Question Paper
Central Banking & Commercial Banking (MB3G2B) : October 2008

Section A : Basic Concepts (30 Marks)

- This section consists of questions with serial number 1 - 30.
- Answer all questions.
- Each question carries one mark.
- Maximum time for answering Section A is 30 Minutes.

1. Under project finance, lenders' appraisal is based on which of the following factors? <Answer>

I. Physical Assets.
II. Projected revenues.
III. Credit worthiness of the sponsor.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

2. Which country by their policy statement, though often referring to price stability, attach importance to controlling inflation? <Answer>

(a) USA
(b) Germany
(c) Canada
(d) Australia
(e) Japan.

3. In which sector problems percolate rapidly into the entire financial system and the economy? <Answer>

(a) Financial Institutional sector
(b) NBFC sector
(c) Banking sector
(d) Investment Institutional sector
(e) Specialized Financial Institutional sector.

4. The Tail end bonds are those whose remaining term of maturity is <Answer>

I. One year.
II. Less than a year.
III. Even 18 months.

(a) Only (I) above
(b) Both (I) and (II) above
(c) Both (I) and (III) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

5. To sustain profitability which of the following factors is **not** a macro and micro level prudent consideration of lending activity prior to and after sanctioning the credit? <Answer>

(a) Amount of credit to be extended during a financial year
(b) The industries to be focused on
(c) Imbalance between competing goals of loan volume and loan quality
(d) The type of credit to offer
(e) The disbursal mechanism.

6. Which of the following is a third component of working funds? <Answer>

I. Owned funds.
II. Float funds.

III. Deposits.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (II) above
(e) All (I), (II) and (III) above.

<Answer>

7. On which of the following institutions IDBI exercises developmental and supervisory functions?

(a) State Financial Corporations
(b) State co-operative banks
(c) Central co-operative banks
(d) RRBs
(e) Housing finance companies.

<Answer>

8. Among various other factors, which of the following mainly influence(s) a nation's economic growth?

I. Money supply.
II. Interest Rates.
III. Exchange rates.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

<Answer>

9. Which of the following ought to be the core objective of a monetary policy?

(a) Stability in employment
(b) Price stability
(c) Money supply
(d) Growth in employment
(e) Economic growth.

<Answer>

10. What is the rationale behind the banking sector being perhaps the most closely regulated sector than any other sector?

(a) Major portion of general public funds are held by banks
(b) Banks intermediate between savings and investment
(c) Banks hold large portion of the total quantity of money supply
(d) Funds may not be deployed in a prudent fashion if no regulations exist
(e) Banks administer the national payments and settlement system.

<Answer>

11. As per RBI decision, which of the following items are included under loans against hypothecation?

(a) All types of automobiles having recognized charge under Motor Vehicles Act
(b) Aircrafts registered with Director General of Civil Aviation
(c) Unregistered Fishing Trawlers with port authorities
(d) Ships registered with Director General of Shipping
(e) Equipment leasing and hire purchase assets of a NBFC for classification as an equipment leasing or hire purchase.

<Answer>

12. Regulation Review Authority was set up by

(a) Government of India
(b) Reserve bank of India
(c) Indian Banks Association
(d) Department of banking Supervision
(e) Board for financial supervision.

<Answer>

13. To carry out banking supervision on a consolidated basis, which of the following is/are the essential element(s) of supervision?

I. Ability to review both banking and non-banking activities.

<Answer>

II. Activities conducted at both domestic and foreign branches.
III. The ability to decide which prudential requirements will be applied.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

14. Which of the following return is **not** common to all scheduled banks operating in India under the First Tranche of DSB returns? <Answer>

(a) Return on assets
(b) Return on large credits
(c) Return on Asset quality
(d) Return on capital adequacy
(e) Return on credit to directors/managers.

15. Which of the following is **not** the constituent of Federal Reserve System? <Answer>

(a) H.M.Treasury
(b) Member Banks
(c) Advisory Committee
(d) Board of Governors
(e) Federal Open Market Committee.

16. In which of the following areas RRBs do operate? <Answer>

I. Rural Areas not covered by scheduled banks.
II. Rural areas not covered by co-operative banks.
III. Rural areas not covered by special purpose rural banks.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

17. Which of the following comes under private sector banks? <Answer>

(a) Urban co-operative bank
(b) National Housing bank
(c) Foreign banks in India
(d) Land development banks
(e) Central co-operative banks.

