NCFM

NSE's CERTIFICATION IN FINANCIAL MARKETS

Commercial Banking in India: A Beginner's Module

Developed by : Mr. Abhijit Roy, Visiting Faculty,
International Management Institute,
New Delhi

Reviewed by : Professor V.S. Kaveri, Visiting Professor
National Institute of Bank Management,
Pune.

NATIONAL STOCK EXCHANGE OF INDIA LIMITED

Test Details

Sr. No.	Name of Module	Fees (Rs.)	Test Duration (in minutes)	No. of Questions	Maximum Marks	Pass Marks (%)	Certificate Validity (in years)
1	Financial Markets: A Beginners' Module	1500	120	60	100	50	5
2	Mutual Funds : A Beginners' Module	1500	120	60	100	50	5
3	Currency Derivatives: A Beginner's Module	1500	120	60	100	50	5
4	Equity Derivatives: A Beginner's Module	1500	120	60	100	50	5
5	Interest Rate Derivatives: A Beginner's Module	1500	120	60	100	50	5
6	Commercial Banking in India: A Beginner's Module	1500	120	60	100	50	5
7	Securities Market (Basic) Module	1500	105	60	100	60	5
8	Capital Market (Dealers) Module *	1500	105	60	100	50	5
9	Derivatives Market (Dealers) Module **	1500	120	60	100	60	3
10	FIMMDA-NSE Debt Market (Basic) Module	1500	120	60	100	60	5
11	Investment Analysis and Portfolio Management Module	1500	120	60	100	60	5
12	NISM-Series-I: Currency Derivatives Certification Examination	1000	120	60	100	60	3
13	NISM-Series-II-A: Registrars to an Issue and Share Transfer Agents - Corporate Certification Examination	1000	120	100	100	50	3
14	NISM-Series-II-B: Registrars to an Issue and Share Transfer Agents - Mutual Fund Certification Examination	1000	120	100	100	50	3
15	NISM-Series-IV: Interest Rate Derivatives Certification Examination	1000	120	100	100	60	3
16	NISM-Series-V-A: Mutual Fund Distributors Certification Examination	1000	120	100	100	50	3
17	NSDL-Depository Operations Module	1500	75	60	100	60 #	5
18	Commodities Market Module	1800	120	60	100	50	3
19	Surveillance in Stock Exchanges Module	1500	120	50	100	60	5
20	Corporate Governance Module	1500	90	100	100	60	5
21	Compliance Officers (Brokers) Module	1500	120	60	100	60	5
22	Compliance Officers (Corporates) Module	1500	120	60	100	60	5
23	Information Security Auditors Module (Part-1)	2250	120	90	100	60	2
	Information Security Auditors Module (Part-2)	2250	120	90	100	60	
24	Options Trading Strategies Module	1500	120	60	100	60	5
25	FPSB India Exam 1 to 4***	2000 per exam	120	75	140	60	NA
26	Examination 5/Advanced Financial Planning	5000	240	30	100	50	NA

* Candidates have the option to take the CMDM test in English, Gujarati or Hindi language. The workbook for the module is presently available in ENGLISH.

** Candidates have the option to take the DMDM test in English, Gujarati or Hindi language. The workbook for the module is also available in ENGLISH, GUJARATI and HINDI languages.

Candidates securing 80% or more marks in NSDL-Depository Operations Module ONLY will be certified as 'Trainers'.

*** Modules of Financial Planning Standards Board India (Certified Financial Planner Certification) i.e. (i) Risk Analysis & Insurance Planning (ii) Retirement Planning & Employee Benefits (iii) Investment Planning and (iv) Tax Planning & Estate Planning.

CONTENTS

CHAPTER 1: INTRODUCTION 5

1.1 Definition of banks 5

1.2 Evolution of Commercial Banks in India 6

1.3 Functions of Commercial Banks 7

1.4 Competitive Landscape of Banks in India 8

CHAPTER 2: BANKING STRUCTURE IN INDIA 10

2.1 Banking Structure in India 10

2.2 Role of Reserve Bank of India vis-à-vis Commercial Banks 14

CHAPTER 3: BANK DEPOSIT ACCOUNTS 16

3.1 Introduction to Bank Deposits 17

3.2 Types of Deposit Accounts 19

3.2.1 Current Deposits 20

3.2.2 Savings Bank Deposits 20

3.2.3 Term Deposits 21

3.3 Strategies of mobilizing deposits 22

3.4 Common Guidelines of Opening and Operating Deposit Accounts 23

3.5 Deposit Related Services 25

3.6 Deposit Services Offered to Non-Resident Indians 28

3.6.1 Non Resident Ordinary Accounts (NRO) 29

3.6.2 Non-Resident (External) Rupee Accounts 29

3.6.3 Foreign Currency Non Resident Account (Banks) 30

3.7 Deposit Insurance 32

3.7.1 Banks insured by the DICGC 32

3.7.2 Features of the scheme 32

CHAPTER 4: BASICS OF BANK LENDING 35

4.1 Principles of Lending and Loan policy 35

4.1.1 Principles of lending 35

4.1.2 Loan Policy 36

4.1.3 Compliance with RBI guidelines 38

4.2 Basics of Loan Appraisal, Credit decision-making and Review 43

4.2.1 Credit approval authorities 43

4.2.2 Credit appraisal and credit decision-making ... 43
4.2.3 Monitoring and Review of Loan Portfolio ... 44
4.3 Types of Advances ... 44
4.3.1 Working Capital Finance ... 45
4.3.2 Project Finance ... 45
4.3.3 Loans to Small and Medium Enterprises ... 46
4.3.4 Rural and Agricultural Loans ... 47
4.3.5 Directed Lending ... 47
4.3.6 Retail Loan ... 49
4.3.7 International Loans Extended by Banks ... 50
4.4 Management of Non Performing Assets ... 50
4.4.1 Classification of non-performing Assets ... 51
4.4.2 Debt Restructuring ... 52
4.4.3 Other recovery options ... 52
4.4.4 SARFAESI Act, 2002 ... 53
CHAPTER 5: BANK INVESTMENTS ... 55
5.1 Investment Policy ... 56
5.2 Statutory Reserve Requirements ... 57
5.2.1 Maintenance of Statutory Liquidity Ratio (SLR) ... 57
5.2.2 Penalties ... 58
5.3 Non-SLR Investments ... 59
5.3.1 Bank Guidelines for investments in other than Government Securities ... 59
5.3.2 Statutory Prescriptions ... 60
5.4 Banks' Investment Classification and Valuation Norms ... 61
5.4.1 Treasury Management ... 62
5.4.2 Forex Treasury Management ... 63
CHAPTER 6: OTHER ACTIVITIES OF COMMERCIAL BANKS ... 64
6.1 Other Basic Banking Activities ... 64
6.1.1 Foreign Exchange Services ... 64
6.1.2 Banks' services to Government ... 64
6.1.3 Payment and Settlement Systems ... 65
6.1.4 NRI Remittances ... 70
6.1.5 Cash Management Services and Remittances ... 70

6.2 Para-banking Activities 70

6.2.1 Primary Dealership Business 70

6.2.2 Investment Banking/ Merchant Banking Services 71

6.2.3 Mutual Fund Business 72

6.2.4 Pension Funds Management (PFM) by banks 72

6.2.5 Depository Services 73

6.2.6 Wealth Management/ Portfolio Management Services 74

6.2.7 Bancassurance 75

CHAPTER 7: RELATIONSHIP BETWEEN BANK AND CUSTOMER 77

7.1 Strategy for expanding customer base 77

7.1.1 Product Life Cycle Strategy 77

7.1.2 Appropriate targeting 78

7.1.3 Expanding product portfolio 78

7.2 Services to different Customer Groups 78

7.2.1 Retail Customers 79

7.2.2 Corporate Customers 80

7.2.3 International Presence 80

7.2.4 Rural Banking Customers 81

7.3 Competition amongst Banks for Customers 81

7.3.1 Competition for Retail Products and Services 81

7.3.2 Competition for Corporate Products and Services 81

7.3.3 Competition for International Banking 82

7.3.4 Competition for Rural Customers 82

7.4 Customer Relationship Management 82

7.4.1 Committees on Customer Service 83

7.4.2 Board-approved Policies on Customer Service 83

7.4.3 Giving Publicity to the Policies 84

7.4.4 Operations of Accounts by Special Category of Customers 84

7.4.5 Customer Confidentiality Obligations 84

7.4.6 National Do Not Call Registry 85

7.5 Banking Ombudsman Scheme 85

7.5.1 Appointment of Banking Ombudsman 85

7.5.2 Filing a Complaint to the Banking Ombudsman 85
7.5.3 Limit on the Amount of Compensation as Specified in an Award 85
7.5.4 Further recourse available 85
7.6 Know Your Customer (KYC) norms 86
7.6.1 Customer Acceptance Policy 86
7.6.2 Customer Identification Procedures 86
7.6.3 Monitoring of Transactions 86
7.6.4 Risk Management 86
7.7 Prevention of Money Laundering Act (PMLA), 2002 89
CHAPTER 8: EVOLVING TRENDS IN MODERN BANKING 90
8.1 Technology 90
8.1.1 Internet Banking 90
8.1.2 Mobile Banking Transactions 91
8.1.3 Point of Sale (PoS) Terminals 91
8.2 Outsourcing of Non-core Activities 92
8.3 Financial Inclusion 94
8.3.1 Initiatives taken by the RBI 94
8.3.2 Micro Credit 96

Distribution of weights in the
Commercial Banking in India: A Beginner's Module Curriculum

Chapter No	Title	Weights (%)
1	Introduction	10
2	Banking structure in India	16
3	Bank Deposit Accounts	17
4	Basics of Bank Lending	16
5	Bank Investments	15
6	Other Activities of Commercial Banks	10
7	Relationship between Bank and customer	6
8	Evolving Trends in modern Banking	10

Note: Candidates are advised to refer to NSE's website: www.nseindia.com, click on 'NCFM' link and then go to 'Announcements' link, regarding revisions/updations in NCFM modules or launch of new modules, if any.

Copyright © 2010 by National Stock Exchange of India Ltd. (NSE)
Exchange Plaza, Bandra Kurla Complex,
Bandra (East), Mumbai 400 051 INDIA

All content included in this book, such as text, graphics, logos, images, data compilation etc. are the property of NSE. This book or any part thereof should not be copied, reproduced, duplicated, sold, resold or exploited for any commercial purposes. Furthermore, the book in its entirety or any part cannot be stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise.

CHAPTER 1: Introduction

Banks have played a critical role in the economic development of some developed countries such as Japan and Germany and most of the emerging economies including India. Banks today are important not just from the point of view of economic growth, but also financial stability. In emerging economies, banks are special for three important reasons. First, they take a leading role in developing other financial intermediaries and markets. Second, due to the absence of well-developed equity and bond markets, the corporate sector depends heavily on banks to meet its financing needs. Finally, in emerging markets such as India, banks cater to the needs of a vast number of savers from the household sector, who prefer assured income and liquidity and safety of funds, because of their inadequate capacity to manage financial risks.

Forms of banking have changed over the years and evolved with the needs of the economy. The transformation of the banking system has been brought about by deregulation, technological innovation and globalization. While banks have been expanding into areas which were traditionally out of bounds for them, non-bank intermediaries have begun to perform many of the functions of banks. Banks thus compete not only among themselves, but also with non-bank financial intermediaries, and over the years, this competition has only grown in intensity. Globally, this has forced the banks to introduce innovative products, seek newer sources of income and diversify into non-traditional activities.

This module provides some basic insights into the policies and practices currently followed in the Indian banking system. The first two chapters provide an introduction to commercial banking in India and its structure. Bank deposits are dealt with in detail in Chapter 3, lending and investments in Chapter 4 & Chapter 5 respectively. Chapter 6 deals with other basic banking activities of commercial banks, while Chapters 7 and 8 explain the relationship between a bank and its customers and the trends in modern banking respectively.

1.1 Definition of banks

In India, the definition of the business of banking has been given in the Banking Regulation Act, (BR Act), 1949. According to Section 5(c) of the BR Act, 'a banking company is a company which transacts the business of banking in India.' Further, Section 5(b) of the BR Act defines banking as, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, order or otherwise.' This definition points to the three primary activities of a commercial bank which distinguish it from the other financial institutions. These are: (i) maintaining deposit accounts including current accounts, (ii) issue and pay cheques, and (iii) collect cheques for the bank's customers.[1]

[1] Each of these functions is described in detail in later chapters.

1.2 Evolution of Commercial Banks in India

The commercial banking industry in India started in 1786 with the establishment of the Bank of Bengal in Calcutta. The Indian Government at the time established three Presidency banks, viz., the Bank of Bengal (established in 1809), the Bank of Bombay (established in 1840) and the Bank of Madras (established in 1843). In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, which took up the role of a commercial bank, a bankers' bank and a banker to the Government. The Imperial Bank of India was established with mainly European shareholders. It was only with the establishment of Reserve Bank of India (RBI) as the central bank of the country in 1935, that the quasi-central banking role of the Imperial Bank of India came to an end.

In 1860, the concept of limited liability was introduced in Indian banking, resulting in the establishment of joint-stock banks. In 1865, the Allahabad Bank was established with purely Indian shareholders. Punjab National Bank came into being in 1895. Between 1906 and 1913, other banks like Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up.

After independence, the Government of India started taking steps to encourage the spread of banking in India. In order to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a state-partnered and state-sponsored bank taking over the Imperial Bank of India and integrating with it, the former state-owned and state-associate banks. Accordingly, State Bank of India (SBI) was constituted in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former state-associate banks as its subsidiaries.

To better align the banking system to the needs of planning and economic policy, it was considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalized. This was an important milestone in the history of Indian banking. This was followed by the nationalisation of another six private banks in 1980. With the nationalization of these banks, the major segment of the banking sector came under the control of the Government. The nationalisation of banks imparted major impetus to branch expansion in un-banked rural and semi-urban areas, which in turn resulted in huge deposit mobilization, thereby giving boost to the overall savings rate of the economy. It also resulted in scaling up of lending to agriculture and its allied sectors. However, this arrangement also saw some weaknesses like reduced bank profitability, weak capital bases, and banks getting burdened with large non-performing assets.

To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system.

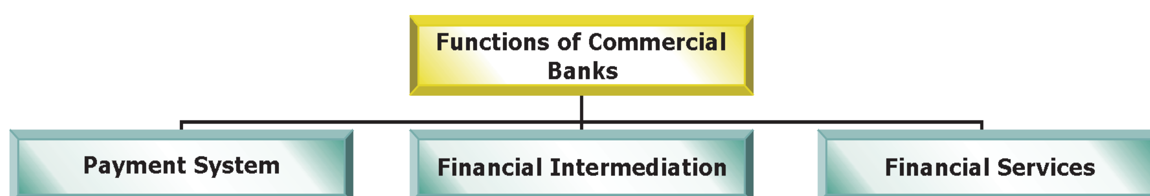
One important feature of the reforms of the 1990s was that the entry of new private sector banks was permitted. Following this decision, new banks such as ICICI Bank, HDFC Bank, IDBI Bank and UTI Bank were set up.

