. In OTS, the defaulter borrower proposes to settle all the dues at once and the bank agrees the amount lesser than what is actually due. The bank settles the loan and write offs against one-time instalment, compromising on a portion of its profits.

The RBI mandate states that banks must have a loan recovery policy for negotiations and settlement of non-performing assets. OTS schemes are available in banks but not every borrower is given this provision. The scheme is available at the sole discretion of the bank and not available to the wilful defaulters.

The OTS affects the banks profits in the form of interest cut down and quality of balance sheet. The benefits include prompt and speedy recovery of NPAs, increase in liquidity position, easy flow of funds for lending process.

BIFR (Board for Industrial and Financial Reconstruction) :

It was an agency of the Government of India, part of the Department of Financial Services of the Ministry of Finance. It was set up in January 1987 with objective to determine sickness of industrial companies and to assist in reviewing those that may be viable and shutting down the others. A new Industrial policy was tabled in Parliament aiming to maintain growth in productivity and gainful employment and to encourage the growth of entrepreneurship and upgrades to technology.

The Board has a Chairman and from 2 to fourteen other members, all to be qualified as High Court judges or to have at least fifteen years of relevant professional experience. The Board only handles large or medium-sized sick industrial companies in which large amounts have been sunk. Under the Sick Industrial Companies Act (SICA), its Board is legally obliged to report it to the BIFR, and the BIFR has the power to make whatever enquires are needed to determine if the company is in fact sick.

Among other objectives the act was to provide a way to revive sick industrial companies and release public funds. If a company is found to be sick, the BIFR can give the company reasonable time to regain health (bring total assets above total liabilities) or it can recommend other measures. The Board can take other actions including changes to management, amalgamation of the sick unit with a healthy one, sale or financial reconstruction. The Board can recommend a sick industrial company for winding up.

The BIFR was intended to bridge the legal gap between sickness and revival. It would impose time schedules for revival related activities to be completed, oversee their implementation and conduct periodic reviews of sick accounts. The BIFR would provide a forum for sharing views, coordinating efforts and developing a unified approach to dealing with sick companies, speeding up the start of corrective action. The BIFR was meant o either turn companies around within six months or order closure.

BIFR has had mixed success. The BIFR in practice often became a way of prolonging the life of unviable companies for years at taxpayer expense.

The SARFAESI Act 2002 placed corporate debt outside the purview of the BIFR. By preventing reference to the BIFR, which had become a heaven for the promoters of sick companies, the Act gives banks and financial institutions a better tool for recovering bad debts. It was complemented by the corporate debt restructuring package under which lenders and borrowers would meet to agree on a way of recasting stressed debt.

In January 2016 BIFR was dissolved and referred all proceedings to the National Company Law Tribunal (NCLT) and National Company Law Appellate Tribunal (NCLAT) as per provisions of Insolvency and Bankruptcy Code.

The NCLT and NCLAT would take over the functions of the BIFR and other bodies and speed up the process of winding down sick companies.

Asset Reconstruction Companies (ARCs):

An ARC is a company incorporated under Companies Act to engage itself in the activity of financial asset reconstruction- such as securitization, takeover of management, sale of assets charged. Earlier they were called as Securitization Companies (SCs) or Reconstruction Companies (RCs). To undertake such activity, the company has to get registered with RBL under provisions of SARFAESI Act. RBI can conduct audit / inspection / issue directives / levy penalties or remove directors of the company. As per RBL rules minimum net owned funds of the company should be Rs. 100 crores on an ongoing basis. ARCs should maintain capital adequacy ratio of minimum 15% of total risk weighted assets.

The term financial asset means the loans, advances and investments, made by the banks and the financial institutions.

ARCs acquire non-performing loans from banks and financial institutions at discount and take steps to recover these loans by way of securitization, reconstruction or sale of assets or in certain cases take over the management. Before bidding company may conduct due diligence within a period of minimum 2 weeks. The realization period can be 5 years which can be extended to 8 years.

For the purpose of take over of the loan, the ARC creates a Trust called Special Purpose Vehicle and ARC acts a s a Trustee and managing agent for ultimate realisation of the financial asset. SPV holds the financial asset on strength of the security available. It issues Security Receipts (SRs) to the investors, mainly the Qualified Institutional Buyers (QIBs). The investors get cash on realization of the financial assets when the security receipts are redeemed. SRs are not debt instruments and currently not listed on Stock Exchange and not traded.

It is mandatory for ARCs to invest in and continue to hold minimum 15% stake of the outstanding amount of the security receipts issued by them till the redemption.

Sale and purchase of NPAs between ARCs is not allowed.

Asset classification

Assets are classified as Standard and non-performing assets. The NPAs to be further classified as – 1. ‘Sub-standard Asset’ for period not exceeding 12 months from the date it was classified as NPA. 2 – ‘Doubtful asset’ if asset remains a substandard asset for a period exceeding 12 months. 3 – ‘Loss asset’ if the asset is non-performing for a period exceeding 5 years or 8 years or the asset is adversely affected by a potential threat of non-recoverability due to erosion or non-availability of the security or it is identified as ‘loss asset’ by the company or the auditors.

Provisioning

- 10% of the outstanding for the Standard Assets.
- 100% for the asset not covered by the estimated realisable value of security and in addition 50% of remaining outstanding in case of “doubtful assets’

- The entire asset to be written off if not 100% provision in case of 'loss assets'

Debt Recovery Tribunals (DRTs):

DRTs are set-up under the provisions of Recovery of Debts Due to Banks and Financial Institutions Act. DRT jurisdiction covers loans of banks and FIs with outstanding of Rs. 10 lac or more. In September 2018, Govt. notified enhancement to Rs. 20 lac (Central Govt. Can reduce the amount to Rs. One lac) Other than DRT no court has jurisdiction over such loans. It is headed by one Presiding Officer. There is one Registrar to take care of administrative matters. Appeal against order of Registrar to DRT can be made within 15 days from the date of order.

Debt Recovery Appellate Tribunal are headed by a Char Person (Qualified to be High Court Judge with age not exceeding 67 years.

On establishment of a DRT no other court is to hear the proceedings for eligible cases. All existing cases are also to be transferred to a DRT.

After the claim is upheld by the Tribunal, a certificate is issued to the Recovery Officer who has powers in execution such as attachment, sale, arrest, appointment of receivers or require the debtor to declare, on affidavit, the particulars of his or its assets. Appeal against order of Recovery Officer to DRT can be made within 30 days from the date of order.

On receipt of application, RT issues summons within 30 days to defendants to show cause within 30 days which can be extended by 15 days. For non-compliance of the order, the borrower can be detained in prison up to 3 months. DRT is expected to dispose of the application within 2 hearings. After hearing the parties, DRT issues Recovery Certificate to Recovery Officer for recovery of the amount specified in the certificate. Borrower can be allowed extra time by DRT to repay the loan, he deposits 25% amount and banks agree to that. If borrower wants to appeal against order of Recovery Officer to DRT, he has to deposit 50% of the amount. The order passed by DRT is appealable within 30 days from the date f the receipt of the order to the Appellate Tribunal unless the appellant deposits 50% of the due amount. DRAT is expected to dispose of the appeal within 6 months from the date of receipt of the appeal.

Application in4 copies should be presented by authorised official of the bank or a legal practitioner to the Registrar of DRT under whose jurisdiction the bank or FL is covered,

Enforcement of security under SARFEASI:

If a borrower defaults, bank (a secured creditor), will have powers as to – take possession, sell or lease secured assets / take over the management of the business / appoint a manager / recover any money payable by 3rd party to the borrowers. (debts also include debt securities)

In case of consortium financing or multiple lending arrangement, if 60% of the secured creditors in value, agree to initiate recovery action, the same is binding on all secured creditors.

Under the Securities Interest (Enforcement) Rules, the enders can dispose off the assets charged to the bank after taking possession of the assets, after serving 60 days possession notice. The sale can be through private treaty and / or public auction or bids. Possession process is allowed only if charge is registered with CERSAI.

If on notice from the lender, the borrower makes any representation or raises any objection, bank shall consider such representation / objection. If the same is not acceptable, bank shall communicate the justification for possession within 15 days of receipt of such representation / objection.

Conditions for sale of assets:

- Sale by way of public tenders or through public auction has to be backed by public notices in two newspapers.

- Minimum 30 days' notice to be given to the owner after taking possession by the authorised officer and the eventual sale of both movable and immovable properties.
- The lenders have to make proper valuation of the assets prior to sale. The reserve price will have to be arrived at only after the valuation exercise.in case of movable secured assets, authorised officer will simply obtain an estimated value, for immovable assets valuation to be obtained from approved valuer by the lender's board of directors.
- If a price equal to reserve price cannot be obtained, the asset can be disposed off at a lower price with the consent of the borrower and the lender except where the asset could have natural decay or where the cost of possession might exceed the value of sale.
- Sale will be confirmed after deposit of 25% by the highest bidder. Balance will be payable within 15 days pf confirmation of sale.

LESSON ROUND UP

- RBI started implementing the prudential guidelines on asset classification, income recognition and provisioning on loan assets based on the recommendations of Narasimham Committee, in a phased manner commencing with the accounting year beginning from 1.4.1992 and modified the original guidelines on a number of occasions. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of security and the erosion over time in the value of security, provisions to be made are prescribed by RBI.
- CDR (Corporate Debt Restructuring) framework will aim at preserving viable corporate that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring program. However, RBI has replaced the debt restructuring schemes with a simplified generic framework for resolution of stressed assets.
- Development in the field of Information Technology, strongly support the growth and inclusiveness of the banking sector, thereby facilitating inclusive economic growth. IT not only enhances the competitive efficiency of the banking sector by strengthening back-end administrative process, it also improves the front end operations and helps in bringing down the transaction costs for the customers. It has potential of furthering financial inclusion by making small ticket retail transactions cheaper, easier and faster for the banking sector as well as for the small customers.

GLOSSARY

NPA- Non Performing Assets

CDR- Corporate Debt Restructuring

OTS- One Time Settlement

BIFR -Board for Industrial and Financial Reconstruction

ARC- Asset Reconstruction Companies

DRT- Debt Recovery Tribunals

SELF TEST QUESTIONS

1. Fill in the blanks:
   (i) Any-where-Anytime banking is possible because of ----------.
   (ii) ------- facilitates bulk transfer of monies from one bank account to many bank accounts or vice versa.

(iii) For Doubtful – more than 3 years (secured / unsecured) category, provision prescribed is ------- %.

(iv) Category 1 CDR system will be applicable only to accounts classified as ---------- and ----------.

2. Write True or False

(i) Only Indian Rupee based domestic services are provided under mobile banking facility.

(ii) Banks are not allowed to appoint an individual as Business Correspondent.

(iii) White Label ATM would provide ATM services to customers of all banks.

(iv) The availability of security or net worth of borrower / guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise.

(v) Advances against gold ornaments and government securities are not be treated as NPAs.

3. Answer the following questions.

(i) Explain RTGS and NEFT?

(ii) What is Asset Classification?

(iii) Whats is One Time Settlement of NPA?

(iv) Explain the procedure of recovery by banks through ARC.

For further reading:

RBI Master Circular /Directions on Income Recognition and Asset classification, CBS, Payment systems.

Lesson 19
Final Accounts of Banking Companies

LESSON OUTLINE

- Definition and Functions of a Bank
- Requirements of Banking Companies as to Accounts and Audit
- Significant Features of Accounting Systems of Banks
- Principal Books of Accounts
- Preparation and Presentation of Financial Statements of Banks
- Accounting Treatment of Specific Items
- Preparation of Profit and Loss Account
- Comments on Profit and Loss Account
- Important Items of Balance Sheet
- Disclosure Requirements of Banks
- Additional Disclosures prescribed by RBI
- Disclosures required under BASEL norms
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Financial Statements of Banking Companies are an important source of information for a variety of stake holders such as, Employees, Management, Depositors, Borrowers, Investors,Academics, Research bodies, Economists, Regulatory Authorities/ Bodies, Students etc. These financial statements are prepared after an extensive compliance with the directions and guidelines issued by RBI and other authorities and therefore contain a wealth of useful information.

In the light of this, the chapter will enable a reader to learn:

- Requirements regarding Accounts and Audit of Banking Companies
- Features of accounting system of banks
- Books of account of banks
- Presentation/formats of Financial statements
- Accounting treatments of various items
- Disclosure requirements

INTRODUCTION

A financial statement is an organized collection of information or data prepared by a business entity (banking is a business) as per acceptable accounting norms and procedures. The major financial statements are the balance sheet and profit and loss account. These are supported by statements which include funds flow statement, cash flow statement, profit and loss appropriation account etc.

- Balance sheet is a statement of financial position of the business entity as at a specified date (31st of March), which represents on one side (right) the assets position of the business entity and on other side (left) the liability position of the business entity.

  Asset are the resources owned by the firm / they the applications or the uses of the funds / they are the debit balances reflected in the General Ledger. Liabilities are the claims of various parties against the assets owned by the firm / they are the sources of the funds / they are the credit balances reflected in the General Ledger.

- Profit and Loss account or Income Statement provides the information relating to income and expenditure of business entity over a period. It covers all the transactions that took place over a time period.

- Funds flow statement is the information which reflects the changes having taken place in the composition or quantum of all the funds (the assets and the liabilities or the revenue or expenditure) over time period of say a year. With in the said period it provides the information about various sources and their uses / applications.

- Cash flow statement offers information which reflects the changes in cash position (the term csh takes into account only cash and bank balances and not funds as in the case with funds flow statement) in a given period.

Objective of Financial Statement Analysis :

- Profitability measurement – Whether adequate profits are generated on the capital employed in the business. The capacity of the business to pay interest, dividend and other obligations.

- Trend indicator – Regarding various types of expenses, purchases, sales, gross / operating and net profit etc.

- Assessment of growth potential –

- Comparative position with other firms which are having business,

- Assess overall financial strength

- Assess solvency of the business entity.

Following are the Users of Financial statements

- Investors / partners / proprietors

- Managemen

- Trade unions / employees

- Lenders

- Suppliers / creditors

- Tax authorities

- Researchers
- Government Agencies
- Stock Exchange,

Tools for financial statement analysis

- Trend analysis
- Vertical analysis / common size statement analysis
- Horizontal analysis / comparative financial statement analysis
- Ratio analysis

Every banking company in India has to comply with provisions of Banking Regulation Act as well as The Companies Act, apart from others. Under The Companies Act a company has to prepare and submit financial statements as per Schedule III of the Act. However banks under the Banking Regulation Act have to prepare and submit their Balance Sheet, Profit & Loss Account in specified formats – Form A and Form B. RBI has also notified detailed guidelines in this regard in respect of these including disclosure norms. As per Government of India guidelines every banking company has to close its books of account as on 31st March every year and therefore they prepare their financial statements as on this date. This chapter is therefore devoted to a detailed coverage on the final accounts of banking companies encompassing all topics with some practical examples for an easy understanding. The contents will reinforce the basic knowledge of banking as well as, how the accounts of banks are prepared and other technical inputs required preparing the same.

The contents are based on Banking Regulation Act, 1949, The Companies Act, RBI directions, ICAI Accounting Standards and other applicable provisions. This will be useful in practical understanding of accounts of banking companies. The contents have been elaborated with backgrounds of the banking transactions, to offer rationale for various accounting procedures followed by banks. The contents are of Level 1 and 2 orientation enabling students to reinforce themselves with deeper operational knowledge.

DEFINITION AND FUNCTIONS OF A BANK

The term Bank has been defined as any company that transacts the business of banking in India. A bank can be a body corporate under Companies Act; it can be a body corporate under a special statute or it can be a cooperative society registered under the cooperative laws of a State Government or Central Government. Also Section 5 of Banking Regulation Act, 1949 defines “banking” as accepting deposits from public, for the purpose of lending or investment, such deposits being repayable on demand by cheque, draft, order or otherwise. A detailed account of main functions as well as other subsidiary functions, which are permitted to be performed by banks are enumerated in Chapter 2 – “Business of Banking”.

REQUIREMENTS OF BANKING COMPANIES AS TO ACCOUNTS AND AUDIT

A banking company being a body corporate has statutory obligation to present annual financial statements in terms of formats prescribed under The Companies Act/Banking Regulation Act. Section 29 to 34A of the Banking Regulation Act, 1949 deal with the accounts and audit of Banking Companies. Section 29 of the Banking Regulation Act, 1949 casts a responsibility on every Banking company incorporated / operating in India which are involved in transacting the business of banking through its branches, prepare and submit Balance Sheet and Profit & Loss account for the financial year, in the specified formats set out in the III Schedule of the Act, as on the last working day of that financial year. Such balance sheet and P&L account should be signed by The Manager or the Principal officer and at least three directors if there are more than three directors and if only

three directors all of them should sign the same. For a foreign bank operating in India The Manager or Principal officer of the concerned bank should sign. The central government has the powers to amend the formats of Balance Sheet and P&L as in Section 29.

According to Section 30 of the Banking Regulation Act, 1949 The Balance Sheet and P&L account prepared are to be audited by a duly qualified person as per applicable law for the time being in force. Without prejudice to anything contained in the Companies Act, 1956 , or any other law for the time being in force, where the Reserve Bank is of opinion that it is necessary in the public interest or in the interest of the banking company or its depositors so to do, it may at any time by order direct that a special audit of the banking company's accounts, for any such transaction or class of transactions or for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order either appoint a person duly qualified under any law for the time being in force to be an auditor of companies or direct the auditor of the banking company himself to conduct such special audit] and the auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company. Banking companies have to seek permission of RBI for appointing, re-appointing or removing any auditor.

As per Section 31 of the Banking Regulation Act, 1949 every banking company has to submit three copies of annual Accounts, Balance sheet along with P& L Account prepared in accordance with Sec 29 of Banking Regulation Act, 1949 together with Auditor's Report to RBI within three months from the end of the period to which they relate. In the case of RRBs they shall furnish the Balance Sheet and P& L accounts to NABARD instead of RBI.

Under Section 32 of the Banking Regulation Act, 1949 a banking company (Not other types of banking entities) has to submit three copies of Balance Sheet and P&L Account to the Registrar of Companies when it submits the same to RBI. Also with in a period of six months of from the date of Accounts and Auditors Report, publish the same in a news paper which is widely circulated where the banking company has its principal place of business. This compliance has to be done according to Banking Companies Regulation (Rules) 1949. Also as per Section 33, in the case of foreign banks operating in India have to display a copy of audited Accounts and Balance sheet in a conspicuous place in their notice board for public display. This has to be done before 1st Monday in the month of August every year.

SIGNIFICANT FEATURES OF ACCOUNTING SYSTEMS OF BANKS

Like any other business entity banks also follow the mercantile system of accounting. However there is a slight difference in methodology followed by banks when compared to other commercial entities. It arises on account of banks entering transactions of customers first, in ledgers (which are subsidiary books under conventional accounting) rather than in journals. This is so because, accounts of customers which are maintained in ledgers should be accurate and without any errors. This is already explained in detail in Chapter 5.

PRINCIPAL BOOKS OF ACCOUNT MAINTAINED BY BANKS

Banks in India maintain following main books of account.

(a) Ledgers of Savings Bank, Current Account, Cash credit, Loans, FD Accounts, Recurring Deposit Accounts, Investment Ledgers, Bill discounted/purchase (Inland & Foreign) etc.

(b) Registers for collection (inland & foreign), cash, clearing, Safe deposit lockers, DD/Pay order issued, DD's paid, Bank Guarantee issued, Bills Margin, LC issued, Clearing cheques returned, NEFT/RTGS issued etc. Pension payment, PPF accounts, Demat accounts, etc.

(c) Registers for P& L heads, Suspense accounting etc.

(d) General Ledger

(e) Cash book/Day Book

(f) P& L registers.

Note: There are differing practices among banks in maintaining registers for various heads of accounts. However under Core Banking Principal books of account are maintained in different software modules However considering the importance of books from bank accounting point of view we will learn about the following in detail:

General Ledger (GL)

The general ledger is a summary of control accounts of various deposit, loan heads as well as Profit and Loss. The GL also contains balancing contra entry accounts for heads of accounts such as collection of bills (inland and foreign), contingent liabilities (such as bank guarantees, LCs) etc. purely for keeping a control over such transactions on a day to day basis.

Profit and Loss account registers

Some banks maintain a common control account in GL for P& L and maintain separate heads in individual registers and income items as well as expenditure heads. Some other banks also maintain important P& L heads separately also in GL.

Daily postings are done in P& L register heads through vouchers on account of various transactions or expenses. In certain cases P & L registers carry detailed heads, much more than what is summarized in GL and published accounts. For example under interest on deposit which is an expenditure head there could be specific subheads such as FD, Cash Certificates, RDs, CDs, etc. Similarly there could be separate heads in Interest on Advances (which is an income head) which may carry sub-heads such as housing loans, personal loans, educational loans, Priority Sector advances etc. Also in respect of establishment expenses such as Salaries, allowances, bonus payments etc. there could be different sub-heads.

Subsidiary Books – Ledgers

In operational banking, ledgers are the basic books of account whose balances are reflected in the control balances of GL.

In banks subsidiaries in the form of ledgers are used for various deposit accounts and loans/cash credit accounts etc.

Sometimes separate registers are maintained in respect of various deposits such as call money, short term deposits, CDs etc. In respect of ledgers separate folios are allotted for each depositors. However in registers there could be more than one depositor per folio. Folios in registers are formatted in such a way that all particulars in detail are entered in sections. Postings in ledgers as well as in registers are made directly from vouchers. All these vouchers after entry are entered in a separate journal (these journals are also known as ‘sub-day book’ in some banks). They are subsequently checked and their summarized total is conveyed to the Cash book (in some banks it is also known as ‘Day Book’) department to balance the day’s transaction. Subsequently these figures are entered in GL to arrive at the control total. In the case ledgers relating to cash credit accounts limits or drawing power is mentioned along with other particulars such as stock value, margin, rate of interest, Limit sanctioned etc. Columns are also made available for putting products in respect of debit balances to enable calculation of interest. Similarly in loan registers columns are provided for entering name and address of borrower and guarantor, amount of loan sanctioned, rate of interest, balance outstanding, space

for products, initials etc. are provided.

Subsidiary Books – Bills Register

Banks handle different transactions relating to bills. Bills are discounted, collected, purchased. Specific registers having different columns for entering various particulars such as serial no, Name of the drawer, Drawee, Amount of bill, discount charged, other charges, address of the drawee bank, particulars of documents, remarks/ special conditions, initial/signature of officials etc. In respect of advances specific folios are allotted for different borrowers where in the respective folios the limit up to which bills can be discounted is also mentioned in the space provided for. Such bills after discounting are sent to the drawee bank for presentation and realization. Once such bills are realized by remittance from drawee bank they are rounded off and accordingly date of realization is mentioned after due checking. At the end of the day summary figures are arrived at and conveyed cash book department for preparing cash book and subsequently preparing GL followed by trial balance.

Other registers maintained by banks

1. Proposal Received Register including details of processing fees collected/share linkage/valuation.
2. Limit / Drawing Power Register
3. Stock Statement Received Register
4. Inspections Register (for field visit/stock verification/stock audit etc.)
5. Security register (For paper securities)
6. Documents register
7. Title Deeds register
8. Register of Service/ Maintenance contracts
9. Register of Death Claims
10. Missing Persons Claim Record Register
11. Stop payment Register
12. Duplicate FDR / Pay slips / DD / Passbook register
13. Sensitive Stock Register
14. Inward / Outward Cheque returned register
15. Cheque passed against clearing register
16. Cheque held for payment register
17. Cheque Book stock/delivery register
18. Pay slip / DD issued register
19. Fixed Asset register
20. Attendance Register
21. IBC / OBC register
22. Locker Register (Locker Rent Received, Locker Rent Due Date, Locker Issued / Surrendered Register, Locker Visit Register)

23. ATM Complaint Register
24. Loose cheque leaves register
25. Key register,
26. Vault Register
27. Solvency Certificate Issued Register
28. Complaint register
29. Register of EDP Complaints
30. Register for soiled notes
31. Foreign LC Due Date register
32. Forex A2 Currency Transaction register
33. Other currency cheque collection register
34. Bank Guarantee issuance register
35. Margin money register
36. Debit Cards/ATM card issued register etc.

From the registers listed above we will discuss a few, which are used on a day to day basis by banks. Many of the registers listed above may not constitute core part of books of account, but are in the nature of supporting in respect of agency services.

Registers linked to Advances

1. **Proposal Received Register including details of processing fees collected/share linkage/ valuation** :Under the directions issued by RBI bank branches are required to maintain registers in respect of credit proposals with particulars such as date of receipt of proposal, date of sanction, if rejected date of rejection and reason for rejection. Along with these particulars they also record the details of processing fee collected etc. In some banks they also note the collateral linkages to the proposal and value thereof of such securities.
2. **Limit / Drawing Power Register**: In respect of CC accounts granted against hypothecation of stock-in-trade, work-in-process, finished goods, debtors etc. the branch has to fix drawing power every month based on the value of these items less margin. This register is used for the purpose of recording drawing powers that would be allowed during the month which would be authenticated by concerned officials.
3. **Stock statements received register**: When banks allow CC limits based on stocks held by a borrower. The value of stock held by the customer has to be submitted by 10th of succeeding month to enable banks to fix drawing power for the current month. If they fail to submit by 10 the month, penal interest will be levied from the 1st of the current month as per agreed sanction terms. To monitor submission of stock statements by a borrower such registers are maintained.
4. **Security register**: This register is used to record detailed particulars of securities tendered by a borrower while availing an advance.
5. **Document register**: In this register particulars of documents executed by a borrower are entered a

separate record.

6. **Title deeds Register**: In this register documents of title given by borrowers are recorded and it is held in safe custody.

PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS OF BANKS

Banks are required to prepare and present their Balance sheet and P& L accounts in the following format under Schedule III.

FORM A :- Form of Balance Sheet

Balance sheet of Bank xxxxxxxxx

Balance sheet as on 31st March.....(Year)

Particulars	**Schedule**	**As on 31-03-20.. (current year)**	**As on 31-03-20.. (previous year)**
Liabilities			
Capital			
Reserve and surplus			
Deposits`			
Borrowings			
Other liabilities and provisions			
Total			
Assets			
Cash and balances with Reserve Bank of India			
Bank of India			
Balance with banks and money at calls & short Notice			
Investments			
Loans & Advances			
Fixed assets			
Other assets			
Total			

Schedule 12.

Contingent liabilities

While presenting the balance sheet following schedules are to be furnished by a banking company.

Schedule 1

Capital

I. For Nationalized Banks

Capital (Fully owned by Central Government)

II. For Banks Incorporated Outside India

(i) Capital (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head).

(ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949

III. For Other Banks Authorized capital

(.....shares of Rs. each)

Issued capital

(.....shares of Rs. each)

Subscribed capital

(..... shares of Rs. each)

Called-up capital

(..... share of Rs. each)

Less : Calls unpaid

Add : Forfeited shares _____ _____

Total _____ _____

Schedule 2 : Reserves and surplus

I. Statutory reserves
Opening balance
Additions during the year
Deductions during the year

II. Capital reserves
Opening balance
Additions during the year
Deductions during the year

III. Share premium
Opening balance
Additions during the year
Deductions during the year

IV. Revenue and other reserves
Opening balance
Additions during the year
Deductions during the year

V. Balance in Profit and Loss Account _____ _____

Total: (I + II + III+ IV + V) _____ _____

Schedule 3 : Deposits

A. I. Demand deposits
(i) From banks
(ii) From others

II. Savings bank deposits

III. Term deposits
(i) From banks
(ii) From others Total: (I + II + III)

B. (i) Deposits of branches in India

(ii) Deposits of branches outside India _____ _____

Total [(i)+(ii)] _____ _____

Total [(A)+(B)] _____ _____

Schedule 4 :Borrowings

I. Borrowings in India

(i) Reserve Bank of India

(ii) Other banks

(iii) Other institutions and agencies

II. Borrowings outside India Total (I + II)

Schedule 5 : Other liabilities and provisions

I. Bills payable

II. Inter-office adjustments (net)

III. Interests accrued

IV. Others (including provisions)

Total : Total [I+II+III+IV] _____ _____

Schedule 6 : Cash and balances with Reserve Bank of India

I. Cash in hand (including foreign currency notes)

II. Balances with Reserve Bank of India

(i) in current account

(ii) in other accounts

Total (I + II) _____ _____

Schedule 7 : Balances with banks and money at call and short notices

I. In India

(i) Balances with banks

(a) in current accounts

(b) in other deposit accounts

(ii) Money at call and short notice

(a) with banks

(b) with other institutions

Total [(i) + (ii)]

II. Outside India

(i) in current accounts

(ii) in other deposit accounts

(iii) Money at call and short notice

Total (I + II + III) _____ _____

Grand total: (I + II) _____ _____

Schedule 8 : Investments

1. Investment in India in
   - (i) Government securities
   - (ii) Other approved securities
   - (iii) Shares
   - (iv) Debentures and Bonds
   - (v) Subsidiaries and/or joint ventures
   - (vi) Other (to be specified) Total : [(i)+(ii)+(iii)+(iv)+(v)+(vi)]

II. Investment outside India in
   - (i) Government securities (including local authorities)
   - (ii) Subsidiaries and/or joint venture abroad
   - (iii) Other investments (to be specified) Total [(i)+(ii)+(iii)]

Grand total: (I + II) _____ _____

Schedule 9 : Advances

I. (i) Bills purchased and discounted

(ii) Cash credits, overdrafts and loans repayable on demand

(iii) Term loans Total

II. (i) Secured by tangible assets

(ii) Covered by bank / government guarantees

(iii) Unsecured Total:

III. I. Advances in India
   - (i) Priority sector
   - (ii) Public sector
   - (iii) Banks
   - (iv) Others Total:

IV. Advances outside India
   - (i) Due from banks
   - (ii) Due from others
     - (a) Bills purchased and discounted
     - (b) Syndicated loans
     - (c) Others

Total: _____ _____

Grand Total (I + II + III + IV) _____ _____

Schedule 10 :Fixed assets

I. Premises

At cost on 31st March of the preceding Year Additions during the year

Deductions during the year Depreciation to date

II. Other fixed assets (including furniture and fixtures) At cost as on 31st March of the preceding year Addition during the year

Deductions during the year Depreciation to date

Total (I+ II) _____ _____

Schedule 11 : Other assets

I. Inter office adjustment (net)

II. Interest accrued

III. Tax paid in advance y tax deducted at source

IV. Stationery and stamps

V. Non-banking assets acquired in satisfaction of claims

VI. Others

Total:_____ _____

* In case there is any unadjusted balance of loss the same may be shown under this item with appropriate footnote

Schedule 12: Contingent liabilities

I. Claims against the bank not acknowledge as debts

II. Liability for partly paid investments

III. Liability on account of outstanding forward exchange contracts

IV. Guarantee given on behalf of constituents

(a) in India

(b) outside India

V. Acceptances, endorsements and other Obligations

VI. Other items for which the bank is liable Total

Balance Sheet items: Notes, Detailed comments and instructions for compilation

1. Capital

Capital includes the capital provided by Govt, and public issue in case of public sector banks. In case of private banks, it comes from the promotors and through public issue.

a. Nationalised Banks: The Capital owned by Central Government as on the date of the balance sheet

should be shown.

b. Other Indian Banks: In the case of other Indian banks, Authorised, Issued, Subscribed, and Called up capital should be given separately. Calls-in- arrears will be deducted from the called-up capital while the paid-up value of forfeited shares should be added thus arriving at the paid-up capital. Where necessary, items which can be combined should be shown under one head for instance 'Issued and Subscribed Capital'.

c. In the case of Banking Companies incorporated outside India, the amount of deposit kept with Reserve Bank of India, under sub-section 2 of section 11 of the Banking Regulation Act, 1949 should be shown under the head 'capital'; the amount, however, should not be extended to the outer column.

Notes – General: The changes in the above items, if any, during the year, say, fresh contribution made by the Government, fresh issue of capital, capitalisation of reserves, etc. may be explained in the notes.

2. Reserves

a. **Statutory Reserves:** Reserve created in terms of section 17 or any other section of Banking Regulation Act must be separately disclosed.

b. **Capital Reserves:** The expression 'capital reserves' not to include any amount regarded as free for distribution through the profit & loss account. Surplus on revaluation or sale of fixed assets should be treated as capital reserves. However surplus on translation of financial statements of foreign branches (including fixed assets of these branches) is not to be taken as revaluation reserve.

c. **Share Premium:** Premium on issue of share capital may be shown separately under this head.

d. **Revenue Reserves & Others:** The expression 'Revenue Reserves' shall mean any reserve other than capital reserve. This item will include all reserves, other than those separately classified. The expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or dimunition in value of assets or retained by way of providing for any known liability.

e. **Balance of profit:** Includes balance of profi t after appropriations. In case of loss the balance may be shown as a deduction.

Notes – General: Movements in various categories of reserves should be shown as indicated in the schedule.

3. Deposits:

A. Demand Deposits:

From banks: Includes all banks deposits repayable on demand.

From others: Includes all demand deposits of others. Credit balances in overdrafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates or certificates of deposit, etc. are to be included under this category.

Savings Bank: Includes all savings bank deposits including inoperative savings bank accounts.

Term Deposits From Banks: Includes all types of banks deposits repayable after a specified term.

Term Deposits From others: Includes all types of deposits of the nonbanking sector repayable after a specified term. Fixed deposits, cumulative and recurring deposits, cash certificates, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, foreign currency non-resident deposits accounts, etc. are to be included under this category.

B. Deposits from branches in India & Deposits from branches outside India.

The total of these two items (A & B) will agree with the total deposits.

Notes – General

(a) Interest payable on deposits (whether accrued and due and accrued but not due) should not be included but shown in Schedule 5 under other liabilities. Deposits, repayment of which is subject to restrictions by its very nature, like margin deposits, security deposits from staff, etc., also should not be included under deposits but shown under 'other liabilities.'

(b) Matured time deposits and cash certificates, etc., should be treated as demand deposits.

(c) Deposits under special schemes should be included under term deposits if they are not payable on demand. When such deposits have matured for payment they should be shown under demand deposits

(d) Deposits from banks will include deposits from the banking system in India, co-operative banks, foreign banks which may or may not have a presence in India.

4. Borrowings: (Includes borrowings/refinance and rediscount obtained from) In India:

From Reserve Bank of India, From Commercial banks (including co operative banks). From IDBI, Exim Bank, NABARD, and other institutions/agencies (including liability against participation certificates, if any). Outside India:

Includes borrowings and rediscounts of Indian branches abroad as well as borrowings of foreign branches.

Includes secured borrowings/refinance in India and outside India.

Notes – General

(i) Inter-office transactions should not be shown as borrowings.

(ii) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc. should be classified, depending upon documentation, as 'Deposits', 'borrowings' etc.

(iii) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head 'Borrowings'. Hence advances will be shown at the gross amount on the asset side.

5. Other Liabilities and Provisions:

Bills payable: Includes drafts, telegraphic transfers, mail transfers payable, pay slip, bankers cheques, other miscellaneous items, etc. remaining unencashed.

Inter-office liabilities: The inter-office adjustments balance, if in credit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign should be shown here.

Interest accrued: Includes interest due and payable and interest accrued but not due on deposits and borrowings

Others : Includes net provision for income tax and other taxes like interest tax(less advance payment, tax deducted at source, etc.), surplus provisions in bad debts provision account, surplus provisions for depreciation in securities, contingency funds which are not disclosed as reserves but are actually in the nature of reserves, proposed dividend/transfer to Government, other liabilities which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc. certain types of deposits like staff security deposits, margin deposits, etc.

where the repayment is not free, should also be included under this head.

Notes – General (i) For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items, (ii) The interest accruing on all deposits, whether the payment is due or not, should be treated as a liability, (iii) It is proposed to show only pure deposits under the head 'deposits' and hence all surplus provisions for bad and doubtful debts contingency funds, secret reserves, etc. which are not netted off against the relative assets should be brought under the head 'Others' (including provisions).

6. Cash and balances with the Reserve Bank of India:

I. Cash in hand (including foreign currency notes) and also of foreign branches in the case of banks having such branches.

II. In Current Account with Reserve Bank of India (Includes the balance maintained with the Reserve Bank of India in Current Account).

7. Balances with banks in India and Money at call and short notice;

I. In India

(i) Balances with Reserve Bank of India (other than in current account) Includes balances held with the Reserve Bank of India other than in current accounts, if any.

(ii) Balances with other banks in India Current accounts Deposit accounts. Includes all balances with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately.

(iii) Money at call and short notice with banks and other institutions. Includes deposits repayable within 15 days or less than 15 days' notice lent in the inter-bank call money market.

(iv) Cash in hand including foreign currency notes.

II. Outside India

Usually classified in foreign countries as money at call Includes balances held by foreign branches and balances held by Indian branches of the banks outside India. Balances held with foreign branches by other branches of the bank should not be shown under this head but should be included in inter branch accounts. The amounts held in 'current accounts' and 'deposit accounts' should be shown separately. Includes deposits and short notice.

8. Investments:

I. Investments in India (Includes Central and State Government securities and Government treasury bills. Securities other than Government securities, which according to the Statutes are treated as approved securities, should be included here).

(i) Government securities.

(ii) Other approved Securities Investments in shares of companies and corporations not included in item (i) should be included here.

(iii) Shares.

(iv) Debentures and Bonds, Investments in debentures and bonds of companies and corporations not

included in item (ii) should be included here.

(v) Investments in subsidiaries/ Associate companies: Investments in subsidiaries/ associate companies should be included here.

A company will be considered as an associate company for the purpose of this classification if more than 25% of the share capital of that company is held by the bank. Includes residual investments, if any, like gold.

(vi) Others.

II. Investments outside India: (i) Government securities (including local authorities) (ii) Others All foreign Government securities including securities issued by local authorities may be classified under this head. All other investments outside India may be shown under this head.

9. Advances:

A. (i) Bills purchased and discounted

(i) Cash Credits, Overdrafts and Loans repayable on demand

(ii) Term loans

B. (i) Secured by tangible assets

(ii) Covered by bank/government guarantees

(iii) Unsecured

C. I. Advances in India

(i) Priority sectors

(ii) Public sector

(iii) Banks

(iv) Others

II. Advances outside India

(i) Due from banks

(ii) Due from others

(iii) Bills purchased and discounted

(iv) Syndicated loans

(v) Others

The item will include advances in India and outside India.

- Advances should be broadly classified into ‘Advances in India’ and ‘Advances outside India’. Advances in India will be further classified on the sectoral basis as indicated.
- Advances to sectors which for the time being are classified as priority sectors according to the instructions of the Reserve Bank is to be classified under the head ‘Priority sectors’.
- Advances to Central and State Governments and other Government undertakings including Government companies and corporations which are, according to the statutes, to be treated as ‘public sector’.

- All advances to the banking sector including co-operative banks will come under the head 'Banks'.
- All the remaining advances will be included under this head 'Others' and typically this category will include non-priority advances to the private, joint and cooperative sector:
- A bank lends advances for various activities. Broadly, the advances it lends can be classified into priority segment lending; public segment lending and non priority segment lending. The priority segment consists of such advances as specified by RBI in its Master circulars to banks and generally consist of agriculture, MSMEs and others.

Notes – General (i) The gross amount of advances including refinance but excluding provisions made to the satisfaction of auditors should be shown as advances. (ii) Term loans will be loans not repayable on demand but over a period of time. (iii) Consortium advances would be shown net of recoveries from other participating banks/ institutions.

A. (i) Bills purchased and discounted: In classification under Section 'A', all outstanding – in India as well as outside – less provisions made, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads.

   (ii) Cash credits, overdrafts and loans repayable on demand (iii) Term loans (All advances or part of advances which are secured by tangible assets may be shown here)

B. (i) Secured by tangible assets (ii) Covered by Bank/ Government Guarantee (iii) Unsecured C.I. Advances in India

C. Sector wise advances: (i) Priority sectors (ii) Public sector (iii) Banks (iv) Others

   II. Advances outside India (i) Due from banks (ii) Due from others

10. Fixed Assets:

These include premises and other fixed assets and are shown at cost on close of previous year, additions and deductions during the year and depreciation till close of the year.

I. Premises

II. Other Fixed Assets (including furniture and fixtures)

III. Capital work-in-progress or premises under construction

Premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown against 'Premises'.

In the case of premises and other fixed assets, the previous balance, additions thereto and deductions there from during the year as also the total depreciation written off should be shown. Where sums have been written off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of revision made. Motor vehicles and all other fixed assets other than premises but including furniture and fixtures should be shown under this head.

11. Other assets

I. Inter-office adjustments (net): The inter-office adjustments balance, if in debt, should be shown under this head. Only net position of inter- office accounts, inland as well as foreign, should be shown here. For arriving at the net balance of inter-office adjustment accounts, all connected inter-office accounts

should be aggregated and the net balances, if in debit, only should be shown representing mostly items in transit and unadjusted items.

II. Interest accrued: Interest accrued but not due on investments and advances and interest due but not collected on investments will be the main components of this item. As banks normally debit the borrowers' account with interest due on the balance sheet date, usually there may not be any amount of interest due on advances. Only such interest as can be realised in the ordinary course should be shown under this head.

III. Tax paid in advance/tax deducted at source: The amount of tax deducted at source on securities, advance tax paid, etc. to the extent that these items are not set off against relative tax provisions should be shown against this item.

IV. Stationery and stamps: Only exceptional items of expenditure on stationery like bulk purchase of security paper, loose leaf or other ledgers, etc. which are shown as quasi-asset to be written off over a period of time should be shown here. The value should be on a realistic basis and cost escalation should not be taken into account, as these items are for internal use.

V. Non-Banking Assets: This will include properties/tangible assets acquired in satisfaction of claims to be shown. Others: Items like claims which have not been met, for instance, clearing items, debit items representing addition to assets or reduction in liabilities which have not been adjusted for technical reasons, want of particulars, etc. advances given to staff by a bank as employer and not as a banker, etc. Items, which are in the nature of expenses, which are pending adjustments, should be provided for and the provision netted against this item so that only realisable value is shown under this head. Accrued income other than interest may also be included here.

12. Contingent liabilities:

I. Claims against the Bank not acknowledged as debts.

II. Liability for partly paid investments.

III. Liability on account of outstanding forward exchange contracts

IV. Guarantee given on behalf of constituents. (a) In India (b) Outside India

V. Acceptances, endorsements and other obligations

VI. Other items for which the bank is contingently liable Bills for collection: Bills and other items in the course of collection and not adjusted will be shown against this item in the summary.

Notes/Instructions for compilation

1. Formats of Balance Sheet and Profit and Loss account cover all items likely to appear in these statements. If a bank does not have any particular item to report, it may be omitted from formats.
2. Corresponding comparative figures for previous year are to be disclosed as indicated in the formats. The words 'Current year', 'Previous year' used in formats are only to indicate the order of presentation and may not appear in accounts.
3. Figures should be rounded off to nearest thousand rupees.
4. Unless otherwise indicated the banks in these statements will include banking companies, nationalized banks, State Bank of India and all other banks including cooperative banks carrying business of banking

whether or not incorporated in India or not or operating in India.

5. The Hindi version of balance sheet will be a part of annual report wherever applicable.

ACCOUNTING TREATMENT OF SPECIFIC ITEMS

The accounting treatments of certain specific items in Balance Sheet and Profit and Loss accounts are as follows:

Bad Debts and Provision for doubtful debts : This will include bad debts and provision for doubtful debts are to be charged to "Provisions and Contingencies' in the P& L account. Advances shown in the Balance Sheet is net of bad debts and provisions for bad debts. Banks collect these details from their branches. The Schedule of Advances filled and submitted by branches include doubtful debts in respect of Cash credit, over drafts, unsecured loans as also bills purchased and discounted. However at the Head office Advances figure shown is net of bad as well as doubtful debts.

Provision of Taxation: This is chargeable under the head '"Provisions and Contingencies' in the P& L account. However this will be shown in the Balance Sheet under the heading 'Other Liabilities and Provisions' on the Liabilities side.

Rebate on Bills discounted

Rebate on bills represents the discount collected for unexpired period in advance. Banks normally collect discount charges for the entire period of Bill of Exchange or Promissory Note. For example a Bill of Rs.100000 payable 60 days at sight is discounted on say 23.3. 2018. Let us also assume the bill will fall due for payment on 23.5.2018. Assume that total discount collected is Rs. 600 and other postage charges Rs.400 is levied.

At the time of discount as on 23.3.2018 following entries will be passed :

Dr Bill Discounted A/s	1,00,000	
Cr Customer's A/c	99,000	
Cr Discount A/c	600	
Cr Postage charges A/c		400

As on 31st March for the purposes of preparing P & L account the bank has collected Rs. 520 excess for the period of 1st April to 22nd May which falls in the next accounting year. The amount of Rs.520 is adjusted in the account of the branch in the following manner;

Dr Discount A/c	520
Cr. Rebate on Bills Discounted	520

Rebate will appear under the head 'Liabilities' side in the balance sheet.

Important Ratios for evaluation of performance of banks.

The performance is evaluated by shareholders and Reserve Bank of India, with following important ratios.

- Capital adequacy ratio – It is calculated as ratio of capital funds to risk weighted assets. Capital funds include Tier I capital and Tier II capital. The risk weightage has been assigned by RBI to various assets that range from 0% to 125% and may be more. The ratio indicates strength of the bank to meet unexpected losses.
- Net NPAs to net advances ratio – it indicates the quality of financial assets created by the bank. Lower

ratio indicates better quality of advances and investments. A higher ratio is a cause for worry as it affects profit position in two ways – one non-recognition of interest income and provisions against gross NPAs.

- Return on assets – the ratio is calculated as net profit as percentage of average assets. It indicates efficiency of use of assets for generation of profits. With increase in assets the return on assets should increase. This ensures long time solvency of a bank.

PREPARATION OF PROFIT AND LOSS ACCOUNT

The format preparing the Profit and Loss Account is given below as per Schedule III Form B of the Banking Regulation Act 1949.

FORM B

Profit and loss account for the year ended on 31st March (year)

	Schedule No.	**31-3-20..... (current year)**	**31-3-20..... (previous Year)**
I. Income			
Interest earned	13		
Other income	14		
Total			
II. Expenditure			
Interest expended	15		
Operating expenses	16		
Provisions and contingencies			
Total			
III. Profit / Loss			
Net profit / loss (-) for the year			
Profit / loss (-) brought forward			
Total			
IV. Appropriations			
Transfer to statutory reserves			
Transfer to other reserves			
Transfer to government/ Proposed dividend			
Balance carried over to Balance sheet			

Total			
Details of Schedules			

Schedule 13 : Interest earned	As on 31-3-20..... (current year)	As on 31-3-20..... (previous year)
I. Interest/discount on advance/bills		
II. Income on investments		
III. Interest on balances with Reserve Bank of India and other inter-bank funds		
IV. Others		
Total	_____	_____
	_____	_____

Schedule 14 : Other income	As on 31-3-20..... (current year)	As on 31-3-20..... (previous year)
I. Commission, exchange and brokerage		
II. Profit on sale of investments		
Less: Loss on sale of investments		
III. Profit on revaluation of investments		
Less: Loss on revaluation of investments		
IV. Profit on sale of land, buildings and other assets		
Less: Loss on sale of land, buildings and other assets		
V. Profit on exchange transactions		
Less: Loss on exchange transactions		
VI. Income earned by way of dividends, etc. from subsidiaries/companies and/or joint ventures abroad/ in India		
VII. Miscellaneous income Total		

Note: Under items II to V loss figures may be shown in brackets.

Schedule 15 : Interest expended	As on 31-3-20..... (current year)	As on 31-3-20..... (previous year)
I. Interest on deposits		
II. Interest on Reserve Bank of India/Inter bank borrowings		
III. Others Total	_____	_____

Schedule 16 : Operating expenses	As on 31-3-20..... (current year)	As on 31-3-20..... (previous year)
I. Payment to and provisions of employees		
II. Rent, taxes and lighting		
III. Printing and stationery		
IV. Advertisement and publicity		
V. Depreciation on bank's property		
VI. Director's fees, allowances and expenses		
VII. Auditors' fees and expenses (including branch auditors)		
VIII. Law charges		
IX. Postages, Telegrams, Telephones, etc.		
X. Repairs and maintenance		
XI. Insurance		
XII. Other expenditure		
Total	_____	_____

COMMENTS ON PROFIT AND LOSS ACCOUNT

Schedule 13: Interest earned: Includes interest, discount on all types of loans and advances, like Cash credit, demand loans, overdraft, term loans, export loans, domestic/foreign bills purchased/discounted (including those rediscounted), overdue interest and interest subsidy, if any relating to such advances.

I. **Income on investments**: Includes all income derived from investment portfolio by way interest and dividend.

II. **Interest on balances with Reserve Bank of India and other inter-bank funds**: Includes interest on balances with Reserve Bank of India and other banks, call loans, money market placements etc.

III. **Others**: Includes any other discount/interest not included in the above.

Schedule 14: Other Income:

I. **Commission, exchange and brokerage**: Includes commission on collection, on remittances, exchange on DDs, commission earned on letters of credit, bank guarantees, letting out lockers, Government business, agency business/consultancy services, brokerage on securities. Foreign exchange income is excluded.

II. **Profit on sale of investments**: From this reduce loss of sale of investments.

III. **Profit on revaluation of investments**: From this reduce loss on revaluation of investments.

IV. **Profit on sale of land, buildings and other assets**: Deduct loss of sale of land, buildings and other assets. Includes profit on sale of securities, furniture, land and buildings, motor vehicles, gold, silver etc. Net position should be only shown. If the net position is a loss, it should be shown as a deduction. Similarly net profit/loss on revaluation of assets may be shown under this.

V. **Profit on exchange transactions**: Includes profit/loss on foreign exchange, all income earned by exchange, commission and other charges on foreign exchange transactions excluding interest which will be shown under interest. Net position only to be shown. If the net position is a loss, it should be shown as a deduction.

VI. Income earned by way of dividends etc. from subsidiaries/companies and/or joint ventures abroad/ in India.

VII. **Miscellaneous income**: Includes charges recovered as godown rents, income from bank's properties, security charges, insurance, other miscellaneous income. If any individual item exceeds more than 1% of the total income, particulars be given in the notes to accounts.

Schedule 15 : Interest expended

I. Interest on deposits: All interest paid on deposits including banks and institutions to be included in this.

II. Interest on Reserve Bank of India/ Inter-bank, borrowings: Interest on all borrowings from banks as well as on refinance from RBI to be included.

III. Others: Includes interest/discount on all borrowings and refinance, penal interest paid.

Schedule 16: Operating Expenses

I. Payment to and provisions of employees: This head includes all salaries/wages, allowances including medical allowances, bonus, other staff benefits like provident fund, pension, gratuity, lave fare travel/ concession, staff welfare etc.

II. Rent, taxes and lighting: This head to include rent paid on building on rent, municipal taxes, other taxes (except income tax, interest tax), electricity and similar types of charges. House Rent allowance paid to staff should appear under, " Payments to and Provisions for Employees'.

III. **Printing and stationery**: This head to include books and stationery used/consumed by the bank, other printing charges (other than by way of publicity expenditure).

IV. **Advertisement and publicity**: Expenses incurred for publicity and advertising including printing charges on publicity materials to be included under this head.

V. **Depreciation on bank's property**: Depreciation bank's own property, motor cars, other vehicles, furniture, fixtures, electrical fittings, lockers, vaults, lease hold assets, other non-banking assets etc.

VI. **Director's fees, allowances and expenses**: Expenses like sitting fee, hotel charges, daily allowances, conveyance and other local expenditure incurred on behalf of directors to be included. Similarly expenses incurred on account of local committee members to be also included. Though these expenses may be of reimbursable nature nevertheless these are to be included.

VII. **Auditors' fees and expenses**: This head should also include fees expenses relating to branch auditors. This expenditure fees and other expenses paid to statutory auditors for their professional services rendered and for performing their duties. Though in practice these are in the nature of reimbursement of such expenses. If external auditors are appointed for internal inspection, audit and other professional services such expenses should be included under this head but under 'other expenditure'.

VIII. **Law charges**: This head should include all legal expenses incurred including reimbursements expenses incurred for providing legal services.

IX. **Postages, Telegrams, Telephones, etc.**: All expenses incurred towards stamps, postage, telegrams,

telephones etc. to be included.

X. **Repairs and maintenance**: Includes expenses incurred for maintaining bank's property.

XI. **Insurance**: Includes insurance premium paid for banks property, premium paid to DICGC for deposit insurance/other loan which are not recovered from customers.

XII. **Other expenditure**: All other expenses which are not included in any of the above are included here. If any such expenditure exceeds 1% of the total income details are to be given in the notes to accounts.

Note: There may be slight variations in the heads of expenditure maintained by banks. For example News papers & periodicals, Local conveyance, Entertainment expenses etc. and accordingly it would be mentioned as a head under expenditure.

IMPORTANT ITEMS OF BALANCE SHEET

Banks balance sheets contain certain unusual items when compared to others. We shall have an over view of the same.

Liabilities Side

1. **Share Capital**: Consist of Authorised, Issued, Subscribed and Paid-up share capital are shown separately. Under the head, Paid-up Capital, calls in arrears are reduced and forfeited share amount is added.
2. **Reserve Fund and others**: As under Banking Regulation Act, 1949 every bank which is incorporated in India has to transfer twenty percent of its profit before declaring dividend each year to the Reserve Fund.
3. **Deposits and other accounts**: Though it appears as a single head, it consists of Fixed Deposits (which are held for a fixed period) , Savings Bank as well as Current Account balances (which are repayable on demand) and others.