18. Which of the following statements is **not true** with respect to the obligations of a bank? <Answer>

(a) A banker must honor customer's cheques if sufficient balance exists in the account
(b) Maintenance of secrecy of customer's account
(c) The bank has obligation to third parties out of his duty to pay it's customer cheques
(d) Bank to give reasonable notice before closing the account
(e) Customer should be informed in case a fraudulent cheque is presented.

19. Which of the following Retail Bank Services is categorized under Facilitating services? <Answer>

(a) Internet banking
(b) Current account
(c) Credit cards
(d) Payment services
(e) Counseling on post retirement savings.

20. In the increased competitive and deregulated market place, both cost and amount of deposits are influenced by which of the following factors? <Answer>

I. Pricing schedules.
II. Competitive maneuverings of banks.
III. Non-banking institutions offering similar services.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

21. In pricing deposits which of the following factors the banks would consider? <Answer>

I. The liquidity needs..
II. The direction and levels of interest rates.
III. Local market conditions.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (III) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

22. Which deposit pricing model favors large denomination deposits? <Answer>

I. Flat rate pricing category.
II. Conditional free pricing category.
III. Free pricing category.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (II) above
(e) All (I), (II) and (III) above.

23. Before deciding on deployment of excess funds/borrowings for meeting the deficit, which of the following factor/s have/has to be considered? <Answer>

I. Deposit withdrawals.
II. Credit accommodation.
III. Profit fluctuation.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (II) above
(e) All (I), (II) and (III) above.

24. A loan that is structured and supported specifically by the operation and performance of a specific business or enterprise is called a <Answer>

(a) Commercial loan
(b) Personal loan
(c) Educational loan
(d) Overdraft
(e) Cash Credit.

25. Which of the following statements is/are **not** true of a lender in a syndicated loan? <Answer>

I. Each bank lends to the extent of its share.
II. Each banks obligation is separate or “several”.
III. If one member bank commitment is not met other banks are bound to make up the difference.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (II) above
(e) All (I), (II) and (III) above.

26. Based on which of the following purpose(s), banks provide a variety of loans to a broad range of customers? <Answer>

I. The nature of credit.
II. The type of security.
III. The purpose of loan.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

27. Which of the following is **not true** with regard to the impact of NPAs on banks? <Answer>

(a) Erode current profits
(b) Diminution in the value of loan assets
(c) Reduction in interest income
(d) Limit recycling of funds
(e) Requires accretion to capital funds.

28. In which of the following financial instruments, other than loans, banks are facing increased credit risk? <Answer>

I. Inter bank transactions.
II. Foreign exchange transactions.
III. Bonds.
IV. Swaps.

(a) Only (I) above
(b) Both (I) and (II) above
(c) (I), (III) and (IV) above
(d) (II), (III) and (IV) above
(e) All (I), (II), (III) and (IV) above.

29. The RBI is assigned the role of performing supervisory functions by virtue of the powers conferred by the RBI Act, 1934. Which one of the following is **not** included under the RBI Act, 1934? <Answer>

(a) Inspection of banks
(b) Issues related to furnishing credit information from the commercial banks
(c) Power of RBI to impose penalties
(d) Definition of NBFCs
(e) Winding petitions of NBFCs.

30. The major risk banks must measure, monitor and manage is <Answer>

(a) Technological risk
(b) Forex risk
(c) Credit or default risk
(d) Liquidity risk
(e) Interest rate risk.

END OF SECTION A

Section B : Caselets (50 Marks)

- This section consists of questions with serial number 1 – 5.
- Answer all questions.
- Marks are indicated against each question.
- Detailed explanations should form part of your answer.
- Do not spend more than 110 - 120 minutes on Section B.

Caselet 1

Read the caselet carefully and answer the following question:

1. a. Explain the loan review process. Is it an indispensable function of a bank management? If yes, why and if no why not? **(3 marks)** <Answer>

b. What are the warning signals to a bank management that indicate the adverse features of a problem loan? **(3 marks)**

c. What steps should a banker initiate in trying to resolve a problem loan situation? **(4 marks)**

d. Which of the following restrictive loan covenants are affirmative or negative covenants - (1) restrictions on payment of dividends, (2) requirement to insure selected assets, (3) restrictions against taking on new debt, (4) the requirement of filing periodic financial statements with the bank, (5) a requirement of securing bank approval before adding to a borrower's stock of fixed assets (6) requiring a borrowing customer to maintain a current ratio not lower than 1.5 and (7) the stipulation that prior bank approval of a proposed merger must be obtained. **(4 marks)**

The late 1980s and early 1990s saw a steady deterioration in the quality of many banks' loan portfolios. Charge-offs increased significantly. Banks reported sharply reduced earnings or increased losses. Failures reached record numbers and bank regulatory examinations got tougher. For all these reasons, prudent bankers had an increased interest in commercial loan review. It represented an effective, consistent way of assessing the quality of commercial loan portfolios.

