Question Paper

Money & Banking and Credit Management (MB3G1B): 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. When the price rises more than 120 percent in less than one year, then it is termed as <Answer>

(a) Crawling inflation
(b) Creeping inflation
(c) Trotting inflation
(d) Running inflation
(e) Galloping inflation.

2. Which of the following is **not** a monetary policy instrument? <Answer>

(a) Cash reserve ratio
(b) Statutory liquidity ratio
(c) Bank rate
(d) Commercial Paper
(e) Open market operations.

3. Which of the following statements is **not true**? <Answer>

(a) Claims to wealth comprise of money, deposits in banks, bills etc.
(b) Money is a stock variable in contrast with a flow variable like real income which refers to its rate per unit of time, say per year
(c) Bond is a form of near money
(d) Money and wealth is one and the same
(e) Major component of the financial requirements of business community and of Government is met through new money created by commercial banks.

4. The loan system of delivery introduced by RBI in 1995 is applicable to borrowers enjoying working capital (fund-based) limits of <Answer>

(a) Rs. 5 crores and above
(b) Rs.10 crores and above
(c) Rs.20 crores and above
(d) Rs.25 crores and above
(e) Rs.30 crores and above.

5. Which of the following forms of business is **not** undertaken by a "Bank"? <Answer>

(a) Undertaking and executing trusts
(b) Negotiating of loans and advances
(c) Undertaking the valuation of properties
(d) Carrying on and transacting every kind of guarantee and indemnity business
(e) Collecting and transmitting of money and securities.

6. When small amounts of savings from individuals and others are collected and pooled for lending to others, it is considered as <Answer>

(a) Maturity disintermediation
(b) Denomination intermediation
(c) Information intermediation
(d) Risk pooling and Diversification
(e) Liquidity intermediation.

7. In which of the following circumstances disclosure of information of a customer by a banker is permitted as per <Answer>

law?

(a) Obligation to maintain secrecy of account extinguishes on the death of the customer
(b) By compulsion of law the particulars of an account can be disclosed
(c) With the account holders implied or express consent, disclosure can be made
(d) In the interest of public, disclosure is a must
(e) When in the interests of the banker.

<Answer>

8. 'A document issued by a bank which guarantees the payment of a customer's drafts for a specified period and upto a specified amount' is known as

(a) Performance guarantee
(b) Deferred payment guarantees
(c) Letter of credit
(d) Financial guarantee
(e) Advance payment guarantee.

<Answer>

9. A type of running (operating) account from which the borrower can withdraw funds as and when needed, is called as

(a) Consumer credit
(b) Cash credit
(c) Term loans
(d) Letters of credit
(e) Money at call.

<Answer>

10. Which of the following is **correct** with regard to application of Corporate Debt Restructuring (CDR) limits?

(a) Sanctioned limits in aggregate exceed Rs.50 crores and above
(b) Outstanding exposure of Rs.25 crores and above
(c) Sanctioned limits of Rs.20 crores and above
(d) Outstanding exposure of Rs.20 crores and below
(e) Outstanding exposure of Rs.20 crores and above.

<Answer>

11. The cut-off rate for a 91 day treasury bill declared by Reserve Bank of India (RBI) is Rs.96.20. The yield on the bill is

(a) 16.28%
(b) 15.84%
(c) 14.93%
(d) 13.49%
(e) 12.25%.

<Answer>

12. The effective cost of deposit bearing 11.5 percent interest, if subjected to CRR of 10%, then the effective rate of interest is (assuming that no interest on CRR balances is received)

(a) 14.15
(b) 13.95
(c) 12.77
(d) 11.92
(e) 11.73.

<Answer>

13. Provision for Income-tax in excess of estimated amount is to be included as a liability

(a) In the computation of NIBL
(b) In the computation of CRR but not for SLR
(c) In the computation of SLR
(d) In the computation of NDTL
(e) It does not form part of NDTL.

<Answer>

14. Which of the following statements is **false**?

FFRs (Financial Follow-up Reports)

(a) FFR II report is to be furnished half-yearly within 8 weeks before the end of the half-year
(b) Are not the only method of supervision and follow-up
(c) Objective is to ensure that the borrower complies with the stipulated terms of sanction
(d) Submission of these reports is also mandatory for non-seasonal industries
(e) Submission of these reports is applicable to all borrowers with fund-based limits of Rs.10 crores and over.

<Answer>

15. The objectives of setting up the SLR are to

I. Provide returns by way of yields on securities to augment its income.
II. Control the money supply for credit deployment.
III. Augment banks investments in government securities.
IV. Ensure solvency of banks.

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

<Answer>

16. Which statement among the following is **false**?

(a) While qualifying an account as NPA (Non-Performing Asset), security, net worth of borrower will not be considered
(b) An asset is to be classified as NPA, only when there is threat of loss or a doubt of its recovery
(c) The interest recovered partially on the NPAs will be taken into the income account
(d) When a particular facility of a borrower becomes an NPA, then all other facilities to the borrower will be treated as NPAs
(e) Currently provisioning on NPAs guaranteed by the State Government is not mandatory.