Assets Side

1. **Money at call and short notice**: Money is borrowed by one bank from another usually for a short period of 1 to 14 days for meeting certain commitments. For a bank which lends this money it is an asset in the form of receivable. This type of transaction is known as inter-bank transaction. When banks have surplus funds they lend and when they have shortage they borrow. Banks also approach RBI and other primary dealers for the same purpose. Banks make use of 'Repo' facility for borrowing with RBI. These are included under this head. The interest rates on such borrowings is charged as an expense. Rate of interest will depend on market demand and supply (except in the case of Repo transaction which will be depend on repo rate.)
2. **Advances**: The advances consist of Loans, Cash credit and overdraft. **Loans** are given a fixed period to customer repayable over a period of time by way of EMI or instalments. **Cash credit** facility is given for a period of one year by way of a hypothecation limit against securities in the form of current assets/ securities. Customers are permitted to draw money up to a limit sanctioned. It is a running account in which deposits will also be made. In case of **Overdraft** a customer will be allowed to draw money from current account against some collateral security like insurance policies, shares, NSC and other tangible securities.
3. **Bills receivable being Bills for collection as per contra**: Bills are given by customers for collection

and subsequent credit to their accounts. Such bills are sent for collection and on realization these are credited to customers' account. During the year end when bills which remain outstanding for collection banks pass the following entries :

Bills received being bills for collection Dr

To Bills for Collection being bills receivable account.

The first entry indicates the amount receivable and it is taken on the assets side. The second entry denotes amount payable is taken on the liabilities side of the balance sheet. The amounts are identical and known as contra items.

4. **Acceptances, Endorsements and other obligations**: During the course of their business banks open letters of credit, issue bank guarantee, endorse promissory notes, accept or co-accept bills on behalf of customers. Under such actions a bank is liable to third parties on behalf of customers. In such cases banks obtain counter guarantees to protect themselves in case if liabilities devolve on them. Such counter guarantees represent an asset. For all such outstanding transactions contra entries are passed :

   Constituents liability for Acceptances, Endorsements /other obligations Dr
   to Acceptances, Endorsements/other obligations.

The former entry is taken in the assets side and the latter is taken on the liabilities side.

Non-Banking Assets: These are non-financial Assets and are tangible. e.g. machinery, equipment, real estate, inventory, vehicles. When a borrower is unable to repay the amount of the loan in cash and as a substitute offers to the bank an asset. This is known as a non-banking asset. This one is provided apart from the asset already given as collateral security to the bank to purchase so as to settle their dues. When these assets are purchased by the banks, they are known as non banking assets. Banks are required to dispose off those assets within a specified timeframe as mandated by RBI. They also have the responsibility to finally convert these non-cash recoveries in to cash as recoveries. Profit or loss on disposal of such assets are to be disclosed in profit and loss of account of the bank.

Gold and Silver: Gold appears as a part of assets and appears under the head 'investments'. Silver appears under "Other assets".

Locker /Safe Deposit vaults: These are assets and as such are included under Furniture and fixtures.

Branch Adjustment Account: In a Bank there are many transactions take place. They may be between Head office and branches vice-versa, between branches. They are properly reconciled at periodical intervals. However at the year-end time there could be outstanding transactions pending reconciliation. Thus there could be a balance in the inter-office. The inter-office adjustment balance, if in debit, should be shown under this head. Only net position of inter-office accounts inland as well as foreign should be shown here. For arriving at the net balance of inter-office adjustment accounts all connected inter-office accounts should be aggregated and the net balance, if in debit, only should be shown, representing mostly items in transit and unadjusted items. If the balance is in credit it is shown under liabilities side.

An illustration of preparation of a bank's Balance Sheet, P & L Account, as per the formats of Banking Regulation Act.

Example 1

M/s Progressive Bank has given you the following information. Prepare Profit & Loss Account and Balance Sheet as at 31st March xx as per the forms under Banking Regulation Act 1949.

Share Capital	300000
Statutory Reserve Fund	180000
Bad debts	19313
Establishment Expenses	191588
Current Deposits	2047841
Interest paid	1122660
Savings Bank Deposits	2580000
Acceptance for customer	71250
Discount	742500
Profit & Loss Account – credit	1230600
Fixed Deposits	1312500
Commission & Exchange	439350
Premises	720000
Cash in hand	975
Balance in RBI	33000
Interest received	1929600
Interest in shares (Market Value 3, 00, 000)	138750
Cash with banks	426750
Term loans in India	1500000
CC Account – Hypothecation	1896000
CC Account – Pledge	1416000
Bill Purchased	2400000
Employee loans	61155
Salaries, Allowances, PF	668201
Government Securities	180000
Dividend on investments	12000

Other Notes

CEO Salary 60000 p.a. included in salaries

Directors fee & Allowances 12000 included in salaries & Allowances

Rebate on bills as at year end is Rs. 72000

Establishment Expenses include

Stamp papers	2250
Revenue Stamps	600

Postage and Telegrams	6900
Audit fees	12000
Lighting	4500
Rent	27000
Stationery	94500
Advertisements	15000

A CC limit of Rs. 12000 needs to be fully provided for. Taxation at 35%

Solution

Progressive Bank Limited

Profit & Loss Account for the year ended on 31st March XX

I Income	**Schedule**	**Rs.**
Interest Earned	13	2600100
Other Income	14	451350
Total		3051450
II Expenditure	15	1122660
Interest Expended	16	859789
Operating Expenses Provision for contingencies		394504
Total		2376953
III Profit		
Net Profit		674497
IV Appropriations		
Transfer to statutory reserves		134899
Carried Forward to Balance Sheet		539598

Notes : Schedule 13 : Interest Earned

Interest received		1929600
Discount	742500	
Less: Rebate	-72000	670500
Total		2600100

Schedule 14 : Other income

Commission & Exchange	439350
Dividend on investment	12000
Total	451350

Schedule 15 : Interest Expended

Interest expended	1122660
Total	1122660

Schedule 16 : Operating Expenses

Salaries & Allowances	656201
Rent & Lighting	31500
Printing & Stationery	94500
Advertisement & Publicity	15000
Directors Fees	12000
Auditors Fees & Exp.	12000
Stamp papers	2250
Postage, Telegrams, Revenue Stamp	7500
Other Expenses	28838
Total	859789

Working Notes :

Establishent Expenses	191588
Salaries Allownances etc	668201
Total	859789

Other expenses is a balancing amount

Income	2600100	
Other income	451350	
Total	3051450	
Less : Interest Expended	1122660	
Less : operating Expenses	859789	
less; Bad debts provision	31313	2013762
Profit Before Tax		1037688
Income Tacx @35% on 1037688		363191
Net Profit After Tax		674497
To Statutory Reserves 20% of Net proft		134899
C/F toBalance sheet		539598

Provision for contigencies

Bad debts	19313
Provision for bad debts	12000
Provision for income tax	363191
Total	394504

Progressive Bank Limited
Balance Sheet as on 31st March 20XX

	Schedule No.	Rs.
Capital and Liabilities		
Capital	1	300000
Reserves & Surpplus	2	2085097
Deposits	3	5940341
Borrowings	4	_
Other Liabilities and Provisions	5	447192
Total		8772630
Assets		
Cash and Balances with RBI	6	33975
Balances with Banks and Money at Call and Short Notice	7	426750
Investments	8	318750
Advances	9	7212000
Fixed assets	10	720000
Other Assets	11	61155
Total		8772630
Contingent Liabilities	12	71250

Schedule 1: Capital		**Rs.**
A. Authorised Capital		
10000 shares of Rs. 100 each		1000000
Issued Capital		
3000 shares of Rs.100 each		300000
Subsribed Capital		
3000 shares of Rs.100 each		300000
Called up and Paid up Capital		
3000 shares of Rs.100 each		300000
Schedule 2: Reserves & Surpplus		
I Statutory reserve		
Opening Balance	180000	
Add: Addition during the year	134899	314899
II Capital Reserve	Nil	
III Share Premium	Nil	
IV Revenue & other Reserves	Nil	
V Balance of Profit & Loss	1770198	1770198
Total		2085097
Schedule 3: Deposits		
A I. Demand Deposits		
From Banks		
From Others		2047841
II Savings Bank Deposits		2580000
III. Term Deposits		
From Banks		
From Others		1312500
Total (I+II+III)		5940341
B. I. Deposits of Branches in India		5940341
II. Deposits of Branches outside India		0

Schedule 4: Borrowings	
I. Borrowings of branches in India	0
II. Borrowings of branches outside India	0
Schedule 5: Other Liabilities & Provisions	
I. Bills Payable	0
II. Inter-office Adjustments	0
III. Interest accrued	0
IV. Others	447192
Schedule 6:Cash and Balances with RBI	
I. Cash in hand	975
II. Balance with RBI	33000
Total	33975
Schedule 7: Balances with Banks and Money at Call and Short Notice	
I. In India	426750
II. Outside India	0
	426750
Schedule 8: Investments	
I. Investments in India in	–
(i) Government Securities	180000
(ii) Other Approved Securities	0
(iii) Shares	138750
(iv) Debentures and Bonds	–
(v) Subsidiaries and/or Joint ventures	–
(vi) Others	–
II. Investments outside India	–
	318750
Schedule 9: Advances	
I. Bills Purchased and Discounted	2400000
II Cash Credit, Overdrafts, Loans repayable on demand	3312000
III Term Loans	1500000
	7212000

Schedule 10: Fixed assets

Premises	720000
Other fixed assets	–
	720000

Schedule 11: Other Assets

I. Inter-office Adjustments	–
II. Interest Accrued	–
III. Taxes Paid in Advance & Deducted at Source	–
IV. Stationery & Stamps	–
V. Non-Banking Assets acquired in satisfaction of claims	–
VI. Others- Loans to Employees	61155
	61155

Schedule 12: Contingent Liabilities

Acceptances, Endorsements and other obligations	71250

DISCLOSURE REQUIREMENTS OF BANKS

In order to encourage market discipline, Reserve Bank has over the years developed a set of disclosure requirements, which allow the market participants to assess key pieces of information on capital adequacy, risk exposures, risk assessment processes and key business parameters, to provide a consistent and understandable disclosure framework that enhances comparability. Banks are also required to comply with the Accounting Standard 1 (AS 1) on Disclosure of Accounting Policies issued by the Institute of Chartered Accountants of India (ICAI). The enhanced disclosures have been achieved through revision of Balance Sheet and Profit & Loss Account of banks and enlarging the scope of disclosures to be made in 'Notes to Accounts'. In addition to the 16 detailed prescribed schedules to the balance sheet, banks are required to furnish the following information In 'Notes to Accounts'. A brief on the same is given below. As a standard practice to bring in uniform reporting 'Summary of Significant Accounting Policies' and 'Notes to Accounts' are to be shown in Schedules 17 and 18 by banks. RBI through its Master Circular No: RBI/2015-16/99 DBR.BP.BC No.23/21.04.018/2015-16 dated July 1, 2015 has provided detailed guidelines in this regard.

As per RBI directions, the disclosures are to be provided on the following:

1.	Capital
2.	Investments
3.	Repo Transactions
4.	Non SLR Investment Portfolio
5.	Sale and Transfers to / from HTM Category
6.	Derivatives
7.	Forward Rate Agreement / Interest Rate Swap

8.	Exchange Traded Interest Rate Derivatives
9.	Disclosures on Risk Exposure in Derivatives
10.	Asset Quality
11.	Non Performing Asset
12.	Particulars of Accounts Restructured
13.	Details of Financial Assets sold to Securitisation / Reconstruction Company for Asset Reconstruction
14.	Details of Non Performing Asset Purchased / Sold
15.	Provisions on Standard Assets
16.	Business Ratio
17.	Asset Liability Management - Maturity Pattern of certain items of Assets and Liabilities
18.	Exposures
19.	Exposure to Real Estate Sector
20.	Exposure to Capital Market
21.	Risk Category wise Country Exposure
22.	Details of Single Borrower Limit (SGL), Group Borrower Limit (GBL) exceeded by the bank
23.	Unsecured Advances
24.	Disclosure of Penalties imposed by RBI
25.	Disclosure Requirements as per Accounting Standards where RBI has issued guidelines
26.	Accounting Standard 5 – Net Profit or Loss for the period, Prior Period items and Changes in Accounting Policies
27.	Accounting Standard 9 – Revenue Recognition
28.	Accounting Standard 15 – Employee Benefits
29.	Accounting Standard 17 – Segment Reporting
30.	Accounting Standard 18 – Related Party Disclosures
31.	Accounting Standard 21 - Consolidated Financial Statements
32.	Accounting Standard 22 – Accounting for Taxes on Income
33.	Accounting Standard 23 – Accounting for Investments in Associates in Consolidated Financial Statements
34.	Accounting Standard 24 – Discontinuing Operations
35.	Accounting Standard 25 – Interim Financial Reporting
36.	Other Accounting Standards
37.	Additional Disclosures
38.	Provisions and Contingencies

39.	Floating Provisions
40.	Draw Down from Reserves
41.	Disclosure of Complaints
42.	Disclosure of Letters of Comfort (LoCs) issued by banks
43.	Provisioning Coverage Ratio (PCR)
44.	Insurance Business
45.	Concentration of Deposits, Advances, Exposures and NPAs
46.	Sector wise Advances
47.	Movement of NPAs
48.	Overseas Assets, NPAs and Revenue
49.	Off Balance Sheet SPVs Sponsored
50.	Unamortised Pension and Gratuity Liabilities
51.	Disclosures on Remuneration
52.	Disclosures relating to Securitisation
53.	Credit Default Swaps
54.	Intra Group Exposures
55.	Transfers to Depositor Education and Awareness Fund (DEAF)
56.	Unhedged Foreign Currency Exposure
57.	Liquidity Coverage Ratio

Note: RBI vide it's circular No. RBI/2018-2019/146 DBR.BP.BC.No.29/21.07.001/2018-19 March 22, 2019 has further deferred the implementation Indian Accounting Standards as legislative amendments recommended by the Reserve Bank are under consideration of the Government of India.

Summary of Significant Accounting Policies

As per RBI's directions banks should disclose the accounting policies regarding key areas of operations at one place (under Schedule 17) along with 'Notes to Accounts' in their financial statements. A suggestive list includes - Basis of Accounting, Transactions involving Foreign Exchange, Investments – Classification, Valuation, etc., Advances and Provisions thereon, Fixed Assets and Depreciation, Revenue Recognition, Employee Benefits, Provision for Taxation, Net Profit, etc.

The model formats of some of such disclosures are as follows:

1. **Basis of Accounting** : The accompanying financial statements have been prepared on the historical cost and conform to the statutory provisions and practices prevailing in the country.
2. **Transactions involving Foreign Exchange** : (a) Monetary assets and liabilities have been translated at the exchange rates, prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost. (b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates, ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year. c) Profit or loss on pending forward

contracts have been accounted for.

3. **Investments**: (a) Investment in governments and other approved securities in India are valued at the lower of cost or market value. (b) Investments in subsidiary companies and associate have been accounted for on the historical cost basis. (c) All other investments are valued at the lower of cost or market value.

4. **Advances** : (a) Provisions for doubtful advances have been made to the satisfaction of the auditors: (i) In respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies; (ii) In respect of general advances, as a percentage of total advances taking into account the guidelines issued by the Government of India and the Reserve Bank of India. (b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have been included under "Other Liabilities and Provisions". (c) Provisions have been made on a gross basis. Tax relief, which will be available when the advance is written-off, will be accounted for in the year of write-off.

5. **Fixed Assets**: (a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the value determined on the basis of such revaluation made by the professional values, profit arising on revaluation has been credited to Capital Reserve. (b) Depreciation has been provided for on the straight line/diminishing balance method. (c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent of revaluation is transferred annually from the Capital Reserve to the General Reserve / Profit and Loss Account.

6. **Employee Benefits**: Provision for gratuity pension benefits to staff have been made on an accrual casual basis. Separate funds for gratuity / pension have been created.

7. **Net Profit** : (a) The net profit disclosed in the Profit and Loss Account in after: (i) provisions for taxes on income, in accordance with the statutory requirements, (ii) Provisions for doubtful advances. (iii) Adjustments to the value of "current investments" in government and other approved securities in India, valued at lower of cost of market value, (iv) Transfers to contingency funds. v) Other usual or necessary provisions. (b) Contingency funds have teen grouped in the Balance Sheet under the head "Other Liabilities and Provisions".

Some Special Transactions Interest on Doubtful Debts when a debt is found to be doubtful at the end of the accounting year, a question may arise whether the interest on that should be credited to interest Account or not. There is no doubt that interest has accrued; but it is equally clear that the realization of this interest is doubtful. Therefore, as prudent accounting policy, such interest should be transferred to Interest Suspense Account.

ADDITIONAL DISCLOSURES PRESCRIBED BY RBI

1. Provisions and Contingencies

To facilitate easy reading of the financial statements and to make the information on all Provisions and Contingencies available at one place, banks are required to disclose in the 'Notes to Accounts' the following information:

		(Amount in ₹ crore)
Break up of 'Provisions and Contingencies' shown under the head Expenditure in Profit and Loss Account	**Current Year**	**Previous Year**
Provisions for depreciation on Investment		
Provision towards NPA		
Provision made towards Income tax		
Other Provision and Contingencies (with details)		

2. Floating Provisions

Banks should make comprehensive disclosures on floating provisions in the 'Notes to Accounts' to the balance sheet as follows:

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**
(a) Opening balance in the floating provisions account		
(b) The quantum of floating provisions made in the accounting year		
(c) Amount of draw down made during the accounting year		
(d) Closing balance in the floating provisions account		
Note: The purpose of draw down made during the accounting year may be mentioned		

3. Draw Down from Reserves

Suitable disclosures are to be made regarding any draw down of reserves in the 'Notes to Accounts' to the Balance Sheet.

4. Disclosure of Complaints

Banks are advised to disclose the following brief details along with their financial results.

A. Customer Complaints

		Current year	**Previous year**
(a)	No. of complaints pending at the beginning of the year		
(b)	No. of complaints received during the year		
(c)	No. of complaints redressed during the year		

(d)	No. of complaints pending at the end of the year		

B. Awards passed by the Banking Ombudsman

		Current year	Previous year
(a)	No. of unimplemented Awards at the beginning of the year		
(b)	No. of Awards passed by the Banking Ombudsmen during the year		
(c)	No. of Awards implemented during the year		
(d)	No. of unimplemented Awards at the end of the year		

It is clarified that banks should include all customer complaints pertaining to Automated Teller Machine (ATM) cards issued by them in the disclosure format specified above. Where the card issuing bank can specifically attribute ATM related customer complaints to the acquiring bank, the same may be clarified by way of a note after including the same in the total number of complaints received.

5. Disclosure of Letters of Comfort (LoCs) issued by banks

Banks should disclose the full particulars of all the Letters of Comfort (LoCs) issued by them during the year, including their assessed financial impact, as also their assessed cumulative financial obligations under the LoCs issued by them in the past and outstanding, in its published financial statements, as part of the 'Notes to Accounts".

6. Provisioning Coverage Ratio (PCR)

PCR (ratio of provisioning to gross non-performing assets) as at close of business for the current year and previous year should be disclosed in the 'Notes to Accounts' to the Balance Sheet.

7. Insurance Business

The details of fees / brokerage earned in respect of insurance broking, agency and bancassurance business undertaken by them should be disclosed in the 'Notes to Accounts' to their Balance Sheet. Disclosures should be made for both the current year and previous year.

8. Concentration of Deposits, Advances, Exposures and NPAs

8.1 Concentration of Deposits

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**
Total Deposits of twenty largest depositors		
Percentage of Deposits of twenty largest depositors to Total Deposits of the bank		

8.2 Concentration of Advances*

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**

Total Advances to twenty largest borrowers		
Percentage of Advances to twenty largest borrowers to Total Advances of the bank		
*Advances should be computed as per definition of Credit Exposure including derivatives furnished in our Master Circular on Exposure Norms.		

8.3 Concentration of Exposures**

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**
Total Exposure to twenty largest borrowers / customers		
Percentage of Exposures to twenty largest borrowers / customers to Total Exposure of the bank on borrowers / customers		
**Exposures should be computed based on credit and investment exposure as prescribed in our Master Circular on Exposure Norms.		

8.4 Concentration of NPAs

		(Amount in ₹ crore)
	Current year	**Previous year**
Total Exposure to top four NPA accounts		

9. Sector wise Advances

							(Amount in ₹ crore)
Sr. No.	**Sector***	**Current year**			**Previous year**		
		Outstanding Total Advances	**Gross NPAs**	**Percentage of Gross NPAs to Total Advances in that sector**	**Outstanding Total Advances**	**Gross NPAs**	**Percentage of Gross NPAs to Total Advances in that sector**
A	Priority Sector						
1	Agriculture and allied activities						
2	Advances to industries sector eligible a s priority sector lending						
3	Services						
4	Personal loans						
	Sub total (A)						
B	Non Priority Sector						

1	Agriculture and allied activities						
2	Industry						
3	Services						
4	Personal loans						
	Sub-total (B)						
	Total (A+B)						

*Banks may also disclose in the format above, sub sectors where the outstanding advances exceeds 10 percent of the outstanding total advances to that sector. For instance, if a bank's outstanding advances to the mining industry exceed 10 percent of the outstanding total advances to 'Industry' sector it should disclose details of its outstanding advances to mining separately in the format above under the 'Industry' sector.

10. Movement of NPAs

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**
Gross NPAs1 as on April 1 of particular year (Opening Balance)		
Additions (Fresh NPAs) during the year		
Sub total (A)		
Less :-		
(i) Upgradations		
(ii) Recoveries (excluding recoveries made from upgraded accounts)		
(iii) Technical / Prudential2 Write offs		
(iv) Write offs other than those under (iii) above		
Sub-total (B)		
Gross NPAs as on 31st March of following year (closing balance) (A-B)		

* Further, banks should disclose the stock of technical write offs and the recoveries made thereon as per the format below:

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**
Opening balance of Technical / Prudential written off accounts as at April 1		
Add : Technical / Prudential write offs during the Year		
Sub total (A)		
Less : Recoveries made from previously technical / prudential written off accounts during the year (B)		
Closing balance as at March 31 (A-B)		

11. Overseas Assets, NPAs and Revenue

		(Amount in ₹ crore)
Particulars	**Current year**	**Previous year**
Total Assets		
Total NPAs		
Total Revenue		

12. Off Balance Sheet SPVs Sponsored

(which are required to be consolidated as per accounting norms)

Name of the SPV sponsored	
Domestic	Overseas

13. Unamortised Pension and Gratuity Liabilities

Appropriate disclosures of the accounting policy followed in regard to amortization of pension and gratuity expenditure may be made in 'Notes to Accounts' to the financial statements.

In addition banks are required to include disclosures on the following as per formats provided by RBI.

Disclosures on Remuneration Disclosures relating to Securitisation Credit Default Swaps Intra Group Exposures Transfers to Depositor Education and Awareness Fund (DEAF) Unhedged Foreign Currency Exposure Liquidity Coverage Ratio.

Further disclosures as per RBI directions are as follows:

- Disclosure in the "Notes to Accounts" to the Financial Statements - Divergence in the asset classification and provisioning. In terms of RBI notifications RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 April 18, 2017 and RBI/2018-19/157 DBR.BP.BC.No.32/21.04.018/2018-19 April 1, 2019 banks should disclose divergences, if either or both of the following conditions are satisfied: (a) the additional provisioning for NPAs assessed by RBI exceeds 10 per cent of the reported profit before provisions and contingencies for the reference period, and (b) the additional Gross NPAs identified by RBI exceed 15 per cent of the published incremental Gross NPAs for the reference period.
- Disclosure on Exposure to Infrastructure Leasing & Financial Services Limited (ILFS) and its group entities (V. In terms of National Company Law Appellate Tribunal's (NCLAT) order dated February 25, 2019 in respect of I.A No. 620 of 2019 in Company Appeal (AT) No. 346 of 2018, in terms of which "no financial institution will declare the accounts of 'Infrastructure Leasing & Financial Services Limited' or its entities as 'NPA' without prior permission of this Appellate Tribunal".

In pursuance of this, RBI, vide it's Notification RBI/2018-19/175 DBR.BP.BC.No.37/21.04.048/2018-19 April 24, 2019,has advised banks to disclose in their notes to accounts, the information in the proforma given below. Disclosure in respect of ILFS and ILFS entities.

Position as on ..... Rs. In Crores

Amount Outstanding (1)	Of (1) Total amount of exposures which are NPAs as per IRAC norms and not classified as NPA. (2)	Provisions required as per IRAC norms (3)	Provisions actually held (4)

DISCLOSURES REQUIRED UNDER BASEL NORMS

In terms of Guidelines on Composition of Capital Disclosure Requirements issued vide circular DBOD. No. BP. BC.98/21.06.201/2012-13 dated May 28, 2013, Pillar 3 disclosures as introduced under Basel III have become effective from July 1, 2013. The first set of disclosures as required by these guidelines was to be made by banks as on September 30, 2013 (with the exception of the Post March 31, 2017 template.).

Scope and Frequency of Disclosures

1. Pillar III applies at the top consolidated level of the banking group to which the Capital Adequacy Framework applies. Disclosures related to individual banks within the groups would not generally be required to be made by the parent bank. An exception to this arises in the disclosure of capital ratios by the top consolidated entity where an analysis of significant bank subsidiaries within the group is appropriate, in order to recognise the need for these subsidiaries to comply with the Framework and other applicable limitations on the transfer of funds or capital within the group. Pillar III disclosures will be required to be made by the individual banks on a stand-alone basis when they are not the top consolidated entity in the banking group.
2. Banks are required to make Pillar III disclosures at least on a half yearly basis, irrespective of whether financial statements are audited, with the exception of following disclosures: (i) Capital Adequacy; (ii) Credit Risk: General Disclosures for All Banks; and (iii) Credit Risk: Disclosures for Portfolios Subject to the Standardised Approach. The disclosures as indicated at (i), (ii) and (iii) above will be made at least on a quarterly basis by banks.

All disclosures must either be included in a bank's published financial results / statements or, at a minimum, must be disclosed on bank's website. If a bank finds it operationally inconvenient to make these disclosures along with published financial results / statements, the bank must provide in these financial results / statements, a direct link to where the Pillar III disclosures can be found on the bank's website. The Pillar III disclosures should be made concurrent with publication of financial results / statements. That is to say Pillar III disclosures are required to be made by all banks including those which are not listed on stock exchanges and / or not required to publish financial results / statement. Therefore, such banks are also required to make Pillar III disclosures at least on their websites within reasonable period.

Banks are required to update these disclosures concurrently whenever a new capital instrument is issued and included in capital or whenever there is a redemption, conversion / write-down or other material change in the nature of an existing capital instrument.