The Loan Review function is an essential part of loan quality with due diligence. Its overriding purpose is to improve the quality of the loan portfolio by providing a framework for making effective and appropriate loan decisions, maximizing earnings and minimizing the risk inherent in lending money. Now the focus of the regulatory bodies has shifted and bankers must now shift their priorities in order to:

- Assess the Loan Management function of the Financial Institution instead of just reviewing files.
- Determine the corrective action capabilities of the institutions' overall loan monitoring system.
- Safety and soundness doctrine.
- Scope of the review (dollar and percentage).
- Credit underwriting.
- Loan documentation.
- Standard of care.
- Loan grading.
- Review checklist
- Loan review officer qualifications.

Regulators insist that all financial institutions are required to have a loan review system in place. The degree to which an institution implements its review system will not only affect its ratings from the regulators but will also have an impact on potential costly loan losses. A loan investigation is a detailed review and evaluation of a potential customer's business that provides lenders with the information necessary to make informed credit judgments.

END OF CASELET 1

Caselet 2

Read the caselet carefully and answer the following questions:

2. Why are Central Banks vital for any economy? **(5 marks)** <Answer>

3. What can Central Banks do to achieve growth by keeping inflation stable through macro policies? **(7 marks)** <Answer>

In recent years, in New Zealand as in many other countries, the public have come to believe that Central Banks can achieve much more than they can; in fact, they can really deliver. There is a serious risk that, when the realization dawns that the power of Central Banks is not in fact unlimited, or when economies which have been performing extremely well in recent years go through a period of slower growth, Central Banks will receive far more than their fair share of blame. Indeed, there are already signs of this blame and anger emerging in the United States for much of the last decade, Alan Greenspan was widely assumed to be able to walk on water. Now there are angry accusations from many quarters that imply that he should have been able to keep the US economy growing above its trend potential indefinitely, and prices in the US share-market growing with it.

Today, focus is on the responsibility the Central Banks have for keeping the value of money stable, for keeping inflation low, rather than on their responsibility for the financial system. The question now is to what extent the Central Banks make a contribution to economic growth and social justice by keeping the value of money stable.

Nobody seriously doubts that both hyperinflation and significant deflation can do real damage to economic growth and that by avoiding both Central Banks can make considerable contribution. But what about the contribution to growth from keeping inflation in low single figures, as compared to the double-digit inflation which endured during much of the '70s and '80s,

Perhaps inevitably, this is still a matter of ongoing debate among economists.

Some claim that the contribution is negligible because beyond avoiding the catastrophies of hyperinflation and significant deflation, the contribution which inflation control makes to economic growth is very small. Others see a rather larger contribution, through the fact that the pricing system works more efficiently to allocate resources when prices are on an average stable; for example, through the avoidance of the distortions caused by the interaction of inflation and a tax system based on the assumption that prices are stable.

To see this latter point vividly, the distortions caused by the interaction of even quite modest levels of inflation with a tax system designed on the assumption that prices are stable as being particularly relevant to the way in which keeping inflation under tight control can assist economic growth, it is hard to escape the conclusion that one of the reasons for New Zealanders' relatively heavy investment in property assets, and relatively low investment in financial assets in recent decades is related to the fact that, under the present tax regime, inflation results in an "under-taxation" of property investment and an "over-taxation" of financial assets. And if, as many believe, an increase in the government's share of GDP is associated with lower economic growth.This is another way in which inflation damages growth.

In many ways, keeping the value of money broadly stable makes a bigger contribution to social justice than it does to economic growth. When money is not stable, in other words, there is inflation or deflation, the value of financial assets and liabilities changes in potentially major and unexpected ways.

Therefore, Central Banks can probably make some modest contribution to trend growth through keeping inflation low and stable and can help avoid the social injustices often caused by unstable money.