<Answer>

17. Which of the statements on Demand-Pull Inflation given below is **false**?

(a) The Demand-Pull theory centres on demand for money
(b) Inflation may be casued by an increase in quantity of money in circulation
(c) Inflation is always and every where a monetary phenomenon
(d) Aggregate demand in the economy rather than the supply of money determines the economy
(e) Price stability is traded off against employment.

<Answer>

18. Which of the following statements is **true** with regard to appropriation by a creditor?

I. The creditor can appropriate and apply the payments made by a debtor to discharge a particular debt as per the written or implied directions of the debtor.
II. When the debtor does not give any directions for appropriation, the creditor may even discharge the payment against a time-barred debt.
III. In the absence of any indication from a debtor, a creditor can appropriate the payments at his discretion.
IV. Debts which are old should be appropriated first based upon the age of the debt is the law when the debtor and creditor are silent as to appropriation of a payment.

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

<Answer>

19. While framing credit policy, a bank needs to address certain significant issues to be incorporated in the policy document. Which of the following is **not** considered for inclusion in the credit policy guidelines?

(a) Loan evaluation procedures
(b) Volume and mix of loans
(c) Prudential norms
(d) Objectives like risk factors, profitability etc.
(e) Evaluation of management.

<Answer>

20. Which of the following is **not** coming under the category of ‘investments’ in a Bank’s balance sheet?

(a) Shares
(b) Money at call
(c) Government securities
(d) Debentures and bonds
(e) Subsidiaries and/or Joint ventures.

<Answer>

21. Micro Credit covers

(a) Financing of industries on long-term basis
(b) Financing agricultural needs for 3 years and more
(c) Financing long-term working capital needs
(d) Financing Working Capital Demand Loan
(e) Financing consumption and production loans for farm and non-farm activities.

<Answer>

22. Which of the following is **not** an important function of interest?

(a) Influences the level of business activity
(b) Influences the movement of capital between countries
(c) Undermines the marginal efficiency of capital
(d) Brings about equality between savings and interest investment
(e) Determines the volume of investment in an economy.

<Answer>

23. Of all money's functions, identify the one that is unique and distinguishes money from other assets.

(a) Medium of exchange
(b) Unit of account
(c) Store of value
(d) Measure of value
(e) Standard of deferred payment.

<Answer>

24. If Capital Adequacy Ratio (CAR) of a bank is 10 percent, Average Risk Weight (ARW) is 65 percent and Capital is Rs.300 crores, then what are the total assets of the Bank?

(a) Rs.5,316 crores
(b) Rs.4,615 crores
(c) Rs.4,729 crores
(d) Rs.4,173 crores
(e) Rs.3,915 crores.

<Answer>

25. Supreme Bank Ltd., has a capital of Rs.163 crores and an asset base of Rs.1500 crores with the following risk weights:

Asset	Risk Weight
Rs.900 crs	100 %
Rs.450 crs	40%
Rs.150 crs	Nil

What is the Capital Adequacy Ratio (CAR) of the bank (approximately)?

(a) 21%
(b) 18%
(c) 16%
(d) 15%
(e) 12%.

<Answer>

26. Which of the following is **not** a debt that is considered as a liability claim by banks/financial institutions, from any person (inclusive of interest), as per Debt Recovery Tribunal?

(a) Unsecured/Secured advance
(b) Assignment
(c) Decree issued by a court
(d) An award of arbitration
(e) A mortgage not subsisting on the date of application.

<Answer>

27. Which of the following is **not** an Interest rate contract?

(a) Basis swaps
(b) Currency futures
(c) Interest rate futures
(d) Forward rate agreements
(e) Interest rate option contract.

<Answer>

28. Which of the following statements is **false** with regard to advances?

(a) The asset categorization in a balance sheet is based on the type/nature of the asset
(b) Net bank credit plus bills rediscounted by the bank with IDBI / SIDBI is gross credit
(c) Balance under advances represents outstanding prior to provisioning
(d) Banks have to make provisions depending on the level of NPAs
(e) The provisions made on account of NPAs are usually less than NPAs.

<Answer>

29. Which of the following is **not** an advantage associated with branch banking?

(a) Diversification by providing mobility of funds
(b) Distribution of capital from surplus regions to deficit areas
(c) Huge resources can be procured easily
(d) Economy of operations
(e) Leads to concentration of resources.

<Answer>

30. The objectives of Regional Rural Banks (RRBs) are:

I. To provide credit and other facilities to the small and marginal farmers.
II. To develop agriculture, trade, commerce and other productive activities in the rural areas.
III. To provide credit to agricultural labourers, artisans and small entrepreneurs.
IV. To provide credit facilities for large corporate agri-farms set up near urban areas.

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

END OF SECTION A

Section B : Problems/Caselets (50 Marks)

- This section consists of questions with serial number 1 – 7.
- Answer all questions.
- Marks are indicated against each question.
- Detailed workings/explanations should form part of your answer.
- Do not spend more than 110 - 120 minutes on Section B.