Commercial banks in India have traditionally focused on meeting the short-term financial needs of industry, trade and agriculture. However, given the increasing sophistication and diversification of the Indian economy, the range of services extended by commercial banks has increased significantly, leading to an overlap with the functions performed by other financial institutions. Further, the share of long-term financing (in total bank financing) to meet capital goods and project-financing needs of industry has also increased over the years.

1.3 Functions of Commercial Banks[2]

The main functions of a commercial bank can be segregated into three main areas: (i) Payment System (ii) Financial Intermediation (iii) Financial Services.

Figure 1.1: Main functions of a commercial bank



(i) Payment System

Banks are at the core of the payments system in an economy. A payment refers to the means by which financial transactions are settled. A fundamental method by which banks help in settling the financial transaction process is by issuing and paying cheques issued on behalf of customers. Further, in modern banking, the payments system also involves electronic banking, wire transfers, settlement of credit card transactions, etc. In all such transactions, banks play a critical role.

(ii) Financial Intermediation

The second principal function of a bank is to take different types of deposits from customers and then lend these funds to borrowers, in other words, financial intermediation. In financial terms, bank deposits represent the banks' liabilities, while loans disbursed, and investments made by banks are their assets. Bank deposits serve the useful purpose of addressing the needs of depositors, who want to ensure liquidity,

[2] The functions of commercial banks have been described in detail in later chapters.

safety as well as returns in the form of interest. On the other hand, bank loans and investments made by banks play an important function in channelling funds into profitable as well as socially productive uses.

(iii) Financial Services

In addition to acting as financial intermediaries, banks today are increasingly involved with offering customers a wide variety of financial services including investment banking, insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc. Income from providing such services improves a bank's profitability.

1.4 Competitive Landscape of Banks in India

Banks face competition from a wide range of financial intermediaries in the public and private sectors in the areas of financial intermediation and financial services (although the payments system is exclusively for banks). Such intermediaries form a diverse group in terms of size and nature of their activities, and play an important role in the financial system by not only competing with banks, but also complementing them in providing a wide range of financial services. Some of these intermediaries include:

- Term-lending institutions
- Non-banking financial companies
- Insurance companies
- Mutual funds

(i) Term-Lending Institutions

Term lending institutions exist at both state and all-India levels. They provide term loans (i.e., loans with medium to long-term maturities) to various industry, service and infrastructure sectors for setting up new projects and for the expansion of existing facilities and thereby compete with banks. At the all-India level, these institutions are typically specialized, catering to the needs of specific sectors, which make them competitors to banks in those areas.[3] These include the Export Import Bank of India (EXIM Bank), Small Industries Development Bank of India (SIDBI), Tourism Finance Corporation of India Limited (TFCI), and Power Finance Corporation Limited (PFCL).

[3] A notable exception is the IFCI Ltd, which lends into a variety of sectors.

At the state level, various State Financial Corporations (SFCs) have been set up to finance and promote small and medium-sized enterprises. There are also State Industrial Development Corporations (SIDCs), which provide finance primarily to medium-sized and large-sized enterprises. In addition to SFCs and SIDCs, the North Eastern Development Financial Institution Ltd. (NEDFI) has been set up to cater specifically to the needs of the north-eastern states.

(ii) Non-Banking Finance Companies (NBFCs)

India has many thousands of non-banking financial companies, predominantly from the private sector. NBFCs are required to register with RBI in terms of the Reserve Bank of India (Amendment) Act, 1997. The principal activities of NBFCs include equipment-leasing, hire-purchase, loan and investment and asset finance. NBFCs have been competing with and complementing the services of commercial banks for a long time. All NBFCs together currently account for around nine percent of assets of the total financial system.

Housing-finance companies form a distinct sub-group of the NBFCs. As a result of some recent government incentives for investing in the housing sector, these companies' business has grown substantially. Housing Development Finance Corporation Limited (HDFC), which is in the private sector and the Government-controlled Housing and Urban Development Corporation Limited (HUDCO) are the two premier housing-finance companies. These companies are major players in the mortgage business, and provide stiff competition to commercial banks in the disbursal of housing loans.

(iii) Insurance Companies

Insurance/reinsurance companies such as Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GICI), and others provide substantial long-term financial assistance to the industrial and housing sectors and to that extent, are competitors of banks. LIC is the biggest player in this area.

(iv) Mutual Funds

Mutual funds offer competition to banks in the area of fund mobilization, in that they offer alternate routes of investment to households. Most mutual funds are standalone asset management companies. In addition, a number of banks, both in the private and public sectors, have sponsored asset management companies to undertake mutual fund business. Banks have thus entered the asset management business, sometimes on their own and other times in joint venture with others.

CHAPTER 2: Banking Structure in India

2.1 Banking Structure in India

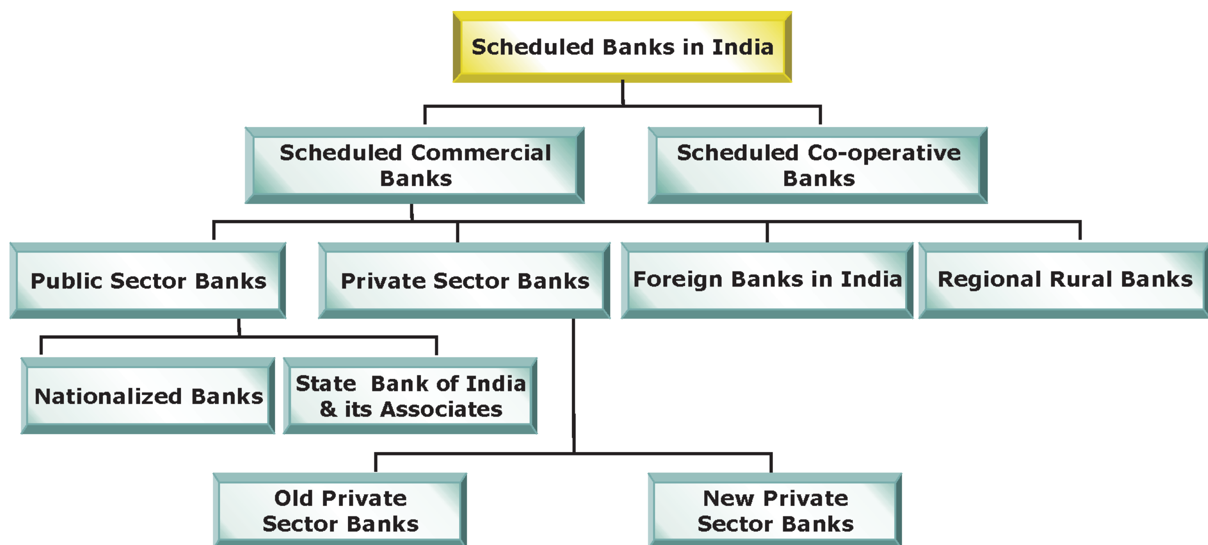
Banking Regulator

The Reserve Bank of India (RBI) is the central banking and monetary authority of India, and also acts as the regulator and supervisor of commercial banks.

Scheduled Banks in India[4]

Scheduled banks comprise scheduled commercial banks and scheduled co-operative banks. Scheduled commercial banks form the bedrock of the Indian financial system, currently accounting for more than three-fourths of all financial institutions' assets. SCBs are present throughout India, and their branches, having grown more than four-fold in the last 40 years now number more than 80,500 across the country (see Table 2.1). Our focus in this module will be only on the scheduled commercial banks. A pictorial representation of the structure of SCBs in India is given in figure 2.1.

Figure 2.1: Scheduled Banking Structure in India



[4] Scheduled banks in India are those that are listed in the Second Schedule of the Reserve Bank of India Act, 1934. RBI includes only those banks in this schedule which satisfy the criteria as laid down vide section 42 (6) (a) of the Act.

Public Sector Banks

Public sector banks are those in which the majority stake is held by the Government of India (GoI). Public sector banks together make up the largest category in the Indian banking system. There are currently 27 public sector banks in India. They include the SBI and its 6 associate banks (such as State Bank of Indore, State Bank of Bikaner and Jaipur etc), 19 nationalised banks (such as Allahabad Bank, Canara Bank etc) and IDBI Bank Ltd.

Public sector banks have taken the lead role in branch expansion, particularly in the rural areas. From Table 2.1, it can also be seen that:

- Public sector banks account for bulk of the branches in India (88 percent in 2009).
- In the rural areas, the presence of the public sector banks is overwhelming; in 2009, 96 percent of the rural bank branches belonged to the public sector. The private sector banks and foreign banks have limited presence in the rural areas.

Table 2.1: Break-up of Bank Branches (as on June 30, 2009)

Type of Bank	1969	2004	2009	Rural Branches as on June 30, 2009	Rural Branches as % of all branches on June 30, 2009
SBI & Associates	2462	13621	16294	5619	34.4
Nationalised Banks	4553	33359	39703	13425	33.8
Regional Rural Banks	...	14486	15199	11644	76.6
Total Public Sector Banks	7015	61466	71196	30688	43.1
Other Scheduled Commercial banks	900	5807	8979	1126	12.5
Foreign Banks	130	218	295	4	1.4
Non-scheduled Commercial Banks	217	32	44	11	25.0
Total (All Commercial Banks)	**8262**	**67523**	**80514**	**31829**	**39.5**

Source: Economic Survey 2009-10, Government of India.

Regional Rural Banks

Regional Rural Banks (RRBs) were established during 1976-1987 with a view to develop the rural economy. Each RRB is owned jointly by the Central Government, concerned State

Government and a sponsoring public sector commercial bank. RRBs provide credit to small farmers, artisans, small entrepreneurs and agricultural labourers. Over the years, the Government has introduced a number of measures of improve viability and profitability of RRBs, one of them being the amalgamation of the RRBs of the same sponsored bank within a State. This process of consolidation has resulted in a steep decline in the total number of RRBs to 86 as on March 31, 2009, as compared to 196 at the end of March 2005.

Private Sector Banks

In this type of banks, the majority of share capital is held by private individuals and corporates. Not all private sector banks were nationalized in in 1969, and 1980. The private banks which were not nationalized are collectively known as the old private sector banks and include banks such as The Jammu and Kashmir Bank Ltd., Lord Krishna Bank Ltd etc.[5] Entry of private sector banks was however prohibited during the post-nationalisation period. In July 1993, as part of the banking reform process and as a measure to induce competition in the banking sector, RBI permitted the private sector to enter into the banking system. This resulted in the creation of a new set of private sector banks, which are collectively known as the new private sector banks. As at end March, 2009 there were 7 new private sector banks and 15 old private sector banks operating in India.[6]

Foreign Banks

Foreign banks have their registered and head offices in a foreign country but operate their branches in India. The RBI permits these banks to operate either through branches; or through wholly-owned subsidiaries.[7] The primary activity of most foreign banks in India has been in the corporate segment. However, some of the larger foreign banks have also made consumer-financing a significant part of their portfolios. These banks offer products such as automobile finance, home loans, credit cards, household consumer finance etc. Foreign banks in India are required to adhere to all banking regulations, including priority-sector lending norms as applicable to domestic banks.[8] In addition to the entry of the new private banks in the mid-90s, the increased presence of foreign banks in India has also contributed to boosting competition in the banking sector.

[5] Some of the existing private sector banks, which showed signs of an eventual default, were merged with state owned banks.

[6] It may be noted that two important erstwhile developmental financial institutions, viz. Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India (ICICI) converted themselves into commercial banks after the new bank licensing policy was announced in July 1993.

[7] In addition, a foreign institution could also invest up to 74% in domestic private bank, in which up to 49% can be via portfolio investment.

[8] Priority sector lending has been described in a later chapter.

Box 2.1: Number of Foreign Banks

At the end of June 2009, there were 32 foreign banks with 293 branches operating in India. Besides, 43 foreign banks were operating in India through representative offices. Under the World Trade Organisation (WTO) Agreement, RBI allows a minimum 12 branches of all foreign banks to be opened in a year.

Source: Report on Trend and Progress of Banking in India 2008-09, RBI.

Co-operative Banks

Co-operative banks cater to the financing needs of agriculture, retail trade, small industry and self-employed businessmen in urban, semi-urban and rural areas of India. A distinctive feature of the co-operative credit structure in India is its heterogeneity. The structure differs across urban and rural areas, across states and loan maturities. Urban areas are served by urban co-operative banks (UCBs), whose operations are either limited to one state or stretch across states. The rural co-operative banks comprise State co-operative banks, district central co-operative banks, SCARDBs and PCARDBs.[9]

The co-operative banking sector is the oldest segment of the Indian banking system. The network of UCBs in India consisted of 1721 banks as at end-March 2009, while the number of rural co-operative banks was 1119 as at end-March 2008.[10] Owing to their widespread geographical penetration, cooperative banks have the potential to become an important instrument for large-scale financial inclusion, provided they are financially strengthened.[11] The RBI and the National Agriculture and Rural Development Bank (NABARD) have taken a number of measures in recent years to improve financial soundness of co-operative banks.

2.2 Role of Reserve Bank of India vis-à-vis Commercial Banks

The Reserve Bank of India (RBI) is the central bank of the country.[12] It was established on April 1, 1935 under the Reserve Bank of India Act, 1934, which provides the statutory basis for

[9] SCARDB stands for state co-operative agricultural and rural development banks and PCARDB stands for primary co-operative agricultural and rural development banks.

[10] In addition, the rural areas are served by a very large number of primary agricultural credit societies (94,942 at end-March 2008).

[11] Financial Inclusion implies provision of financial services at affordable cost to those who are excluded from the formal financial system.

[12] Every country has its own central bank. The central bank of USA is called the Federal Reserve Bank, the central bank of UK is Bank of England and the central bank in China is known as the People's Bank of China and so on. Most central banks were established around the early twentieth century.

its functioning. When the RBI was established, it took over the functions of currency issue from the Government of India and the power of credit control from the then Imperial Bank of India.

As the central bank of the country, the RBI performs a wide range of functions; particularly, it:

- Acts as the currency authority
- Controls money supply and credit
- Manages foreign exchange
- Serves as a banker to the government
- Builds up and strengthens the country's financial infrastructure
- Acts as the banker of banks
- Supervises banks

As regards the commercial banks, the RBI's role mainly relates to the last two points stated above.

RBI as Bankers' Bank

As the bankers' bank, RBI holds a part of the cash reserves of banks,; lends the banks funds for short periods, and provides them with centralised clearing and cheap and quick remittance facilities.

Banks are supposed to meet their shortfalls of cash from sources other than RBI and approach RBI only as a matter of last resort, because RBI as the central bank is supposed to function as only the 'lender of last resort'.

To ensure liquidity and solvency of individual commercial banks and of the banking system as a whole, the RBI has stipulated that banks maintain a Cash Reserve Ratio (CRR). The CRR refers to the share of liquid cash that banks have to maintain with RBI of their net demand and time liabilities (NDTL).[13] CRR is one of the key instruments of controlling money supply. By increasing CRR, the RBI can reduce the funds available with the banks for lending and thereby tighten liquidity in the system; conversely reducing the CRR increases the funds available with the banks and thereby raises liquidity in the financial system.

[13] These are mainly deposits. NDTL is discussed in Chapter 3 under section 3.3.

RBI as supervisor

To ensure a sound banking system in the country, the RBI exercises powers of supervision, regulation and control over commercial banks. The bank's regulatory functions relating to banks cover their establishment (i.e. licensing), branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. RBI controls the commercial banks through periodic inspection of banks and follow-up action and by calling for returns and other information from them, besides holding periodic meetings with the top management of the banks.