In seeking to keep inflation low and stable, Central Banks may also have a tendency to smoothen the economic cycle. It is now well understood that one of the most important determinants of changes in the inflation rate is the extent to which actual output diverges from potential output. When actual output falls short of what the economy could produce without difficulty where, in other words, resources of capital and labor are underutilized there is a tendency for inflation to fall. Conversely, when the economy is straining to produce more than it can on a sustainable basis, when capital is being used round-the-clock and the labor market is tight, there is a tendency for inflation to rise. For this reason, all Central Banks, even those with no formal mandate to be concerned about output or employment, have to watch carefully about what is happening to keep inflation under control. Indeed, once inflation has been brought down to a low-level, it is not much of an exaggeration to say that keeping inflation low and stable is mainly about trying to keep actual output tracking close to potential. Reducing economic and social dislocation caused by booms and busts is a useful contribution which Central Banks can make.

END OF CASELET 2

Caselet 3

Read the caselet carefully and answer the following question:

4. Briefly outline a framework through which a bank can manage its liquidity risk. **(12 marks)** <Answer>

In the early months of 1999, the directors of US insurer General American slept soundly in the knowledge that they had an Al rating from rating agency Moody's Investors Service, and that a reinsurance strategy was in place to protect the interests of the company's 300,000 policy holders. But a tactic that General American had developed to raise funds in the short-term markets had put the future of the company in the hands of just 37 institutional investors. These investors, mainly money market mutual funds, had lent the insurer nearly $7 billion of funds that they had the right to call back at just a few days' notice. General American had concentrated so much of its funding in these short-term instruments that it had about 60 percent of the seven-day puttable funding agreement market, and 19 percent of the total short-term insurer funding agreement market.

General American could see no reason why its counterparties would call in their funds abruptly and risk ruining what had become a mutually beneficial relationship. But that's what had just happened, in what has become the classic recent example of how liquidity risk can destroy a major institution. First, in spring 1999, investors were spooked by worsening financial conditions at a company that had marketed General American's funding agreement program and that had reinsured some of the program's liabilities. On July 29, the markets were told that General American would recapture the reinsurance portfolio and assume the whole of the obligations of the funding agreement program, a move that led Moody's to downgrade General American's credit rating on July 30. Another downgrade followed a few days later, as the institutional investors began to scramble to pull their funding back as fast as their contracts allowed them to. Faced with this cash outflow, on August 9, General American admitted it did not have enough liquid assets to honor its contractual obligations and the next day -just 10 days after its cash flow crisis began - it was forced to look to Missouri's insurance regulator for protection.

As General American discovered, liquidity risk is the assassin of institutions. If an institution leaves itself vulnerable, a cycle of market concerns and credit downgrades, followed by short-term demands for cash and rising funding costs, can put a substantially healthy concern in its grave almost overnight.

Liquidity risk is not just a concern for insurers. It's a risk that has helped to cripple all manner of companies from banks to fund managers to manufacturers and has played this year a key role in the fall in fortunes of energy risk management giant Enron. Yet it has proved problematic to define,measure and the best practices associated with managing liquidity are in a state of flux.

END OF CASELET 3

Caselet 4

Read the caselet carefully and answer the following question:

5. Discuss the essential components of a bank's deposit pricing policy. **(12 marks)** <Answer>

The Bank prices all credit products according to market conditions and as per the following specific criteria:

- The Bank's cost of funds;
- Competitive sources of funds for borrowers;
- The Bank's alternative investment opportunities;

- The Bank's cost of delivering products (general and administrative expenses); and Bank profitability targets.

To effectively minimize funding costs through effective deposit pricing decisions, you need to do three things:

a. Implement an effective deposit pricing process.

b. Use financially sound pricing tools in making your pricing decisions.

c. Use segmentation techniques to avoid paying up for non-rate sensitive deposits. An effective deposit pricing process includes:

   - Making sure you have the right kind of information to make decisions.
   - Dividing deposit accounts into sectors.
   - Developing a pricing rule for each sector.

END OF CASELET 4

END OF SECTION B

Section C : Applied Theory (20 Marks)

- This section consists of questions with serial number 6 - 7.
- Answer all questions.
- Marks are indicated against each question.
- Do not spend more than 25 - 30 minutes on Section C.