1. Devine Instrumentation Limited is proposing to acquire a new machine to replace an existing machine <Answer>

- With a book-value of Rs.15,000 and resale value @ Rs.7,500.
- The salvage value of old machine is estimated to be Zero in four years and is depreciated on a straight-line basis.
- It is expected that the new machine would reduce the costs by around Rs.35, 000 per year over the old machine.
- The new machine's life is expected to be four years and costs Rs.70,000 and it is estimated to fetch Rs.10,000 on its re-sale at the end of 4th year.

Considering 40% tax- rate and depreciation on straight- line basis, you are expected to define the cash flows associated with the investment. Assume that the straight-line method of depreciation is used for tax-purposes. **(8 marks)**

2. Consider the following data: **(3 marks)** <Answer>

Particulars	No. of days
Gross operating cycle	160
Net operating cycle	110
Raw material storage period	80
Conversion period	4
Finished goods storage period	40

You are **required** to calculate the average collection period.

<Answer>

3. The non-performing assets of a Excelsior Bank at the beginning of the year 2007 are as under:

Name of the Asset	Rs. in crores	Recovery during the year (%)
Standard	1,600	–
Sub-standard	400	16
Doubtful		
Upto 1 year	120	6
1 to 3 years	66	5
Above 3 years	58	4
Loss	95	12

Credit extended during the year is Rs.240 crores, which can be classified as standard asset. Of the sub-standard assets, Rs.125 crores got degraded and Rs.100 crores got upgraded. Of the doubtful assets of Rs.120 crores, Rs.40 crores was upgraded.
You are **required** to find out:

a. The provisionary requirement for the current year. **(7 marks)**

b. The additional amount of provisions required for the current year. **(3 marks)**

Caselet 1

Read the caselet carefully and answer the following questions:

<Answer>

4. 'Bancassurance relates to selling insurance through banks which benefits insurance companies, banks and the customers'. Explain this concept. **(9 marks)**

<Answer>

5. 'Bancassurance though beneficial to the bankers, insurers and customers, yet, entails certain potential areas of conflict which must be carefully monitored and addressed suitably'. Explain. **(6 marks)**

Bancassurance symbolizes the convergence of banking and insurance. It involves distribution of insurance products through a bank's branch network. The bancassurance, with the potential to redefine the ways in which insurance products are sold, has developed into a tremendous success story in Europe. However, it is gradually gaining ground in India.

The growth story of the Indian Banking sector for the obvious reasons of a zooming economy, expanding middle class and the vast branch network, is unlikely to be matched by any banking industry across the emerging market economies. However, the growth prospects have also led to an intense competition in the Indian banking industry. Traditional bases for differentiation, such as product features or cost are becoming less tangible. Therefore, a bank's management is forced to look out for new ways to attract new customers and simultaneously retain the existing ones, besides boosting their bottom lines. With the interest income coming under pressure, banks are looking for expanding fee-based income activities. Bancassurance and selling of mutual funds are the most tapped business opportunities by the bankers today.

The Indian insurance industry has revealed its true potential only after liberalisation. With the opening up of the insurance sector and so many players entering the Indian insurance industry, the insurance companies are compelled to come up with innovative products, more consumer awareness about their products and offer them at a competitive price. The Indian insurance market provides untapped potential of about 30 crores lives with insurable interest outside the insurance cover. Besides life insurance, the increasing levels of income and consequent expansion in assets provide a huge scope for general insurance. To reach such a huge untapped market, insurance companies need a wide and trustworthy network. While the old giants such as Life Insurance Corporation of India and other Government - owned general insurance companies have a good network, maintaining and managing such network is definitely a daunting task for the new entrants. Even the old public sector biggies are now looking to supplement their distribution channels in response to the competitive forces prevailing in the Indian insurance market.

It is an established fact that insurance is a business of faith and solicitation. 'Bancassurance' as a business proposition, involves distribution of insurance products through a bank's branch network, has the potential for generating synergic benefits both for bankers as well as insurers. It symbolizes the convergence of banking and insurance. The bancassurance, with the potential to redefine the ways in which insurance products are sold, has developed into a tremendous success story in Europe. However, it is gradually gaining ground in India with the liberlisation and opening up of Indian insurance industry. With many players entering the field, competition compelled the industry to come up with innovative products to create more consumer awareness about their products and services at competitive prices. To reach a huge and untapped market, insurance companies need a wide and trustworthy network.

In India, banks continue to command the highest trust among all financial sector players as out of the total pool of financial savings of households, the largest share goes to bank deposits. In addition, a huge network of 69,417 bank branches comprising of 30,776 rural branches, 15,370 semi-urban branches and 23,272 urban and metropolitan branches (as per RBI report 2005-06) is virtually impossible to replicate and will be indispensable in penetrating novel segments such as rural markets.

Bancassurance addresses the twin objectives of portfolio diversification by retail customers and synergic integration of marketing management of banks and insurance companies. If taken in a right spirit and implemented properly, this can be a win-win situation for all the participants, viz., banks, insurers and the customers.