Banks have to maintain a 'Regulatory Disclosures Section' on their websites, where all the information relating to disclosures will be made available to the market participants. The direct link to this page should be prominently provided on the home page of a bank's website and it should be easily accessible. This requirement is essentially to ensure that the relevance / benefit of Pillar III disclosures is not diminished by the challenge of finding the disclosure in the first place. An archive for at least three years of all templates relating to prior reporting periods

should be made available by banks on their websites.

In addition to the specific disclosure requirements as set out in the guidelines, banks operating in India should also make additional disclosures in the following areas: (i) Securitisation exposures in the trading book; (ii) Sponsorship of off-balance sheet vehicles; (iii) Valuation with regard to securitisation exposures; and (iv) Pipeline and warehousing risks with regard to securitisation exposures.

In addition to the disclosure requirements set out in above paragraphs, banks are required to make the following disclosure in respect of the composition of capital: (i) Full Terms and Conditions: banks are required to make available on their web sites the full terms and conditions of all instruments included in regulatory capital. The requirement for banks to make available the full terms and conditions of instruments on their websites will allow supervisors and market participants to investigate the specific features of individual capital instruments.

(ii) Banks are required to keep the terms and conditions of all capital instruments up-to-date Whenever there is a change in the terms and conditions of a capital instrument, banks should update them promptly and make publicly available such updated disclosure.

Banks listed on stock exchanges

Banks which have been listed in stock exchanges in India and abroad have to comply with terms of listing agreement/ stock exchange rules under which they are listed including reporting and other compliances in a timely manner failing which they would face penal action including fines.

Some terms used in Analysis of Bank Performance.

- Cash coverage ratio – (Cash divided by total business liabilities x 100). An upward trend indicates presence of more of idle investments.
- Total business growth ratio – (business of the year divided by previous year business). Increasing trend is desirable.
- Productivity indicators – (per employee Deposits / Advances / Profits) increasing trend shows improving productivity.
- Business – (Aggregate Deposits plus aggregate advances), Increasing trend is healthy, shows growth.
- Interest income – the sum total of discount, interest from loans, advances, investments and balances with other banks.
- Non-interest income – other income of the bank and includes commission, brokerage, gains on sales and revaluation of investments and fixed assets, profits from exchange transactions etc.
- Interest spread – excess of total interest earned over total interest paid. It has strong influence on bank's bottom line.
- Working funds – they are total resources – total liabilities or total assets.

LESSON ROUND UP

– A Banking Company has to prepare it's Financial Statements in specified formats under Banking Regulation Act. These statements are required to be prepared in accordance with specific guidelines issued by RBI and other authorities from the books of account maintained by banks, in which transactions are accounted. In doing so banks have to comply with standard practices/procedures prescribed.

- Banks have to maintain a 'Regulatory Disclosures Section' on their websites, where all the information relating to disclosures will be made available to the market participants.
- Banks which have been listed in stock exchanges in India and abroad have to comply with terms of listing agreement/stock exchange rules under which they are listed including reporting and other compliances in a timely manner failing which they would face penal action including fines.
- Disclosures related to individual banks within the groups would not generally be required to be made by the parent bank.

GLOSSARY

Principal books of account, Ledgers, Registers, General Ledger, Cash book/Day book Money at call and short notice, Revenue Reserves, Inter-office Adjustments, Loan, Cash credit, Overdraft, Rebate on Bills, Non-banking Assets, Disclosure, Divergence, Basel III, Pillar III disclosures.

SELF TEST QUESTIONS

1. **Fill in the blanks**

   a. Section 29 to 34A of the___Act deal with the accounts and audit of Banking Companies.

   b. Banks enter transactions of customers first, in_____(which are subsidiary books under conventional accounting) rather than in journals.

   c. If customers fail to submit stock-statements by 10th of the month,__will be levied from the 1st of the current month as per agreed sanction terms.

   d. When a borrower is unable to repay the amount of the loan in cash and as a substitute offers to the bank an asset. This is known as a_____.

   e. Gold appears as a part of assets and appears under the head 'investments'. Silver appears under ____.

   f. Banks should disclose divergences for the reference period, if either or both, the additional provisioning for NPAs assessed by RBI exceeds__ % of the reported profit before provisions and contingencies, and the additional Gross NPAs identified by RBI exceed___% of the published incremental Gross NPAs. .

2. **Write True or False**

   a. Copies of Annual Accounts, Balance sheet along with P& L Account prepared in accordance with Sec 29 of Banking Regulation Act, 1949 together with Auditor's Report to be submitted to RBI within six months from the end of the period to which they relate.

   b. The general ledger is a summary of control accounts of various deposit, loan heads as well as Profit and Loss.

   c. Advances of a bank generally consist of (i) Bills purchased and discounted, (ii) Cash credits, overdrafts and loans repayable on demand, (iii) Term loans

   d. Rebate on bills represents the discount collected for unexpired period in advance.

   e. Branch Adjustment Account is an account reflecting transactions between Head office and branches and vice-versa. Also it may take place between branches.

3. **Answer the following questions:**
   a. What are financial statements banking companies are required to compile and present?
   b. Mention the principal books account and subsidiary books of account a banking company is required to keep?
   c. Write about rebate, giving an example.
   d. What are the contra entries passed by banks? Mention particulars of the same. .
   e. Mention at least five of the disclosures to be made by banks.
   f. What are the significant accounting policies to be followed by banks? Write briefly about the same.

FOR FURTHER READING

1. RBI Master circulars
2. Guidance note on Audit of Banks by ICAI
3. Shodganga- Balance Sheet of Banks
4. The Banking Regulation Act.

Lesson 20

Risk Management in Banks and Basel Accords

LESSON OUTLINE

- Introduction to Risk Management
- Credit Risk Management
- Liquidity and Market Risk Management
- Operational Risk Management
- Interest Rate Risk
- Reporting of Banking Risk
- Risk Adjusted Performance Evaluation
- Basel- I, II & III Accords
- LESSON ROUND UP
- SELF TEST QUESTIONS

LEARNING OBJECTIVES

Risk is the main cause of uncertainty in any organisation. Thus, Banks increasingly focus more on identifying risks and managing them before they even affect the business. The ability to manage risk will help organisations act more confidently on future business decisions. Their knowledge of the risks they are facing will give them various options on how to deal with potential problems.

This chapter will enable a reader-

- To understand the concepts of simple, compound interest
- To understand the concepts of annuities and sinking funds
- To understand the concept of risk in Banking Industry
- To understand various types of risks that impact the banking industry
- To analyse and study management and mitigation of risks
- To apprise the learners about BASEL norms

INTRODUCTION

In the assets portfolio of a bank, the investments of banks have significant impact after the funds involved in loans and advances. The returns on investments are comparatively lower than the returns on loans and advances.

Every organization faces risks in their operations. Banking organizations too are prone to risks which need to be managed. Banks being financial sector organizations face risks – some originate within the organization and some outside the organization. If these risks are not properly managed they have potential to destabilize not only a particular bank, but can create a system wide chaos. To manage these risks regulatory bodies have given directions and guidelines which need to be followed and implemented as applicable in the respective cases of each bank.

A student of banking therefore requires to be fully acquainted of this aspect of banking so that he/she remains knowledgeable so as to safeguard the interests of the organization and its customers should he choose to join banking later. Keeping this objective in mind the chapters covers areas of risks a bank faces and methods, tools to handle the same as per prescriptions of regulatory authorities including Basel norms. In view of its importance risk management has become a field of specialization for many professional giving them a career path. The contents are of level 1 and 2 orientation providing over view of risks and regulations to be followed, for compliance as well as managing them.

INTRODUCTION TO RISK MANAGEMENT

The Banking sector has a very important role in the development of an economy of any country. As one of the key drivers of economic growth of a country, banking sector plays a pivotal role in making use of idle funds for nation building. The foundation of a strong economy depends on how strong the Banking sector is and vice versa.

Banking is always considered to be a very risky business. Risk can be defined as the potential loss from a banking transaction – in the form of a loan, or investment in securities or any other transaction that a bank undertakes for itself or for its customer. Banks are exposed to both, financial (e.g. monetary loss) as well as non-financial (e,g. reputation loss) risks. Basic function of any bank is to accept funds from public for the purpose of lending and investment. In case something goes wrong, banks can collapse and 'failure of one bank is sufficient to send shock waves right through the economy.' It is imperative that bank managements must be very careful in identifying the types as well as the degrees of risk exposure and mitigate them. positively. Therefore, banks must recognise risk management as an ongoing and unavoidable activity with the active participation of the Board of Directors.

In economic/financial/business activities risk is directly proportional to returns; higher the risk a bank takes, it can expect to gain more profits. However, greater risk also increases the danger that the bank may incur big losses and can be out of the business and perhaps out of existence. In fact, today, a bank must run its operations with twin objectives in mind – generate profit and stay in business. However banks must ensure that their risk taking decisions are calculated, informed and prudent.

Some Important Requirements

The following are some of the salient requirements in respect of risk management in banks.

- A comprehensive Risk Management Policy approved by the Board of Directors should be in place.
- A Training/Learning set up to inculcate and sensitize the risk management culture in the organization on an ongoing basis.
- Information Technology department should be fully geared up for generating Management Information System ('MIS'). MIS plays a vital role in mitigation of risk.

- Strong internal control systems should be in place. Audit department of a Bank plays a significant role in this.

Stages of Risk Management

1. Risk Identification

This is the first and the most important stage of risk management. The process starts with identifying the risks. Risk identification originates from where the problem starts. Risk identification can be objective based, scenario based, taxonomy based and common risk checking based. It will help the bank or any organization to take the corrective measures.

2. Risk Analysis (Risk measurement or quantification)

It includes analysing the risk and measuring its vulnerability and impact on the organisation. Frequency and severity of the risk can be analysed as well in this stage. Risk management can be both quantitative as well as qualitative. Numerically determining the probabilities of various adverse events and expected extent of losses if any unexpected event occurs, is termed as Quantitative Analysis whereas defining the various threats, devising counter-measures for mitigation and determining the extent of vulnerabilities is known as Qualitative Risk Analysis.

3. Risk Control (Risk mitigation)

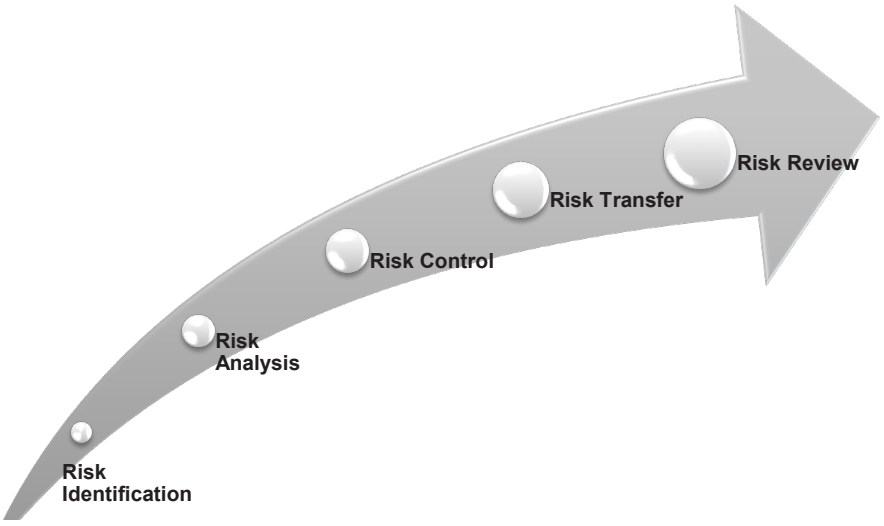
Only after properly analyzing the risk, a bank can decide as to how it can be controlled. If the risk can be controlled by in house efforts it is well and good; it can also seek professional help from outside. Risk control is the entire process of procedures, systems, policies an organization needs to manage prudently all risks which may arise.

4. Risk Transfer

If the risk is not manageable, one cannot retain that risk; then we have to transfer that risk to a third party. This is the stage where insurance comes in to play. Insurance will be willing to take on those risks which the organization can't handle. But it should also be understood that insurance alone is not a solution or a panacea for all risks.

5. Risk Review (Risk monitoring)

Risk review is the last stage in which all the above mentioned steps are evaluated. Review must be regular and on a continuous basis, as conditions and circumstances of the business as well as organizations change continuously. It should be monitored to see that the desired results of the risk management are achieved. If not, then identifying as to where the problem occurred and subsequently reviewing all stages and making changes in the management of risk according to the scenario.



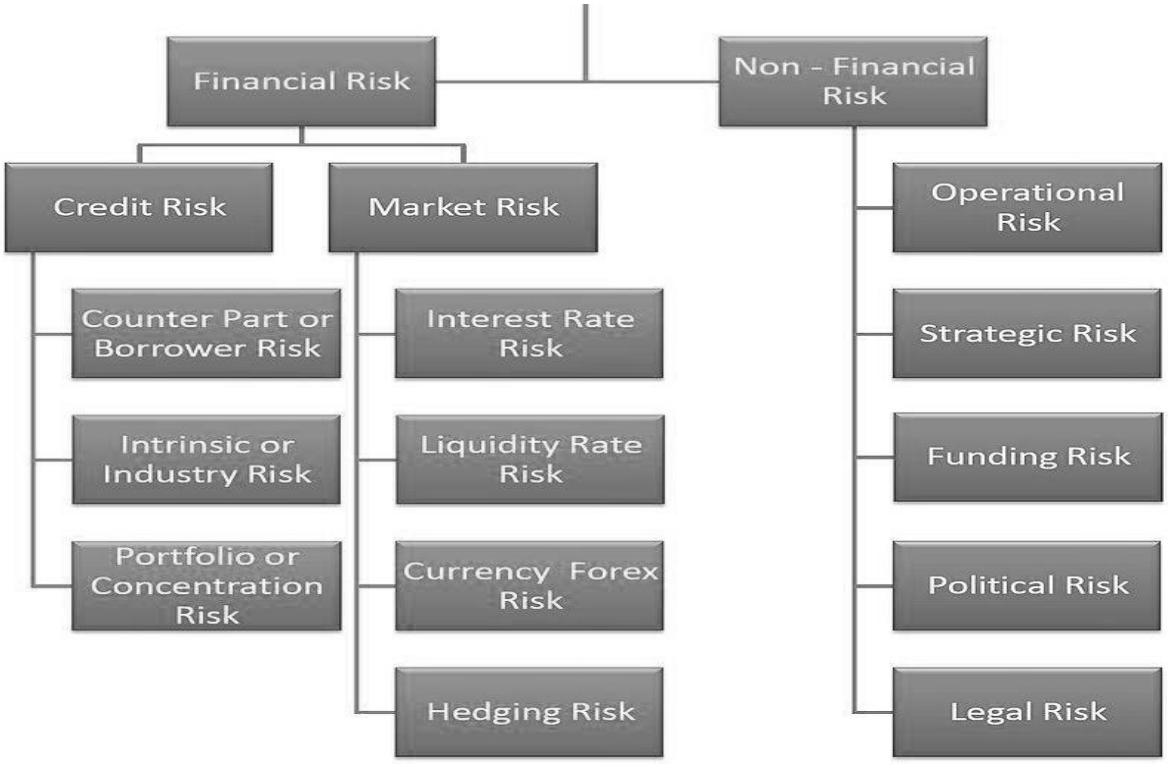
Types of Risks

Risks can be basically classified in to two types, viz. Financial and Non-Financial Risk. Financial risks would involve all those aspects which deal mainly with financial aspects of the bank.

- **Credit Risk:** It is also called as a default risk (borrower not meeting his obligations to pay instalments and or interest) It is prevalent in case of loans A credit risk is the risk of default on a debt that may arise from inability of a borrower to make required payments as per commitments. In the first resort, the risk is that of the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs. The loss may be complete or partial. In an efficient market, higher levels of credit risk will be associated with higher borrowing costs. Because of this, measures of borrowing costs such as yield spreads can be used to infer credit risk levels based on assessments by market participants. The recent episodes of Mr Nirav Modi, Vijay Mallya. are the examples of Credit / Default risk.
- **Market Risk:** It is also called price risk. Market risk is the possibility of an investor experiencing losses due to external factors that affect the overall performance of financial markets in which he or she is involved. Market risk, also called "systematic risk," cannot be eliminated through diversification, though it can be hedged against. Sources of market risk include recessions, political turmoil, changes in interest rates, natural disasters and terrorist attacks. The 2009 sub-prime crisis of US is an example in this regards. The market risk arises due to adverse movement of value of the investments / trading portfolio during the period when the securities are held by the bank. The price risk arises when investments are to be sold before their maturity.
- **Operational Risk:** This risk arises due to failed internal processes, people, system, or from external events. It includes no of risks such as - fraud, communication, documentation, competence, legal, compliance etc. However it will not include strategic risk or reputational risk. Operational risk is "the risk of a change in value caused by the fact that actual losses, incurred for inadequate or failed internal processes, people and systems, or from external events (including legal risk), differ from the expected losses". This definition, adopted by the European Union Solvency II Directive for insurers, is a variation from that adopted in the Basel II regulations for banks. In October 2014, the Basel Committee on Banking Supervision proposed a revision to its operational risk capital framework that sets out a new standardized approach to replace the basic indicator approach and the standardized approach for calculating operational risk capital, It can also include other classes of risk, such as fraud, security, privacy protection, legal risks, physical (e.g. infrastructure shutdown) or environmental risks. The study of operational risk is a broad discipline, close to good management and quality management. The behaviour of staff of Punjab National Bank, Fort Mumbai branch is an example in this regard.
- **Strategic Risk:** Strategic risks are those that arise from the fundamental / adversed decisions that directors take concerning an organisation's objectives / improper implementation od decisions. Essentially, strategic risks are the risks of failing to achieve these business objectives.
- **Reputation Risk :** It arises from negative public opinion. It may lead to litigation, financial loss or decline in customer base of a bank / institution.
- **Liquidity Risk:** A bank's inability to meet its payment obligations as and when they are demanded is known as Liquidity risk. Deposits of banks as liabilities and loans/advances as assets of the bank are the prominent items in a bank's balance sheet. Types of deposits held and the interest rates offered on them on the one hand and types of loans and advances sanctioned and interest rates charged on them on the other hand may not match. In view of this liquidity risk is encountered by the banks. It arises when bank funds long term assets by short term liabilities or short term assets by long term liabilities.
- **Political Risk:** Political risk is the risk faced by investors, corporations, and governments due to political decisions of Governments, events, or conditions. This will significantly affect the profitability of

a business or the expected value of an economic move. Political risk can be understood and managed with reasoned anticipation and investment.

- **Legal Risk:** Legal risk is the risk of financial or reputational loss that can be caused to an organization from lack of awareness or misunderstanding of, ambiguity in, or reckless indifference to, the way law and regulation apply to a business, its relationships, processes, products and services. Some of the recent examples in the Indian context are - the Auditors of Satyam Infotech Limited had to face legal risk due to a reckless action of its personnel; Nestle India, the manufacturer of Maggi noodles faced the legal risk due to faulty product produced by them.



CREDIT RISK MANAGEMENT

In recent years the banking industry, globally as well as locally, has been affected by developments that has highlighted the need to identify more sophisticated methods in Credit Risk Management and monitoring. These developments have demonstrated that the process of risk management has assumed enormous importance, in particular about the credit risk for banks.

For measurement of Credit Risk, RBI suggested banks to implement Internal Rating Based (IRB) approach from April 1, 2012.

Forms of Credit Risks

Credit risk may take the following forms**:**

- In the case of direct lending: Non payment of principal/and or interest amount.
- In the case of guarantees or letters of credit: Not meeting financial commitments by constituents on crystallization of these contingent liabilities;
- In the case of treasury operations: Default or cessation in payment or series of payments that have fallen due from the counter parties under respective contracts.

- **In the case of securities trading businesses**: Non settlement of funds/ securities.
- **In the case of cross-border exposure**: Embargo or restrictions of free transfer of foreign currency funds imposed by foreign governments. (sovereigns).

Taking Measures for Credit Risk Management

(a) Policy and Strategy

The Board of Directors of every bank is responsible for approving and periodically reviewing the credit risk strategy and significant credit risk policies.

i. Credit Risk Policy

- Every bank should have their Board of Directors ('Board') approved credit risk policy document. The document should include risk identification, risk measurement, risk grading/ aggregation techniques, reporting and risk control/ mitigation techniques, documentation, legal issues and management of problem loans.
- Such credit risk policies should also define target markets, criteria for risk acceptance, credit approval authority, credit origination/ maintenance procedures and guidelines for portfolio management.
- Board approved credit risk policies should be communicated to branches/controlling offices. All operating officials should clearly understand the bank's approach for credit sanction and should be held accountable for complying with established policies and procedures. Senior management of a bank shall be responsible for implementing such credit risk policy/policies.

ii. Credit Risk Strategy

- Each bank should develop, its own credit risk strategy or plan that establishes objectives, that guide the bank's credit-dispensing activities and adopt necessary policies/ procedures for

conducting such activities with the approval of its Board.. This strategy should identify and articulate clearly the organisation's credit appetite and the acceptable level of risk-reward trade-off for its activities.

- Such strategy should include a statement of the bank's willingness to grant loans based on the type of economic activity, geographical location, currency, market, maturity and anticipated profitability. This would essentially result in identification of target markets and business sectors, preferred levels of diversification and concentration, the cost of capital in granting credit and the cost of bad debts.
- The credit risk strategy should provide continuity in approach. It should also take into account cyclical aspects of the economy and attendant shifts in the composition/ quality of the overall credit portfolio. This strategy should be viable through various credit cycles on a long term basis.
- Senior management of a bank will be responsible for implementing the credit risk strategy approved by the Board.

(b) Organisational Structure

For a successful implementation of an effective credit risk management system, in a bank, a sound organizational structure is a pre-requisite. The organizational structure should have the following basic features:

The Board should have the overall responsibility for management of risks. The Board should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks.

In terms of RBI's directions every bank should have a **Risk Management Committee (RMC)** comprising select directors as members. It will be a Board level Sub-committee including CEO and heads of Credit, Market and Operational Risk Management Committees. It will formulate the policy and strategy for integrated risk management containing various risk exposures of the bank including the credit risk. For this purpose, RMC should effectively coordinate between the Credit Risk Management Committee (CRMC), the Asset Liability Management Committee ('**ALCO'**) and other risk committees of the bank, if any. It is imperative that the independence of this RMC is preserved and the Board should, ensure that it is not compromised at any cost. In the event of the Board not accepting any recommendation of this Committee, there should be proper systems in place to spell out the rationale for such an action and the same properly documented. This document should be made available to the internal and external auditors for their scrutiny and comments. The credit risk strategy and policies adopted by the committee should be effectively communicated throughout the bank.

Each bank may, depending upon the size of the organization or loan/ investment portfolios, constitute a high level Credit Risk Management Committee (CRMC). The Committee should be headed by the Chairman/CEO/ ED, and should comprise of heads of Credit Department, Treasury, Credit Risk Management Department (CRMD) and the Chief Economist. The scope and functions of the Credit Risk Management Committee should be as spelt out below:

- Implement of the credit risk policy/ strategy approved by the Board on a bank-wide basis.
- Monitor credit risk on a bank-wide basis and ensure compliance with limits approved by the Board.
- Recommend to the Board, clear policies on standards for presentation of credit/loan proposals, financial covenants, rating standards and benchmarks for its approval.
- Decide delegation of credit approval powers, prudential limits on large credit exposures, standards for loan collateral, portfolio management, loan review mechanism, risk concentrations, risk monitoring and evaluation, pricing of loans, provisioning, regulatory/legal compliance, etc.

Summary of RBI directive on appointing Chief Risk Officer (CRO)

As part of risk management, banks are required, inter-alia, to have a system of separation of credit risk management function from the credit sanction process. As banks follow diverse practices in this regard, to bring uniformity in approach followed by banks and to align the risk management system with the best practices, banks are advised as under:

a. Each bank to lay down a Board-approved policy clearly defining the role and responsibilities of the CRO.

b. Appointment of the CRO shall be for a fixed tenure with the approval of the Board of Directors. The CRO may be transferred/removed from his post before completion of the tenure only with the approval of the Board and such premature transfer/removal shall be reported to the Department of Banking Supervision, RBI, Mumbai. In case of listed banks, any change in incumbency of CRO shall be reported to the stock exchanges also.

c. CRO should be a senior official in the banks' hierarchy and shall have the necessary and adequate professional qualification/experience in the areas of risk management.

d. The CRO shall have direct reporting lines to the MD & CEO / Risk Management Committee (RMC) of the Board. If the CRO reports to the MD & CEO, the RMC shall meet the CRO on one-to-one basis, without the presence of the MD & CEO, at least every quarter.

e. The CRO not to have any reporting relationship with the business verticals of the bank and not be given any business targets.