6. Advances cover all types of lending and must satisfy the bank's need for security and its wish to have the money repaid on the due date. What are the different types of advances offered by banks? **(10 marks)** <Answer>

7. Both monetary and fiscal policies are important policies for any country. These policies have different objectives. Explain the objectives of both of these policies and state how these policies differ from each other. **(10 marks)** <Answer>

END OF SECTION C

END OF QUESTION PAPER

Suggested Answers
Central Banking & Commercial Banking (MB3G2B) : October 2008

Section A : Basic Concepts

Answer	Reason	
1.B	In project financing transactions, the lenders base credit appraisal on projected revenues from the operation of the project rather than on physical assets or the credit worthiness of the sponsor.	< TOP >
2.A	The US monetary officials have made a point by their public statements which nevertheless attach importance to controlling inflation, though often referring to price stability.	< TOP >
3.C	Unlike the other sectors, problems in the banking sector percolate rapidly into the entire financial system and the economy.	< TOP >
4.B	The instruments whose maturity periods are less than one year, or one year (some times 18 months) are termed as short term instruments. Tail end Bonds are those whose remaining term to maturity is one year or less than one year.	< TOP >
5.C	All other options except (c) relate to Macro and Micro level prudent considerations .However the imbalance between competing goals of loan volumes and loan quality will be addressed in the loan policy..	< TOP >
6.B	Float funds, which are the 3rd component of working funds, are much similar to the volatile funds.	< TOP >
7.A	All India financial institutions are covered by on-site supervisory process as per (CAMELS standards). IDBI inspects SFCs .Options b, c and d are under inspection by NABARD and NHB supervises Housing finance companies.	< TOP >
8.E	Money supply, interest rates and exchange rates mainly influenced a nation's economic growth.	< TOP >
9.B	There is growing recognition that price stability ought to be the core objective of monetary policy. This is due to the reason that real growth itself would be in jeopardy, if inflation rates go beyond the margin of tolerance.	< TOP >
10.D	RBI has to ensure that a sound and healthy banking system emerges in the country. Any problems in the banking sector percolate rapidly into the entire financial system and the economy. In the absence of prudent regulations funds may not be deployed in a prudent fashion.	< TOP >
11.C	All options except (C) are correct .Un registered fishing trawlers with the port authorities do not come under hypothecation loans..	< TOP >
12.B	RBI passes regulations, issues guidelines and circulars on a continuous basis for better functioning of the financial system. Such regulations etc may become outdated and may not be attuned to the changing times. Hence RBI set up RRA whose function is primarily to review the regulations.	< TOP >
13.E	The essential element of banking supervision is the ability of the supervisor to supervise over the banking organization as a consolidated whole.	< TOP >
14.E	Off-site prudential supervisory returns were first introduced in 1995.These are called DSB returns. Return on connected lending (Credit to directors and managers) is not a common return for banks operating in India..	< TOP >
15.A	The Federal Reserve System has a decentralized structure. The FRS comprises the Board of Governors .FOMC, Federal Reserve banks, member Banks and Advisory committee. HM treasury is the constituent of UK Financial system.	< TOP >
16.	RRBs operate in rural areas, not covered by the scheduled banks; and the co-operative and special purpose rural banks.	
17.C	The banking system in India has three tiers.Foreign banks in India fall under private banks category.	< TOP >

18. C The bank has no obligation to 3rd parties arising out of the duty to pay its customers' cheques and the payee of cheques issued by a customer cannot sue the paying banker. < TOP >

19. B Current Accounts come under facilitating services. While the options a, c ,d and e are supporting services payment services relate to core services. < TOP >

20. E In the deregulated place both cost and amount of deposits of the banks are heavily influenced by all the factors mentioned. < TOP >

21. E In pricing deposits banks consider all options.. < TOP >

22. B Conditional fee pricing category favors large denomination deposits because services are free if the account balance stays above minimum figure. < TOP >

23. E The liquidity level to be maintained by a bank should first, provide for deposit withdrawals and second, to accommodate the increase in credit demands. While deposit withdrawals must be honored immediately, it is also of priority to ensure that legitimate loan requests of customers are met regardless of the fund's position. Satisfactory credit accommodation ultimately results in more business for the bank. < TOP >

24. A The right answer is commercial loan.. < TOP >

25. C Each bank lends only the amount known as the commitment that it has agreed to make available. In common laws it is known as "several". As such other banks are not legally bound to make up the difference. < TOP >

26. E Banks present their entire advances in 3 different ways based on all the options. < TOP >

27. B The efficiency of a bank is not always reflected only by the size of its balance sheet but by the level lo return on assets .Diminution in the value of loan assets by it self will not make the asset NPA if other factors are met. < TOP >

28. E For most banks loans are the largest and most obvious source of credit risk .However banks are facing risks in inter bank transactions, forex transactions, bonds and swaps also. < TOP >

29. A Inspection of the banks is mentioned the Section 35 of the BR Act of 1949. < TOP >

30. C The risk that has caused the greatest fluctuation in bank earnings has been due to credit risk. This is the reason for the burgeoning NPAs on the balance sheets of banks. < TOP >

Section B : Problems

1. a. Loan review is a process of periodic investigation of outstanding loans on a bank's books to make sure each loan is paying out as planned, all necessary documentation is present, and the bank's loan officers are following the institution's loan policy. While banks today use a variety of different loan review procedures, a few general procedures are followed by most of them. < TOP >

These include:

Carrying out reviews of all types of loans on a periodic basis.