END OF CASELET 1

Caselet 2

Read the caselet carefully and answer the following questions:

6. Why credit derivatives are used and classify briefly the participant's/operators in the 'derivatives market'? **(8 marks)** <Answer>

7. What are the practical difficulties in handling credit derivatives? **(6 marks)** <Answer>

In the era of globalization, we are witnessing innovations in financial engineering which result in the evolution of a new set of products in the banking and financial sector named Derivatives. The growth of these products in the last 25 years has been one of the most extraordinary and important features of the financial market place. Although commodity forwards and futures have been traded actively since the turn of the century and historians find antecedents for the options contracts in ancient Greek writings and it was not until 1972 that the market for modern derivatives was born.

Representatives of 44 nations assembled at Bretton Woods (USA) and agreed on a fixed rate exchange rate system till the early 1970s. Two months before the collapse of Breton Woods's system, the Chicago Mercantile Exchange (CME) launched the world's first exchange traded currency futures. In 1975, interest rate futures contracts started on GNMA CDRs (Government Nation Mortgage Association Certificates of Deposit Rollover) on the Chicago Board of Trade (CBOT) and in the T-Bills on the CME.

Introduction of credit derivatives in India is a watershed development for bank's credit risk management practices. It will fundamentally change the way banks price, manage, transact, originate, distribute and account for credit risk. Banks can use the credit derivatives to diversify their portfolios of loans and other risky assets. Credit derivatives are contracts that transfer an asset's risk and return from one counter party to another without transferring ownership of the underlying assets. The three major types of credit derivatives are default swaps, total rate of return swaps and credit spread put options.

It will become more common to observe banks taking exposure to borrowers with whom they have no meaningful relationships and shedding risk to make room for further business with those borrowers they have good relationships with. Such transactions will occur both on a one-off-basis and increasingly through large bilateral portfolio swaps. Credit derivatives will bring greater efficiency of pricing and greater liquidity. With enhanced liquidity, credit derivatives will help in achieving the financial equivalent of a free lunch, whereby both buyers and sellers of risk benefit from the associated efficiency gains, a win-win situation.

Hurdles and Potential for Future

Credit derivatives will help managing credit risk effectively and efficiently. Market participants could face several practical difficulties.

While global market for credit derivatives is not wide, analysts found that growth potential is virtually unlimited. A number of recent developments should facilitate the growth of credit derivatives. For example in 1999, the International Swaps and Derivatives Association (ISDA) introduced new streamlined default swap documentation that should reduce the likelihood of interpretation disputes. The recent launch of two Internet trading platforms for credit derivatives (www.credittrade.com and www.creditex.com) could bring some much needed transparency to the market.

Analysts feel that credit derivatives will change the face of finance but still there are some disturbing questions. How will the products change the way banks invest in the bond market? How will the regulator view the capital adequacy of banks? What effects will they have on others areas of the financial world? And imagine what might happen three years from now, if credit derivatives really catch on.

END OF CASELET 2

END OF SECTION B

Section C : Applied Theory (20 Marks)

- This section consists of questions with serial number 8 - 9.
- Answer all questions.
- Marks are indicated against each question.
- Do not spend more than 25 - 30 minutes on Section C.

Write short notes on: <Answer>

a. The mechanism of Letter of credit and the limitations of Letter of credit. **(5 marks)**

b. Post shipment credit. **(5 marks)**

With the type of service a bank provides, the relationship of banker-customer assumes a different role. Explain with examples. **(10 marks)** <Answer>

END OF SECTION C

END OF QUESTION PAPER

Suggested Answers
Money & Banking and Credit Management (MB3G1B): October 2008

Section A : Basic Concepts

Answer	Reason	
1. E	When the price rise more than 120 percent in less than one year, then it is termed as galloping inflation. It is also called as hyper inflation.	< TOP >
2. D	Commercial paper is not a monetary policy instrument. It is a fiscal policy instrument.	< TOP >
3. D	Money and wealth are two distinct entities. Wealth is the total financial and real assets owned by people. Wealth can be expressed in terms of money but wealth and money are not one and the same.	< TOP >
4. B	RBI introduced loan system for bank credit to bring about greater discipline in credit utilization and to gain better control over flow of credit. Under this banks are required to bifurcate working capital limit of Rs. 10 crores and above from the banking system into loan and cash credit components.	< TOP >
5. C	Undertaking the valuation of properties is not an activity that is undertaken by any bank. For this purpose, it engages the services of others. The rest of the options relate to the business activity of a bank. Tb 33	< TOP >
6. B	: Denomination intermediation is a kind that occurs when small amount of savings from individuals and others are collected and pooled so as to give loans to others is the correct statement. Under Default-risk intermediation refers to the willingness of financial intermediaries to lend loans to risky borrowers. Maturity intermediation refers to borrowing funds for short term from savers. Liquidity intermediation refers to issuing of indirect financial claims to savers. Information intermediation refers to the process by which financial intermediaries substitute their skill in gathering and processing loans.	< TOP >
7. A	A banker at all times maintains secrecy of its customers account details even when the customer dies except with the implied or written consent of the customer. Failing to do so, the banker shall be liable to pay damages to his customer as well to the third party. Options (b) to (e) are all disclosures permitted as per law.	< TOP >
8. C	A letter of credit is defined as a document issued by a bank which guarantees the payment of a draft for a specified period and upto a specified amount. When any bank other than the issuing bank does not confirm a letter of credit, it is called an unconfirmed letter of credit. A guarantee is a contract to perform the promise, or to discharge the liability of third person in case of his default. The options relate to various types of guarantees a banker issues. (108).	< TOP >
9. B	Cash credit and overdraft are running accounts form which the borrower can withdraw funds as and when needed upto the credit limit sanctioned by his banker is	< TOP >