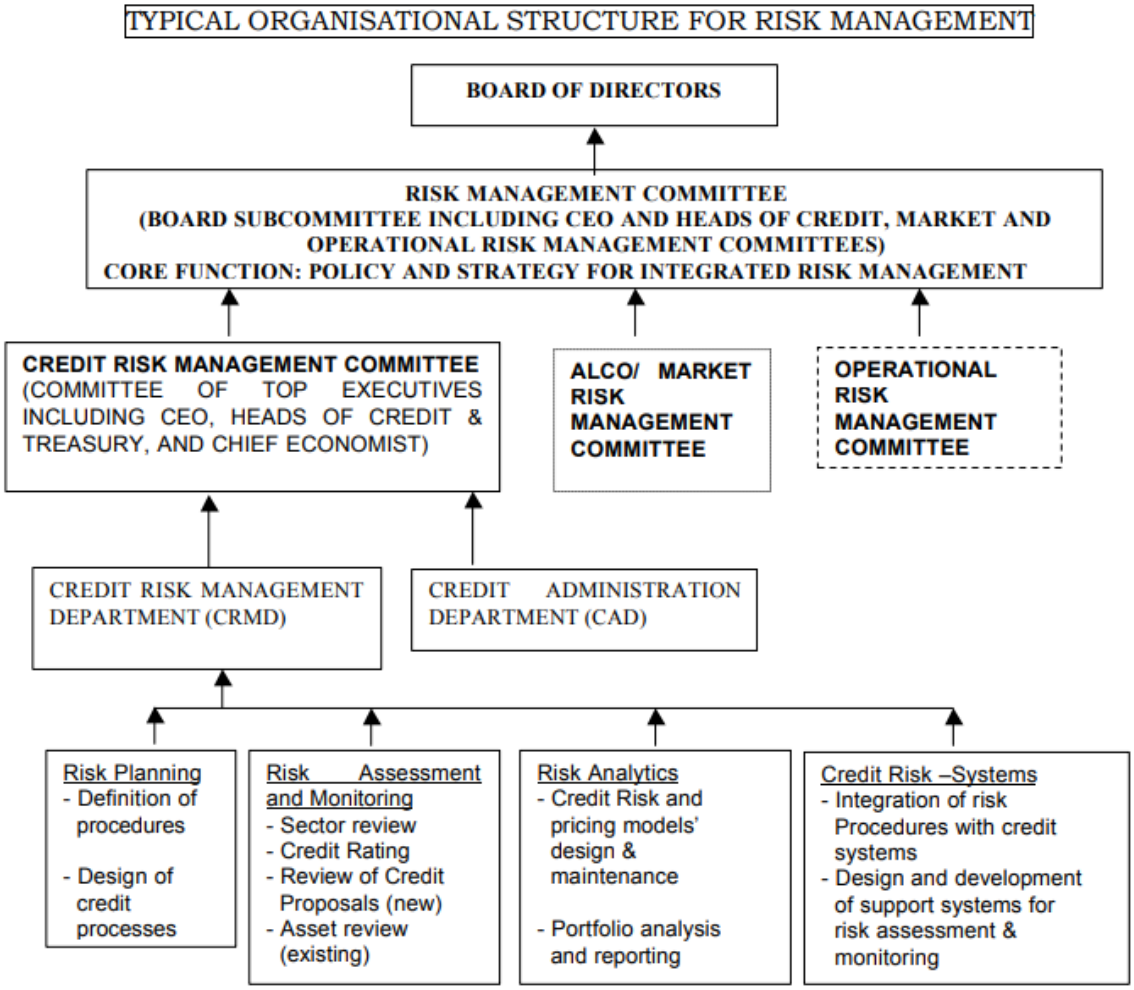
f. In case the CRO is associated with the credit sanction process, it has to be clearly spelt out whether the CRO's role would be that of an adviser or a decision maker. The policy to include the necessary safeguards to ensure the independence of the CRO.

g. In banks that follow committee approach in credit sanction process for high value proposals, if the CRO is one of the decision makers in the credit sanction process, he shall have voting power and all members who are part of the credit sanction process, shall individually and severally be liable for all the aspects, including risk perspective related to the credit proposal. If the CRO is not a part of the credit sanction process, his role will be limited to that of an adviser.

h. In banks which do not follow committee approach for sanction of high value credits, the CRO can only be an adviser in the sanction process and with no sanctioning power.

i. The CRO in his role as an adviser shall be an invitee to the credit sanction/approval committee without any voting rights in the proceedings of the committee.

j. There shall not be any 'dual hatting' i.e. the CRO shall not be given the responsibility of Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Chief of the internal audit function or any other function.



(c) Operations / Systems

For a proper risk management, banks should have the following processes in place for credit administration, credit risk measurement and monitoring. The process of credit administration essentially involves the following phases:

- Relationship management phase i.e. business development.
- Transaction management phase covering risk assessment, loan pricing, structuring facilities, internal approvals/sanctions, documentation, loan administration, on going monitoring and risk measurement.
- Portfolio management phase involves monitoring of the portfolio at a macro level and the management of problem loans.

Under the broad management framework stated above, banks should have the following credit risk measurement and monitoring procedures:

- Proactive credit risk management practices like annual / half yearly industry studies and individual payment (obligor) reviews, periodic credit calls that are documented, periodic visits of plant and business site, and at least quarterly management reviews of troubled exposures/weak credits.
- A robust system of checks and balances in place for extension of credit viz.:

  - Separation of credit risk management and credit sanction.
  - Multiple credit approvers making financial sanction subject to approvals at various stages viz. credit ratings, risk approvals, credit approval grid, etc.
  - An independent audit and risk review function.

- The level of authority required to approve credit will increase as amounts and transaction risks increase and as risk ratings worsen.
- Assigned/Specific risk rating for every borrower (obligor) and credit facility.
- Mechanism to price facilities linked to the risk grading of the customer, and to attribute accurately the associated risk weightings to the facilities.
- Consistent standards for the origination, documentation and maintenance for extensions of credit.
- Consistent approach towards early problem recognition, the classification of problem exposures, and remedial action.
- Maintain a diversified portfolio of risk assets; have a system to conduct regular portfolio analysis to ensure ongoing control of risk concentrations.
- Obligor and concentration limits by industry or geography. Proper Board authorization for efficient and effective credit approval processes for operating within the approval limits.
- Accurate, comprehensive and timely reporting of set of risk data to ensure transparency of risks taken, into the independent risk system.
- Systems and procedures for monitoring financial performance of customers and for controlling outstanding within limits.
- A conservative policy for provisioning in respect of non-performing advances may be adopted.
- A clear, well-documented scheme of delegation of powers for credit sanction.

Successful credit management requires experience, judgement and commitment to technical development. A sound MIS, which should enable them to manage and measure the credit risk inherent in all on and off balance sheet activities. The MIS should provide adequate information on the composition of the credit portfolio, including identification of any concentration of risk. Pricing of loans should be linked to the risk profile of the borrower and risks associated with loans.

Credit Risk Models

A credit risk model tries to determine, directly or indirectly, the answer to the following question: Given our past experience and our assumptions about the future, what is the present value of a given loan or fixed income security? A credit risk model would also seek to determine the (quantifiable) risk that the promised cash flows will not be forthcoming. Techniques for measuring credit risk that have evolved over the last twenty years are prompted by these questions and dynamic changes in the loan market.

The increasing importance of credit risk modelling can be attributed to the following three factors: ·

1. Banks are becoming increasingly quantitative in their treatment of credit risk.
2. New markets are emerging in credit derivatives and the marketability of existing loans is increasing through securitisation/ loan sales market.
3. Regulators are concerned to improve the current system of bank capital requirements especially as it relates to credit risk.

Credit Risk Models have assumed importance due to the fact that they provide the decision maker with insight or knowledge that would not otherwise be readily available or that could be obtained at a high cost. In a marketplace where margins are fast disappearing and the pressure to lower pricing is unrelenting, models give their users a competitive edge. Credit risk models are intended to assist banks in quantifying, aggregating and managing risk across geographical and product lines. The outputs of these models also play significant roles in banks' risk management and performance measurement processes, customer profitability analysis, risk based pricing, active portfolio management and capital structure decisions. Credit risk modelling may lead to better internal risk management and may have the potential to be used in the supervisory oversight of banking organisations.

In the measurement of credit risk, models may be classified along three different dimensions: the techniques employed, the domain of applications in the credit process and the products to which they are applied.

Techniques of Credit Risk Measurement

The following are the more commonly used techniques-

(a) Econometric Techniques such as linear and multiple discrimnant analysis, multiple regression, logic analysis and probability of default, etc.

(b) Neural networks are computer-based systems that use the same data employed in the econometric techniques but arrive at the decision model using alternative implementations of a trial and error method.

(c) Optimisation models are mathematical programming techniques that discover the optimum weights for borrower and loan attributes that minimize lender error and maximise profits.

(d) Rule-based or expert systems are characterised by a set of decision rules, a knowledge base consisting of data such as industry financial ratios, and a structured inquiry process to be used by the analyst in obtaining the data on a particular borrower.

(e) Hybrid Systems - In these systems simulation are driven in part by a direct causal relationship, the parameters of which are determined through estimation techniques.

Type of Risks in Banking Business

The major risks in the banking business as commonly referred can be broadly classified into:

- Liquidity Risk
- Interest Rate Risk
- Market Risk
- Credit or Default Risk
- Operational Risk

1. Liquidity Risk

Liquidity is capacity of a bank to fund, increase in assets as well as meet both expected and unexpected cash and collateral obligations at reasonable cost, at the same time without incurring unacceptable losses. Liquidity risk is the inability of a bank to meet such obligations as they become due, without adversely affecting the bank's financial condition. Liquidity risk management helps a bank to meet its obligations as they fall due and reduces the probability of an adverse situation developing. This assumes significance due to the fact that liquidity crisis, even at a single institution, can have systemic implications or cascading effect.

Traditionally, liquidity has been defined as the capacity of financial institutions to finance increases in their assets and comply with their liabilities as these mature. Bank liquidity has two distinct but interrelated dimensions: liability (or cash) liquidity, which refers to the ability to obtain funding from the market and asset (or market) liquidity, associated with the possibility of selling the assets. Both concepts are interrelated, and the interaction between them tends towards their mutual reinforcement.

However, under adverse conditions this dependency tends to weaken market liquidity because adverse circumstances that affect one dimension can rapidly be transferred to the other. Under normal circumstances liquidity management is basically a cost-benefit trade off, because a financial institution will be able to obtain funding provided it is willing to pay the prevailing market prices, or has the choice of selling or committing its assets. In like manner a bank can store a stock of liquid assets to ensure some liquidity (liquidity warehousing), although at the expense of smaller returns. However, in the event of a crisis specific to a bank, its access to liquidity may be found to be severely restricted because its counterparties may be unwilling to provide it neither with funds, not even providing collateral nor in exchange for high rates. In a systemic liquidity crisis it may even be impossible for the bank to place its assets on the market. The liquidity risk in banks manifest in different dimensions – (a) Funding Risk: Funding Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations. For banks, funding liquidity risk is crucial. This arises from the need to replace net out flows due to unanticipated withdrawal/ non-renewal of deposits (wholesale and retail). (b) Time Risk: Time risk arises from the need to compensate for non-receipt of expected inflows of funds i.e., performing assets turning into non-performing assets. (c) Call Risk: Call risk arises due to the crystallisation of contingent liabilities. It may also arise when a bank may not be able to undertake profitable business opportunities when it arises.

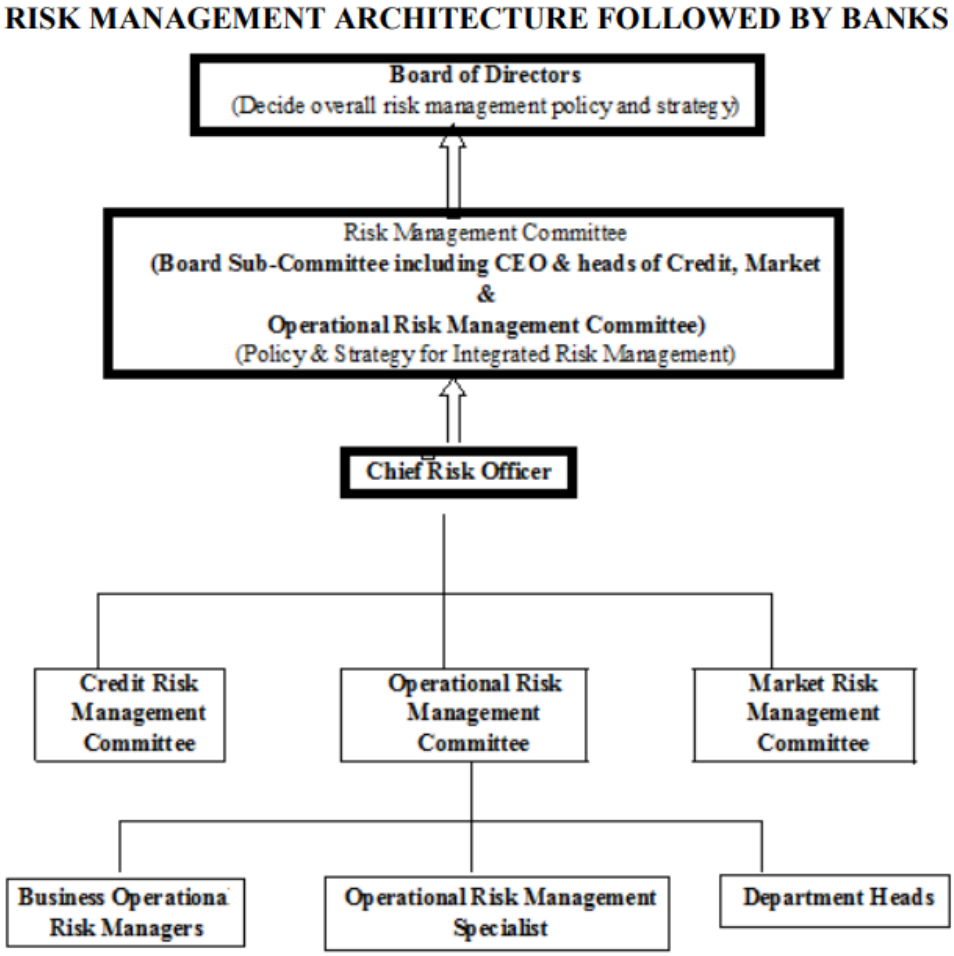
Liquidity Risk Management

The liquidity risk of banks arises from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk. For example, banks accept deposits for a maximum period of 10 years whereas they advance Housing Loans for 20 or 30 years. Liquidity risk is usually of an individual nature, but in certain situations may compromise the liquidity of the financial system. In totality, it is about a situation that is very dependent on the individual characteristics of each financial institution; defining the liquidity policy is the primary responsibility of each bank, in terms of the way it operates and its specialization. Bank Deposits generally have a much shorter contractual maturity than loans and liquidity management needs to provide a cushion to cover anticipated deposit withdrawals. Liquidity is the ability to efficiently accommodate deposit as also reduction in liabilities and to fund the loan growth and possible funding of the off-balance sheet claims. The cash flows are placed in different time buckets based on future likely behaviour of assets, liabilities and off-balance sheet items. The liquidity risk is closely linked to other dimensions of the financial structure of the financial institution, like the interest rate and market risks, its profitability, and solvency etc. The interest rate risk that results from mismatches of maturities or the dates for interest rate adjustments may appear as either market or refinancing (and/or reinvestment) risk. Also, as it operates to transform maturities, subject to these risks, the bank collects a yield that is related to its profitability. Having a larger amount of liquid assets or improving the matching of asset and liability flows reduces the liquidity risk, but also its profitability. This relationship also operates in the opposite direction as explained below. Loans in an irregular situation will impact jointly

on profitability and liquidity, as the expected cash flows do not appear. In addition, there is a relationship with solvency- more capital reduces liquidity creation, but allows for more strength to face financial crises.

Liquidity risk can be further segmented into funding liquidity risk and asset liquidity risk. Asset liquidity risk means the incurring a loss due to inability to effect a transaction at current market prices due to either relative position size or a temporary drying up of markets. Having to sell in such circumstances can result in signifi cant losses. Funding liquidity risk means risk of incurring loss if an institution is unable to meet its cash needs. This can create various problems, such as failure to meet margin calls or capital withdrawal requests, comply with collateral requirements or achieve rollover of debt. These problems may force an institution to liquidate assets; in such a case, asset liquidity and funding liquidity risks may combine if the institution is forced to sell illiquid assets at fire- between falling prices (resulting in margin calls) and additional rounds of forced selling. In the case of asset liquidity risk, it can be managed through controlling concentrations and relative market sizes of portfolios. Similarly funding liquidity risk can be managed through diversification, securing credit lines or other back-up funding, and limiting cash flow gaps. In such a situation, if portfolio leverage is high, the forced selling may create a positive feedback loop between falling prices (resulting in margin calls) and additional rounds of forced selling.

Risk Management Architecture



At the apex level, there is the Supervisory Committee of Directors on Risk Management, which is a Board level Committee and oversees the Risk Management functioning of the Bank. This followed by the Executive level Committees such as Asset Liability Management. Committee (ALCO) for Market Risk, Credit Risk Management

Committee for Credit Risk and Operational Risk Management Committee for Operational Risk function at the Bank. These Committees meet regularly to supervise and monitor the risks in various areas on an ongoing basis. Some Banks have appointed Consultants for advising and assisting the Management in implementing the Risk Management Systems and making them Basel compliant. The shift from transaction based supervision to Risk based Supervision was necessitated due to the complexity of modern times. The most important of the risks viz., Credit Risk, Market Risks (Interest Rate Risk, Foreign Exchange Risk and Liquidity Risk), Operational risk (People Risk, Control Risk, IT Risk, Legal/Regulatory Risk and Reputational Risk) need skillful planning and careful handling by the Banks.

The Supervisory mechanism too needs to upgrade their skills for prompt detection of the failure of the Risk Management systems. RBI has been directing the banks on setting up proper Risk Management Systems in Banks. It is to the credit of the Indian Regulatory Agencies like the RBI, Securities Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) that the Indian Financial System remained comparatively unscathed despite the catastrophic failures of the financial systems elsewhere in the world.

Liquidity risk management in banks is defined as the risk of being unable either to meet their obligations to depositors or to fund increases in assets as they fall due without incurring unacceptable costs or losses. This risk occurs when the depositors collectively decide to withdraw more funds than the bank immediately has on hand, or when the borrowers fail to meet their financial obligation to the banks. In other words, liquidity risk occurs in two cases. Firstly, it arises symmetrically to the borrowers in their relationship with the banks, for example when the banks decide to terminate the loans but the borrowers cannot afford it. Secondly, it arises in the context of the banks' relationships with their depositors, for example, when the depositors decide to redeem their deposits but the banks cannot afford it. In practice, the banks regularly find imbalances (gaps) between the asset and the liability side that need to be equalized because, by nature, banks accept liquid liabilities but invest in illiquid. If a bank fails to balance such a gap, liquidity risk might occur, followed by some undesirable consequences such as insolvency risk, government bailout risk, and reputation risk. The failure or inefficiency of liquidity management is caused by the strength of liquidity pressure, the preparation of a bank's liquid instruments, the bank's condition at the time of liquidity pressure, and the inability of the bank to find internal or external liquid sources.

Liquidity risk can be managed by putting in place certain prudential limits to avoid liquidity crisis:

1. Cap on inter-bank borrowings, especially call borrowings;
2. Purchased funds vis-à-vis liquid assets;
3. Core deposits vis-à-vis Core Assets i.e. Cash Reserve Ratio, Liquidity Reserve Ratio and Loans;
4. Duration of liabilities and investment portfolio;
5. Maximum Cumulative Outflows. Banks should fix cumulative mismatches across all time bands;
6. Commitment Ratio – track the total commitments given to Corporates/banks and other financial institutions to limit the off-balance sheet exposure;
7. Swapped Funds Ratio, i.e. extent of Indian Rupees raised out of foreign currency

2. Interest Rate Risk

Interest Rate Risk arises when the Net Interest Margin or the Market Value of Equity (MVE) of an institution is affected due to changes in the interest rates. IRR can be viewed in two ways – its impact is on the earnings of the bank or its impact on the economic value of the bank's assets, liabilities and Off-Balance Sheet (OBS) positions. Interest rate Risk can take different forms.

3. Market Risk

The risk of adverse deviations of the mark-to-market value of the trading portfolio, due to market movements, during the period required to liquidate the transactions is termed as Market Risk. This risk results from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities, and currencies. It is also referred to as Price Risk.

Market Risk Management

Market risk is the risk of price fluctuation of a financial instrument, as a result of market price changes, irrespective of whether these changes are caused by factors typical for individual instruments or their issuer (counterparty), or by factors pertaining to all the instruments traded on the market.

The four most common factors connected with market risk are

1. Interest rates;
2. Currency exchange rates;
3. Costs of investments in trade portfolio (regardless of the instruments' character – debt or capital);
4. Prices of exchange commodities and other market variables related to the bank's activity.

The market risk pertaining to both individual and portfolio instruments can be a function of one or more or mix of all these factors, and in many cases it can be very complex inter-play of all these factors. In general, market risk can be defined as a risk arising from market movements – of prices, interest rates and currency exchange rates. The policy for market risk control and management should be aligned to several objectives as below:

- to protect the bank against unexpected losses and to maintain income stability via independent identification, assessment and understanding of business market risks;
- to contribute in bringing the bank's organizational structure and management process in line with the best international practices and to set minimum standards for market risks control;
- to create transparent, objective and consistent information system of the market risks as a base for reasonable decision-making;
- to establish a structure that will help the bank to realize the connection between the business strategy and the operations on one hand, and between the purposes of risk control and monitoring, on the other.

The admissible threshold of market risk is the amount of potential unexpected loss which the bank is willing to assume because of unexpected and unfavourable changes in the market factors without damaging its financial stability. The bank's ability to counter losses caused by market risk depends on its capital and reserves, on the potential losses originating from other non-market risks and on the regulatory capital required for maintaining the business activity. Risk monitoring is fundamental for effective management process. That is the reason why the banking institutions should have adequate internal reporting systems reflecting their exposure to market risk. Sufficiently detailed regular reports should be submitted to the top management and to the various management levels.

Types of Market Risk

1. Interest rate risk

Interest rate risk is the probability that variations in the interest rates will have a negative influence on the quality of a given financial instrument or portfolio, as well as on the institution's condition as a whole. Assuming that risk is a normal aspect of the bank's activity, it can be an important source of profit and share value. However, excessive interest rate risk can significantly jeopardize the bank's income streams and capital base. Variations

in the interest rates influence the bank's incomes and change its net interest revenues and the level of other interest-sensitive earnings and operative costs. Interest rate variations also affect the basic value of the bank's assets, liabilities and off-balance instruments, because the present value of the future cash flows (and in some cases the cash flows themselves) alters when interest rates change. Interest rates variations can also influence the level of credit risk and the ability to retain the attracted resources. The effective interest risk management keeps risk within reasonable limits is of vital importance for bank stability.

2. Currency risk

Currency risk is the risk where the fair value or future cash flows of a given financial instrument fluctuate as a result from changes in the currency exchange rates. Currency exchange rates can be subject to big and unexpected changes, and understanding and managing of the risk related to the currency exchange rates' volatility can be very complicated. Although it is important to acknowledge that currency exchange rates are definitely a market risk factor, the currency instruments' valuation usually requires knowledge about the behaviour of both spot currency exchange rates and interest rates. Each forward premium or value discount of a given foreign currency against the local one is determined to a great extent by the relative interest rates on the two national markets. Like all market risks, the currency risk evolves from both open and improperly balanced or hedged positions. The imperfect correlations between the currencies and the international interest markets put forward concrete challenges to the efficiency of the hedging currency strategies.

3. Price risk

Price risk occurs when the fair value or future cash flows of capital and debt financial instruments (stocks, bonds, indexes and derivatives connected with them) fluctuate as a result from market prices' changes, no matter whether these changes are caused by factors typical for individual instruments or for their issuer (counterparty), or by factors related to all the instruments traded on the market. The risk connected with the commodity exchange prices is the probability of unfavourable changes in the value of commodities traded by the bank. Price risks associated with commodities differ significantly from interest rate and currency risks, and require careful monitoring and management as most of the commodities are traded on markets where the supply concentration can increase the price volatility. What is more, changes in the market liquidity are often accompanied by significant price volatility. It is because of this commodities' prices are in broad lines more unstable than those of most financial assets commonly traded. The risk assessment associated with commodities prices should be performed market by market and it should include not only analysis of historical price movements, but also assessment of the supply and demand structure on the market, so that the probability for unusually large price movements can be assessed.

4. Default or Credit Risk

Credit risk is more simply defined as the potential of a bank borrower or counterparty to fail to meet its obligations in accordance with the agreed terms. For most banks, loans are the largest and most obvious source of credit risk. It is the most significant risk, more so in the Indian scenario where the NPA level of the banking system is significantly high.

Now, let's discuss the two variants of credit risk –

(a) Counterparty Risk: This is a variant of Credit risk and is related to non-performance of the trading partners due to counterparty's refusal and or inability to perform. The counterparty risk is generally viewed as a transient financial risk associated with trading rather than standard credit risk.

(b) Country Risk: This is also a type of credit risk where non-performance of a borrower or counterparty arises due to constraints or restrictions imposed by a country. Here, the reason of non-performance is external factors on which the borrower or the counterparty has no control Credit Risk depends on both external and internal factors.

The internal factors include Deficiency in credit policy and administration of loan portfolio, Deficiency in appraising borrower's financial position prior to lending, Excessive dependence on collaterals and Bank's failure in post sanction follow-up, etc.

The major external factors are the state of Economy, Swings in commodity price, foreign exchange rates and interest rates, etc.

Credit Risk can't be avoided but can be mitigated by applying various risk-mitigating processes – Banks should assess the credit-worthiness of the borrower before sanctioning loan i.e., the Credit rating of the borrower should be done beforehand. Credit rating is the main tool for measuring credit risk and it also facilitates pricing the loan.

By applying a regular evaluation and rating system of all investment opportunities, banks can reduce its credit risk as it can get vital information of the inherent weaknesses of the account.

Banks should fix prudential limits on various aspects of credit – benchmarking Current Ratio, Debt-Equity Ratio,

Debt Service Coverage Ratio, Profitability Ratio etc.

There should be maximum limit exposure for single/ group borrower.

There should be provision for flexibility to allow variations for very special circumstances.

Alertness on the part of operating staff at all stages of credit dispensation – appraisal, disbursement, review/ renewal, post-sanction follow-up can also be useful for avoiding credit risk.

5. Operational Risk Management

What is operational risk?

It is the risk of loss resulting from inadequate or failed internal processes of an organization, in human actions, systems or due to external events. Authors on the subject agree that problems related to operational risks arise because of inadequate attention given to the processes and systems, or because people fail in their performance, or their functions are poorly clarified. Operational risks are diffi cult to defi ne because of the broad spectrum of potential loss events, it covers. According to the segment where the company acts, this may be subject to various operational risks inherent to the business.

Definition of operational risk has evolved rapidly over the past few years. Operational risk has been defined by the Basel Committee on Banking Supervision as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. This definition is based on the underlying causes of operational risk. It seeks to identify why a loss happened and at the broadest level includes the breakdown by four causes: people, processes, systems and external factors.

Likely forms of manifestation of operational risk

A clear appreciation and understanding by banks of what is meant by operational risk is critical to the effective management and control of this risk category. It is also important to consider the full range of material operational risks facing the bank and capture all significant causes of severe operational losses. Operational risk is pervasive, complex and dynamic. Unlike market and credit risk, which tend to be in specific areas of business, operational risk encompasses in all business processes. It is also inherent in all operations. It may manifest in a variety of ways in the banking industry. The examples of operational risks listed at paragraph above can be considered as illustrative.

The Basel Committee has identified the following types of operational risk events as having the potential to result in substantial losses:

- Internal fraud. Examples - Intentional misreporting of positions, employee theft, and insider trading on an employee's own account.
- External fraud. Examples - Robbery, forgery, cheque kiting, and damage from computer hacking.
- Employment practices and workplace safety. Examples - Workers compensation claims, violation of employee health and safety rules, organised labour activities, discrimination claims, and general liability.
- Clients, products and business practices. Examples - Fiduciary breaches, misuse of confidential customer information, improper trading activities on the bank's account, money laundering, and sale of unauthorised products.
- Damage to physical assets. Examples - Terrorism, vandalism, earthquakes, fires and floods.
- Business disruption and system failures. Examples - Computer hardware and software failures,telecommunication problems, and utility outages.
- Execution, delivery and process management. Examples - Data entry errors, collateral management failures, incomplete legal documentation, and unauthorized access given to client accounts, non-client counterparty under performance/non-performance and vendor disputes.