While RBI is directly involved with commercial banks in carrying out these two roles, the commercial banks help RBI indirectly to carry out some of its other roles as well. For example, commercial banks are required by law to invest a prescribed minimum percentage of their respective net demand and time liabilities (NDTL) in prescribed securities, which are mostly government securities.[14] This helps the RBI to perform its role as the banker to the Government, under which the RBI conducts the Government's market borrowing program.

[14] The concept of demand and time liabilities has been explained in Chapter 3.

CHAPTER 3: Bank Deposit Accounts

As stated earlier, financial intermediation by commercial banks has played a key role in India in supporting the economic growth process. An efficient financial intermediation process, as is well known, has two components: effective mobilization of savings and their allocation to the most productive uses. In this chapter, we will discuss one part of the financial intermediation by banks: mobilization of savings. When banks mobilize savings, they do it in the form of deposits, which are the money accepted by banks from customers to be held under stipulated terms and conditions. Deposits are thus an instrument of savings.

Since the first episode of bank nationalization in 1969, banks have been at the core of the financial intermediation process in India. They have mobilized a sizeable share of savings of the household sector, the major surplus sector of the economy. This in turn has raised the financial savings of the household sector and hence the overall savings rate. Notwithstanding the liberalization of the financial sector and increased competition from various other saving instruments, bank deposits continue to be the dominant instrument of savings in India.

It can be seen from Table 3.1 that gross domestic savings of the Indian economy have been growing over the years and the household sector has been the most significant contributor to savings. Household sector saves in two major ways, viz. financial assets and physical assets. Table 3.2 shows that within the financial savings of the household sector, bank deposits are the most prominent instrument, accounting for nearly half of total financial savings of the household sector.

Table 3.1: Gross Domestic Savings

Item	Percent of GDP (at current market prices)		
	2000-01	2006-07	2007-08
1. Household Savings, of which	21.9	24.1	24.3
a) Financial Assets	10.7	11.7	11.7
b) Physical Assets	11.3	12.4	12.6
2. Private corporate sector	4.1	8.3	8.8
3. Public sector	-2.3	3.3	4.5
4. Gross domestic saving	23.7	35.7	37.7

Source: Central Statistical Organization.

Table 3.2: Financial Savings of the Household Sector (Gross)

	Percent to Total Financial Savings of Household Sector		
	2006-07	**2007-08**	**2008-09**
Financial Savings	100	100	100
a) Currency	10.2	11.4	12.5
b) Deposits	49.1	52.2	58.5
i) With Banks	47.8	50.4	54.9
ii) Non-banking Cos.	0.2	0.5	1.8
iii) Co-operative banks/ societies	0.0	0.0	0.0
c) Shares & Debentures	9.0	12.4	2.6
d) Claims on Government	3.0	-4.0	-3.1
e) Insurance Funds	17.7	18.0	20.1
f) Provident & Pension Funds	11.1	9.9	9.5

Source: RBI Annual Report, 2008-09

3.1 Introduction to Bank Deposits

One of the most important functions of any commercial bank is to accept deposits from the public, basically for the purpose of lending. Deposits from the public are the principal sources of funds for banks.

Table 3.3 provides the share of deposits of different classes of scheduled commercial banks (SCBs). It can be seen that the public sector banks continue to dominate the Indian banking industry. However, the share of the new private sector banks has been rising at the expense of the public sector banks, particularly in the last few years.

Table 3.3: Share of Deposits of SCBs-Groupwise

Bank Group	At end-March (in percent)	
	2003	**2009**
Public Sector Banks	79.6	76.7
- Nationalised Banks	50.8	49.1
- State Bank Group	28.8	24.8
- Other Public Sector Banks	--	2.8
Private Sector Banks	15.3	18.1
- Old Private Sector Banks	6.7	4.9
- New Private Sector Banks	8.5	13.2
Foreign Banks	5.1	5.2
Total SCBs	100.0	100.0

Source: Report on Trend and Progress of Banking in India 2008-09 & 2003-04, RBI

Safety of deposits

At the time of depositing money with the bank, a depositor would want to be certain that his/ her money is safe with the bank and at the same time, wants to earn a reasonable return.

The safety of depositors' funds, therefore, forms a key area of the regulatory framework for banking. In India, this aspect is taken care of in the Banking Regulation Act, 1949 (BR Act). The RBI is empowered to issue directives/advices on several aspects regarding the conduct of deposit accounts from time to time. Further, the establishment of the Deposit Insurance Corporation in 1962 (against the backdrop of failure of banks) offered protection to bank depositors, particularly small-account holders. This aspect has been discussed later in the Chapter.

Deregulation of interest rates

The process of deregulation of interest rates started in April 1992. Until then, all interest rates were regulated; that is, they were fixed by the RBI. In other words, banks had no freedom to fix interest rates on their deposits. With liberalization in the financial system, nearly all the interest rates have now been deregulated. Now, banks have the freedom to fix their own deposit rates with only a very few exceptions. The RBI prescribes interest rates only in respect of savings deposits and NRI deposits, leaving others for individual banks to determine.[15]

[15] Savings deposits and NRI deposits have been described later in this chapter.

Deposit policy

The Board of Directors of a bank, along with its top management, formulates policies relating to the types of deposit the bank should have, rates of interest payable on each type, special deposit schemes to be introduced, types of customers to be targeted by the bank, etc. Of course, depending on the changing economic environment, the policy of a bank towards deposit mobilization, undergoes changes.

3.2 Types of Deposit Accounts

The bank deposits can also be classified into (i) demand deposits and (b) time deposits.

(i) **Demand deposits** are defined as deposits payable on demand through cheque or otherwise. Demand deposits serve as a medium of exchange, for their ownership can be transferred from one person to another through cheques and clearing arrangements provided by banks. They have no fixed term to maturity.

(ii) **Time deposits** are defined as those deposits which are not payable on demand and on which cheques cannot be drawn. They have a fixed term to maturity. A certificate of deposit (CD), for example, is a time deposit (See box 3.2)

Box 3.1: Certificate of Deposit

A Certificate of Deposit (CD) is a negotiable money market instrument and is issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are currently governed by various directives issued by the RBI, as amended from time to time.

CDs can be issued by (i) scheduled commercial banks (SCBs) excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by the RBI to raise short-term resources within the umbrella limit fixed by RBI. Deposit amounts for CDs are a minimum of Rs.1 lakh, and multiples thereof.

Demand and time deposits are two broad categories of deposits. Note that these are only categories of deposits; there are no deposit accounts available in the banks by the names 'demand deposits' or 'time deposits'. Different deposit accounts offered by a bank, depending on their characteristics, fall into one of these two categories. There are several deposit accounts offered by banks in India; but they can be classified into three main categories:

- Current account
- Savings bank account
- Term deposit account

Current account deposits fall entirely under the demand-deposit category and term deposit account falls entirely under time deposit. Savings bank accounts have both demand-deposit and time-deposit components. In other words, some parts of savings deposits are considered demand deposits and the rest as time deposits. We provide below the broad terms and conditions governing the conduct of current, savings and term-deposit accounts.

3.2.1 Current Deposits

A current account is a form of demand-deposit, as the banker is obliged to repay these liabilities on demand from the customer. Withdrawals from current accounts are allowed any number of times depending upon the balance in the account or up to a particular agreed amount. Current deposits are non-interest bearing. Among the three broad categories of deposits--current account deposit, savings accounts deposit and term deposits--current account deposits account for the smallest fraction.

A current account is basically a running and actively operated account with very little restriction on the number and amount of drawings. The primary objective of a current account is to provide convenient operation facility to the customer, via continuous liquidity.

On account of the high cost of maintaining such accounts, banks do not pay any interest on such deposits. In addition, many banks insist on customers maintaining minimum balances to offset the transaction costs involved. If minimum balances are not maintained, these banks charge the customers a certain amount.

Current accounts can be opened by rich individuals/ partnership firms/ private and limited companies/ Hindu Undivided Families (HUFs)/ societies/ trusts, etc.

3.2.2 Savings Bank Deposits

Savings deposits are a form of demand deposits, which is subject to restrictions on the number of withdrawals as well as on the amounts of withdrawals during any specified period. Further, minimum balances may be prescribed in order to offset the cost of maintaining and servicing such deposits. Savings deposits are deposits that accrue interest at a fixed rate set by RBI (3.5 percent as of January 2010).

Savings bank accounts are used by a large segment of small depositors as they can put their regular incomes into these accounts, withdraw the money on demand and also earn interest on the balance left in the account.

The flexibility provided by such a product means that savings bank accounts cannot be opened by big trading or business firms. Similarly, institutions such as government departments and bodies, local authorities, etc. cannot open savings bank accounts.

Savings account deposits together with current account deposits are called CASA deposits (See Box 3.2).

Box 3.2: CASA Deposits

From a bank's viewpoint, CASA deposits (Current Account and Savings Account deposits) are low-cost deposits, as compared to other types of deposits. Current account is non-interest bearing, while interest payable on savings accounts is very low (currently 3.5 percent). To be competitive, it is important for banks to garner as much low-cost deposits as possible, because by doing so banks can control the cost of raising deposits and hence can lend at more competitive rates. The methods used by banks to mobilize CASA deposits include offering salary accounts to companies, and encouraging merchants to open current accounts, and use their cash-management facilities.

Banks with low CASA ratios (CASA deposits as % of total deposits) are more dependent on term deposits for their funding, and are vulnerable to interest rate shocks in the economy, besides the lower spread they earn. (As discussed above, banks earn profit on the spread between their deposit and loans rates.)

The table given below shows that the share of current account and savings account (CASA) deposits in total deposits is the highest for foreign banks followed by the State Bank Group. It can also be observed that the share of CASA deposits in total deposits of the scheduled commercial banks as a whole has been declining. This means that the cost of deposit mobilization of the commercial banks is rising, which may pose a challenge for the banking sector in the coming years.

Bank-wise Share of CASA Deposits in Total Deposits (in percent)

	March end			
Bank Group	**2006**	**2007**	**2008**	**2009**
State Bank Group	43.4	42.9	42.0	38.6
Nationalised Banks	38.2	35.4	33.0	29.9
Private Banks	30.4	29.8	32.8	32.9
Foreign Banks	50.5	45.1	44.7	41.7
Total SCBs	38.6	36.6	35.7	33.2

Source: Report on Trend and Progress of Banking 2008-09, RBI.

3.2.3 Term Deposits

A "Term deposit" is a deposit received by the Bank for a fixed period, after which it can be withdrawn. Term deposits include deposits such as Fixed Deposits / Reinvestment deposits/

Recurring Deposits etc. The term deposits account for the largest share and have remained within the range of 61% to 67 % of total deposits in the recent years.

Interest is paid on term-deposits, either on maturity or at stipulated intervals depending upon the deposit scheme under which the money is placed. Also, a customer can earn interest on a term-deposit for a minimum period of 7 days. Interest rates on term-deposits are usually higher than on savings deposits. Term deposits include:

- Fixed deposits on which a fixed rate of interest is paid at fixed, regular intervals;
- Re-investment deposits, under which the interest is compounded quarterly and paid on maturity, along with the principal amount of the deposit. Some banks have introduced "flexi" deposits under which, the amount in savings deposit accounts beyond a fixed limit is automatically converted into term-deposits; and
- Recurring deposits, under which a fixed amount is deposited at regular intervals for a fixed term and the repayment of principal and accumulated interest is made at the end of the term. These deposits are usually targeted at persons who are salaried or receive other regular income. A Recurring Deposit can usually be opened for any period from 6 months to 120 months.

3.3 Strategies of mobilizing deposits

To maximize their profits, commercial banks always attempt to mobilize savings at the lowest cost possible. While mobilizing deposits, banks have to comply with various directives issued by the RBI, the Indian Bank Association (IBA), Government of India and other statutory authorities/agencies. At the same time, since banks operate in a very competitive environment, they have to reach out to a wide spectrum of customers and also offer deposit products that lead to higher customer satisfaction.

Banks devise various strategies to expand the customer base and reducing the cost of raising deposits. This is done by identifying target markets, designing the products as per the requirements for customers, taking measures for marketing and promoting the deposit products. It is essential not only to expand the customer base but also to retain it. This is done by providing counselling, after-sales information and also through prompt handling of customer complaints.

While the strategies for mobilizing bank deposits vary from bank to bank, one common feature is to maximize the share of CASA deposits (Box 3.2). The other common features generally observed are as follows:

- Staff members posted at branches are adequately trained to offer efficient and courteous service to the customers and to educate them about their rights and obligations.

- A bank often offers personalized banking relationship for its high-value customers by appointing Customer Relationship Managers (CRMs).
- Senior citizens/pensioners have become an important category of customers to be targeted by a bank. Products are developed by banks to meet the specific requirements of this group.
- While banks endeavour to provide services to the satisfaction of customers, they put in place an expeditious mechanism to redress the complaints of the customers.

3.4 Common Guidelines of Opening and Operating Deposit Accounts

To open and operate a bank account, the following guidelines need to be followed.

Due Diligence Process: A bank before opening any deposit account has to carry out due diligence as required under "Know Your Customer" (KYC) guidelines issued by RBI and or such other norms or procedures adopted by the bank.[16] The 'due diligence' process, while opening a deposit account, involves the bank having adequate knowledge of the person's identity, occupation, sources of income, and location. Obtaining an introduction of the prospective depositor from a person acceptable to the bank, obtaining recent photographs of people opening/ operating the account are part of the due diligence process. For customers providing proof of identification and address, there is no need for personal introduction to the bank for opening of a new savings bank account. To promote financial inclusion in rural areas / tribal areas, KYC norms have been relaxed for below the poverty line (BPL) families.

Minimum Balance: For deposit products like a savings bank account or a current account, banks normally stipulate certain minimum balances to be maintained as part of terms and conditions governing operation of such accounts. But for people below the poverty line, banks encourage the opening of 'No-frills Accounts', typically a special savings bank account where no minimum balance requirement is required. For a savings bank account, the bank may also place restrictions on number of transactions, cash withdrawals, etc., during a given period.

Transparency: Failure to maintain minimum balance in the accounts, where applicable, will attract levy of charges as specified by the bank from time to time. Similarly, the bank may specify charges for issue of cheques books, additional statement of accounts, duplicate passbook, folio charges, etc. All such details regarding terms and conditions for operation of the accounts and schedule of charges for various services provided should be communicated to the prospective depositor while opening the account for the sake of transparency.

[16] The KYC guidelines have been described in detail in Chapter 7.

Eligibility: A savings bank account can be opened by eligible person(s) and certain organizations/agencies, as advised by the RBI from time to time. But current accounts can be opened by individuals, partnership firms, private and public limited companies, Hindu Undivided Families (HUFs), specified associates, society trusts, etc. Eligibility criteria for a savings account and a current account are largely similar, but there are important differences too. While both the accounts can be opened by individuals, the savings account cannot be opened by a firm. Term Deposit Accounts can be opened by all categories of account holders.

Requirement of PAN: In addition to the due diligence requirements, under KYC norms, banks are required by law to obtain a Permanent Account Number (PAN) from the prospective account holder or alternate declarations as specified under the Income Tax Act.