the correct answer. The other options relate to different type of credit facilities extended where this type of running account facility is not permitted.

10E CDR will only apply to multiple banking accounts, syndicates and consortium accounts with outstanding exposure of Rs. 20 crores and above to and the rest of the options are incorrect < TOP >

11B The amount of investment is Rs.96.20 and the amount of interest earned on investment is Rs.3.80 and the Treasury bill is for a maturity period of 91 days. < TOP >

Hence the yield will be = 3.80 x 365 x 100 / 96.20 x 91 = 15.84%

12C Assuming the deposit is for Rs.100, the interest on the deposit is Rs.11.50 and the CRR is @ 10@ < TOP >

Then 100-10 = 90   11.50/90 = 12.77%

13E Excess provision made in excess of the actuals or estimates is not to be included for computation of NDTL is the correct answer. Rest of the options are all incorrect statements. < TOP >

14A The FFR II reports are to be submitted to banks within 8 weeks from the end of the half-year and not as stated in the option to the question. The other options are all correct. < TOP >

15D To provide returns on income by way of yields is a benefit and not an objective. The other options are all correct objectives of SLR. < TOP >

16E All advances guaranteed by Central/State Governments will not be classified as NPAs until the time the guarantee is invoked and the Government repudiates. Rest of the statements are all true.

17A The correct statement is that the Demand-Pull Inflation theory centers on the supply of money and not on the demand for money as stated. All the other statements are true... < TOP >

18D Options II and III are correct statements of appropriation by a creditor and they are as given below: < TOP >

a. When the debtor does not give directions for appropriation, the creditor may even discharge the payment against a time-barred debt

b. In the absence of directions of a debtor, a creditor can appropriate the payments at his discretion.

The statement in option (I) relates to appropriation by the debtor and the option (I) relates

To appropriation by law where neither party appropriates.

19C While formulating a credit policy, a bank needs to address certain significant issues that are to be incorporated in the policy. Few considerations that the loan policy may address are: < TOP >

- Objectives like profitability, liquidity, risk factors etc
- Volume and mix of loans in terms of industry/location etc
- Geographical spread like locations, demand areas etc
- Loan evaluation procedures for processing of loans
- Management evaluation to assess the ability to repay etc

Normally, prudential norms are not forming part of policy document And these are communicated by RBI for implementation by the Bank/s. Hence 'C' is considered as the right answer

20B A major asset item in balance sheet of a bank is investment in various kinds of securities. Bank's investments are classified into six different baskets depending upon the nature of security. These are: < TOP >

- Government securities
- Approved securities
- Shares
- Debentures and Bonds

- Subsidiaries and or JVs
- Other Investments

All loans made in the inter bank call money market that are repayable within 15 days notice are included under the head 'Money at Call and short notice'.

21E Micro-finance has been defined by the task force set-up by the NABARD as 'provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards. Other alternatives are not correct. Such credit covers not only consumption and production loans for various farm and non-farm activities of the poor but also include other credit needs such as housing and shelter improvements. TB 201Ch 14 < TOP >

22C The rate of interest determines the marginal efficiency of capital and not otherwise as stated in the option. All other statements are true and correct functions of rate of interest. < TOP >

23A Everyone recognizes money for its noted value and for its cognizable features of universal acceptability as a means of payment. Durability bestows money its long life for its intrinsic value. In fact, no other asset can effectively act as the medium of exchange other than money. Lastly its divisibility and general acceptability enables it to carry out all kinds of transactions. Where as other assets can perform only limited functions. Hence (a) is the correct answer. < TOP >

24B Total assets is computed as under: < TOP >

Total assets = Capital (divided by) CAR X Average Risk Weight

Rs. 300 crs / 65 % X 10 % = Rs. 4615.384 crores.