Structuring the loan review process carefully to make sure the most important features of each loan are checked.

Reviewing the largest loans most frequently.

Conducting more frequent reviews of troubled loans.

Accelerating the loan review schedule if the economy slows down or if industries in which the bank has made a substantial portion of its loans develop significant problems.

Loan review has become a necessity for a sound bank lending program. It not only helps management spot problem loans more quickly but also acts as a continuing check on whether loan officers are adhering to a bank's loan policy. For this reason, as well as to promote objectivity in the loan review-process, many of the largest banks separate their loan review personnel from the loan department, itself. Loan reviews also aid senior management and the bank's board of directors in assessing the bank's overall exposure to risk and its possible need for more capital in the future.

b. Problem loans are often characterized by reduced communication between borrower and lender, delays in receiving financial reports, evidence of reevaluations of assets (such as inventory or pension-plan assets), declining stock prices, changes in management, or the restructuring of other loans the borrower has taken out.

c. The most important first step is to move quickly to contact the borrower, to ascertain if the borrower understands the nature of the loan problem, to explore for creative solutions to the problem, and to get the borrower to reach a decision on the best solution possible.

d. Loan agreements between banks and their business borrowing customers generally contain covenants which require that the borrower "do certain things1' (affirmative covenants) and "not do others" (negative covenants) during the term of the loan agreement. Covenant requirements can be extensive depending upon the amount and term of the loan and the credit standing of the borrower.

Negative covenants typically address issues affecting fundamental nature of borrowers' businesses (e.g., mergers, acquisitions). Breaching of negative covenants usually constitutes immediate default under most loan agreements. Negative covenants limit managerial flexibility and, consequently, are intensely negotiated. Intrusive negative covenants can lead to allegations that the bank wrongfully interfered with borrower's operations or accelerated circumstances leading to borrower's default - potentially exposing the bank to a legal action. Banks should seek no more "control" than absolutely necessary to maintain its position. Most hazardous provisions for banks are: (i) borrowers to maintain management acceptable to bank; and (ii) give bank voting control of borrower.

Negative covenants prohibit acts of the borrower that would jeopardize its continued creditworthiness. The lender should keep only as short a restriction as is necessary in the particular instance. Moreover, the breach of many covenants, while creating a default, may also create rights in third parties that may endanger the lender's rights, for which there is no recourse or remedy. Financial covenants prohibit borrowers' key ratios and financial conditions from exceeding specified limits

Affirmative Covenants vs. Representations: While "reps and warranties" convey assumptions underpinning loans, covenants attempt to maintain those assumptions by controlling borrowers' actions. Affirmative covenants serve many purposes, including maintaining borrowers' creditworthiness and preserving borrowers' assets. These covenants require borrowers to maintain corporate existence and property (e.g., licenses, patents, trademarks). It also requires borrowers to comply with all applicable laws and regulations while conducting business. Covenants require borrowers to pay all taxes, assessments, and levies on income or property, maintain property and liability insurance (self-insuring boirowers require exceptions). Financial covenants {e.g., current ratio, working capital) require borrowers to maintain key financial ratio at stipulated levels.

Some of the standard covenants are-maintaining adequate insurance, furnish financial statements quarterly and annually, do not merge with or acquire another company, not allow other liens on company assets etc. Examples of tailor made covenants are-maintaining a current ratio of not less than 1.5 to 1, maintaining tangible net worth in excess of Rs. Xxxxxxx (varies with the size of company), and a ratio of total liabilities to tangible net worth of no greater than 3 to 1 etc

Most banks will monitor compliance with the loan covenants on a quarterly basis with the receipt of quarterly and annual financial statements. Sometimes the bank will require a periodic certification by a corporate officer or independent accountant that no covenant violation has occurred

i. Restrictions on payment of dividends represent negative loan covenants.

ii. A requirement to insure selected assets is an affirmative loan covenant.

iii. Restrictions against taking on new debt represent negative loan covenants.

iv. The requirement of filing periodic financial statements with the bank is an affirmative loan covenant.

v. A requirement of securing bank approval before adding to a borrower's stock of fixed assets is considered a negative loan covenant.

vi. Requiring a borrowing customer to maintain a current ratio - a liquidity measure - no lower than 1.5x is an affirmative loan covenant.

vii. The stipulation that prior bank approval of a proposed merger must be obtained is a negative loan covenant.