Monitoring of Operational Risk

- An effective monitoring process is essential for adequately managing operational risk. Regular monitoring activities can offer the advantage of quick detection and correction of deficiencies in the policies, processes and procedures for managing operational risk. Promptly detecting and addressing these deficiencies can substantially reduce the potential frequency and/or severity of a loss event.
- In addition to monitoring operational loss events, banks should identify appropriate indicators that provide early warning of an increased risk of future losses. Such indicators (often referred to as early warning indicators) should be forward-looking and could reflect potential sources of operational risk such as rapid growth, introduction of new products, employee turnover, transaction breaks, system downtime, and so on.
- When thresholds are directly linked to these indicators, an effective monitoring process can help identify key material risks in a transparent manner and enable the bank to act upon these risks appropriately.

6. Other Risks

Apart from the above-mentioned risks, following are the other risks confronted by Banks in course of their business operations –

(a) Strategic Risk: Strategic Risk is the risk arising from adverse business decisions, improper implementation of decisions or lack of responsiveness to industry changes.

(b) Reputation Risk: Reputation Risk is the risk arising from negative public opinion. This risk may expose the institution to litigation, financial loss or decline in customer base.

(c) `Systematic Risk: It is a risk inherent to the entire market segment and is not sector specific it is also known as undiversifiable risk.

(d) Unsystematic Risk: It is kind of specific risk which comes with the industry you invest in also referred to diversifiable risk.

Risk Management is actually a combination of management of uncertainty, risk, equivocality and error.

Uncertainty – where the outcomes cannot be estimated even randomly, arises due to lack of information and this

uncertainty gets transformed into risk (where the estimation of outcome is possible) as information gathering progresses.

Initially, the Indian banks have used risk control systems that kept pace with legal environment and Indian accounting standards. But with the growing pace of deregulation and associated changes in the customer's behaviour, banks are exposed to mark-to-market accounting.

Therefore, the challenge of Indian banks is to establish a coherent framework for measuring and managing risk consistent with corporate goals and responsive to the developments in the market. As the market is dynamic, banks should maintain vigil on the convergence of regulatory frameworks in the country, changes in the International accounting standards and fially and most importantly changes in the clients' business practices.

ROLE OF RBI IN RISK MANAGEMENT IN BANKS

Here, we will discuss the role of RBI in Risk Management and how the tools called CAMELS was used by RBI to evaluate the financial soundness of the Banks. CAMELS is the collective tool of six components namely

- Capital Adequacy
- Asset Quality
- Management (Effectiveness)
- Earnings Quality
- Liquidity (asset-liability management)
- Sensitivity to Market risk

Ratings are given from 1 (best) to 5 (worst) point scale of A to E in each of the above categories. Each of these components is weighed on a scale of 1 to 100 and contains several sub parameters with individual weightages.

A – basically sound in every respect.

B – Fundamentally sound but with moderate weakness.

C – Financial, operational, compliance weaknesses that give cause for supervisory concern.

D – Serious finance, operational and managerial weaknesses that could impair future viability.

E – Critical financial weaknesses that render the possibility of failure high in near future.

In India, for supervision (inspection) of banks an extended framework is used which is names – C A M E L S C where the alphabets C A M E L stand for what is mentioned above but S means System (like Management Information System – MIS) and C mean Compliance to various rules, regulations Acts etc.

The CAMEL was recommended for the financial soundness of a bank in 1988 while the sixth component called sensitivity to market risk (S) was added to CAMEL in 1997.

In India, the focus of the statutory regulation of commercial banks by RBI until the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements.

RBI in 1999 recognised the need for an appropriate risk management and issued guidelines to banks regarding assets liability management, management of credit, market and operational risks. The entire supervisory mechanism has been realigned since 1994 under the directions of a newly constituted Board for Financial Supervision (BFS), which functions under the aegis of the RBI, to suit the demanding needs of a strong and stable financial system. A process of rating of banks on the basis of CAMELS in respect of Indian banks and CACS (Capital, Asset Quality, Compliance and Systems & Control) in respect of foreign banks has been put in place from 1999.

Prompt Corrective Action – 2017

The existing framework was revised b RBI and made effective based on bank financials for the year ended March 2017. It would be reviewed after 3 years.

- Capital, asset quality, and profitability shall be the key areas for monitoring.
- Indicators to tracked are CRAR / CET – I ratio, Net NPA and Return on Assets – respectively.
- In addition, leverage would be monitored,
- Breach of any risk threshold as under would result in invocation of PCA
- The framework would apply to all banks operating in India.
- A bank will be placed under PCA framework based on audited Annual Financial Results and the Supervisory Assessment made by RBI.

Risk Threshold 1:

- Restriction on dividend distribution / remittance of profit
- Promoters / owners / parent in case of foreign banks to bring in capital

Risk Threshold 2: (addition to 1 above)

- Restriction on branch expansion.
- Higher provisions as a part of coverage regime

Risk Threshold 3: (addition to 1 and 2)

Restriction on management compensation and director's fees as applicable

Reporting of Banking Risk

The frequency of monitoring should reflect the risks involved and the frequency and nature of changes in the operating environment. Monitoring should be an integral part of a bank's activities. The results of these monitoring activities should be included in regular management and Board reports, as should compliance reviews performed by the internal audit and/or risk management functions. Reports generated by (and/or for) intermediate supervisory authorities may also inform the corporate monitoring unit which should likewise be reported internally to senior management and the Board, where appropriate. Senior management should receive regular reports from appropriate areas such as business units, group functions, the operational risk management unit and internal audit. The operational risk reports should contain internal financial, operational, and compliance data, as well as external market information about events and conditions that are relevant to decision making. Reports should be sent to appropriate levels of management and to areas of the bank on which areas of concern may have an impact. Reports should fully reflect any identified problem areas and should motivate timely corrective action on outstanding issues. To ensure the usefulness and reliability of these risk reports and audit reports, management should regularly verify the timeliness, accuracy, and relevance of reporting systems and internal controls in general. Management may also use reports prepared by external sources (auditors, supervisors) to assess the usefulness and reliability of internal reports. Reports should be analysed with a view to improving existing risk management performance as well as developing new risk management policies, procedures and practices.

Management information systems

Banks should implement a process to regularly monitor operational risk profi les and material exposures to losses. There should be regular reporting of pertinent information to senior management and the Board of Directors that supports the proactive management of operational risk. In general, the Board of Directors should

receive sufficient higher-level information to enable them to understand the bank's overall operational risk profile and focus on the material and strategic implications for the business. Towards this end it would be relevant to identify all activities and all loss events in a bank under well defined business lines.

RISK-ADJUSTED PERFORMANCE MEASUREMENT

Risk-adjusted performance Measurement consists of a set of concepts. Those concepts may vary in detail depending on the context they are used in. However, all risk adjusted performance measures have one thing in common: they compare the return on capital to the risk taken to earn this return – i.e. some kind of risk adjustment is adopted.

Generally speaking, return in risk-adjusted performance measures is measured either by absolute returns or by relative returns (i.e. excess returns), whereas disagreement prevails in literature on how exactly risk should be taken into account. This has given rise to the development of a considerable number of alternative risk adjusted performance measures. Thus, risk-adjusted performance measures can take many forms as shall be shown in the following chapters. In the past, risk-adjusted performance measures have gained great importance. The first reason for this development is the emergence of investment funds as an important investment category. Investors needed an effective tool to evaluate the respective performance of the various funds compared to the risk taken by the fund managers to choose the right option for capital allocation

The second reason is the introduction of the Basel II regulatory framework, which requires financial institutions to hold a certain amount of equity as a cushion against unexpected losses for each risky position taken. As a result financial institutions have a great interest in efficiently allocating capital not only according to the resulting return but also to the risk shouldered.

BASEL I, II AND III ACCORDS

Basel I

Since late 1970s, internationally several banks had experienced deterioration in their asset quality. More than 75% of IMF member countries were among them. Since assets have a direct linkage with profitability levels, the banking sector stability started suffering. In short credit risk was the trigger of the stability problems of banks. This in turn led to the question of stability and survival of banks. This problem engaged the attention of Bank of International Settlements (BIS) an apex body of Central banks in the world. A series of deliberations led to The Basel Capital Accord in 1988 proposed by Basel Committee of Bank Supervision (BCBS) which is a part of BIS.

The deliberation of BCBS focused on credit risk and prescribed a minimum capital risk adjusted ratio (CRAR) of 8%.of risk weighted assets. Although it was originally meant for banks in G10 countries, it was adopted by more than 100 countries. This accord was known as Basel I, named after the town in Switzerland where BIS is based. As was expected Basel I covered the credit risk and its standards prescribed minimum capital in terms risk weighted assets. It can be said the focus of Basel I was on capital and risk weighted assets.

India being a member of BIS since its inception, RBI had prescribed capital adequacy norms for the Indian banks in 1992. It was also the year in which NPA norms were introduced in India. Banks were asked to identify their Tier I and Tier-II capital and assign risk weights to the assets followed by an assessment of their Capital to Risk Weighted Assets Ratio (CRAR).

According to Basel 1 norms Capital (known as regulatory capital) is derived as a sum of Tier I and Tier II capital which a bank is required to maintain in relation to its risk-weighted assets. Under both Basel I (also later under Basel II), the regulatory definition of capital is comprised of three levels (or 'tiers') of capital. Tier 1 Capital (also called 'core capital') has only those elements which have the highest capacity for absorbing losses on an ongoing basis. Tier 2 Capital (also known as 'supplementary capital') is made up a mix of near equity components and hybrid capital/debt instruments, the total of which is restricted to 100 per cent of Tier 1 Capital. It is further divided into two categories: (i) Upper Tier 2 consisting of items very close to common equity, like

perpetual subordinated debt; (ii) Lower Tier 2 consisting of items close to debt. It also includes various types of reserves whose values and/or availability are more uncertain than disclosed reserves. Tier 3 Capital (or 'additional supplementary capital') was added in 1996 and can only be used to meet capital requirements for market risk.

Tier-I Capital of banks in India consisted of

- Paid-up capital
- Statutory Reserves
- Disclosed free reserves
- Capital reserves representing surplus arising out of sale proceeds of assets [Equity investments in subsidiaries, intangible assets and losses in the current period and those brought forward from previous periods will be deducted from Tier I capital].

Elements of Additional Tier -I (AT – I) Capital (After making regulatory adjustments / deductions from total of 1 to 4 below)

1. PNCPS (Perpetual Non-Cumulative Preference Shares) which comply with regulatory requirements.
2. Share premium resulting from issue of instrumets.
3. Debt Capital instruments, complying with regulatory requirements.
4. Any other instruments as notified by RBI

Tier-II Capital

- Undisclosed Reserves and Cumulative Perpetual Preference Shares
- Revaluation Reserves
- General Provisions and Loss Reserves

Risk weighting

Additionally BCBS Committee recommended a weighted risk ratio in which capital is linked with different categories of asset or off-balance-sheet exposure. The weighs were according to perceived broad categories of relative risk of each asset class as the preferred method for assessing the capital adequacy. The risk weighted approach was chosen over simple gearing ratio approach due to "(i) it provides a fairer basis for making international comparisons between banking systems whose structures may differ; (ii) it allows off-balance-sheet exposures to be incorporated more easily into the measure; (iii) it does not deter banks from holding liquid or other assets which carry low risk."

The following table provides Asset class and Risk weights according to BCBS

Asset Class	Risk Weights
• Cash held Claims on OECD central governments • Claims on central governments in national currency	0%

• Cash to be received • Claims on OECD banks and regulated securities firms • Claims on non-OECD banks below 1 year • Claims on multilateral development banks • Claims on foreign OECD public-sector entities	20%
• Residential mortgage loans	50%
• Claims on the private sector (corporate debt, equity, etc.) • Claims on non-OECD banks above 1 year • Real estate • Plant and Equipment	100%
Source: Basel Committee on Banking Supervision (2005)	

As seen above in the table according to the Basel I norms, assets were divided in to four groups in terms of risk weights (0%, 20%, 50% and 100%) according to the obligor category. Also off-balance sheet items also were required to be converted in to notional credit equivalent by multiplying then with assigned conversion factor and again multiplied by risk weights for consideration of capital charge.

The following table gives Credit conversion factors of various off-balance sheet items.

Credit Conversion Factors for Off-Balance Sheet Items		
Instruments		**Credit Conversion Factors (Per cent)**
1.	Direct credit substitutes, for example, general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances)	100
2.	Certain transaction-related contingent items (for example, performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions)	50
3.	Short-term self-liquidating trade-related contingencies (such as documentary credits collateralised by the underlying shipments)	20
4.	Sale and repurchase agreements and asset sales with recourse, where the credit risk remains with the bank	100
5.	Forward asset purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown	100
6.	Note issuance facilities and revolving underwriting facilities	50
7.	Other commitments (for example, formal standby facilities and credit lines) with an original maturity of over one year	50

8.	Similar commitments with an original maturity of up to one year, or which can be unconditionally cancelled at any time	0

Additionally RBI as RBI wanted to strengthen capital position of banks advised them to increase the quantum of reserve fund transfer from profits, from the existing statutory level of 20% to 25% or 30% wherever possible. RBI had also issued directions to achieve CRAR of 8 per cent for foreign banks operating in India by March 1993; for Indian banks with branches abroad by March 1995 and for the rest to achieve a capital adequacy norm of 4 per cent by March 1993 and the 8 per cent norm by March 1996. In its Credit Policy statement in October 1998, RBI directed all banks to achieve this level by March 31, 2009. In terms of amendment of Basel I norms in 1996 RBI announced capital charges such as investment fluctuation reserve of 5 per cent of the bank‘s portfolio and a 2.5 per cent risk weight on the entire portfolio for these risks between 2000 and 2002. All categories of banks reached a CRAR level of 10% or more in March 2006, signifying a healthier state of banking industry with respect to capital adequacy norms. Yet the Government had to supplement infusion of equity capital in respect of several banks during that period. Additionally these banks raised capital from markets through IPOs, to comply with capital adequacy norms.

Advantages and Disadvantages of Basel I norm

Basel 1 norms had their advantages as well as disadvantages. Advantages were discipline in managing capital, level playing field in competition among peer banks and the structure was simple. However these norms had certain weaknesses also such as it hard considered only credit risk/market risks (though there are many others risks a bank faces); market values were ignored in preference to book values; made no differentiation between different classes of debtors among others. These were addressed by an amendment in 1996 and the amended norms were brought for implementation.

The 1988 accord was amended in 1996. Under this frame work BCBS by removing trading positions in bonds, equities, foreign exchange and commodities from the credit risk framework and gave capital charges related to the bank’s open position for each. Essentially this introduced the element of market risk as a factor to be considered for arriving at capital adequacy standards. The main purpose was to ensure “more level playing field” by ensuring banks build business volume with adequate capital.

Basel II

In June 2004, BCBS announced a revised frame work of capital adequacy norms titled as “International Convergence of Capital Measurement and Capital Standards: A revised Framework”- commonly known as Basel II Accord. Basel II took cognizance of, Operational Risk apart from apart from Credit & Market Risk in computing Capital Adequacy Ratio.

In essence Basel II accord is based on the following norms. They are known as three Pillars structure as depicted in the following table:

Pillar I	Pillar II	Pillar III
Minimum Regulatory Capital ● Credit Risk ● Market Risk ● Operational Risk	Supervisory Review Process	Market Discipline

Pillar 1: Minimum Regulatory Capital

The calculation of Minimum Regulatory Capital included operational risk also apart from Credit risk and Market risk. Basel 1 and Basel II differed in Risk Weighted Assets calculation.

Under Basel 2, calculation of Capital to Risk (Weighted) Asset Ratio (CRAR), the formulae are similar to Basel 1.

$$\text{Total CRAR} = \frac{\text{[Eligible total capital funds]}}{\text{[Credit RWA + Market RWA + Operational RWA]}} \times 100$$

$$\text{Tier I CRAR} = \frac{\text{[Eligible Tier I capital funds]}}{\text{[Credit RWA* + Market RWA + Operational RWA]}} \times 100$$

BCBS had recommended at least 8% CRAR and 4% for Tier 1 CRAR signifying core capital should be at least 50% of total CRAR. However in India RBI stipulated a stringent higher level of overall CRAR of 9% and Tier 1 CRAR of 6%.

It can be seen that CRAR is supported by 1.Eligible Capital Funds (Core capital) 2. Risk Weighted Assets (Additional or Supporting) capital.

The components that formed Tier 1 & Tier 2 capital of banks are as follows:

Tier I Capital items	Tier II Capital items
1. Paid up Capital, Statutory Reserves, disclosed free reserves	1. Revaluation Reserve (at a discount of 55%)
2.Capital Reserve (E.g. Surplus from sales of assets)	2. General Provision & Loss Reserves
3. Eligible Innovative Perpetual Debt Instruments(IPDI)- up to 15% of Tier 1 Capital	3. Hybrid Debt Capital Instruments: E.g. Perpetual Cumulative Preference Shares, Redeemable Non-Cumulative Preference Share, Redeemable Cumulative Preference Share
4. Perpetual Non-Cumulative Preference Shares (PNPS) - 3 & 4 can be max 40% of Tier1	4. Subordinate Debt: fully paid up, unsecured, subordinated to other creditors, free of restrictive clauses
	5. Remaining IPDI & PNPS from Tier1 Capital (i.e. Surplus)

Risk Weighted Assets:

Another Important dimension in calculation of CRAR is Risk weighted assets. Basel II seems to give an advantage for banks with better asset quality as it reduces capital requirements which in turn results assigning of lesser weights. In this regard RBI has suggested options for arriving at risk weighted assets. These are as follows:

Risks Approaches	Credit Risk	Market Risk	Operational Risk
1*	Standardised Approach	Standardized Approach Internal Model Approach	Basic Indicator Approach
2**	Foundation Internal Rating Based Approach	Advanced Internal Rating Based Approach	Standardized Approach
3***	Advanced Internal Rating Based Approach	_	Advanced Measurement Approach

* Represents Simple method,

** Intermediate method,

*** Sophisticated & Advanced method.

Credit Risk Assessment: Under Basel II BCBS had devised three approaches for calculation of credit risk weighted assets:

1. Standardized Approach to Credit Risk: The standardized approach has fixed risk weights which vary from 0 to 150%, corresponding to various risk categories based on ratings of approved external credit rating agencies. Loans which are unrated carry 100% risk weight. This approach has widened risk sensitivity by taking in to account a broad range of collateral, guarantees and credit derivatives. The residential mortgage exposure carries a lesser risk weight vis-a –vis Basel I.

2. Foundation Internal Rating Based Approach: credit risk under this approach is based on internal ratings of a bank instead of external credit rating agencies. The ratings correspond to risk characteristics of borrower and the transaction. Expected loss arrived at based on Probability of Default (PD) of borrower, Loss Given Default (LGD), Bank's Exposure at Default (EAD) and remaining Maturity (M) of exposure.

- Probability of Default is a measure of (PD) the likelihood that a borrowers default over a time horizon.
- Loss Given Default (LGD) computes the proportion of the exposure that will be lost if Default occurs.
- Exposure at Default (EAD) give an estimate of loan amount outstanding at the time of default.
- Maturity (M) measures the remaining economic maturity of the exposure.

Parameters PD, LGD, EAD and are useful in calculating types of losses.

Types of losses can be classified in to two categories - Expected loss and Unexpected loss. Expected Loss (PL), is a normal business risk of a bank, can be found by multiplying PD, LGD, EAD and M.

Expected Loss (EL)= PD X LGD X EAD X M

Unexpected Loss (UL) is an inherent part of credit risk which for which pricing cannot be done and therefore banks are required to provide capital for the same through risk weighing their assets. Unexpected Loss is an upward variable of expected loss over a specified time horizon. It can be calculated using the formula as under: UL = EL x LGD x Standard Deviation of PD.

- In Foundation IRB ('FIRB'), PD can be calculated and the remaining are based on values set by Basel Committee or RBI (in India).

3. Advanced Internal Rating Based Approach: It is an improved version of FIRB. Under this LGD,EAD,M are estimated based on historical data by the bank itself.

- Assessment of Operational Risk

Operational risk is a risk of loss that can occur "from inadequate or failed internal control processes, people, systems or from external events". As defined by BIS, "it is the risk of loss arising from the potential that inadequate information system; technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in unexpected losses or reputation problems"

The Basel II specifies three methods of calculation of risk weighted assets which are : (i) the Basic Indicator Approach (BIA); (ii) the Standardized Approach (TSA); and (iii) Advanced Measurement Approaches (AMA). These are explained briefly as under:

1. Basic Indicator Approach (BIA): Under this method a fixed percentage of average previous three years annual gross income, is held as a capital for operational risk. If there is loss in a particular which is under consideration, it should be excluded from calculation (both in the numerator and denominator) when calculating the average. It is designated as Alpha (α).

2. (i) The Standardized Approach (TSA): Under this approach banks' activities are divided into eight business segments: corporate finance, trading & sales, retail banking, commercial banking, payment & settlement, agency services, asset management, and retail brokerage. The capital charge required for each business segment is calculated by multiplying gross income by a factor (denoted beta-β as 12, 15 and 18) assigned to that segment. The sum of gross income of all business line should be equal to gross income of the bank

(ii) Alternative Standardized Approach (ASA): This is a variation of TSA. Method of computing capital charge is same as in TSA excepting for two segments - retail & commercial banking. For these business segments loans and advances, they are multiplied by a separate fixed factor 'm' – replaces gross income as the exposure indicator. The betas for retail and commercial banking are same as in TSA.

3. Advanced Measurement Approach ('AMA'): Under this approach the regulatory capital requirement equals the risk measure generated by the bank's internal Operational Risk Measurement System (ORMS). After satisfying these criteria the required operational risk capital charge is derived from the unexpected loss of Value at Risk (VaR) at the 99.9 percent confidence level, across a one year time horizon subject to the expected loss is taken care through provisions.

Arithmetically a bank should arrive the value of its regulatory operational risk capital requirement, as the sum of total of expected loss (EL) and unexpected loss (UL). Expected Loss is to be covered by provisions & pricing. Unexpected loss to be covered through infusion of additional capital. Mathematically it is represented as below:

Operational Risk Capital Requirement = EL (#) + UL (***)

Covered by Provisions *** Covered by infusion of additional capital.

- Market Risk Assessment: Market risk (MR) is a potential loss that can arise from adverse movement in market related risk factors such as interest rates, foreign exchange rates/ currency values, stock prices and commodity prices etc. In Basel 2, MR are divided into two categories viz. interest rate risk and volatility risk. This creates a distinction between fixed income products and others like such as shares, commodity and foreign exchange products. The approaches for calculating market risk in terms of capital charge are:

1. Standardized Approach: Under this method there are two options. A "maturity" method and a "duration" method. As "duration" method is considered more accurate over "maturity", for measuring interest rate risk, RBI opted for adopting standardized duration method for calculating capital charge. Regarding interest rate risk, it has been suggested to provide capital charge from 0% to 12.5% of asset value, depending on the time to maturity/ duration of the fixed income asset as a cushion against interest rate movements. For countering volatility risk of fixed income assets, it has been recommended that risk weightings be tied to the credit risk ratings given to underlying bank assets.

2. Internal risk management Models Approach: Under this methodology, RBI had advised banks to develop an internal model of their own to calculate shares, commodity, currency risks on a case by case basis involving VaR, based on a five year, position to position data, which will be validated by RBI. Based on this capital requirements are predicted.

Pillar 2: Supervisory Review: Basel II had mandated powers to Central banks (Banking regulators) for supervising and checking of banks' risk management system and capital assessment policy in their respective countries. The regulators were also empowered to ask banks in their jurisdiction an additional buffer capital apart from applicable minimum capital requirement. In tune with this RBI had mandated 9% CRAR, which is 1% more than 8% as indicated by BCBS. Additionally Regulators were also empowered to assess the internal risk evaluation methodologies of banks as in Pillar I.

Pillar 3: Market Discipline: Under Pillar III banks have to mandatorily disclose risk taking positions & capital. This was done to bring in market discipline through such process. .

Basel II regime: Indian Banking Industry scenario

RBI issued the first draft guidelines on Basel 2 in the month of February 2005. The time line for initial implementation was set for March 2007 but due to certain developments postponed the same to 2008. However by March 2008 RBI could implement Basel 2 standardized approach (for credit & market risk) and basic indicator approach in Internationally active banks from India. In case of other scheduled commercial banks it was done by March 2009.

RBI has set a higher minimum standard of 9% CRAR than BCBS prescribed 8%. Also for Tier I CRAR it had set a higher minimum standard of 6% against BCBS recommendation of 4.5%. This had its own effect of Government of India who had to infuse funds in respect of some of the PSU banks in India. In the Indian banking system by March 2009, all Scheduled commercial Banks excluding Local Area Banks and Regional Rural Banks had implemented the Basel II guidelines with basic approaches. In general CRAR ratios recorded by Indian banks were at a satisfactory level.

Basel III

In December 2010 Basel III guidelines were released by BCBS, in the aftermath of global financial crisis triggered by sub-prime crisis of the United States. It will not an exaggeration to say that the sub-prime crisis was the trigger point for announcement of Basel III guidelines.

Objectives :

a. To improve banking sector's ability to absorb shocks arising from financial and economic stress.

b. To reduce the risk of spillover from the financial sector to the real economy.

Scope :

The banks are to comply with the capital adequacy ratio (CAR) requireents at two levels – (a) the consolidated level CAR requirements – after consolidating the assets and liabilities of it's subsidiaries, except those engaged in insurance and other non-financial activities and (b) CAR requirements as standalone.

Basel III framework is based on 3 components called 3 pillars as under:

Pillar 1 – Minimum capital standards .

Pillar 2 – Spevisory review

Pillar 3 – Market discipline

Pillar 1 minimum capital standards :

(i) Tier 1 capital (going concern capital) – Common Equity Tier 1 and Additional Tier 1

(ii) Tier 2 capital (gone concern capital)

The problems had their origin in banks of developed countries which were under-capitalised, over-leveraged and relied excessively on short term funding through markets. It also came to the attention that "quantity and quality" of capital under Basel II were found to be insufficient to withstand such crisis. In short, Basel III norms were "the response of BCBS to improve banking sector ability to absorb shocks arising from financial and economic stress, whatever be the source, thus reducing the risk of spill over from financial sector to real economy".

Basel III norms focus on making most of banking activities, including trading book activities" more capital intensive". With this in view, these norms focus on four vital banking parameters viz. Capital, Leverage, Funding and Liquidity. The implementation of Basel III commenced from April 2013 and in view of transitional arrangement RBI has proposed a full scale implementation by March 31, 2019.

Features of the Basel III Accord:

1. Enhanced Capital Requirement

Tier 1 Capital requirements: Scheduled commercial banks (excluding LABs and RRBs) operating in India shall maintain a minimum total capital (MTC) of 9% of total risk weighted assets (RWAs) i.e. capital to risk weighted assets (CRAR). This will be further divided into different components. Common Equity Tier 1 (CET1) capital must be at least 5.5% of RWAs i.e. for credit risk + market risk + operational risk on an ongoing basis. Tier 1 capital must be at least 7% of RWAs on an ongoing basis. Thus, within the minimum Tier 1 capital, Additional Tier 1 capital can be admitted maximum at 1.5% of RWAs. Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 9% of RWAs on an ongoing basis. Thus, within the minimum CRAR of 9%, Tier 2 capital can be admitted maximum up to 2%.