Operation of Joint Account: Deposit accounts can be opened by an individual in his own name or by more than one individual in their own names (known as a 'joint account').

A joint account can be operated by a single individual or by more than one individual jointly. The mandate for who can operate the account can be modified with the consent of all account holders. Joint accounts opened by minors with their parents or guardians can be only operated by the latter.

Accountholders of a joint account can give mandates on the operation of the account, and the disposal of balances in the event of the demise of one or more of the holders. Banks classify these mandates as 'Either or Survivor', and 'Anyone or Survivor(s)', etc.

Power of Attorney: At the request of the depositor, the bank can register mandate/power of attorney given by him authorizing another person to operate the account on his behalf.

Closure/renewal of deposits: Term-deposit account holders at the time of placing their deposits can give instructions with regard to closure of deposit account or renewal of deposit for further period on the date of maturity. In absence of such mandate, the bank will usually seek instructions from the depositor(s) as to the renewal of the deposit or otherwise by sending intimation before say, 15 days of the maturity date of the term deposit. If no mandate is given or received by the bank before the date of maturity of term deposit, the bank will be at liberty to roll over the deposit on due date.

Nomination: A depositor is permitted to officially authorize someone, who would receive the money of his account when the depositor passes away. This is called the nomination process. Nomination facility is available on all deposit accounts opened by individuals. Nomination is also available to a sole proprietary concern account. Nomination can be made in favour of one individual only. Nomination so made can be cancelled or changed by the account holder/s any time. Nomination can be made in favour of a minor too.

Box 3.3: Operation of Special Classes of Deposit Account Holders

Minors' Accounts

Savings bank accounts can be opened by minors along with their guardians, and operated solely by the guardians, until the minor attains majority. Verification of signatures and other identification is repeated before the major starts operating the account.

Account of illiterate/visually challenged persons

Accounts of illiterate/visually challenged individuals are usually opened by banks at their own discretion, in the presence of a mutually known witness. Terms and conditions of operating the account in this case are then specifically explained by the bank to the account-holder.

Deposit schemes for Senior Citizens

Banks have developed fixed-deposit schemes specifically meant for senior citizens (i.e., individuals over the age of 60 years). Such schemes usually provide an incentive by way of additional interest, over and above the normal rate of interest, on term-deposits across various maturities. Such schemes are applicable for both fresh deposits as well as renewals of maturing deposits.

3.5 Deposit Related Services

As per the RBI guidelines, banks are required to provide some services to the depositors and to recognise the rights of depositors. The ultimate objective of the banking industry should be to provide a customer different services they are rightfully entitled to receive without demand. We take a quick look at some such services provided by banks in India.

Customer Information

Customer information collected from the customers should not be used for cross-selling of services or products by the bank, its subsidiaries and affiliates. If the bank proposes to use such information, it should be strictly with the 'express consent' of the account-holder.

Banks are not expected to disclose details/particulars of the customer's account to a third person or party without the expressed or implied consent from the customer. However, there are some exceptions, such as disclosure of information under compulsion of law or where there is a duty to public for the bank to disclose.

Interest Payments

- **Savings bank accounts:** Interest is paid on savings bank deposit account at the rate specified by RBI from time to time. In case of savings bank accounts, till recently, banks paid interest on the minimum balance between the 11th and the last day of the

month. With effect from April 1, 2010, banks have been advised to calculate interest on savings bank deposit by considering daily product, which would benefit the holders of savings bank accounts.

- **Term deposits:** Term-deposit interest rates are decided by individual banks within these general guidelines. In terms of RBI directives, interest is calculated at quarterly intervals on term deposits and paid at the rate decided by the bank depending upon the period of deposits. The interest on term deposits is calculated by the bank in accordance with the formulae and conventions advised by Indian Bank Association.[17] Also, a customer can earn interest on a term deposit for a minimum period of 7 days, as stated earlier.
- **Tax deducted at source (TDS):** The bank has statutory obligation to deduct tax at source if the total interest paid/payable on all term deposits held by a person exceeds the amount specified under the Income Tax Act and rules there under. The Bank will issue a tax deduction certificate (TDS Certificate) for the amount of tax deducted. The depositor, if entitled to exemption from TDS, can submit a declaration to the bank in the prescribed format at the beginning of every financial year.

Premature Withdrawal of Term Deposit

The bank on request from the depositor, at its discretion, may allow withdrawal of term-deposit before completion of the period of the deposit agreed upon at the time of placing the deposit. Banks usually charge a penalty for premature withdrawal of deposits. The bank shall declare their penal interest rates policy for premature withdrawal of term deposit, if any, at the time of opening of the account.

Premature Renewal of Term Deposit

In case the depositor desires to renew the deposit by seeking premature closure of an existing term deposit account, the bank will permit the renewal at the applicable rate on the date of renewal, provided the deposit is renewed for a period longer than the balance period of the original deposit. While prematurely closing a deposit for the purpose of renewal, interest on the deposit for the period it has remained with the bank will be paid at the rate applicable to the period for which the deposit remained with the bank and not at the contracted rate.

Advances against Deposits

The Bank may consider requests of the depositor(s) for loan/overdraft facility against term deposits duly discharged by the depositor(s) on execution of necessary security documents.

[17] The Indian Banks' Association (IBA) is an association of banks from both the public and the private sector and represents the management of banks.

The bank may also consider giving an advance against a deposit standing in the name of minor. However, a suitable declaration stating that the loan is for the benefit of the minor, is to be furnished by the depositor-applicant.

Settlement of Dues in Deceased Deposit Account

a) If the depositor has registered nomination with the bank; the balance outstanding in the account of the deceased depositor will be transferred/ paid to the nominee after the bank is satisfied about the identity of the nominee, etc.

b) The above procedure will be followed even in respect of a joint account where nomination is registered with the bank.

c) In case of joint deposit accounts where joint account holders do not give any mandate for disposal, when one of the joint account holders dies, the bank is required to make payment jointly to the legal heirs of the deceased person and the surviving depositor(s). In these cases, delays may ensue in the production of legal papers by the heirs of the deceased. However, if the joint account holders had given mandate for disposal of the balance in the account in the forms such as 'either or survivor', 'former/latter or survivor', 'anyone of survivors or survivor'; etc., the payment will be made as per the mandate. In such cases, there is no delay in production of legal papers by the heirs of the deceased.

d) In the absence of nomination, the bank will pay the amount outstanding to all legal heirs against joint application and on receipt of the necessary documents, including court order.

Stop Payment Facility

The Bank will accept 'stop payment' instructions from the depositors in respect of cheques issued by them. Charges, as specified, will be recovered.

Dormant Accounts

Accounts which are not operated for a considerable period of time (usually 12/24 months for savings bank accounts and 6/12 months for current accounts), will be transferred to a separate dormant/inoperative account status in the interest of the depositor as well as the bank.[18] The depositor will be informed if there are charges that the bank would levy on dormant/inoperative accounts. Such accounts can be used again on an activation request to the bank.

[18] Such a practice is in the interest of the depositor since it avoids the possibility of frauds on the account. It is also in the interest of the bank as it reduces the servicing costs that the bank would have had to incur if the account were to remain active.

Safe Deposit Lockers

This facility is not offered through all bank branches and wherever the facility is offered, allotment of safe deposit vault will be subject to availability and compliance with other terms and conditions attached to the service. Safe deposit lockers may be hired by an individual (not a minor) singly or jointly with another individual(s), HUFs, firms, limited companies, associates, societies, trusts etc. Nomination facility is available to individual(s) holding the lockers singly or jointly. In the absence of nomination or mandate for disposal of contents of lockers, with a view to avoid hardship to common persons, the bank will release the contents of locker to the legal heirs against indemnity on the lines as applicable to deposit accounts.

Redress of Complaints and Grievances

Depositors having any complaint/grievance with regard to services rendered by the bank have a right to approach the authorities designated by the bank for handling customer complaints/ grievances. In case the depositor does not get a response from the bank within one month after the bank receives his representation /complaint or he is not satisfied with the response received from the bank, he has a right to approach the Banking Ombudsman appointed by RBI.[19]

3.6 Deposit Services Offered to Non-Resident Indians

Banks actively seek banking business from Non-Resident Indians (NRIs) by offering different types of deposit accounts (and related services) in accordance with RBI guidelines, including:

- Non-resident ordinary account;
- Non-resident (external) Rupee account; and
- Foreign currency non resident account (Banks)

Definition of Non-Resident Indian (NRI)[20]

As per the Foreign Exchange Management Act (FEMA), 1999, an NRI means:

- Non-Resident Indian National (i.e. Non-resident Indian holding Indian passport), and
- Persons of Indian Origin (i.e., Non-residents holding foreign passports)

Non-resident Indian Nationals include

(i) Indian citizens who proceed abroad for employment or for any business or vocation in circumstances indicating an indefinite period of stay outside India;

[20] NRI is defined differently under different acts. For the purpose of bank accounts, FEMA definition holds.

(ii) Indian citizens working abroad on assignments with foreign governments, international/ multinational agencies such as the United Nations, the International Monetary Fund, the World Bank etc.

(iii) Officials of Central and State Governments and Public Sector Undertakings (PSUs) deputed abroad on assignments with foreign governments, multilateral agencies or Indian diplomatic missions abroad.

PIO (Persons of Indian Origin) is defined as a citizen of any country other than Bangladesh or Pakistan, if

a. he has at any time held an Indian passport; or

b. he or either of his parents or any of his grand parents was a citizen of India; or

c. the person is a spouse of an Indian citizen or a person referred to in sub-clause (a) or (b).

In general, NRI is thus a person of Indian nationality or origin, who is resident abroad for business or employment or vocation, or with the intension of seeking employment or vocation and the period of stay abroad is uncertain.[21]

3.6.1 Non Resident Ordinary Accounts (NRO)

These are Rupee accounts and can be opened by any person resident outside India. Typically, when a resident becomes non-resident, his domestic Rupee account gets converted into an NRO account. In other words, it is basically a domestic account of an NRI which help him get credits which accrue in India, such as rent from property or income from other investments. New accounts can be opened by sending fresh remittances from abroad. NRO accounts can be opened only as savings account, current account, recurring deposits and term-deposit accounts. Regulations on interest rates, tenors etc. are similar to those of domestic accounts. While the principal of NRO deposits is non-repatriable, current income such as interest earnings on NRO deposits are repatriable. Further, NRI/PIO may remit an amount, not exceeding US$1million per financial year, for permissible transactions from these accounts.

3.6.2 Non-Resident (External) Rupee Accounts

The Non-Resident (External) Rupee Account NR(E)RA scheme, also known as the NRE scheme, was introduced in 1970. This is a rupee account. Any NRI can open an NRE account with funds remitted to India through a bank abroad.

An NRE rupee account may be opened as current, savings, recurring or term deposit account. Since this account is maintained in Rupees, the depositor is exposed to exchange risk.

[21] Thus, a student going abroad for studies or a tourist going abroad for brief visit is not an NRI.

This is a repatriable account (for both interest and principal) and transfer from/to another NRE account or FCNR (B) account (see below) is also permitted. Local payments can also be freely made from NRE accounts. NRIs / PIOs have the option to credit the current income to their NRE accounts, provided income tax has been deducted / provided for. Interest rates on NRE accounts are determined by the RBI, for both savings and term deposits.

3.6.3 Foreign Currency Non Resident Account (Banks)

The Foreign Currency Non-Resident Account (Banks) or FCNR(B) accounts scheme was introduced with effect from May 15, 1993 to replace the then prevailing FCNR(A) scheme introduced in 1975.

- These are foreign currency accounts, which can be opened by NRIs in only designated currencies: Pound Sterling, US Dollar, Canadian Dollar, Australian Dollar, EURO and Japanese Yen.
- Repatriation of principal amount and interest is permitted.
- These deposits can be opened only in the form of term deposits.
- Deposits are in foreign currency and are repaid in the currency of issue. Hence, there is no exchange risk for the account holder.
- Transfer of funds from existing NRE accounts to FCNR(B) accounts and vice- versa, of the same account holder, is permissible without the prior approval of RBI.

A bank should obtain the prior approval of its Board of Directors for the interest rates that it will offer on deposits of various maturities, within the ceiling prescribed by RBI.

Table 3.4 compares the different features of the deposit accounts available to the NRIs.

Table 3.4 Comparison of Deposit Schemes available to NRIs

Particulars	Foreign Currency (Non-Resident) Account (Banks) Scheme (FCNR(B) Account)	Non-Resident (External) Rupee Account Scheme (NRE Account)	Non-Resident Ordinary Rupee Account Scheme (NRO Account)
Who can open an account?	NRIs (individuals/entities of Bangladesh/Pakistan nationality/ownership require prior approval of RBI)	NRIs (individuals/entities of Bangladesh/Pakistan nationality/ownership require prior approval of RBI)	Any person resident outside India (other than a person resident in Nepal and Bhutan). (Individuals/entities of Bangladesh Pakistan nationality ownership as well as erstwhile OCBs require prior approval of RBI)
Currency in which account is denominated	Pound Sterling, US Dollar, Japanese Yen, Euro, Canadian Dollar and Australian Dollar	Indian Rupees	Indian Rupees
Repatriability	Repatriability	Repatriability	Not repatriable *
Type of Account	Term Deposit only	Savings, Current, Recurring, Fixed Deposit	Savings, Current, Recurring, Fixed Deposit
Period for fixed deposits	For terms not less than 1 year and not more than 5 years.	At the discretion of the bank	As applicable to resident accounts
Rate of Interest	Subject to cap #	Subject to cap #	Banks are free to determine interest rates for term deposits.

Source: FAQ section, Reserve Bank of India Website

Note:

* Except for the following: (i) current income, (ii) up to USD 1 million per financial year (April-March), for any bonafide purpose out of the balances in the account / sale proceeds of assets in India acquired by way of inheritance / legacy inclusive of assets acquired out of settlement subject to certain conditions.

As determined by the RBI from time to time.

3.7 Deposit Insurance

Deposit insurance helps sustain public confidence in the banking system through the protection of depositors, especially small depositors, against loss of deposit to a significant extent. In India, bank deposits are covered under the insurance scheme offered by Deposit Insurance and Credit Guarantee Corporation of India (DICGC), which was established with funding from the Reserve Bank of India. The scheme is subject to certain limits and conditions. DICGC is a wholly-owned subsidiary of the RBI.

3.7.1 Banks insured by the DICGC

All commercial banks including branches of foreign banks functioning in India, local area banks and regional rural banks are insured by the DICGC.[22]

Further, all State, Central and Primary cooperative banks functioning in States/Union Territories which have amended the local Cooperative Societies Act empowering RBI suitably are insured by the DICGC. Primary cooperative societies are not insured by the DICGC.

3.7.2 Features of the scheme

When is DICGC liable to pay?

In the event of a bank failure, DICGC protects bank deposits that are payable in India. DICGC is liable to pay if (a) a bank goes into liquidation or (b) if a bank is amalgamated/ merged with another bank.

Methods of protecting depositors' interest

There are two methods of protecting depositors' interest when an insured bank fails: (i) by transferring business of the failed bank to another sound bank[23] (in case of merger or amalgamation) and (ii) where the DICGC pays insurance proceeds to depositors (insurance pay-out method).