Based primarily on the operating efficiencies that accrue from large transactions, nonstandard rates are offered as needed to secure profitable business for the Bank that would otherwise be transacted by members into competing, non-bank products.

2. In all developed countries and most developing countries, the Central Bank is charged with promoting stable money and a stable financial system. And these are extremely important goals. To see just how important, it is worth reflecting on the economic and human cost incurred by many countries when Central Banks got policy wrong and contributed to the strong deflation of the thirties, or reflecting on the economic and human cost incurred by those countries which experienced hyperinflation at some stage during the last century or reflecting on the economic and human cost incurred by those countries, including many in our own region, which experienced severe banking sector crises in recent years. When Central Banks get it wrong, when they allow the value of the money which they issue to fluctuate substantially, as in the case of serious deflation or high inflation, or when they allow banking systems to become unstable, the damage which can be done is enormous. Savings can be destroyed as also businesses and jobs. < TOP >

So, not to understate the importance of the role which Central Banks can play. When central banking is done well, it not only avoids those catastrophic results which have been seen around the globe from time to time, but also makes some positive contribution to economic growth, to social justice, and perhaps even to the integrity of society itself.

3. There is nothing fair, just, or even honest in a monetary system which steals people's savings, or rewards those lucky enough to go heavily into debt at the right time. There can be little doubt that some of those who today are wealthy became wealthy as much through having the real! value of their borrowings evaporate before their eyes as through their own efforts and initiative. And this sends absolutely the wrong message to everyone making saving, spending and investment decisions. < TOP >

Because in most societies interest rates are used as a way to try to compensate savers for the erosion of the principal value of their savings through inflation, there is an additional problem which often makes it particularly difficult for those with low incomes or few other assets to borrow at a time of high inflation. The problem arises from the fact that, when inflation is high and nominal interest rates are similarly high, the cash-flow problem of servicing a loan is quite difficult in the first few years of the loan, but very easy in the last few years of the loan. Putting it in another way, using interest rates to compensate savers for the effects of inflation on their savings has the effect of front-loading the real burden of debt service. This may effectively deny those on low incomes any access to borrowing facilities in times of high inflation, even though the real interest rate on the loan is at a moderate level.

4. The first step towards liquidity management is to put in place an effective liquidity management policy, which, inter alia, should spell out the funding strategies, liquidity planning under alternative scenarios, prudential limits, liquidity reporting/ reviewing, etc. < TOP >

Liquidity measurement is quite a difficult task and can be measured through stock or cash flow approaches. The key ratios, adopted across the banking system are:

Loans to Total Assets

Loans to Core Deposits

Large Liabilities (minus) Temporary Investments to Earning Assets (minus) Temporary Investments, where large liabilities represent wholesale deposits which are market sensitive and temporary investments are those which mature within one year and temporary investments are held in the trading book and are readily sold in the market;

Purchased Funds to Total Assets, where purchased funds include the entire inter-bank and other money market borrowings, including Certificate of Deposits and institutional deposits; and

Loan Losses/Net Loans.

While the liquidity ratios are the ideal indicator of liquidity of banks operating in developed financial markets, the ratios do not reveal the intrinsic liquidity profile of Indian banks, which operate generally in an illiquid market. Experience shows that assets commonly considered as liquid like Government securities, other money market instruments, etc. have limited liquidity as the market and players are unidirectional. Thus, analysis of liquidity involves tracking of cash flow mismatches. For measuring and managing net funding requirements, the use of maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is recommended as a standard tool. The format prescribed by RBI in this regard under ALM System should be adopted to measure cash flow mismatches at different time bands. The cash flows should be placed in different time bands based on future behavior of assets, liabilities and off-balance-sheet items. In other words, banks should have to analyze the behavioral maturity profile of various components of on/off-balance sheet items on the basis of assumptions and trend analysis supported by the time series analysis. Banks should also undertake variance analysis, at least, once in six months to validate the assumptions. The assumptions should be fine-tuned over a period, which facilitates near reality predictions about future behavior of on/off-balance sheet items. Apart from the above cash flows, banks should also track the impact of prepayments of loans, premature closure of deposits and exercise of options built in certain instruments which offer put/call options after specified times. Thus, cash outflows can be ranked by the date on which liabilities fall due, the earliest date a liability holder could exercise an early repayment option or the earliest date contingencies could be crystallized.