If a bank has complied with the minimum Common Equity Tier 1 and Tier 1 capital ratios, then the excess Additional Tier 1 capital can be admitted for compliance with the minimum CRAR of 9% of RWAs. (vi) In addition to the minimum Common Equity Tier 1 capital of 5.5% of RWAs, banks are also required to maintain a capital conservation buffer (CCB) of 2.5% of RWAs in the form of Common Equity Tier 1 capital. Thus, with full implementation of capital ratios and CCB the capital requirements are summarised as follows:

Sl. No.	Regulatory Capital	As % to RWAs
1	Minimum Common Equity Tier 1 Ratio	5.5%
2	Capital Conservation Buffer (comprised of Common Equity)	2.5%
3	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(1)+(2)]	8%
4	Additional Tier 1 Capital	1.5%
5	Minimum Tier 1 Capital Ratio [(1) +(4)]	7%
6	Tier 2 Capital	2%
7	Minimum Total Capital Ratio (MTC) [(5+(6)]	9%
8	Minimum Total Capital Ratio plus Capital Conservation Buffer [(7)+(2)]	11.5%

Accordingly, under revised guidelines (Basel III), minimum total regulatory capital will consist of the sum of the following categories:

(i) Tier 1 Capital (going-concern capital)

  (a) Common Equity Tier 1 capital

  (b) Additional Tier 1 capital

(ii) Tier 2 Capital (gone-concern capital)

2. Introduction of a Capital Conservation Buffer: The Capital Conservation Buffer is an additional reserve buffer of 2.5% to “withstand future periods of stress”, bringing the total Tier 1 Capital reserves required to 7%. This buffer is introduced to meet one of the four key objectives identified by the Committee in the December 2009 Consultative Document “Strengthening the resilience of the banking sector”; conserve enough capital to build buffers at individual banks and the entire banking sector which can then be used in times of stress. RBI has given minimum capital conservation standards for a bank as per the table below:

Minimum Capital Conservation Standards	
Common Equity Tier 1 Ratio after including the current periods retained earnings	**Minimum Capital Conservation Ratios (expressed as a percentage of earnings)**
5.5% - 6.125%	100%
>6.125% - 6.75%	80%
>6.75% - 7.375%	60%
>7.375% - 8.0%	40%
>8.0%	0

If a bank has complied with the minimum Common Equity Tier 1 and Tier 1 capital ratios, then the excess Additional Tier 1 capital can be considered for compliance with the minimum CRAR of 9% of RWAs. In addition to the minimum Common Equity Tier 1 capital of 5.5% of RWAs, banks are also required to maintain a capital conservation buffer (CCB) of 2.5% of RWAs in the form of Common Equity Tier 1 capital.

RBI has vide it's circular RBI/2018-19/106 DBR.BP.BC.No.20/21.06.201/2018-19 dt. January 10, 2019 has decided to defer the implementation of the last tranche of 0.625% of Capital Conservation Buffer (CCB) from March 31, 2019 to March 31, 2020. Accordingly, minimum capital conservation ratios as applicable from March 31, 2018 will also apply from March 31, 2019 till the CCB attains the level of 2.5% on March 31, 2020. Further the pre-specified trigger for loss absorption through conversion / write-down of Additional Tier 1 instruments (PNCPS and PDI) shall remain at 5.5% of RWAs and will rise to 6.125% of RWAs on March 31, 2020.

3. Counter Cyclical Buffer: As per Basel III norms country regulators of banks are also responsible for regulating credit volume in their national economies. Banks should build up a buffer of capital in good times to be used to maintain flow of credit in difficult times. Banks operating in India shall be maintaining CCCB on a solo / consolidated basis. If credit growth is rapidly expands than GDP growth, bank regulators can increase their capital requirements with the help of the Countercyclical Buffer to curb the excessive credit growth. The counter cyclical buffer suggested varies between 0% - 2.5% and it is meant to restrict excess credit growth which may turn out to be counter- productive. The aim of the Countercyclical Capital Buffer (CCCB) regime is twofold. Firstly, it requires banks to build up a buffer of capital in good times which may be used to maintain flow of credit to the real sector in difficult times. Secondly, it achieves the broader macro-prudential goal of restricting the banking sector from indiscriminate lending in the periods of excess credit growth that have often been associated with the building up of system-wide risk.

4. Leverage Ratio: It is defined as Ratio of Tier 1 Capital to Total Assets. According to Basel III this ratio should be a minimum of at least 3% even where there is no risk weighting. According to Basel III rules BCBS agreed to test minimum Tier 1 leverage ratio of 3% during the parallel run period by 2017. This was also is made applicable for banks in India. During the period of parallel run, banks should strive to maintain their existing level of leverage ratio but, in no case the leverage ratio should fall below 4.5%. A bank whose leverage ratio is below 4.5% may endeavour to bring it above 4.5% as early as possible. According to the data released by RBI, most of the banks are maintaining leverage ratio of over 4.5%.

5. Liquidity Risk Measurement: Basel III has introduced a new instrument for liquidity risk measurement

– Liquidity Coverage Ratio (LCR). The objective behind this is to make banks maintain an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by central banks of the respective countries. The standard requires that the ratio be no lower than 100%. According to RBI by 2019 March banks in India should reach a LCR of 100%.

At present the assets allowed as Level 1 High Quality Liquid Assets (HQLAs) for the purpose of computing the LCR of banks, inter alia, include (a) Government securities in excess of the minimum SLR requirement and, (b) within the mandatory SLR requirement, Government securities to the extent allowed by RBI under (i) Marginal Standing Facility (MSF) [presently 2 per cent of the bank's NDTL] and (ii) Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) [presently 13 per cent of the bank's NDTL]. RBI has decided to permit banks to reckon an additional 2.0 percent Government securities held by them under FALLCR within the mandatory SLR requirement as Level 1 HQLA for the purpose of computing LCR, in a phased manner, as under:

Effective date	FALLCR (per cent of NDTL)	Total HQLA carve out from SLR (per cent of NDTL)
April 4, 2019	13.50	15.50
August 1, 2019	14.00	16.00
December 1, 2019	14.50	16.50
April 1, 2020	15.00	17.00

For the purpose of LCR, banks are required to value such government securities reckoned as HQLA at an amount not greater than their current market value (irrespective of the category under which the security is held, i.e., HTM, AFS or HFT)

To meet their commitments under investment banking inventories, off-balance sheet items, securitization deals, and such other assets and activities bank should have a minimum amount of stable liabilities in relation to their liquidity risk profiles Basel III proposed Funding Stability Ratio (NFSR). It is defined as the ratio, for a bank, of its "available amount of stable funding" divided by its "required amount of stable funding". The standard requires that the ratio be no lower than 100%.

Transition Phase for the Liquidity Standards under Basel III: Both the LCR and NSFR were introduced as on 1 January 2015. Though RBI had instructed banks to comply with LCR and NSFR by January 1, 2019, through it's circular RBI/2018-19/84 DBR.BP.BC.No.08/21.04.098/2018-19 November 29, 2018 it has indicated that the NSFR guidelines will come into effect from April 1, 2020.

LESSON ROUND UP

A risk is indispensable for banking business, proper assessment of risk is an integral part of a bank's risk management system. Banks are focusing on the magnitude of their risk exposure and formulating strategies to tackle those effectively. In the context of risk management practices, the introduction of Basel II norms and its subsequent adoption by RBI is a significant measure that promises to promote sound risk management practices. BASEL II seeks to enhance the risk sensitivity of capital requirements, promote a comprehensive coverage of risks, offer a more flexible approach through a menu of options, and is intended to be applied to banks worldwide. Moreover, the RBI has adopted a series of steps to ensure that individual banks tackle risks effectively by setting up risk management cells and also through internal assessment of their risk exposure. Apart from this, RBI has opted for on-site and off-site surveillance methods for effective risk management in the Indian Banking sector, so that systemic risk and financial turmoil can be averted in the country.

GLOSSARY

Organizational Structure, Liquidity Risk, Market Risk, Basel Accords, Countercyclical Buffer, Capital Conservation

Buffer, Liquidity Coverage Ratio, Leverage Ratio, Operational risk

SELF TEST QUESTIONS

Fill in the blanks

i. Risk _____ includes analysing the risk and measuring its vulnerability and its impact on the organisation.

ii. _____risk is the risk of default on a debt that may arise from a borrower failing to make required payments

iii. The liquidity risk of banks arises from funding of _____ by _____, thereby making the liabilities subject to rollover or refinancing risk.

iv. _____ of each bank shall be responsible for approving and periodically reviewing the credit risk strategy and significant credit risk policies.

v. A bank must hold equity capital to at least a fixed per cent (_____ per cent) of its risk-weighted credit exposures as well as capital to cover market risks in the bank's trading account.

Write True or False

1. Every Bank should have a Board of Directors approved comprehensive Risk Management Policy.
2. Market risk is experiencing losses due to external factors that affect the overall performance of financial markets.
3. The liquidity risk of banks arises from funding of long-term assets by short-term liabilities.
4. Currency risk is a market risk.
5. Under Basel 1 norms Capital is derived as a sum of Tier I and Tier II capital which a bank is required to maintain in relation to its risk-weighted assets.

Answer the following questions briefly

1. Discuss briefly stages of Risk Management?
2. Discuss briefly different types of risks a bank faces.
3. What is Liquidity Risk? How it is managed?
4. How operational risks are measured?
5. What are the features of Basel III accord?

For further reading

1. Operational risk management in Financial Institutions- researchgate.net
2. Guidance note on management of operational risk- RBI
3. Guidance note on credit risk management, RBI.
4. AIMA Journal of Management & Research, May 2013, volume 7, issue 2/4,
5. Market Risk Management in Banks – Models for Analysis and Assessment - UDC 330.131.7:005]:336.7 Emilia Milanova
6. Evolution of the Basel framework on bank capital regulation- Research Paper – RBI by "Anupam Prakash*

Lesson 21
Audit in Banks

LESSON OUTLINE

- Auditing and Features of Audit
- Principles of Internal Audit
- Risk Based Internal Audit
- Credit Audit
- Information System Audit (overview)
- Computer assisted Audit Tools & Techniques (CAATTs)
- Concurrent Audit
- Audit of Financial Statements of Bank
- Long Form Audit Form (LFAR)
- Special Audit
- Stock & Receivables Audit
- Forensic Audit
- Revenue Audit
- SELF TEST QUESTIONS

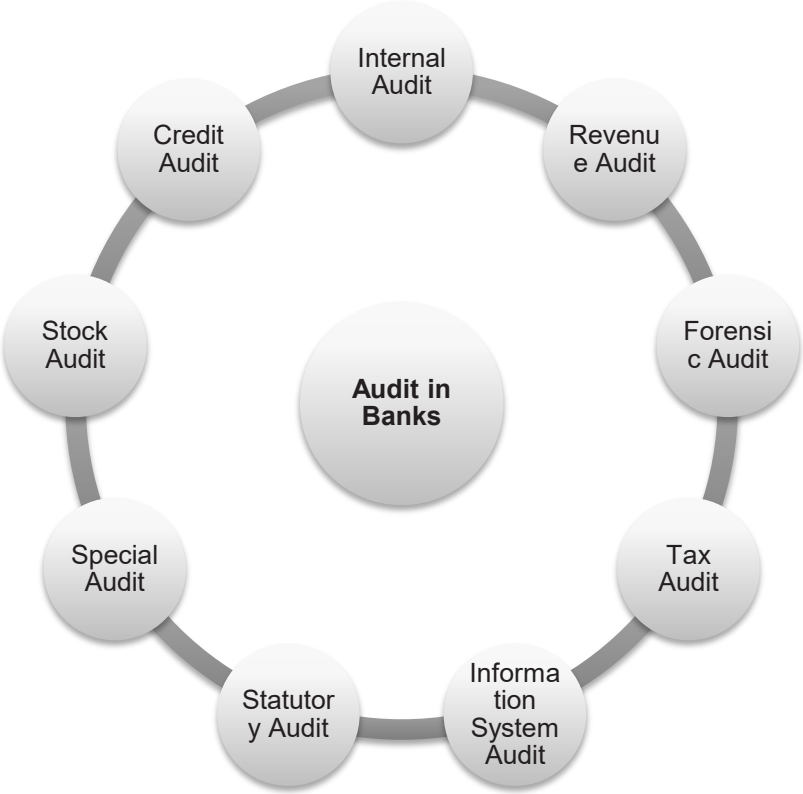
LEARNING OBJECTIVES

An audit is a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the concern. This chapter will enable a reader to learn about –

- Different types of Audit in Banks
- Understanding legal framework for Bank Audit.
- Why is Concurrent Audit necessary
- Credit Audit and its importance
- How risk based supervision is ensured by banks
- How IS Audit is performed
- How Government and other authorities regulate audit in banks

Note : This lesson has been given to students for information purpose only.

CHAPTER OVERVIEW:



INTRODUCTION:

Banks play an important role in any financial system by virtue of the significant role they play in spurring economic growth by undertaking maturity transformation and supporting the critical payment systems. The specificity of banks, the volatility of financial markets, increased competition and diversification, however, expose banks to risks and challenges. The protection of depositors' interests and ensuring financial stability are two of the major drivers for putting in place an effective system of supervision of banks.

Credibility of an institution, particularly that of financial institution depends on its internal control and supervision mechanism which can promptly detect irregularities, if any, and take corrective measures and ensure non recurrence of irregularities. Business of banking is susceptible to frauds. It is therefore necessary to have an internal control and supervision mechanism for ensuring that no one person is in a position to violate procedures, rules, regulations, guidelines, do an unauthorized act detrimental to the organization which remains undetected for an indefinite period or long time. Therefore, inspection and audit plays crucial role in success of banking operations.

AUDITING

An audit is a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the concern. The word audit is derived from a Latin word "audire" which means "to hear". During the medieval times when manual book-keeping was prevalent, auditors in Britain used to hear the accounts read out for them and checked that the organization's personnel were not negligent or fraudulent.

The International Federation of Accountants has given the following definition of an audit, "audit is an independent inspection of the financial information of any organization, whether profit-oriented or not profit-oriented, irrespective of its legal form, status or size when such examination is conducted with a view to express an opinion thereof".

Auditing has become such a ubiquitous phenomenon in the corporate and the public sector that academics started identifying an "Audit Society". The auditor perceives and recognizes the propositions before them for examination, obtains evidence, evaluates the same and formulates an opinion on the basis of his judgment which is communicated through their audit report.

FEATURES OF AUDIT

1. making a critical review of the system and procedures in an organisation.
2. making such tests and enquiries into the results as well as the operation of such systems and procedures, as the auditor may consider necessary to form an opinion.
3. expressing that opinion in the accepted phraseology that has been developed.
4. Ensuring that the opinion covers all aspects which are required to be covered by law/statute or accepted professional norms.

Auditing is a systematic process. It is a logical and scientific procedure to examine the accounts of an organization for their accuracy. There are rules and procedures to follow.

STANDARDS ON AUDITING

To ensure that information provided in the financial statements are of high quality and are acceptable worldwide the Auditing and Assurance Standards board under the council of Institute of Chartered Accountants (ICAI) have formulated few Standards. These are in line with the International Standards issued by the International Auditing and Assurance Board (IAASB) established by International Federation of Accountants (IFAC).

The Institute of Chartered Accountants of India has issued 35 (thirty five) Auditing and Assurance Standards (AASs) (status as on 01.04.2019). All the Standards are mandatory in nature. This means that while carrying out an attest function, it will be the duty of the auditor to ensure that these AASs are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the AASs, his report should draw attention to the material departures therefrom.

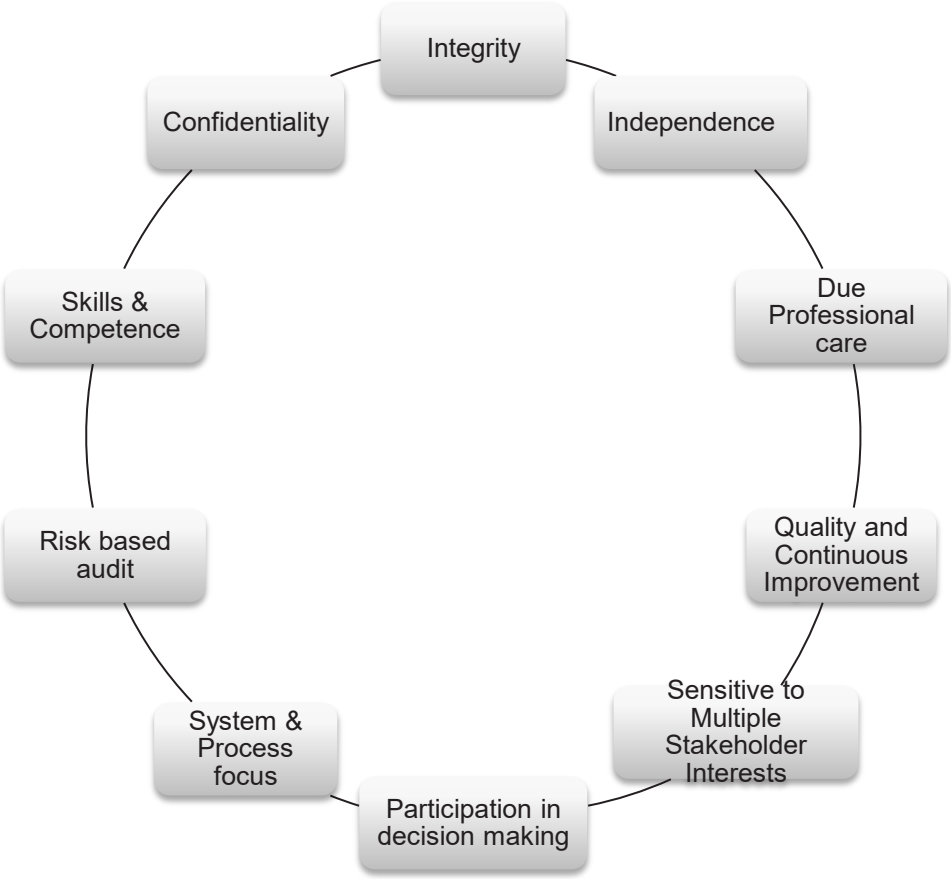
INTERNAL AUDIT

As defined by The Institute of Internal Auditors (IIA), "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Internal auditing is a catalyst for improving an organization's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes.

PRINCIPLES OF INTERNAL AUDIT

Basic Principles of Internal Audit as enumerated by Institute of Chartered Accountants of India (ICAI) are given below:



i) **Independence-** The independence of the internal audit function as a whole, and the Internal Auditor within the organisation, plays a large part in establishing the independence of the Internal Auditor.

ii) **Integrity and Objectivity**- The Internal Auditor shall be honest, truthful and be a person of high integrity. He shall operate in a highly professional manner and seen to be fair in all his dealings. He shall avoid all conflicts of interest and not seek to derive any undue personal benefit or advantage from his position.

iii) **Due Professional Care**- The Internal Auditor shall exercise due professional care and diligence while carrying out the internal audit. "Due professional care" signifies that the Internal Auditor exercises reasonable care in carrying out the work to ensure the achievement of planned objectives.

iv) **Confidentiality-** Internal Auditor shall at all times, maintain utmost confidentiality of all information acquired during the course of the audit work. He shall not disclose any such information to a party outside the internal audit function and any disclosure shall be on a "need to know basis".

v) **Skills and Competence**- Internal Auditor shall have sound knowledge, strong interpersonal skills, practical experience and professional expertise in certain areas and other competence required to conduct a quality audit. He shall undertake only those assignments for which he has the requisite competence.

vi) **Risk Based Audit** – An Internal Auditor shall identify the important audit areas through a risk assessment exercise and tailor the audit activities such that the detailed audit procedures are prioritised and conducted over high risk areas and issues, while less time is devoted to low risk areas through curtailed audit procedures

vii) **System and Process Focus -** An Internal Auditor shall adopt a system and process focused methodology in conducting audit procedures.

viii) **Participation in Decision Making**- In conducting internal audit assignments, the Internal Auditor shall avoid passing any judgement or render an opinion on past management decisions. As part of his advisory role, the Internal Auditor shall avoid participation in operational decision making which may be subject of a subsequent audit.

ix) **Sensitive to Multiple Stakeholder Interests-** The Internal Auditor shall evaluate the implications of his observations and recommendations on multiple stakeholders, especially where diverse interests may be conflicting in nature. In such situations, the Internal Auditor shall remain objective and present a balanced view.

x) **Quality and Continuous Improvement**- The quality of the internal audit work shall be paramount for the Internal Auditor since the credibility of the audit reports depends on the reliability of reported findings.

Internal Audit:

- Bridges the gap between management and the board
- Assesses the ethical climate and the effectiveness and efficiency of operations
- Serves as an organization's safety net for compliance with rules, regulations and overall best business practices
- Is a cornerstone of strong governance
- Gives an assurance that :
  - Internal controls are sufficient to mitigate risks
  - Governance processes are adequate
  - Organizations goals and objectives are met
- While external audit confirms the validity of the financial position expressed by an organisation, investigation may be supported by internal audit function
- Internal audit confirms the effectiveness of business process controls in reducing financial risk
- Assures compliance with the law
- Indicates areas where business processes may be improved upon

SCOPE OF INTERNAL AUDITOR IN BANK:

Scope of internal auditor in bank basically includes the following:

- Examination and evaluation of the **adequacy and effectiveness of the internal control, risk management and governance systems and processes** of the entire bank
- Preparation of **Risk Audit Matrix** based on intensity / magnitude and frequency of risk.
- Review of the application and effectiveness of the **risk management procedures and risk assessment methodologies.**
- Suggesting **measures for mitigating risks** through risk focused audit

- Review of **ICAAP (Internal Capital Adequacy Assessment Process)** Processes, Risk Management Framework & Risk Management System.

Internal auditors work within an organisation and report to its audit committee and/or directors.

BASEL GUIDANCE ON INTERNAL AUDIT

The Basel Committee on Banking Supervision updated its guidance for Supervisors in 2012, for assessing the adequacy of the internal audit function in banks. It formed part of the Basel Committee's on-going efforts to address bank supervisory issues and enhance supervision through guidance that encourages sound practices within banks. The guidance takes into account developments in supervisory practices and in banking organisations and incorporates lessons drawn from the recent financial crisis. The 20 principles issued by the Basel Committee were divided into 3 sections:

- Principles 1 to 15 related to the expectations relevant to the internal audit;
- Principle 16 related to the relationship of the supervisory authority with the internal audit function, and;
- Principles 17 to 20 related to the supervisor's assessment of the internal audit function.

RISK BASED INTERNAL AUDIT (RBIA)

Over the last few years, the need to manage risks has become recognized as an essential part of good corporate governance practice. This has put organisations under increasing pressure to identify all the business risks they face and to explain how they manage them. In fact, the activities involved in managing risks have been recognized as playing a central and essential role in maintaining a sound system of internal control. RBIA is not about auditing risks but about auditing the management of risk. Its focus is on the processes applied by the management team. The primary focus of risk-based internal audit is to provide reasonable assurance to the Board and top management about the adequacy and effectiveness of the risk management and control framework in the banks' operations. Transaction testing would continue to remain an essential aspect of risk-based internal audit. The extent of transaction testing will have to be determined based on the risk assessment. The risk based supervision process ('RBS') is designed to work as a structured process that identifies the most critical risks faced by an individual bank and systemic risks in the financial system.

Risk Audit Matrix

The Audit Plan should prioritize audit work to give greater attention to the areas of:

(i) High Magnitude and high frequency

(ii) High Magnitude and medium frequency

(iii) Medium magnitude and high frequency

(iv) High magnitude and low frequency

(v) Medium Magnitude and medium frequency.

Scope of RBIA

The precise scope of risk-based internal audit must be determined by each bank for low, medium, high, very high and extremely high risk areas. However, at the minimum, it must review/report on:-

- process by which risks are identified and managed in various areas;
- the control environment in various areas;

- gaps, if any, in control mechanism which might lead to frauds, identification of fraud prone areas;
- data integrity, reliability and integrity of MIS;
- internal, regulatory and statutory compliance;
- budgetary control and performance reviews;
- transaction testing/verification of assets to the extent considered necessary
- monitoring compliance with the risk-based internal audit report
- variation, if any, in the assessment of risks under the audit plan vis-à-vis the risk-based internal audit.
- a review of the systems in place for ensuring compliance with money laundering controls;
- identifying potential inherent business risks and control risks, if any;
- suggesting various corrective measures and,
- undertaking follow up reviews to monitor the action taken thereon

The communication channels between the risk-based internal audit staff and management should encourage reporting of negative and sensitive findings. Significant issues posing a threat to the bank's business should be promptly brought to the notice of the Board of Directors, Audit Committee or top management, as appropriate.

CREDIT AUDIT

Credit Risk is defined as "the possibility of losses associated with diminution in the credit quality of borrowers or counter-parties. **In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively, losses result from reduction in portfolio value arising from actual or perceived deterioration in credit quality.** It is imperative that banks have a robust credit risk management system. The effective management of credit risk is a critical component of comprehensive risk management and is essential for the long term success of any banking organisation. Credit risk management encompasses identification, measurement, monitoring and control of the credit risk exposures. Credit audit/Loan Review Mechanism is one of the means to mitigate credit risk.

Credit Audit examines compliance with extant sanction and post-sanction processes/ procedures laid down by the bank from time to time. Credit Audit is an integral part of risk based internal audit system, aimed at identification of credit risk and may also suggest the remedial measures for controlling the credit risk underlying the loan & investment portfolios of high value.

Credit Audit is an effective tool for periodic evaluation of quality of the credit portfolio and to bring about qualitative improvement in credit administration. Loan Review Mechanism / Credit Audit for large value accounts includes evaluating the effectiveness of loan appraisal and administration, maintaining the integrity of credit rating process, portfolio quality, etc.

Objectives of Credit Audit

- To review sanction process and compliance status of large value loans vis-à-vis Bank's loan policies, procedures and laid down credit processes.
- To bring about improvement in the quality of Bank's credit portfolio.
- To make an independent review of Credit Risk Assessment

- To suggest /recommend corrective actions to improve credit quality, credit administration and credit skills of the staff.
- Pick-up early warning signals and suggest remedial measures

Credit Auditable accounts (CAA) are identified by banks based on the quantum of loan and risk category of borrower. For example, a sample of 10% of the CAAs falling in the bracket of Rs.10 crores to Rs.20 crores will be subject to review by Credit Audit Division of bank. Identification of signs of stress and initiation of adequate steps is crucial to ensure the quality of the credit portfolio and therefore needs careful examination during the audit. CAAs identified as Medium and High Risk are reviewed at shorter intervals at the discretion of Internal audit department of bank.