Types of deposit covered by DICGC

The DICGC insures all deposits such as savings, fixed, current, recurring, etc. except the following types of deposits:

- Deposits of foreign Governments;
- Deposits of Central/State Governments;

---

[22] Primary agricultural credit societies (PACS) are village-level cooperatives that disburse short-term credit. There are over 95000 such societies in the country.

[23] In 2004, Global Trust Bank was merged into Oriental Bank of Commerce, after significant losses from NPAs, and a three-month Govt. imposed moratorium.

- Inter-bank deposits;
- Deposits of the State Land Development Banks with the State co-operative bank;
- Any amount due on account of any deposit received outside India;
- Any amount, which has been specifically exempted by the corporation with the previous approval of RBI.

Maximum deposit amount insured by the DICGC

Each depositor in a bank is insured up to a maximum of Rs100,000 for both principal and interest amount held by him in the same capacity and same right. For example, if an individual had a deposit with principal amount of Rs.90,000 plus accrued interest of Rs.7,000, the total amount insured by the DICGC would be Rs.97,000. If, however, the principal amount were Rs. 99,000 and accrued interest of Rs 6,000, the total amount insured by the DICGC would be Rs 1 lakh.

The deposits kept in different branches of a bank are aggregated for the purpose of insurance cover and a maximum amount up to Rs 1 lakh is paid. Also, all funds held in the same type of ownership at the same bank are added together before deposit insurance is determined. If the funds are in different types of ownership (say as individual, partner of firm, director of company, etc.) or are deposited into separate banks they would then be separately insured.

Also, note that where a depositor is the sole proprietor and holds deposits in the name of the proprietary concern as well as in his individual capacity, the two deposits are to be aggregated and the insurance cover is available up to rupees one lakh maximum.

Cost of deposit insurance

Deposit insurance premium is borne entirely by the insured bank. Banks are required to pay the insurance premium for the eligible amount to the DICGC on a semi-annual basis. The cost of the insurance premium cannot be passed on to the customer.

Box 3.4: Premium charged and claims paid by DICGC

The premium rates charged by DICGC were raised to Re 0.10 per deposit of Rs.100 with effect from April 1, 2005. While the premiums received by DICGC during the years 2006-07, 2007-08 and 2008-09 were Rs.2321 crores, Rs.2844 crores and Rs.3453 crores respectively, the net claims paid by DICGC during these three years were Rs.323 crores, Rs.180 crores and Rs.909 crores respectively.

Source: DICGC - Annual Report 2009.

Withdrawal of insurance cover

The deposit insurance scheme is compulsory and no bank can withdraw from it. The DICGC, on the other hand, can withdraw the deposit insurance cover for a bank if it fails to pay the premium for three consecutive half year periods. In the event of the DICGC withdrawing its cover from any bank for default in the payment of premium, the public will be notified through the newspapers.

CHAPTER 4: Basics of Bank Lending

Banks extend credit to different categories of borrowers for a wide variety of purposes. For many borrowers, bank credit is the easiest to access at reasonable interest rates. Bank credit is provided to households, retail traders, small and medium enterprises (SMEs), corporates, the Government undertakings etc. in the economy.

Retail banking loans are accessed by consumers of goods and services for financing the purchase of consumer durables, housing or even for day-to-day consumption. In contrast, the need for capital investment, and day-to-day operations of private corporates and the Government undertakings are met through wholesale lending.

Loans for capital expenditure are usually extended with medium and long-term maturities, while day-to-day finance requirements are provided through short-term credit (working capital loans). Meeting the financing needs of the agriculture sector is also an important role that Indian banks play.

4.1 Principles of Lending and Loan policy

4.1.1 Principles of lending

To lend, banks depend largely on deposits from the public. Banks act as custodian of public deposits. Since the depositors require safety and security of their deposits, want to withdraw deposits whenever they need and also adequate return, bank lending must necessarily be based on principles that reflect these concerns of the depositors. These principles include: safety, liquidity, profitability, and risk diversion.

Safety

Banks need to ensure that advances are safe and money lent out by them will come back. Since the repayment of loans depends on the borrowers' capacity to pay, the banker must be satisfied before lending that the business for which money is sought is a sound one. In addition, bankers many times insist on security against the loan, which they fall back on if things go wrong for the business. The security must be adequate, readily marketable and free of encumbrances.

Liquidity

To maintain liquidity, banks have to ensure that money lent out by them is not locked up for long time by designing the loan maturity period appropriately. Further, money must come back as per the repayment schedule. If loans become excessively illiquid, it may not be possible for bankers to meet their obligations vis-à-vis depositors.

Profitability

To remain viable, a bank must earn adequate profit on its investment. This calls for adequate margin between deposit rates and lending rates. In this respect, appropriate fixing of interest rates on both advances and deposits is critical. Unless interest rates are competitively fixed and margins are adequate, banks may lose customers to their competitors and become unprofitable.

Risk diversification

To mitigate risk, banks should lend to a diversified customer base. Diversification should be in terms of geographic location, nature of business etc. If, for example, all the borrowers of a bank are concentrated in one region and that region gets affected by a natural disaster, the bank's profitability can be seriously affected.

4.1.2 Loan Policy

Based on the general principles of lending stated above, the Credit Policy Committee (CPC) of individual banks prepares the basic credit policy of the Bank, which has to be approved by the Bank's Board of Directors. The loan policy outlines lending guidelines and establishes operating procedures in all aspects of credit management including standards for presentation of credit proposals, financial covenants, rating standards and benchmarks, delegation of credit approving powers, prudential limits on large credit exposures, asset concentrations, portfolio management, loan review mechanism, risk monitoring and evaluation, pricing of loans, provisioning for bad debts, regulatory/ legal compliance etc. The lending guidelines reflect the specific bank's lending strategy (both at the macro level and individual borrower level) and have to be in conformity with RBI guidelines. The loan policy typically lays down lending guidelines in the following areas:

- Level of credit-deposit ratio
- Targeted portfolio mix
- Hurdle ratings
- Loan pricing
- Collateral security

Credit Deposit (CD) Ratio

A bank can lend out only a certain proportion of its deposits, since some part of deposits have to be statutorily maintained as Cash Reserve Ratio (CRR) deposits, and an additional part has to be used for making investment in prescribed securities (Statutory Liquidity Ratio or SLR

requirement).[24] It may be noted that these are minimum requirements. Banks have the option of having more cash reserves than CRR requirement and invest more in SLR securities than they are required to. Further, banks also have the option to invest in non-SLR securities. Therefore, the CPC has to lay down the quantum of credit that can be granted by the bank as a percentage of deposits available. Currently, the average CD ratio of the entire banking industry is around 70 percent, though it differs across banks. It is rarely observed that banks lend out of their borrowings.

Targeted Portfolio Mix

The CPC aims at a targeted portfolio mix keeping in view both risk and return. Toward this end, it lays down guidelines on choosing the preferred areas of lending (such as sunrise sectors and profitable sectors) as well as the sectors to avoid.[25] Banks typically monitor all major sectors of the economy. They target a portfolio mix in the light of forecasts for growth and profitability for each sector. If a bank perceives economic weakness in a sector, it would restrict new exposures to that segment and similarly, growing and profitable sectors of the economy prompt banks to increase new exposures to those sectors. This entails active portfolio management.

Further, the bank also has to decide which sectors to avoid. For example, the CPC of a bank may be of the view that the bank is already overextended in a particular industry and no more loans should be provided in that sector. It may also like to avoid certain kinds of loans keeping in mind general credit discipline, say loans for speculative purposes, unsecured loans, etc.

Hurdle ratings

There are a number of diverse risk factors associated with borrowers. Banks should have a comprehensive risk rating system that serves as a single point indicator of diverse risk factors of a borrower. This helps taking credit decisions in a consistent manner. To facilitate this, a substantial degree of standardisation is required in ratings across borrowers. The risk rating system should be so designed as to reveal the overall risk of lending. For new borrowers, a bank usually lays down guidelines regarding minimum rating to be achieved by the borrower to become eligible for the loan. This is also known as the 'hurdle rating' criterion to be achieved by a new borrower.

---

[24] Each bank has to statutorily set aside a certain minimum fraction of it net demand and time liabilities in prescribed assets to fulfill these requirements. CRR and SLR have been discussed in chapter 1 and Chapter 5 respectively.

[25] For example, in the last decade, a number of banks identified retail finance as an area with potential for strong growth and have therefore sought to increase their financing in retail space. One advantage of financing a large number of small loans is that risk concentration is reduced. However, during an economic downturn, the retail portfolio may also experience significantly high credit defaults.

Pricing of loans

Risk-return trade-off is a fundamental aspect of risk management. Borrowers with weak financial position and, hence, placed in higher risk category are provided credit facilities at a higher price (that is, at higher interest). The higher the credit risk of a borrower the higher would be his cost of borrowing. To price credit risks, banks devise appropriate systems, which usually allow flexibility for revising the price (risk premium) due to changes in rating. In other words, if the risk rating of a borrower deteriorates, his cost of borrowing should rise and vice versa.

At the macro level, loan pricing for a bank is dependent upon a number of its cost factors such as cost of raising resources, cost of administration and overheads, cost of reserve assets like CRR and SLR, cost of maintaining capital, percentage of bad debt, etc. Loan pricing is also dependent upon competition.

Collateral security

As part of a prudent lending policy, banks usually advance loans against some security. The loan policy provides guidelines for this. In the case of term loans and working capital assets, banks take as 'primary security' the property or goods against which loans are granted.[26] In addition to this, banks often ask for additional security or 'collateral security' in the form of both physical and financial assets to further bind the borrower. This reduces the risk for the bank. Sometimes, loans are extended as 'clean loans' for which only personal guarantee of the borrower is taken.

4.1.3 Compliance with RBI guidelines

The credit policy of a bank should be conformant with RBI guidelines; some of the important guidelines of the RBI relating to bank credit are discussed below.

Directed credit stipulations

The RBI lays down guidelines regarding minimum advances to be made for priority sector advances, export credit finance, etc.[27] These guidelines need to be kept in mind while formulating credit policies for the Bank.

Capital adequacy

If a bank creates assets-loans or investment-they are required to be backed up by bank capital; the amount of capital they have to be backed up by depends on the risk of individual assets that the bank acquires. The riskier the asset, the larger would be the capital it has to be

[26] For example, in case of a home loan, the house for which the loan is taken serves as the 'primary security'.

[27] Priority sector advances and export credit have been discussed later in this chapter.

backed up by. This is so, because bank capital provides a cushion against unexpected losses of banks and riskier assets would require larger amounts of capital to act as cushion.

The Basel Committee for Bank Supervision (BCBS) has prescribed a set of norms for the capital requirement for the banks for all countries to follow. These norms ensure that capital should be adequate to absorb unexpected losses.[28] In addition, all countries, including India, establish their own guidelines for risk based capital framework known as Capital Adequacy Norms. These norms have to be at least as stringent as the norms set by the Basel committee.

A key norm of the Basel committee is the Capital Adequacy Ratio (CAR), also known as Capital Risk Weighted Assets Ratio, is a simple measure of the soundness of a bank. The ratio is the capital with the bank as a percentage of its risk-weighted assets. Given the level of capital available with an individual bank, this ratio determines the maximum extent to which the bank can lend.

The Basel committee specifies a CAR of at least 8% for banks. This means that the capital funds of a bank must be at least 8 percent of the bank's risk weighted assets. In India, the RBI has specified a minimum of 9%, which is more stringent than the international norm. In fact, the actual ratio of all scheduled commercial banks (SCBs) in India stood at 13.2% in March 2009.

The RBI also provides guidelines about how much risk weights banks should assign to different classes of assets (such as loans). The riskier the asset class, the higher would be the risk weight. Thus, the real estate assets, for example, are given very high risk weights.

This regulatory requirement that each individual bank has to maintain a minimum level of capital, which is commensurate with the risk profile of the bank's assets, plays a critical role in the safety and soundness of individual banks and the banking system.

Credit Exposure Limits

As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank has fixed limits on bank exposure to the capital market as well as to individual and group borrowers with reference to a bank's capital. Limits on inter-bank exposures have also been placed. Banks are further encouraged to place internal caps on their sectoral exposures, their exposure to commercial real estate and to unsecured exposures. These exposures are closely monitored by the Reserve Bank. Prudential norms on banks'

[28] A Bank typically faces two types of losses in respect of any borrower or borrower class - expected and unexpected losses. Expected losses should be budgeted for, and provisions should be made to offset their adverse effects on the Bank's balance sheet. However, to cushion against unexpected losses, which are unpredictable, banks have to hold adequate amount of capital.

exposures to NBFCs and to related entities are also in place. Table 4.1 gives a summary of the RBI's guidelines on exposure norms for commercial banks in India.

Table 4.1: Exposure norms for Commercial banks in India

Exposure to	Limit
1. Single Borrower	15 per cent of capital fund (Additional 5 percent on infrastructure exposure)
2. Group Borrower	40 percent of capital fund (Additional 10 percent on infrastructure exposure)
3. NBFC	10 percent of capital fund
4. NBFC - AFC	15 percent of capital fund
5. Indian Joint Venture/Wholly owned subsidiaries abroad/ Overseas step down subsidiaries of Indian corporates	20 percent of capital fund
6. Capital Market Exposure	
(a) Banks' holding of shares in any company	The lesser of 30 percent of paid-up share capital of the company or 30 percent of the paid-up capital of banks
(b) Banks' aggregate exposure to capital market (solo basis)	40 percent of its net worth
(c) Banks' aggregate exposure to capital market (group basis)	40 percent of its consolidated net worth
(d) Banks' direct exposure to capital market (solo basis)	20 percent of net worth
(e) Banks' direct exposure to capital market (group basis)	20 percent of consolidated net worth
7. Gross Holding of capital among banks / financial institutions	10 per cent of capital fund

Source: Financial Stability Report, RBI, March 2010

Some of the categories of the above table are discussed below:

- **Individual Borrowers:** A bank's credit exposure to individual borrowers must not exceed 15 % of the Bank's capital funds. Credit exposure to individual borrowers may exceed the exposure norm of 15 % of capital funds by an additional 5 % (i.e. up to 20 %) provided the additional credit exposure is on account of infrastructure financing.

- **Group Borrowers:** A bank's exposure to a group of companies under the same management control must not exceed 40% of the Bank's capital funds unless the exposure is in respect of an infrastructure project. In that case, the exposure to a group of companies under the same management control may be up to 50% of the Bank's capital funds.[29]
- **Aggregate exposure to capital market:** A bank's aggregate exposure to the capital market, including both fund based and non-fund based exposure to capital market, in all forms should not exceed 40 percent of its net worth as on March 31 of the previous year.

In addition to ensuring compliance with the above guidelines laid down by RBI, a Bank may fix its own credit exposure limits for mitigating credit risk. The bank may, for example, set upper caps on exposures to sensitive sectors like commodity sector, real estate sector and capital markets. Banks also may lay down guidelines regarding exposure limits to unsecured loans.

Lending Rates

Banks are free to determine their own lending rates on all kinds of advances except a few such as export finance; interest rates on these exceptional categories of advances are regulated by the RBI.

It may be noted that the Section 21A of the BR Act provides that the rate of interest charged by a bank shall not be reopened by any court on the ground that the rate of interest charged is excessive.