5. Developing a good deposit pricing methodology has gained even greater importance in the recent years because most of the banks fund their loans from non-core sources. Though the non-core sources have increased the marginal funding costs for banks, they were readily available and not very expensive, especially short-term borrowings. The increase in the marginal funding costs increased the interest rates. This rapid increase in interest rates has increased the cost of incremental funding significantly. As borrowings become an increasingly larger component of a bank's funding base, the cost of funds will become even more closely tied to the market rates. < TOP >

The most important factors in pricing of deposit products are risk, demand, market share, growth opportunities, size, capital, sales culture, demographics, cannibalization, price elasticity, cost elasticity, capacity, marketing and incentives and profitability. Careful consideration of each of the factors listed above is necessary to develop an optimal pricing strategy. However, the bank may price advances on a differential basis, based on the creditworthiness of members, volume, or other reasonable criteria applied consistently to all members.

The Bank is required by regulation to price its credit products consistently and without discrimination to all members applying for advances. The Bank is also prohibited from pricing its advances below its cost of funds. However, the Bank may price advances on a differential basis, based on the creditworthiness of members, volume, or other reasonable criteria applied consistently to all members.

Section C: Applied Theory

6. Types of Advances < TOP >

Loans are generally classified into secured or unsecured loans. Their features are discussed below:

Unsecured Advances; When the advance given by the bank has a personal security of any individual or the borrower with or without a guarantor, it will be classified as an unsecured advance. In the absence of any tangible security, though personal security is given by an individual by way of an obligation for repayment, the loans are treated as unsecured. However, all those loans that have the guarantee of a bank/government are categorized as "Advances covered by Bank/Government Guarantees" and hence are not reported under unsecured loans category. An unsecured loan is also a loan without any collateral being offered as security. Two examples of unsecured loans are, a Letter of Credit (LOC) and Signature Loans. If the borrower defaults on an unsecured loan, the creditor has no priority claim against any particular property of the borrower. The creditor can try to obtain just a money judgment against the borrower. Until a small business has an established credit history, it cannot usually get unsecured loans because of the business's risk.

Secured Advances: Secured advances on the other hand, have impersonal security, i.e., the security has to be a tangible asset against which the loan is to be granted. Primary security is an asset against which the loan is given and collateral security is a security, which is given in addition to the existing primary security. These primary and collateral securities can be movable or immovable assets and depending on the same the charge created on the security may vary. Because the value of pledged collateral is critical to a secured lender, loan conditions and covenants, such as insurance coverage, are always required of a borrower.

Charge on the movable properties can be created in the following five different ways:

Pledge
Hypothecation
Assignment Banker's
Lie Set-off
Banker's Lien

7. The main objectives of monetary policy are two-fold: regulate the supply of money and control the cost and availability of credit in the economy. The monetary policy also aims to maintain price stability, full employment and economic growth. < TOP >

In India, the responsibility for formulating and implementing the monetary policy lies with the Reserve Bank of India. The RBI may adopt various measures to increase or decrease the currency supply, regulate interest rates, carry-out open market operations, control credit and vary the reserve requirements.

Fiscal policy is different from monetary policy. Fiscal policy is a broader tool with the government, as compared to monetary policy, which regulates the economy through changes in money supply and interest rates. In fact, fiscal policy may be defined as a deliberate change in government revenue and expenditure to influence the level of national output and prices. Fiscal policy is mainly used as the tool to overcome recession and control inflation.

During recession, in order to increase demand levels, the government may either increase expenditures or cut taxes or. do both. Similarly, during inflation, the government can reduce the expenditure or raise taxes. Essentially, the fiscal policy aims at bringing about changes in aggregate demand by making suitable changes in government spending and taxes.

Fiscal policy focuses on the structural changes in the economy to be achieved through proper budget planning mechanism. Further, this policy enables the government to aim at the maintenance of economic activity and employment since it takes long-term investment decisions especially with regard to infrastructure.

Monetary policy is also different from fiscal policy by virtue of the methods adopted to bring about changes in the economy. Monetary policy is brought into effect by changing money supply and interest rates, whereas fiscal policy is a broader tool with the government.

Monetary policy also distinguishes itself from the fiscal policy by concentrating on contemporary issues related to economic development. By relating itself to the short-term economic adjustments, monetary policy has greater flexibility and ability to respond to the conditions that immediately affect the economy. Both the monetary and the fiscal policies play complementary roles.

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