Scores/ risk ratings are awarded under credit risk & control risk areas separately at CAA level as High / Medium / Low / Very Low Risk. Final rating of CAA is arrived at based on the RBI's Risk Matrix, considering inherent business risk and control risk as under:

(i) Extremely High Risk

(ii) Very High Risk

(iii) High Risk

(iv) Medium Risk

(v) Low risk.

Learnings from analysis of credit audit report

The analysis of the Credit Audit Reports generally reveals irregularities. Certain such irregularities are given as under: -

- Frequent irregularities observed in the accounts
- Equity not infused
- Opinion reports on borrowers/ guarantors not updated periodically.
- Reasonableness of valuation and ownership of property not verified.
- Common ''Stock & Receivable Audit'' for the group accounts not conducted as per Sanctioned terms
- End - use of funds was not ensured
- Incomplete Loan document as arrangement letter was not signed by the borrower / individual guarantors
- The frequency of Stock & Receivable Audit was not adhered to.
- Periodicity of inspection not maintained.

INFORMATION SYSTEM AUDIT OR INFORMATION TECHNOLOGY AUDIT (IS AUDIT)

The deployment of Information Technology in banks and financial institutions, both in the front and back office operations, has facilitated greater systemic efficiency in the banking and financial sector. It has, at the same time, introduced new areas of risk. Risk is inherent in the traditional banking and financial activities. However, risk in a computerized and networked environment is multifarious such as operational risk, reputational risk, legal risk, credit risk, liquidity risk, interest rate risk, foreign exchange risk etc.

RBI vide its Notification No. DBS.CO.PP.BC. 10/11.01.005/2002-03 dated 27.12.2002 has advised banks to

implement IS Audit as a part of the risk-based internal audit system. IS audit system in banks has replaced the earlier computer/ EDP audit.

IS audit is a systematic process of objectively obtaining and evaluating evidence/ information regarding the proper implementation, operation and control of information and the Information System resources.

IS Audit shall identify risks and methods to mitigate risk arising out of IT infrastructure such as server architecture, local and wide area networks, physical and information security, telecommunications etc.

Coverage

IS Audit should cover effectiveness of policy and oversight of IT systems, evaluating adequacy of processes and internal controls, recommend corrective action to address deficiencies and follow-up. IS Audit also evaluate the effectiveness of business continuity planning, disaster recovery set up and ensure that BCP is effectively implemented in the organization. During the process of IS Audit, due importance shall is given to compliance of all the applicable legal and statutory requirements.

The Information Systems Audit encompasses the review and evaluation (wholly or partly) of automated information processing systems, related non-automated processes and the interfaces among them.

Objectives

The major objectives of IS audit include, among others, the following:

a) Safeguarding of Information System Assets/Resources

b) Maintenance of Data Integrity

c) Maintenance of System Effectiveness

d) Ensuring System Efficiency

Information Systems Audit Approaches:

There are three approaches for conducting Information Systems Audit viz. auditing around the computer, auditing through the computer and auditing with the computer.

I. Auditing around the computer:

Under this approach, the emphasis is on checking the correctness of the output data/documents with reference to the input of a process without going into the details of the processing involved. This approach is preferred, where auditors themselves do not have the desired level of technical skills to adopt the other approaches. This is also preferred, when high reliance is placed on the users rather than the computer controls to safeguard the assets, maintain data integrity and attain effectiveness and efficiency objectives. The focus is on the procedural controls rather than the computer controls.

II. Auditing through the Computer :

Auditing through the computer requires fair knowledge of the operating system, hardware being used and certain technical expertise in systems development. Under this approach, the computer programs and the data constitute the target of IS audit. Compliance and substantive tests are performed on the computer system, its software (both operating system and application system) and the data. IS auditor can test the application system effectively using this approach. The IS auditors can use computer to test logic and controls existing within the system and also records produced by the system. This approach increases the IS auditor's confidence in the reliability and applicability of the evidence/information collected and evaluated. This approach is time

consuming, as it needs understanding of the internal working of an application system. It also needs some technical expertise.

III. Auditing with the Computer :

Under this approach, the computer system and its programs are used as tools in the audit process. The objective is to perform substantive tests using the computers and its programs. The data from the auditee's computer system are retrieved to an independent environment. Audit interrogation and query is carried out on such data, using special programs designed for the purpose. This method is used where Application system consists of a large volume of inputs, producing large volume of outputs and where the direct examination of the inputs/ outputs is difficult and logic of the system is complex.

Computer-Assisted Audit Tools and Techniques (CAATTs): CAATTS are efficient and effective ways to audit system-generated files, records and documents and to evaluate internal controls of an accounting system in many Information Systems. Banks should adopt a proper mix of manual techniques and CAATs for conducting IS Audit. CAATs may be used in critical areas (such as detection of revenue leakage, treasury functions, assessing impact of control weaknesses, monitoring customer transactions under AML requirements and generally in areas where a large volume of transactions are reported) particularly for critical functions or processes having financial/regulatory/legal implications. There are five basic approaches, as under, for testing the application controls using CAATT (Computer Aided Audit Tools and Techniques).

a) **Test Data Method** – This method is used to establish application integrity by processing specially prepared sets of input data. The results of each test are compared with the pre-determined expected results. The auditor first obtains the current version of the application and then generates the test transaction files and test master files. Thereafter, the test transaction files are input into the program and the result in the form of routine output reports, transaction listing and error reports are collected. The test results are compared with the expected results, either manually or again through a computer program.

b) **Base Case System Evaluation –** Under this method, a base test set of transactions is prepared along with the expected results. This set of transactions is comprehensive and all possible transaction types are included. Whenever testing is done, the results are compared with the results of the base test data results, which were obtained initially.

c) **Tracing** – Under this method, the test data does a virtual walk through the application logic. The application under review must undergo a special compilation to activate a trace option. The test data, prepared for tracing, is run and the result shows the exact listing of the programmed instructions, executed while the test data was processed.

d) **Integrated Test Facility –** This is an automated test technique, where the audit module is designed in the application program itself to be run in the normal course of operations by the application program with a specific choice of test data and where the application program distinguishes between the actual transactional data and test transactional data for simultaneous integrated audit and normal operations.

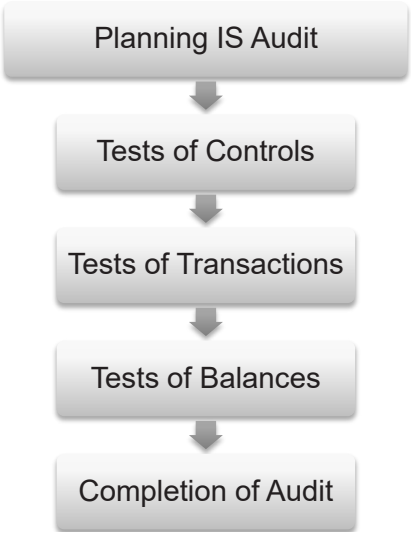
e) **Parallel Simulation –** This requires the auditor to write a program that simulates the key features and processes of the application. The program is run on the pre-processed actual transactional data and the results obtained are compared with the actual results obtained.

The IS auditors, while performing the software audit, should ensure from the system documents that the database is properly normalized and there is not much redundancies and dependencies, as poorly normalized database could affect the integrity of data. The database constraints will also required to be properly examined.

Network Audit

With the advent of Corporate Networks, Payment Gateways and new products like Internet Banking, Anywhere Anytime Banking etc., which primarily rely on various public and private networks for their operation, Network Audit forms a key area of IS audit. Network Audit covers all aspects of the network, right from the communication channels, network equipment like switches, bridges, routers, firewalls to internetworking issues and security controls. To ensure continuous adequacy of security controls in networked environment, each bank is required to regularly conduct penetration testing in respect of the Information Systems with the help of third parties under well specified terms and conditions, agreed therefor with such third parties.

Audit activity is broadly divided into 5 major steps for the convenience and effective conduct of audit:



Review of Policies and Compliance:

The IS auditor is required to consider whether the policies issued cover all of the appropriate areas for which board-level direction is necessary in order to provide reasonable assurance that the business objectives are met. Such policies on board level direction will require to be documented ones only and such documented policies shall, among others, include Security Policy, Human Resources Policy, Data Ownership Policy, End-user Computing Policy, Copyright Policy, Data Retention Policy, System Acquisition and Implementation Policy and Outsourcing Policy.

Reporting

The IS audit reports are placed before the top management and the compliance should be ensured within the time frame as outlined in the audit policy. Such audits should be preferably undertaken prior to the statutory audit so that the IS audit reports are available to the statutory auditors well in time for examination and incorporating comments, if any, in the audit reports. The IS audit report on corporate governance of information systems should, among others, include the following:

a) A statement that the Board of Directors is responsible for the organisation's Information Systems and formulation and implementation of the system of internal controls.

b) A statement that a system of internal controls can only provide reasonable and not absolute assurance against material misstatement or loss.

c) A description of the key procedures, which the Board of Directors has approved/established, to provide effective internal control and the related supporting documentation presented to the Board of Directors.

d) Information on any non-compliance with the national or industry codes of practice for corporate governance.

e) Information on any major uncontrolled risks.

f) Information on any ineffective or inefficient control structures or control measures together with the IS auditor's recommendations for improvement.

g) The IS auditor's overall conclusion on the corporate governance of the information systems, as defined in the scope of audit.

CONCURRENT AUDIT

Concurrent audit aims at shortening the interval between a transaction and its independent examination. It is, therefore, integral to the establishment of sound internal accounting functions and effective controls and is regarded as part of a bank's early warning system to ensure timely detection of serious errors and irregularities, which also helps in averting fraudulent transactions and preventive vigilance in banks.

It is a continuous audit, which goes on all the year around, usually conducted by external auditors (Chartered Accountants) on monthly basis.

RBI vide its circular no. RBI/2019-20/64, DBS.CO.ARS.No.BC.01/08.91.021/2019-20 dated 18.09.2019 has reviewed the existing guidelines and issued the revised guidelines.

Coverage:

i) The scope of work to be entrusted to concurrent auditors, coverage of business/branches, etc. is left to the discretion of the head of internal audit of banks, with the due prior approval of the Audit Committee of the Board of Directors (ACB)/Local Management Committee ((LMC) in case of foreign banks) of the bank.

ii) Banks may, however, ensure that risk sensitive areas identified by them as per their specific business models are covered under concurrent audit. The detailed scope of the concurrent audit may be determined and approved by the ACB/LMC. The broad areas of coverage under concurrent audit shall be based on the identified risk of the unit and must include random transaction testing of sufficiently large sample of such transactions wherever required. Minimum areas of coverage are given in Annex.

iii) Care may be taken to ensure that all Centralized Processing Centres (business origination and monitoring) are covered under concurrent audit.

Scope of concurrent audit

Concurrent audit is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. It attempts to shorten the interval between a transaction and its examination by an independent person. There is an emphasis in favour of substantive checking in key areas rather than test checking. This audit is essentially a management process integral to the establishment of sound internal accounting functions and effective controls and setting the tone for a vigilant internal audit to preclude the incidence of serious errors and fraudulent manipulations.

A concurrent auditor may not sit in judgement of the decisions taken by a branch manager or an authorised official. This is beyond the scope of concurrent audit. However, the audit will necessarily have to see whether

the transactions or decisions are within the policy parameters laid down by the Head Office, they do not violate the instructions or policy prescriptions of the RBI, and that they are within the delegated authority.

The main role of concurrent audit is to supplement the efforts of the bank in carrying out simultaneous internal check of the transactions and other verifications and compliance with the procedures laid down. The detailed scope of the concurrent audit should is determined for the bank as a whole by the bank's Inspection and Audit Department in consultation with the bank's Audit Committee of the Board of Directors (ACB).

Minimum areas of coverage under Concurrent Audit:

1. Cash transactions including physical verification of cash, etc.
2. Loans & Advances including physical verification of securities, delegation of Powers for sanction, Security Charge Creation, end use verification of funds, monitoring of accounts with excess drawings, monitoring of projects, etc.
3. Adherence to KYC / AML guidelines including monitoring of transactions in accounts, compliance with Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS), monitoring of transactions in new accounts/staff accounts, reporting of CTR/STR, etc.
4. Remittances/ Bills for Collection including SWIFT transactions, monitoring of overdue statements (bills purchased / discounted / negotiated, etc.).
5. House Keeping including reconciliation of accounts, monitoring of General Ledger/Subsidiary General Ledger/Parking Accounts, opening of internal accounts, etc.
6. Treasury operations.
7. Non fund based business.
8. Foreign Exchange transactions.
9. Clearing transactions.
10. Verification of Merchant Banking Business.
11. Verification of Credit Card / Debit card business.
12. Conduct of employees, mis-selling of products, etc.
13. Compliance to RBI guidelines and internal Policy guidelines issued from time to time.

Appointment of Auditors :

The option to consider whether concurrent audit should be done by bank's own staff or external auditors (which may include retired staff of its own bank) is left to the discretion of individual banks. The head of internal audit in the bank should participate in selection of concurrent auditors where such function is outsourced and should be responsible for the quality review (including skills of the staff employed) of the work of the concurrent auditors reporting to her/him. It may, however, be ensured that if any partner of a Chartered Accountant firm is a Director on the Board of a bank, no partner of the same firm should be appointed as concurrent auditor in the same bank.

Accountability:

If external firms are appointed and any serious acts of omission or commission are noticed in their working, their appointments may be cancelled after giving them reasonable opportunity to be heard and the fact shall be

reported to ACB/ LMC of the bank, RBI and ICAI.

The bank should frame a policy for fixing accountability in cases of serious acts of omission or commission noticed in the working of bank's own staff or retired staff, working as concurrent auditors.

Reporting System:

i) Banks' Internal Audit Department develops a reporting system for concurrent auditors with the approval of ACB/LMC. The findings of the concurrent auditors are received in a structured format prescribed by the bank.

ii) Whenever fraudulent transactions are detected, they should immediately be reported to Internal Audit Department (Head Office) as also to the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).

iii) Follow-up action on the concurrent audit reports and rectification of the deficiencies should be accorded high priority by the Head Office/Controlling Office of the concerned branch/business unit of the bank.

Review of effectiveness of Concurrent Audit:

ACB/ LMC of the bank should review the effectiveness of the Concurrent Audit system as well as the performance of the concurrent auditors on an annual basis and take necessary measures to suitably strengthen the system.

AUDIT OF FINANCIAL STATEMENTS OF BANK:

Every banking company's account needs to be verified and certified by the Statutory Auditors as per the provisions of legal frame work The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. An audit conducted in accordance with (Standard on Auditing) SAs and relevant ethical requirements enables the auditor to form that opinion.

The balance sheet and the profit and loss account of a banking company are audited in accordance with Section 30 of the Banking Regulation Act, 1949. Section 30 of Banking Regulation Act, 1949 states that the Balance-Sheet and Profit and Loss Account prepared in accordance with section 29 shall be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

Under section 143(3)(i) of the Companies Act 2013, the independent auditor is required to also report on the adequacy and operating effectiveness of the internal financial controls. The auditor of the banking company or a nationalised bank including SBI and a regional rural bank has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers.

Auditor in the case of a banking company incorporated in India is required to state the following in his report:

(a) whether in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any information or explanation, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank which have come to his notice, have been within the powers of the bank;

(c) whether or not the returns received from branch offices of the bank have been found adequate for the purposes of his audit;

(d) whether the profit and loss account shows a true balance [of profit or loss]for the period covered by

such account;

(e) any other matter which he considers should be brought to the notice of the shareholders of the company.

Notwithstanding anything contained in any law for the time being in force or in any contract to the contrary, every banking company shall, before appointing, re-appointing or removing any auditor or auditors, obtain the previous approval of the Reserve Bank. Special responsibility is cast on the bank auditor in certifying the bank's balance sheet and profit and loss account, since that reflects the sound financial position of the banking company.

The Statutory Auditors should ensure that the audit report issued by them complies with the requirements of Revised **SA 700** – Forming an Opinion and reporting on financial statements, **SA 705** – Modifications to the opinion in the Independent Auditor's Report & **SA 706** – Emphasis of matter paragraphs and other matter paragraphs in the Independent Auditor's Report.

Long Form Audit Report (LFAR):

Besides the normal audit report as per the statutory requirements, auditors are also required to furnish Long Form Audit Report. The matters which the banks require their auditors to deal with in the LFAR have been specified by Reserve Bank of India. The format of LFAR is in a questionnaire form. The LFAR is not a substitute for Statutory Audit Report. Nor is it deemed to be a part of Statutory Audit Report. The Statutory Audit Report is a self contained document and the auditor should not make any cross reference to the observation in the LFAR. In case of any matter of emphasis, the auditor should mention the same in the report clearly.

LFAR is an elaborate reporting on the operations and controls in the branch which is based on the audit observations made by the auditor during the course of the audit. The whole bank LFAR is drafted by the Central Statutory Auditors based on the LFAR received from the Branch Auditors.

Enforcement action framework for the lapses in the statutory audit of commercial banks:

Statutory Auditors (SAs) of banks play an important role in contributing to financial stability when they deliver quality bank audits which foster market confidence in banks' financial statements. Quality bank audits are also a valuable input in the supervisory process of the Reserve Bank of India (RBI) for commercial banks.

Various statutes, viz., Banking Regulation Act, 1949, Banking Companies (Acquisition and Transfer of Undertaking) Act 1970/1980 and State Bank of India Act, 1955 stipulate that commercial banks shall obtain previous approval of the Reserve Bank of India (RBI) before appointing any SA. In exercise of these statutory powers, in case of those auditors whose audit quality or conduct is not found satisfactory by the RBI, it decides on enforcement action against them by way of not approving their appointments for undertaking statutory audit in commercial banks for a specified period. Further, the RBI may also not approve auditor/s, who have been debarred by other regulators/law-enforcement agencies/government agencies. As regards the cases pending against auditors with the aforesaid agencies, the RBI would debar such audit firms, provided the case is of serious nature, where public interest is involved and it is established, prima facie, that the firm is culpable, either by the RBI or by the above entities and brought to the RBI's notice.

Types of lapses to be considered:

The lapses on the part of the SAs that are considered for invoking the enforcement framework would, illustratively, cover the following areas:

a) Lapses in carrying out audit assignments resulting in misstatement of a bank's financial statements;

b) Wrong certifications given by the auditors with respect to list of certifications as advised by the RBI to banks;

c) Wrong information given in the Long Form Audit Report (LFAR);

d) Issues related to misconduct by auditors in respect of their bank audit assignments; and

e) Any other violations/lapses vis-à-vis the RBI's directions/guidelines regarding the role and responsibilities of the SAs in relation to banks.

SPECIAL AUDIT:

Reserve Bank of India is empowered by the provisions of the Banking Regulation Act, 1949 to conduct/order a special audit of the accounts of any banking company. The special audit may be conducted if in the opinion of the Reserve Bank of India, special audit is necessary in the public interest and/or in the interest of the banking company and/or in the interest of the depositors. The special audit report should be submitted to the Reserve Bank of India with a copy to the banking company. The cost of the audit is to be borne by the banking company.

STOCK & RECEIVABLES AUDIT:

The Stock Audit system is required to monitor the available Drawing power in relation to the balance outstanding of borrowal accounts enjoying working capital limits (Both Fund and Non-fund based) with bank where the primary security is hypothecation of Stock and/or Book Debts. In order to have uniform procedure and practice and to regulate the system of stock audit process, a Policy document on Stock Audit is prepared by banks. Generally, bank engages the services of External Stock Auditors to conduct Stock Audit every year. The External Stock Auditors are instructed to institute receivables audit for large borrowal accounts to check the position of book debts with the invoices, bills raised, book debt and age of book debts in relation to normal credit period.

FORENSIC AUDIT:

The forensic audit is normally performed by a forensic accountant who has the skill in both accounting and investigation. Forensic Accounting is the type of engagement that undertaking the Financial Investigation in response to a particular subject matter, where the findings of the investigation normally are used as evidence in court. The investigation is covering numbers of areas include fraud, crime, insurance claims as well as a dispute among shareholders. A forensic audit is also needed to have a proper plan, procedure, and report like other audit engagement.

A Forensic Audit is conducted in order to determine whether or not a fraud has taken place.

REVENUE AUDIT:

Revenue audit is usually conducted at large and medium-sized branches and is aimed at identifying cases of leakage of revenue due to wrong computation of interest, non-application of interest on time, application of incorrect rates of interest/exchange/commission, non-application of penal interest, non-recovery or short-recovery of service charges on guarantees and letters of credit, etc. This type of audit is also known as 'income and expenditure audit' or 'income leakage audit'.

SELF TEST QUESTION

1. Terminal Questions (MCQs)

   a. _____ are efficient and effective ways to audit system- generated files, records and documents and to evaluate internal controls of an accounting system in many Information

Systems

(i) Auditing with Computer

(ii) Computer-Assisted Audit Tools and Techniques

(iii) Encryption

(iv) Hedging

b. From amongst the following, what is not true in case of Concurrent Audit?

(i) The emphasis is on substantive checking in key areas rather than test checking

(ii) Concurrent Auditor has to sit in judgement of decisions taken by the Branch Head / authorized official

(iii) Concurrent Auditor may not sit in judgement of decisions taken by the Branch Head / authorised official

(iv) Concurrent Auditor must see whether decisions / transactions are within prescribed policies and delegated powers or constitute violations

c. IS Audit examines if the objectives of ___, ____ and ___ of data are maintained.

(i) IS, IT and Cyber Security Policy

(ii) Audit Manual, Audit Policy and Audit Procedure

(iii) Confidentiality, Integrity and Availability

(iv) Encryption, Integration and Safety

d. As per Basant Seth Committee report, large Banks' audit reports will be put up to ACB in case of_____?

(i) High Risk Audit Reports (Below 60% marks)

(ii) Very High Risk Reports -Critical Findings (Below 40% marks)

(iii) Very High Risk Reports (Below 50% marks)

(iv) High Risk Audit Reports (Below 70% marks)

e. Multiplicity of audit results in _____

(i) Audit excellence

(ii) Wastage of time and money

(iii) Audit inefficacy

(iv) Audit fatigue

f. What role has the Internal Audit got vis-a-vis Regulatory function and risk management?

a. Internal Audit forms a policy for implementation

b. Lays down structure for implementation

c. Checks and provides counsel to top management

d. No role to play in these areas

2. State whether the following is True of False.
   a. The LFAR is to be submitted before 30th June every year.
   b. Sub- Section (1) of section 30 of Companies Act, 2013 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.
   c. Regulatory body in case of banks is IRDA.
   d. In the computerized environment, the auditor needs to be familiar with latest applicable RBI circulars, guidelines that have bearing on the classification/provisions and income recongition
3. Write Short note on –
   i. Forensic Audit
   ii. Audit with computer
   iii. LFAR

PROFESSIONAL PROGRAMME

BANKING – LAW & PRACTICE (PAPER 9.1)

PP-BL&P

TEST PAPER

A Guide to CS Students

To enable the students in achieving their goal to become successful professionals, Institute has prepared a booklet "A Guide to CS Students" providing the subject specific guidance on different papers and subjects contained in the ICSI curriculum. The booklet is available on ICSI website and students may down load from http://www.icsi.edu/Portals/0/AGUIDETOCSSTUDENTS.pdf

WARNING

It is brought to the notice of all students that use of any malpractice in Examination is misconduct as provided in the explanation to Regulation 27 and accordingly the registration of such students is liable to be cancelled or terminated. The text of regulation 27 is reproduced below for information:

"27. Suspension and cancellation of examination results or registration.

In the event of any misconduct by a registered student or a candidate enrolled for any examination conducted by the Institute, the Council or the Committee concerned may suo motu or on receipt of a complaint, if it is satisfied that, the misconduct is proved after such investigation as it may deem necessary and after giving such student or candidate an opportunity to state his case, suspend or debar the person from appearing in any one or more examinations, cancel his examination result, or studentship registration, or debar him from future registration as a student, as the case may be.

Explanation – Misconduct for the purpose of this regulation shall mean and include behaviour in a disorderly manner in relation to the Institute or in or near an Examination premises/centre, breach of any regulation, condition, guideline or direction laid down by the Institute, malpractices with regard to postal or oral tuition or resorting to or attempting to resort to unfair means in connection with the writing of any examination conducted by the Institute".

PROFESSIONAL PROGRAMME

BANKING – LAW & PRACTICE (PAPER 9.1) – TEST PAPER

[*This Test Paper is for recapitulate and practice for the students. Students need not to submit responses/ answers to this test paper to the Institute.*]

Time Allowed: 3 Hours *Maximum Marks: 100*

• All questions are compulsory

• Marks for each question is indicated alongside of the question.

1. (a) Mr. A is one of your valued customers. He approaches your bank to avail loans/credit facilities and offers the following Securities listed below. Evaluate the acceptability or otherwise of each of the securities offered by Mr. A from the Bank's point of view and also indicate the type of charge that can be created as well as documentation required to be taken in respect of these securities. **(20)**

a. Gold ornaments of receipted value is Rs. 5 lacs, belonging to Mrs. A.

b. FD of Face Value Rs. 50,000 in the name of his son issued by an NBFC.

c. A flat in the name of Mr. A, which is twenty years old. The original agreement value of the flat is Rs. 40 lacs.

d. A 15 year old LIC policy, where age of the policy holder is not admitted. Nominee is Mrs. A. The latest Surrender Value of the policy is Rs. 8,00,000.

e. Demated Shares of 5 blue chip companies jointly held with wife and nomination is in favour of his son in all these shares . Present market value Rs. 3 lacs.

(b) Give the comparative account of Hypothecation, Pledge and Mortgage. **(10)**

(c) What is KYC? What are the KYC documents banks obtain for Individuals, Partnership and Companies? And how are they verified for authenticity? **(10)**

(d) Give an overview of RBI's Objectives, Functions and Powers. **(10)**

2. (a) Explain various types of risks faced by banks. **(10)**

(b) Discuss various instruments of Monetary Policy used by RBI to control inflation in India. **(10)**

(c) Mention significant features of Accounting system of banks. **(10)**

OR

2A. (a) Write short notes on Asset Classification, Income Recognition and Provisioning norms followed by banks. **(10)**

(b) What is a LC transaction? Explain. How it differs from a Guarantee transaction? Who are the different parties involved in the transaction? Briefly mention different types of LCs? **(10)**

(c) Discuss Nomination facility for Deposit Accounts, Safe Custody Accounts and Safe Deposit Lockers. **(10)**

3. What are the duties of Collecting and Paying bankers? **(5)**

4. Explain the difference/s between Cash credit facility and Term loan facility. **(5)**

5. Give salient features of the following Government Schemes:

(a) MUDRA Scheme

(b) DAY – NRLM & NULM **(5)**

6. Write a brief note on Role of NBFC's in Indian Banking. **(5)**

NOTES