The concept of benchmark prime lending rate (BPLR) was however introduced in November 2003 for pricing of loans by commercial banks with the objective of enhancing transparency in the pricing of their loan products. Each bank must declare its benchmark prime lending rate (BPLR) as approved by its Board of Directors. A bank's BPLR is the interest rate to be charged to its best clients; that is, clients with the lowest credit risk. Each bank is also required to indicate the maximum spread over the BPLR for various credit exposures.

However, BPLR lost its relevance over time as a meaningful reference rate, as the bulk of loans were advanced below BPLR. Further, this also impedes the smooth transmission of monetary signals by the RBI. The RBI therefore set up a Working Group on Benchmark Prime Lending Rate (BPLR) in June 2009 to go into the issues relating to the concept of BPLR and suggest measures to make credit pricing more transparent.

[29] Banks may, in exceptional circumstances, with the approval of their boards, enhance the exposure by additional 5% for both individual, and group borrowers

Following the recommendations of the Group, the Reserve Bank has issued guidelines in February 2010. According to these guidelines, the 'Base Rate system' will replace the BPLR system with effect from July 01, 2010.All categories of loans should henceforth be priced only with reference to the Base Rate. Each bank will decide its own Base Rate. The actual lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, which will include product-specific operating costs, credit risk premium and tenor premium.

Since transparency in the pricing of loans is a key objective, banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels. Apart from transparency, banks should ensure that interest rates charged to customers in the above arrangement are non-discriminatory in nature.

Guidelines on Fair Practices Code for Lenders

RBI has been encouraging banks to introduce a fair practices code for bank loans. Loan application forms in respect of all categories of loans irrespective of the amount of loan sought by the borrower should be comprehensive. It should include information about the fees/ charges, if any, payable for processing the loan, the amount of such fees refundable in the case of non-acceptance of application, prepayment options and any other matter which affects the interest of the borrower, so that a meaningful comparison with the fees charged by other banks can be made and informed decision can be taken by the borrower. Further, the banks must inform 'all-in-cost' to the customer to enable him to compare the rates charged with other sources of finance.

Regulations relating to providing loans

The provisions of the Banking Regulation Act, 1949 (BR Act) govern the making of loans by banks in India. RBI issues directions covering the loan activities of banks. Some of the major guidelines of RBI, which are now in effect, are as follows:

- **Advances against bank's own shares:** a bank cannot grant any loans and advances against the security of its own shares.
- **Advances to bank's Directors:** The BR Act lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.
- **Restrictions on Holding Shares in Companies:** In terms of Section 19(2) of the BR Act, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

4.2 Basics of Loan Appraisal, Credit decision-making and Review

4.2.1 Credit approval authorities

The Bank's Board of Directors also has to approve the delegation structure of the various credit approval authorities. Banks establish multi-tier credit approval authorities for corporate banking activities, small enterprises, retail credit, agricultural credit, etc.

Concurrently, each bank should set up a Credit Risk Management Department (CMRD), being independent of the CPC. The CRMD should enforce and monitor compliance of the risk parameters and prudential limits set up by the CPC.

The usual structure for approving credit proposals is as follows:

- Credit approving authority: multi-tier credit approving system with a proper scheme of delegation of powers.
- In some banks, high valued credit proposals are cleared through a Credit Committee approach consisting of, say 3/ 4 officers. The Credit Committee should invariably have a representative from the CRMD, who has no volume or profit targets.

4.2.2 Credit appraisal and credit decision-making

When a loan proposal comes to the bank, the banker has to decide how much funds does the proposal really require for it to be a viable project and what are the credentials of those who are seeking the project. In checking the credentials of the potential borrowers, Credit Information Bureaus play an important role (see Box)

Box 4.1: Credit Information Bureaus

The Parliament of India has enacted the Credit Information Companies (Regulation) Act, 2005, pursuant to which every credit institution, including a bank, has to become a member of a credit information bureau and furnish to it such credit information as may be required of the credit institution about persons who enjoy a credit relationship with it. Credit information bureaus are thus repositories of information, which contains the credit history of commercial and individual borrowers. They provide this information to their Members in the form of credit information reports.

To get a complete picture of the payment history of a credit applicant, credit grantors must be able to gain access to the applicant's complete credit record that may be spread over different institutions. Credit information bureaus collect commercial and consumer credit-related data and collate such data to create credit reports, which they distribute to their Members. A Credit Information Report (CIR) is a factual record of a borrower's credit payment history compiled from information received from different credit grantors. Its purpose is to help credit grantors make informed lending decisions - quickly and objectively. As of today, bureaus provide history of credit card holders and SMEs.

4.2.3 Monitoring and Review of Loan Portfolio

It is not only important for banks to follow due processes at the time of sanctioning and disbursing loans, it is equally important to monitor the loan portfolio on a continuous basis. Banks need to constantly keep a check on the overall quality of the portfolio. They have to ensure that the borrower utilizes the funds for the purpose for which it is sanctioned and complies with the terms and conditions of sanction. Further, they monitor individual borrowal accounts and check to see whether borrowers in different industrial sectors are facing difficulty in making loan repayment. Information technology has become an important tool for efficient handling of the above functions including decision support systems and data bases. Such a surveillance and monitoring approach helps to mitigate credit risk of the portfolio.

Banks have set up Loan Review Departments or Credit Audit Departments in order to ensure compliance with extant sanction and post-sanction processes and procedures laid down by the Bank from time to time. This is especially applicable for the larger advances. The Loan Review Department helps a bank to improve the quality of the credit portfolio by detecting early warning signals, suggesting remedial measures and providing the top management with information on credit administration, including the credit sanction process, risk evaluation and post-sanction follow up.

4.3 Types of Advances

Advances can be broadly classified into: fund-based lending and non-fund based lending.

Fund based lending: This is a direct form of lending in which a loan with an actual cash outflow is given to the borrower by the Bank. In most cases, such a loan is backed by primary and/or collateral security. The loan can be to provide for financing capital goods and/or working capital requirements.

Non-fund based lending: In this type of facility, the Bank makes no funds outlay. However, such arrangements may be converted to fund-based advances if the client fails to fulfill the terms of his contract with the counterparty. Such facilities are known as contingent liabilities of the bank. Facilities such as 'letters of credit' and 'guarantees' fall under the category of non-fund based credit.

Let us explain with an example how guarantees work. A company takes a term loan from Bank A and obtains a guarantee from Bank B for its loan from Bank A, for which he pays a fee. By issuing a bank guarantee, the guarantor bank (Bank B) undertakes to repay Bank A, if the company fails to meet its primary responsibility of repaying Bank A.

In this chapter, we will discuss only some important types of fund-based lending.

4.3.1 Working Capital Finance

Working capital finance is utilized for operating purposes, resulting in creation of current assets (such as inventories and receivables). This is in contrast to term loans which are utilized for establishing or expanding a manufacturing unit by the acquisition of fixed assets.

Banks carry out a detailed analysis of borrowers' working capital requirements. Credit limits are established in accordance with the process approved by the board of directors. The limits on Working capital facilities are primarily secured by inventories and receivables (chargeable current assets).

Working capital finance consists mainly of cash credit facilities, short term loan and bill discounting. Under the cash credit facility, a line of credit is provided up to a pre-established amount based on the borrower's projected level of sales inventories, receivables and cash deficits. Up to this pre-established amount, disbursements are made based on the actual level of inventories and receivables. Here the borrower is expected to buy inventory on payments and, thereafter, seek reimbursement from the Bank. In reality, this may not happen. The facility is generally given for a period of up to 12 months and is extended after a review of the credit limit. For clients facing difficulties, the review may be made after a shorter period.

One problem faced by banks while extending cash credit facilities, is that customers can draw up to a maximum level or the approved credit limit, but may decide not to. Because of this, liquidity management becomes difficult for a bank in the case of cash credit facility. RBI has been trying to mitigate this problem by encouraging the Indian corporate sector to avail of working capital finance in two ways: a short-term loan component and a cash credit component. The loan component would be fully drawn, while the cash credit component would vary depending upon the borrower's requirements.

According to RBI guidelines, in the case of borrowers enjoying working capital credit limits of Rs. 10 crores and above from the banking system, the loan component should normally be 80% and cash credit component 20 %. Banks, however, have the freedom to change the composition of working capital finance by increasing the cash credit component beyond 20% or reducing it below 20 %, as the case may be, if they so desire.

Bill discounting facility involves the financing of short-term trade receivables through negotiable instruments. These negotiable instruments can then be discounted with other banks, if required, providing financing banks with liquidity.

4.3.2 Project Finance

Project finance business consists mainly of extending medium-term and long-term rupee and foreign currency loans to the manufacturing and infrastructure sectors. Banks also provide financing by way of investment in marketable instruments such as fixed rate and floating rate

debentures. Lending banks usually insist on having a first charge on the fixed assets of the borrower.

During the recent years, the larger banks are increasingly becoming involved in financing large projects, including infrastructure projects. Given the large amounts of financing involved, banks need to have a strong framework for project appraisal. The adopted framework will need to emphasize proper identification of projects, optimal allocation and mitigation of risks.

The project finance approval process entails a detailed evaluation of technical, commercial, financial and management factors and the project sponsor's financial strength and experience. As part of the appraisal process, a risk matrix is generated, which identifies each of the project risks, mitigating factors and risk allocation.

Project finance extended by banks is generally fully secured and has full recourse to the borrower company. In most project finance cases, banks have a first lien on all the fixed assets and a second lien on all the current assets of the borrower company. In addition, guarantees may be taken from sponsors/ promoters of the company. Should the borrower company fail to repay on time, the lending bank can have full recourse to the sponsors/ promoters of the company. (Full recourse means that the lender can claim the entire unpaid amount from the sponsors / promoters of the company.) However, while financing very large projects, only partial recourse to the sponsors/ promoters may be available to the lending banks.

4.3.3 Loans to Small and Medium Enterprises

A substantial quantum of loans is granted by banks to small and medium enterprises (SMEs). While granting credit facilities to smaller units, banks often use a cluster-based approach, which encourages financing of small enterprises that have a homogeneous profile such as leather manufacturing units, chemical units, or even export oriented units. For assessing the credit risk of individual units, banks use the credit scoring models.

As per RBI guidelines, banks should use simplified credit appraisal methods for assessment of bank finance for the smaller units. Further, banks have also been advised that they should not insist on collateral security for loans up to Rs.10 lakh for the micro enterprises.

Box 4.2: Specialised Branches for SME Credit

Given the importance of SME sector, the RBI has initiated several measures to increase the flow of credit to this segment. As part of this effort, the public sector banks (PSBs) have been operationalizing specialized SME bank branches for ensuring uninterrupted credit flow to this sector. As at end-March 2009, PSBs have operationalised as many as 869 specialized SME bank branches.

Source: Report on Trend and Progress of Banking in India 2008-09, RBI

Small Industries Development Bank of India (SIDBI) also facilitates the flow of credit at reasonable interest rates to the SME sector. This is done by incentivising banks and State Finance Corporations to lend to SMEs by refinancing a specified percentage of incremental lending to SMEs, besides providing direct finance along with banks.

4.3.4 Rural and Agricultural Loans

The rural and agricultural loan portfolio of banks comprises loans to farmers, small and medium enterprises in rural areas, dealers and vendors linked to these entities and even corporates. For farmers, banks extend term loans for equipments used in farming, including tractors, pump sets, etc. Banks also extend crop loan facility to farmers. In agricultural financing, banks prefer an 'area based' approach; for example, by financing farmers in an adopted village. The regional rural banks (RRBs) have a special place in ensuring adequate credit flow to agriculture and the rural sector.

The concept of 'Lead Bank Scheme (LBS)' was first mooted by the Gadgil Study Group, which submitted its report in October 1969. Pursuant to the recommendations of the Gadgil Study Group and those of the Nariman Committee, which suggested the adoption of 'area approach' in evolving credit plans and programmes for development of banking and the credit structure, the LBS was introduced by the RBI in December, 1969. The scheme envisages allotment of districts to individual banks to enable them to assume leadership in bringing about banking developments in their respective districts. More recently, a High Level Committee was constituted by the RBI in November 2007, to review the LBS and improve its effectiveness, with a focus on financial inclusion and recent developments in the banking sector. The Committee has recommended several steps to further improve the working of LBS. The importance of the role of State Governments for supporting banks in increasing banking business in rural areas has been emphasized by the Committee.

4.3.5 Directed Lending

The RBI requires banks to deploy a certain minimum amount of their credit in certain identified sectors of the economy. This is called directed lending. Such directed lending comprises priority sector lending and export credit.

A. Priority sector lending

The objective of priority sector lending program is to ensure that adequate credit flows into some of the vulnerable sectors of the economy, which may not be attractive for the banks from the point of view of profitability. These sectors include agriculture, small scale enterprises, retail trade, etc. Small housing loans, loans to individuals for pursuing education, loans to weaker sections of the society etc also qualify as priority sector loans.

To ensure banks channelize a part of their credit to these sectors, the RBI has set guidelines

defining targets for lending to priority sector as whole and in certain cases, sub-targets for lending to individual priority sectors (See Table 4.2).

Table 4.2: Targets under Priority Sector Lending

	Domestic commercial banks	**Foreign banks**
Total Priority Sector advances	40 per cent of ANBC or CEOBSE, whichever is higher	32 percent of ANBC or CEOBSE, whichever is higher
Total agricultural advances	18 percent of ANBC or CEOBSE, whichever is higher	No Target
Small Enterprise advances	No Target	10 per cent of ANBC or CEOBSE, whichever is higher
Export credit	Export credit is not a part of priority sector for domestic commercial banks	12 per cent of ANBC or CEOBSE, whichever is higher
Advances to weaker sections	10 percent of ANBC or CEOBSE, whichever is higher	No target
Differential Rate of Interest Scheme	1 percent of total advances outstanding as at the end of the previous year	No target

Source: Master Circular on Lending to Priority Sector dated July 1, 2009, Reserve Bank of India

Note: ANBC: Adjusted Net Bank Credit
CEOBSE: Credit Equivalent of Off-Balance Sheet Exposure

The RBI guidelines require banks to lend at least 40% of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure (CEOBSE), whichever is higher. In case of foreign banks, the target for priority sector advances is 32% of ANBC or CEOBSE, whichever is higher.

In addition to these limits for overall priority sector lending, the RBI sets sub-limits for certain sub-sectors within the priority sector such as agriculture. Banks are required to comply with the priority sector lending requirements at the end of each financial year. A bank having shortfall in lending to priority sector lending target or sub-target shall be required to make contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD or funds with other financial institutions as specified by the RBI.

Box 4.3: Differential Rate of Interest (DRI) Scheme

Government of India had formulated in March, 1972 a scheme for extending financial assistance at concessional rate of interest @ 4% to selected low income groups for productive endeavors. The scheme known as Differential Rate of Interest Scheme (DRI) is now being implemented by all Scheduled Commercial Banks. The maximum family incomes that qualify a borrower for the DRI scheme is revised periodically. Currently, the RBI has advised the banks that borrowers with annual family income of Rs.18,000 in rural areas and Rs.24,000 in urban and semi-urban areas would be eligible to avail of the facility as against the earlier annual income criteria of Rs.6,400 in rural areas and Rs.7,200 in urban areas. The target for lending under the DRI scheme in a year is maintained at one per cent of the total advances outstanding as at the end of the previous year.