(300,00,00,000 / 6500 x 1000 = 4615.384)

25D CAR is Capital / Risk weighted Assets < TOP >

163 crs / (900 x1 + 450 x 0.4 + 150 x 0) = 163 / 1080 percentage = 15%

26E Debt means any liability including interest which is claimed as due from any person by a bank or FI etc during the course of any business activity undertaken by the bank or FIs, for the time being in force in cash or otherwise, whether secured or unsecured or assigned or whether payable under a decree or order of any Civil Court or arbitration award or otherwise or under a mortgage and subsisting on and legally recoverable on the date of the application. < TOP >

27B Currency futures is not an interest rate related contract. Single currency interest rate swaps, bias swaps, forward rate agreements, interest rate futures, interest rate option purchased are all interest rate related contracts. < TOP >

28C As in the case of investments, the balance under the advances is reflected in the balance sheet after reducing the provisions is the correct answer... All the other options are correct. < TOP >

29E Concentration of resources is a disadvantage associated with branch banking as huge resources are left under the control of some individuals only. The other options are all the advantages and are correct. < TOP >

30D RRBs are not to finance large Corporates near urban areas. The area of operation of RRBs is mostly to < TOP >

function only in rural areas and semi-urban areas only.

Section B : Problems

1. Cash Flows associated with Replacement Decision: < TOP >

Year	Particulars	0	1	2	3	4
1	Net investment in new machine	(62,500)				
2	Savings in costs		35,000	35,000	35,000	35,000
3	Incremental depreciation		11,250	11,250	11,250	11,250
4	Pre-tax profits		23,750	23,750	23,750	23,750
5	Taxes		9,500	9,500	9,500	9,500
6	Post-tax profits		14,250	14,250	14,250	14,250
7	Initial flow (1)	(62,500)				
8	Operating flow (6 + 3)		25,500	25,500	25,500	25,500
9	Terminal flow					
10	Net cash flow (7 + 8)	(62,500)	25,500	25,500	25,500	25,500

Computation of depreciation
on existing machine Rs.15,000 / 4 = Rs. 3,750 per annum

on new machine Rs.60,000 / 4 = Rs. 15,000 per annum

Incremental depreciation = Rs. 11,250 per annum.

2. Average collection period = Gross operating cycle – (RM storage period + Conversion period + FG storage period) = 160 – (80 + 4 + 40) = 36 days cbm7 0708/1b < TOP >

3. a. Provisioning of Excelsior Bank for the earlier year: < TOP >

Provisioning

Nature of Asset	Provisioning	Amount of provisioning Rs. in crores.
Standard Assets	1600×0.0025	4.00
Sub-standard Assets	400×0.10	40.00
Doubtful Assets < 1 year	120×0.20	24.00
1 to 3 years	66×0.30	19.80
Above 3 years	58×0.50	29.00
Loss Assets	95×1.00	95.00
Total		211.80

for the year 2007

b.

	Nature of asset	Provisioning	Amount of provision Rs. crores
1.	Standard assets	$(1,600 + 240 + 100) = 1,940 \times 0.0025$	4.85
2.	Sub-standard assets	$(400 – 125 – 100 – 64 + 40) = 151 \times 0.1$	15.10
3.	Doubtful assets		
	Up to 1 year	$(120 + 125 – 40 – 7.2) = 197.8 \times 0.2$	39.56
	1 – 3 year	$(66 – 3.30) = 62.70 \times 0.3$	18.81
	Above 3 years	Above 3 years $(58 – 2.32) = 55.68 \times 0.5$	27.84
4.	Loss assets	$(95 – 11.40) = 83.60 \times 1$	83.60
		Total	**189.76**

The bank need not make any additional provision for the current year as the provision of Rs.211.80 crores made earlier is more than the current year provision of Rs.189.76 crores.

4. Bancassurance, as a business proposition has the potential for generating synergic benefits both for bankers as well as insurers. While it boosts the bank's bottom lines, it also leads to a significant lowering of distribution costs for insurers besides opening new business for further expansion and growth. Bancassurance addresses the twin objectives of portfolio diversification by retail customers and synergic integration of marketing management of banks and insurance companies. If taken in a right spirit and implemented properly, this can be a win-win situation for the partisans, viz., banks, insurers and the customers. < TOP >

i. Bancassurance means a major gain for the banks. While it is a source of additional income for them, it also helps them in enhancing employee productivity with additional business. Distribution of insurance products through banking channels helps them to add more customers while providing additional services to the existing ones. For a common man, his banker is still the beset financial consultant and this trust provides a unique advantage to the banks in distribution of the insurance products as well as other investment instruments such as mutual funds or even unit-linked insurance plans as a combination of insurance and mutual fund products. A bank providing a whole range of financial services definitely stands a better chance to attract more customers and increase revenue. Cost reduction as a corollary to the rise in the number of policies sold per employee is an obvious benefit that the banks derive from enhanced customer access fostered by the bancassurance.

ii. For insurers, the biggest benefit is the huge and trusted banking network without any administrative hassles for maintaining such network. Insurance not being an off-the-shelf product requires personal counseling and persuasion. Hence, the distribution poses a major challenge for the insurance companies. Further, the vast untapped insurable interest spread all over the country makes the traditional channels of the insurance distributi0n uneconomical. The increasing competition has made it impossible for the insurers to enjoy the flexibility of incurring heavy distribution expenses and passing them to the customer in the form of high premiums. As such, the far and wide reach of the banking network provides the most obvious and economical distribution alternative. In addition, insurers also get the benefit of customer database like customers financial standing, spending habits, investment and purchasing capability which can be used to customize products and sell accordingly. Since the banks already have an established relationship with their customers, conversion ratio of leads to sales is also likely to be high. Furthermore, service aspect can also be tackled easily.