Source: RBI Circulars

B. Export Credit

As part of directed lending, RBI requires banks to make loans to exporters at concessional rates of interest. Export credit is provided for pre-shipment and post-shipment requirements of exporter borrowers in rupees and foreign currencies. At the end of any fiscal year, 12.0% of a bank's credit is required to be in the form of export credit. This requirement is in addition to the priority sector lending requirement but credits extended to exporters that are small scale industries or small businesses may also meet part of the priority sector lending requirement.

4.3.6 Retail Loan

Banks, today, offer a range of retail asset products, including home loans, automobile loans, personal loans (for marriage, medical expenses etc), credit cards, consumer loans (such as TV sets, personal computers etc) and, loans against time deposits and loans against shares. Banks also may fund dealers who sell automobiles, two wheelers, consumer durables and commercial vehicles. The share of retail credit in total loans and advances was 21.3% at end-March 2009.

Customers for retail loans are typically middle and high-income, salaried or self-employed individuals, and, in some cases, proprietorship and partnership firms. Except for personal loans and credit through credit cards, banks stipulate that (a) a certain percentage of the cost of the asset (such as a home or a TV set) sought to be financed by the loan, to be borne by the borrower and (b) that the loans are secured by the asset financed.

Many banks have implemented a credit-scoring program, which is an automated credit approval system that assigns a credit score to each applicant based on certain attributes like income, educational background and age. The credit score then forms the basis of loan evaluation. External agencies such as field investigation agencies and credit processing agencies may be

used to facilitate a comprehensive due diligence process including visits to offices and homes in the case of loans to individual borrowers. Before disbursements are made, the credit officer checks a centralized delinquent database and reviews the borrower's profile. In making credit decisions, banks draw upon reports from agencies such as the Credit Information Bureau (India) Limited (CIBIL).

Some private sector banks use direct marketing associates as well as their own branch network and employees for marketing retail credit products. However, credit approval authority lies only with the bank's credit officers.

Two important categories of retail loans--home finance and personal loans--are discussed below.

Home Finance: Banks extend home finance loans, either directly or through home finance subsidiaries. Such long term housing loans are provided to individuals and corporations and also given as construction finance to builders. The loans are secured by a mortgage of the property financed. These loans are extended for maturities generally ranging from five to fifteen years and a large proportion of these loans are at floating rates of interest. This reduces the interest rate risk that banks assume, since a bank's sources of finance are generally of shorter maturity. However, fixed rate loans may also be provided; usually with banks keeping a higher margin over benchmark rates in order to compensate for higher interest rate risk. Equated monthly installments are fixed for repayment of loans depending upon the income and age of the borrower(s).

Personal Loans: These are often unsecured loans provided to customers who use these funds for various purposes such as higher education, medical expenses, social events and holidays. Sometimes collateral security in the form of physical and financial assets may be available for securing the personal loan. Portfolio of personal loans also includes micro-banking loans, which are relatively small value loans extended to lower income customers in urban and rural areas.

4.3.7 International Loans Extended by Banks

Indian corporates raise foreign currency loans from banks based in India as well as abroad as per guidelines issued by RBI/ Government of India. Banks raise funds abroad for on-lending to Indian corporates. Further, banks based in India have an access to deposits placed by Non Resident Indians (NRIs) in the form of FCNR (B) deposits, which can be used by banks in India for on-lending to Indian customers.

4.4 Management of Non Performing Assets

An asset of a bank (such as a loan given by the bank) turns into a non-performing asset (NPA) when it ceases to generate regular income such as interest etc for the bank. In other words, when a bank which lends a loan does not get back its principal and interest on time, the loan is said to have turned into an NPA. Definition of NPAs is given in 4.4.1. While NPAs are a natural fall-out of undertaking banking business and hence cannot be completely avoided, high levels of NPAs can severely erode the bank's profits, its capital and ultimately its ability to lend further funds to potential borrowers. Similarly, at the macro level, a high level of non-performing assets means choking off credit to potential borrowers, thus lowering capital formation and economic activity. So the challenge is to keep the growth of NPAs under control. Clearly, it is important to have a robust appraisal of loans, which can reduce the chances of loan turning into an NPA. Also, once a loan starts facing difficulties, it is important for the bank to take remedial action.

Box 4.4: Level of Non Performing Assets

The gross non-performing assets of the banking segment were Rs. 68, 973 crores at the end of March 2009, and the level of net NPAs (after provisioning) was Rs.31, 424 crores. Although they appear to be very large amounts in absolute terms, they are actually quite small in comparison to total loans by banks. The ratio of gross non-performing loans to gross total loans has fallen sharply over the last decade and is at 2.3 per cent as at end-March 2009. This ratio, which is an indicator of soundness of banks, is comparable with most of the developed countries such as France, Germany and Japan. The low level of gross NPAs as a percent of gross loans in India is a positive indicator of the Indian banking system.

Source: Report on Trend and Progress of Banking in India 2008-09, RBI and Report on Currency and Finance 2006-08.

4.4.1 Classification of non-performing Assets

Banks have to classify their assets as performing and non-performing in accordance with RBI's guidelines. Under these guidelines, an asset is classified as non-performing if any amount of interest or principal instalments remains overdue for more than 90 days, in respect of term loans. In respect of overdraft or cash credit, an asset is classified as non-performing if the account remains out of order for a period of 90 days and in respect of bills purchased and discounted account, if the bill remains overdue for a period of more than 90 days.

All assets do not perform uniformly. In some cases, assets perform very well and the recovery of principal and interest happen on time, while in other cases, there may be delays in recovery or no recovery at all because of one reason or the other. Similarly, an asset may exhibit good quality performance at one point of time and poor performance at some other point of time. According to the RBI guidelines, banks must classify their assets on an on-going basis into the following four categories:

Standard assets: Standard assets service their interest and principal instalments on time; although they occasionally default up to a period of 90 days. Standard assets are also called performing assets. They yield regular interest to the banks and return the due principal on time and thereby help the banks earn profit and recycle the repaid part of the loans for further lending. The other three categories (sub-standard assets, doubtful assets and loss assets) are NPAs and are discussed below.

Sub-standard assets: Sub-standard assets are those assets which have remained NPAs (that is, if any amount of interest or principal instalments remains overdue for more than 90 days) for a period up to 12 months.

Doubtful assets: An asset becomes doubtful if it remains a sub-standard asset for a period of 12 months and recovery of bank dues is of doubtful.

Loss assets: Loss assets comprise assets where a loss has been identified by the bank or the RBI. These are generally considered uncollectible. Their realizable value is so low that their continuance as bankable assets is not warranted.

4.4.2 Debt Restructuring

Once a borrower faces difficulty in repaying loans or paying interest, the bank should initially address the problem by trying to verify whether the financed company is viable in the long run. If the company/ project is viable, then rehabilitation is possible by restructuring the credit facilities. In a restructuring exercise, the bank can change the repayment or interest payment schedule to improve the chances of recovery or even make some sacrifices in terms of waiving interest etc.

RBI has separate guidelines for restructured loans. A fully secured standard/ sub-standard/ doubtful loan can be restructured by rescheduling of principal repayments and/or the interest element. The amount of sacrifice, if any, in the element of interest, is either written off or provision is made to the extent of the sacrifice involved. The sub-standard accounts/doubtful accounts which have been subjected to restructuring, whether in respect of principal instalment or interest amount are eligible to be upgraded to the standard category only after a specified period.

To create an institutional mechanism for the restructuring of corporate debt, RBI has devised a Corporate Debt Restructuring (CDR) system. The objective of this framework is to ensure a timely and transparent mechanism for the restructuring of corporate debts of viable entities facing problems.

4.4.3 Other recovery options

If rehabilitation of debt through restructuring is not possible, banks themselves make efforts to recover. For example, banks set up special asset recovery branches which concentrate on

recovery of bad debts. Private and foreign banks often have a collections unit structured along various product lines and geographical locations, to manage bad loans. Very often, banks engage external recovery agents to collect past due debt, who make phone calls to the customers or make visits to them. For making debt recovery, banks lay down their policy and procedure in conformity with RBI directives on recovery of debt.

The past due debt collection policy of banks generally emphasizes on the following at the time of recovery:

- Respect to customers
- Appropriate letter authorizing agents to collect
- Due notice to customers
- Confidentiality of customers' dues
- Use of simple language in communication and maintenance of records of communication

In difficult cases, banks have the option of taking recourse to filing cases in courts, Lok Adalats, Debt Recovery Tribunals (DRTs), One Time Settlement (OTS) schemes, etc. DRTs have been established under the Recovery of Debts due to Banks and Financial Institutions Act, 1993 for expeditious adjudication and recovery of debts that are owed to banks and financial institutions. Accounts with loan amount of Rs. 10 lakhs and above are eligible for being referred to DRTs. OTS schemes and Lok Adalats are especially useful to NPAs in smaller loans in different segments, such as small and marginal farmers, small loan borrowers and SME entrepreneurs.

If a bank is unable to recover the amounts due within a reasonable period, the bank may write off the loan. However, even in these cases, efforts should continue to make recoveries.

4.4.4 SARFAESI Act, 2002

Banks utilize the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) as an effective tool for NPA recovery. It is possible where non-performing assets are backed by securities charged to the Bank by way of hypothecation or mortgage or assignment. Upon loan default, banks can seize the securities (except agricultural land) without intervention of the court.[30]

[30] SARFAESI is effective only for secured loans where bank can enforce the underlying security eg hypothecation , pledge and mortgages. In such cases, court intervention is not necessary, unless the security is invalid or fraudulent. However, if the asset in question is an unsecured asset, the bank would have to move the court to file civil case against the defaulters.

The SARFAESI Act, 2002 gives powers of "seize and desist" to banks. Banks can give a notice in writing to the defaulting borrower requiring it to discharge its liabilities within 60 days. If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures:

- Take possession of the security for the loan
- Sale or lease or assign the right over the security
- Manage the same or appoint any person to manage the same

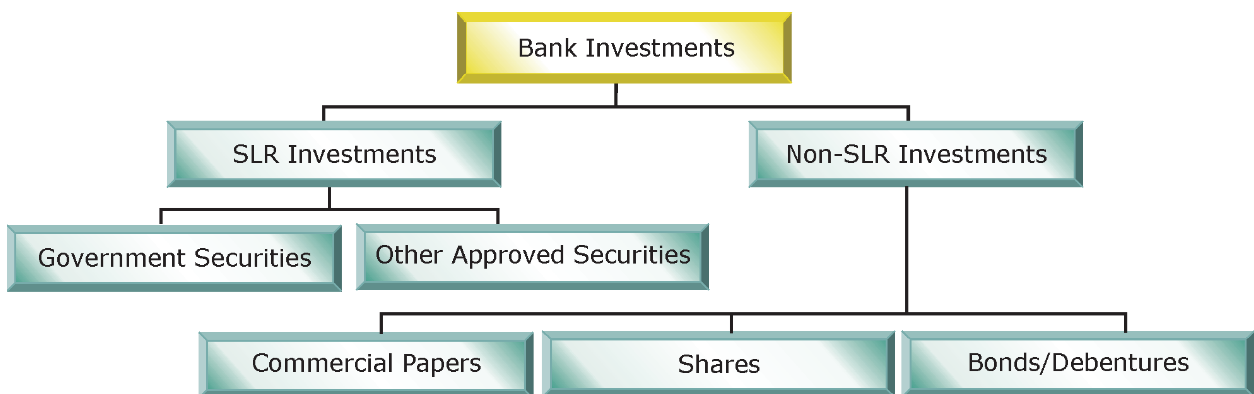
The SARFAESI Act also provides for the establishment of asset reconstruction companies regulated by RBI to acquire assets from banks and financial institutions.

The Act provides for sale of financial assets by banks and financial institutions to asset reconstruction companies (ARCs). RBI has issued guidelines to banks on the process to be followed for sales of financial assets to ARCs.

CHAPTER 5: Bank Investments

In addition to loans and advances, which were discussed in Chapter 4, banks deploy a part of their resources in the form of investment in securities/ financial instruments. The bulk of a bank's assets are held either in the form of (a) loans and advances and (b) investments. Investments form a significant portion of a bank's assets, next only to loans and advances, and are an important source of overall income. Commercial banks' investments are of three broad types: (a) Government securities, (b) other approved securities and (c) other securities. These three are also categorised into SLR (Statutory Liquidity Ratio) investment and non-SLR investments. SLR investments comprise Government and other approved securities, while non-SLR investments consist of 'other securities' which comprise commercial papers, shares, bonds and debentures issued by the corporate sector.

Figure 5.1 : Classification of Bank Investments



Under the SLR requirement, banks are required to invest a prescribed minimum of their net demand and time liabilities (NDTL) in Government- and other approved securities under the BR act, 1949. (Note that SLR is prescribed in terms of banks' liabilities and not assets). This provision amounts to 'directed investment', as the law directs banks to invest a certain minimum part of their NDTL in specific securities. While the SLR provision reduces a bank's flexibility to determine its asset mix, it helps the Government finance its fiscal deficit.[31]

[31] The Government finances its fiscal deficit (broadly, government expenditure minus government revenue) by borrowing, in other words, through the issue of Government securities. Because of the legal provision mandating

It is the RBI that lays down guidelines regarding investments in SLR and non-SLR securities. Bank investments are handled by banks through their respective Treasury Department. This chapter discusses banks' investment policy and operational details and guidelines relating to investments.

5.1 Investment Policy

Each bank is responsible for framing its own Internal Investment Policy Guidelines (or, simply, Investment policy). The Asset Liability Committee (ALCO) of a bank, comprising senior bank officials and headed in most cases by the CEO, plays a key role in drafting the investment policy of the bank. The investment policy and the changes made therein from time to time have to obtain the bank Board's approval for it. The aim of an Investment Policy of a bank is to create a broad framework within which investment decisions of the Bank could be taken. The actual decisions regarding investment are to be taken by the Investment Committee set up by the Board.

The Investment Policy outlines general instructions and safeguards necessary to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. The parameters on which the policy is based are return (target return as determined in individual cases), duration (target duration of the portfolio), liquidity consideration and risk. Thus, while the Policy remains within the framework of the RBI guidelines with respect to bank investment, it also takes into consideration certain bank-specific factors, viz., the bank's liquidity condition and its ability to take credit risk, interest rate risk and market risk. The policy is determined for SLR and non-SLR securities, separately.

The Investment Policy provides guidelines with respect to investment instruments, maturity mix of investment portfolio, exposure ceilings, minimum rating of bonds/ debentures, trading policy, accounting standards, valuation of securities and income recognition norms, audit review and reporting and provisions for Non-Performing Investments (NPI). It also outlines functions of front office/ back office/ mid office, delegation of financial powers as a part of expeditious decision-making process in treasury operations, handling of asset liability management (ALM) issues, etc.

Several banks follow the practice of a strategy paper. Based on the market environment envisaged by Asset Liability Committee (ALCO) in the Asset Liability Management (ALM) Policy, a Strategy Paper on investments and expected yield is usually prepared which is placed before the CEO of the Bank. A review of the Strategy Paper may be done at, say half yearly basis and put up to the CEO.

---

banks to invest a minimum fraction of their NDTL in government securities, banks are captive financiers of the Government's fiscal deficit. Of course, banks are not the only subscribers of government securities.