iii. Retail saving choices are becoming increasingly complex at the international level and India is no exception. There is a growing need for better instruments and diversified avenues of investment with minimal transaction costs which are usually associated with diversification. The benefits of the convergence of banking and insurance are expected to reach the customers in the form of decreased prices and a sound insurance product. Globally, insurance products are major instruments for savings and this is likely to be the case in India too, as insurance penetration gathers momentum. Bancassurance benefits the customers by providing comprehensive financial super-malls, customers stand to benefit the most. Enhanced convenience in paying premiums and getting other facilities at his familiar and friendly place is of course an added advantage.

5. Bancassurance though beneficial to the bankers, insurers and customers, yet, entails certain potential areas of conflict which must be carefully monitored and addressed suitably. < TOP >

Compelling Products: In India, insurance is perceived more as a 'savings product' rather than as a 'risk management product.' This makes an insurer's products to compete directly with the deposit products of banks. In such a situation, bankers may not find it in their interest to hard-sell insurance products.

Conflicting Interests: Another potential source of conflict arises in a situation where an insurance company is promoted by an international bank which may also have a non-insurance business interest in India. This may cause strategic withholding of customer information by the domestic banking partner of the bancassurance.

Staff reluctance: For banks, especially the public sector banks, it is very important to manage any staff unrest due to additional work on account of bancassurance. Lack of knowledge about the nitty-gritty of an insurance product could also be another deterrent.

Identity Predicament: Developing and promoting brand equity of bancassurance while retaining the unique identity of the bank is also a matter of conflict. After all, for a banker, bancassurance is primarily a source of additional income and obviously, it cannot become a substitute of the regular business of the bank. Maintaining an 'arms length relation' between a bank's regular and insurance business is another difficult issue.

Functional Incongruities: Although banking and insurance are both financial services, yet they are quite different in terms of systems, procedures, culture and business ethics.

Such difficulties in the convergence of banking and insurance may be resolved by a high degree of functional co-ordination with suitable institutional mechanism and business models. Developing appropriate human resource policies to groom the staff to undertake the additional responsibility is equally important to make the venture successful.

6. Major uses of credit derivatives that attract the market participants to purchase protection against credit risk are credit line management and regulatory arbitrage. Factors that motivate the market participants to sell protection against credit risk are funding arbitrage and product restructuring. < TOP >

Credit line management is relevant for dealing with a situation where a bank is over-concentrated in loans to companies in a specific sector of the economy. Though selling the loan in secondary market or origination of loans in non-traditional sectors can transfer the concentration risk, credit derivatives can be used effectively and efficiently to mitigate the concentration risk. For example, if the bank sells the loan in the secondary market, it will damage the valuable relationship with the customer. The bank can also face new risks while diversifying its loan portfolio in non-traditional sector. By using the credit derivative, a bank can diversify its loan portfolio more cost effectively and maintain the valuable relationship with customers. Credit derivatives can also be used for regulatory arbitrage under Basel covenants.

The participants in the derivative market can be banks, Financial Institutions (FIs), Corporates, Brokers and Individuals etc. All these can be classified into three categories, called operators in the market. as:

- Hedgers
- Speculators, and
- Arbitrageurs.

7. One of the practical difficulties in handling them is complex/lengthy documentation underlying these transactions. Further, credit risk will always be less standardized and more complex than interest rate and currency risk. Another hurdle is regulatory capital charges on credit derivative positions; particularly when they are being used in hedging context they make credit derivatives a prohibitively expensive instrument. < TOP >

If used inappropriately, market participants could face several new risks. For example, while regulatory arbitrage may lead to a more appropriate allocation of capital, there is a risk that this activity can cause higher risk profile for banks. Another potential downside of credit derivatives, particularly with respect to credit derivatives on bank loans, concerns with loan monitoring incentives.

Section C: Applied Theory

8. a. In order to make payment to the overseas supplier, the buyer of goods approaches his bank for opening a letter of credit in favor of the supplier. < TOP >

After considering the request of the buyer and fulfillment of the necessary formalities, the issuing bank (i.e. the buyer’s bank) opens the letter of credit in favor of the supplier.

The letter of credit is transmitted to the advising bank (usually an intermediary bank located in supplier’s country) with a request to advise the credit to the beneficiary. After being satisfied with the authenticity of the credit, the advising bank advises the credit to the beneficiary (i.e. the supplier).

The beneficiary verifies the letter of credit and checks for any discrepancies vis-à-vis, the sale contract. If any discrepancies are noticed, the buyer is asked to incorporate the necessary changes/amendments to the LC. The supplier then proceeds to ship the goods.

Shipment of goods is followed by submission of necessary documents by the supplier to the negotiating bank in order to obtain payment for the goods. The negotiating bank, upon receipt of commercial documents and the bill of lading from the exporter, scrutinizes the documents in relation to the LC and if found to be in order, negotiates the bill and makes payment to the supplier.

The negotiating bank then claims reimbursement from the issuing bank by mailing the documents to it or any other bank authorized for the said purpose.

Disadvantages/Limitations

A letter of credit is not a cent per cent safe deal either for the exporter or for the importer. To the exporter, the undertaking of the issuing bank is only conditional. The documents tendered should strictly comply with the requirements of the credit. It is only the bank that would decide if the documents are as per the terms of the credit; any slight variation or non-fulfillment or excess detail in the documents tendered give scope for the bank to claim that the documents are not as per the terms of the credit. Moreover, the credit does not protect the exporter from the governmental action that may deter payment.

To the importer, the major disadvantage is that it does not ensure that he would be receiving the goods of the specific condition and order. In letter of credit transactions, all parties deal with documents and not in goods. He stands committed to reimburse the issuing bank when documents as required are tendered to him. But this does not ensure the receipt of proper goods. Though the risk is safeguarded by calling for special documents like packing list, etc., the risk of falsification of documents still remains.

b. **Post-shipment credit for financing exports**

Post-shipment finance is defined as "any loan or advance granted or any other credit provided by an institution to an exporter from the date of extending the credit after shipment of the goods to the date of realization of the export proceeds". It is basically meant for financing export receivables of the exporter. Post-shipment finance can be availed on submission of commercial documents evidencing export of goods, from the authorized dealer. The exporter is required to submit the documents to the bank within 21 days from the date of shipment of goods. The documents to be submitted include all shipping documents and an extra copy of invoice, relating to any export declaration form endorsed by Customs/Postal authorities.

Post-shipment finance can be extended as under:

– Negotiation/Payment/Acceptance of export documents under letter of credit

– Purchase/discount of export documents under confirmed orders/export contracts, etc.

– Advances against export bills sent on collection basis

– Advances against exports on consignment basis

– Advances against cash incentives

– Advances against undrawn balances

– Advances against deemed exports.

9. Relationship between Banker and Customer

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i. Banker as a depository/trustee: Traditionally, the role of a banker was that of a reliable depository who takes care of the money deposited with him by the customer and repays it on demand. Interest is paid on certain deposits like savings account and time deposits while current accounts don't entail any interest The bank becomes a trustee in the event of a customer's death in that it may be responsible for looking after his estate; it can provide professional trustee services, which include the appointment of trustees and the management of the customer's assets. Hence the banker is not merely a depository or a trustee as he performs multiple functions.

ii. Debtor and Creditor relationship: The relationship between the banker and the customer would be that of a debtor and creditor when money is deposited or when money is lent The respective position of either debtor or creditor is determined by the state of account By virtue of receiving money, the banker dons the role of a debtor whereby he has the obligation to honor the cheques drawn by the customer who is creditor in this case. In the other circumstance where the customer has over drawn the account or has taken a loan, he would be the debtor while the banker will be the creditor. Such a relationship, i.e., the depositor-banker-borrower, illustrates the original functions of a bank. When the money is deposited in the bank the ownership transfers from the customer to the bank and the amount now is at its disposal. The bank pays interest and gets the right to use the money for further lending. And even if it does not pay interest on certain accounts like current accounts, it can utilize the money deposited by the customer to earn interest. However it has the obligation to repay the amount available in customer's account on demand. However, the customer has no right to ask for the same coins or rupee notes, which he initially deposited.

iii. Banker acting as the agent / Bailee etc: Safe custody services such as safe deposit boxes, handling of securities deposited by customers, are examples of bailment. Bailment arises when one person (bailor) deposits goods with another (bailee) for a specific purpose on terms that the goods should be redelivered to the bailor. The bailor retains ownership of the goods. If a sealed box is deposited with the bank for safe custody then the relationship between the customer and the banker is that of the bailor and bailee. According to Section 148 of the Indian Contract Act, 1872, the bank becomes a custodian of the securities of the customer and hence a bailee and the bailee is liable for any loss caused to the bailor due to his negligence. The term "agent" refers to the services that the bank provides to a customer, i.e., the bank acts as an agent to collect and process a customer's cheques and accepts a customer's instructions in providing other services including foreign exchange services, investment advice, financial management, share purchasing and selling. The banker while acting as an agent has to make good losses and account for the profits if accrued to the principal who is the customer.

iv. Lesser and Lessee Relationship: When a bank provides the service of giving out a safe deposit locker on rental basis to a customer, the relationship is strictly that between a lessor (the Bank) and a lessee (the customer). The bank provides the facility of safe deposit lockers, which the customer can use for keeping his valuables. The amount paid towards the use of locker is the rent. In some banks the relationship is termed as between the licensor and licensee. Though the banker does not know the contents in the locker, it is his responsibility to ensure safety of the contents.

v. Miscellaneous: The developments in the banking sector and a drive towards universal banking has ushered a lot of changes in the banker customer relationship. In the present scenario the banker provides consultancy and advisory services to the customer.

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