5.2 Statutory Reserve Requirements

5.2.1 Maintenance of Statutory Liquidity Ratio (SLR)

Banks' investments in Central and State Government dated securities including treasury bills are governed by the RBI guidelines regarding maintenance of minimum level of SLR securities as well as their own approved policy.

As stated earlier, under the Banking Regulation Act, 1949, the RBI prescribes the minimum SLR level for Scheduled Commercial Banks (SCBs) in India in specified assets as a percentage of the bank's NDTL. The actual percentage (that is, the value of such assets of an SCB as a percentage of its NDTL) must not be less than such stipulated percentage. The RBI may change the stipulated percentage from time to time.

Over the years, this ratio (SLR ratio) has changed a lot, but has broadly moved on a downward trajectory, from the of 38.5% of NDTL in the early 90's (September 1990) to 25% by October 1997, with the financial sector reforms giving banks greater flexibility to determine their respective asset mix. The SLR was further reduced to 24 percent of NDTL in November 2008, but has been raised back to 25 percent level since October 2009. Currently, it is at 25 percent level.

Banks can and do invest more than the legally prescribed minimum in SLR, as can be seen from Table 5.1.

Table 5.1: SLR Investment of SCBs: Actual vs. Statutory Requirement

End-March	Actual SLR Investment as % of NDTL	Statutory SLR requirement as % of NDTL
2006	31.3	25
2007	27.9	25
2008	27.8	25
2009	28.1	24

Source: Report on Trend and Progress of Banking in India, RBI, 2008-09

The RBI has prescribed that all SCBs should maintain their SLR in the following instruments which will be referred to as "statutory liquidity ratio (SLR) securities":

i. Dated securities as notified by RBI;

ii. Treasury Bills of the Government of India;

iii. Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilisation Scheme;

iv. State Development Loans (SDLs) of the State Governments issued from time to time under their market borrowing programme; and

v. Any other instrument as may be notified by RBI.

These investments must be unencumbered.

The composition of investment by commercial banks is given in the following Table. It can be seen that SLR investments, particularly government securities, form the bulk of total securities. Non-SLR investments form a relatively small part of banks' total investment.

Table 5.2: Investments by Commercial Banks

(Rupees crore)

End-March	SLR Investments			Non-SLR Investments	Total Investments
	Government Securities	Other Approved Securities	Total SLR		
2006	700,742	16,712	717,454	135,340	852,794
	(82)	(2)	(84)	(16)	(100)
2007	776,058	15,458	791,516	140,455	931,971
	(83)	(2)	(85)	(15)	(100)
2008	958,661	13,053	971,714	170,609	1,142,323
	(84)	(1)	(85)	(15)	(100)
2009	1,155,786	10,624	1,166,410	207,517	1,373,927
	(84)	(1)	(85)	(15)	(100)

Source: Handbook of Statistics on Indian Economy, RBI 2008-09.

Note: The figures in bracket show the investments as a percent to the total investment.

5.2.2 Penalties

If a banking company fails to maintain the required amount of SLR securities on any given day, it shall be liable to pay to the RBI penal interest for that day at the rate of 3 per cent per annum above the Bank Rate on the shortfall and, if the default continues on the next succeeding working day, the penal interest may be increased to a rate of 5 per cent per annum above the Bank Rate for the concerned days of default on the shortfall.[32]

32 The Bank Rate is determined by the RBI from time to time. It is the rate at which the RBI lends to the banks, and should not be confused with the repo rate, which is the lending rate the RBI uses in the daily repo (repurchase) markets.

5.3 Non-SLR Investments

If there is any proposal to invest or disinvest in non-SLR securities, the concerned officials must refer these proposals to the Investment Committee of the bank. Upon vetting and clearance by the Investment Committee, financial sanction should be obtained from the appropriate authority in terms of the Scheme of Delegation of Financial Powers.

Non-SLR Investments can include:

- Investments in Associates/ Subsidiaries and Regional Rural Banks
- Strategic Investments
- Venture Capital Investments
- PSU Bonds
- Corporate Investments
- Mutual Funds
- Bonds/debentures issued by Securitisation Companies (SCs) and Reconstruction Companies (RCs)

However, as per RBI guidelines, the investments (SLR as well as Non-SLR) will be disclosed in the balance sheet of the Bank as per the six-category classification listed below:

a. Government securities,

b. Other approved securities,

c. Shares,

d. Debentures & Bonds,

e. Investment in subsidiaries/ joint ventures in the form of shares, debentures, bonds etc, and

f. Others (Commercial Paper, Mutual Fund Units, etc.).

5.3.1 Bank Guidelines for investments in other than Government Securities

According to the RBI, banks desirous of investing in equity shares/ debentures should observe the following guidelines:

i. Build up adequate expertise in equity research by establishing a dedicated equity research department, as warranted by their scale of operations;

ii. Formulate a transparent policy and procedure for investment in shares, etc., with the approval of the Board; and

iii. The decision in regard to direct investment in shares, convertible bonds and debentures should be taken by the Investment Committee set up by the bank's Board. The Investment Committee should also be held accountable for the investments made by the bank.

Further, with the approval of respective Boards, banks should clearly lay down the broad investment objectives to be followed while undertaking transactions in securities on their own investment account and on behalf of clients, clearly define the authority to put through deals, procedure to be followed for obtaining the sanction of the appropriate authority, procedure to be followed while putting through deals, various prudential exposure limits and the reporting system. Accordingly, the Boards of banks lay down policy and prudential limits on investments in various categories, as stated earlier.

Investment proposals should be subjected to the same degree of credit risk analysis as any loan proposal. Banks should have their own internal credit analysis and ratings even in respect of issues rated by external agencies and should not entirely rely on the ratings of external agencies. The appraisal should be more stringent in respect of investments in instruments issued by non-borrower customers.

As a matter of prudence, banks should stipulate entry-level minimum ratings/ quality standards and industry-wise, maturity-wise, duration-wise and issuer-wise limits to mitigate the adverse impacts of concentration of investment and the risk of illiquidity.

5.3.2 Statutory Prescriptions

Statutory prescriptions relating to the investment portfolio are to be complied with. The investments have to be within the specific and general prudential limits fixed by RBI and in conformity with the provisions of the BR Act and other applicable laws and guidelines that are issued by the regulators like RBI, Securities Exchange Board of India (SEBI), etc.

For example, banks should not invest in non-SLR securities of original maturity of less than one-year, other than Commercial Paper and Certificates of Deposits, which are covered under RBI guidelines.

Further, according to RBI guidelines, a bank's investment in unlisted non-SLR securities should not exceed 10 per cent of its total investment in non-SLR securities as on March 31, of the previous year, and such investment should comply with the disclosure requirements as prescribed by Securities Exchange Board of India (SEBI) for listed companies. Bank's investment in unlisted non-SLR securities may exceed the limit of 10 per cent, by an additional 10 per cent, provided the investment is on account of investment in securitised papers issued for infrastructure projects, and bonds/ debentures issued by Securitisation Companies (SCs) and Reconstruction Companies (RCs) set up under the SARFAESI Act and registered with RBI.

A bank may also decide to put in place additional quantitative ceilings on aggregate non-SLR investments as a percentage of the bank's net worth (equity plus reserves). There are also restrictions regarding exposure to a particular industry.

Rating requirements

Banks must not invest in unrated non-SLR securities. However, the banks may invest in unrated bonds of companies engaged in infrastructure activities, within the ceiling of 10 per cent for unlisted non-SLR securities as mentioned earlier. Furthermore, the debt securities shall carry a credit rating of not less than investment grade from a credit rating agency registered with the SEBI.

Limits on Banks' Exposure to Capital Markets

The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40% of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and all exposures to venture capital funds (both registered and unregistered) should not exceed 20 per cent of its net worth.

The above-mentioned ceilings are the maximum permissible and a bank's Board of Directors is free to adopt a lower ceiling for the Bank, keeping in view its overall risk profile and corporate strategy. Banks are required to adhere to the ceilings on an ongoing basis.

Restrictions on Investments in a Single Company

No bank can hold shares, as a pledgee, mortgagee or absolute owner in any company other than a subsidiary, exceeding 30 per cent of the paid up share capital of that company or 30 per cent of its own paid-up share capital and reserves, whichever is less.

5.4 Banks' Investment Classification and Valuation Norms

The key features of RBI guidelines on categorization and valuation of banks' investment portfolio are given below.

The investment portfolio of a bank normally consists of both "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The Bank should classify their entire investment portfolio under three categories viz. 'Held to Maturity' (HTM)[33], 'Held for Trading' (HFT), and 'Available for Sale' (AFS).

HTM includes securities acquired with the intention of being held up to maturity; HFT includes securities acquired with the intention of being traded to take advantage of the short-term

[33] HTM must not be more than 25% of the portfolio.

price/ interest rate movements; and AFS refers to those securities not included in HTM and HFT. Banks should decide the category of investment at the time of acquisition.

Profit or loss on the sale of investments in both HFT and AFS categories is taken in the income statement. Shifting of investments from / to HTM may be done with the approval of the Board of Directors once a year, normally at the beginning of the accounting year. Similarly, shifting of investments from AFS to HFT may be done with the approval of the Board of Directors, the ALCO or the Investment Committee. Shifting from HFT to AFS is generally not permitted. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

HTM securities are not marked to market and are carried at acquisition cost or at an amortised cost if acquired at a premium over the face value. (In the case of HTM securities, if the acquisition cost is more than the face value, premium should be amortised or written off over the period remaining to maturity.) AFS and HFT securities are valued at market or fair value as at the balance sheet date.

Valuation of investments is to be done as per guidelines issued by RBI from time to time. However, banks may adopt a more conservative approach as a measure of prudence.

The 'market value' for the purpose of periodic valuation of investments included in the AFS and HFT would be the market price of the scrip as available from the trades/ quotes on the stock exchanges, price list of RBI and prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically. In respect of unquoted securities, RBI has laid down the detailed procedure to be adopted. For example, banks should value the unquoted Central Government securities on the basis of the prices/ yield to maturity (YTM) rates put out by the PDAI/ FIMMDA at periodic intervals.

5.4.1 Treasury Management

Investment transactions are undertaken as per the approved investment policy of the bank and in accordance with the trading policy and Manual of Instructions. With a view to synergising strengths, a bank usually operates an integrated treasury department under which both domestic and forex treasuries are brought under a unified command structure. The following distinction is important to note. The task of domestic treasury operations is predominantly to make investments on their own account, while the task of forex treasury is to predominantly conduct operations on behalf of clients. The discussions so far on SLR and non-SLR operations fall under domestic treasury management.

5.4.2 Forex Treasury Management

The Forex department of a bank does the following:

- administers and monitors merchant or client transactions emanating from branches,
- undertakes cover operation for merchant transactions, trades in inter-bank forex market,
- manages foreign currency funds like Foreign Currency Non Resident (FCNR) Accounts, Exchange Earners Foreign Currency (EEFC) Accounts, etc. and maintains Nostro Accounts [34].

While bulk of the forex treasury operations are on behalf of the clients, the banks also handle proprietary trading, i.e., forex trading on the banks' own account.

One important safeguard that banks are required to take is to make a clear separation between their transactions on their own account and those on behalf of their clients.

[34] FCNR accounts are maintained by NRIs, while EEFC accounts are maintained by exporters; a Nostro account is an account a bank holds with another bank in a foreign country, usually in the currency of that foreign country

CHAPTER 6: Other Activities of Commercial Banks

As a continuation of their main deposit taking and lending activities, banks pursue certain activities to offer a number of services to customers. They can be put into two broad categories: (a) Other basic banking activities and (b) Para-banking activities. The former includes provision of remittance facilities including issuance of drafts, mail transfers and telegraphic transfers, issuance of travellers' cheques & gift cheques, locker facility etc. Banks also undertake various para-banking activities including investment banking services, selling mutual funds, selling insurance products, offering depository services, wealth management services, brokerage, etc. While the services offered assist the banks to attract more depositors and borrowers, they also manage to increase their income in the process. Banks earn fees by offering these services to the customers, as opposed to interest income earned from the lending activities.

6.1 Other Basic Banking Activities

6.1.1 Foreign Exchange Services

Banks undertake foreign exchange transactions for their customers. The foreign exchange contracts arise out of spot (current) and forward foreign exchange transactions entered into with corporate and non-corporate customers and counter-party banks for the purpose of hedging and trading. Banks derive income from the spread or difference between buying and selling rates of foreign exchange.

Leading banks provide customer specific products and services which cater to risk hedging needs of corporates at domestic and international locations, arising out of currency and interest rate fluctuations. These include products such as options and swaps, which are derived from the foreign exchange market or the interest rate market. These are tailor made products designed to meet specific risk hedging requirements of the customer.

In addition to the direct foreign exchange related income on buying and selling of foreign exchange, income is generated in related services while undertaking the main foreign exchange business. These services include the establishment of letters of credit, issuance of guarantees, document collection services, etc.

Some banks, including leading public sector banks, private sector banks and local branches of foreign banks earn significant income from foreign exchange related transactions.

6.1.2 Banks' services to Government

Banks offer various types of services to government departments including direct and indirect tax collections, remittance facilities, payments of salaries and pensions, etc. Banks also

undertake other related businesses like distribution of Government and RBI bonds and handling public provident fund accounts. Government departments pay fees to banks for undertaking this business. Banks such as State of Bank of India, with a wide network of branches, are able to earn significant income by offering these services to government departments.

6.1.3 Payment and Settlement Systems

As stated in Chapter 1, in any economy, banks are at the core of the payment and settlement systems, which constitute a very important part of the commercial banks' functions. The payment and settlement systems, as a mechanism, facilitate transfer of value between a payer and a beneficiary by which the payer discharges the payment obligations to the beneficiary. The payment and settlement systems enable two-way flow of payments in exchange of goods and services in the economy. This mechanism is used by individuals, banks, companies, governments, etc. to make payments to one another.

The RBI has the power to regulate the payment system under the provisions of the Payment and Settlement Systems (PSS) Act 2007, and the Payment and Settlement Systems Regulations 2008.[35] The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) is a sub-committee of the Central Board of RBI and is the highest policy making body on the payment system. The Board is assisted by a technical committee called National Payments Council (NPC) with eminent experts in the field as members.

There are two types of payments: paper based and electronic. Payments can be made in India in paper based forms (in the forms of cash, cheque, demand drafts), and electronic forms (giving electronic instructions to the banker who will make such a payment on behalf of his customers; credit card; debit card).

Paper based clearing systems

The primary paper based payment instrument is the cheque. The process of cheque payment starts when a payer gives his personal cheque to the beneficiary. To get the actual payment of funds, the receiver of the cheque has to deposit the cheque in his bank account. If the beneficiary has an account in the same bank in the same city then the funds are credited into his account through internal arrangement of the bank. If the beneficiary has an account with any other bank in the same or in any other city, then his banker would ensure that funds are collected from the payer's banker through the means of a 'clearing house'.

---

35 Aside from the regulatory role, the RBI, as the central bank of the country, has been playing a developmental role in this important area and has taken several initiatives for a secure and efficient payment system.

A clearing house is an association of banks that facilitates payments through cheques between different bank branches within a city/ place. It acts as a central meeting place for bankers to exchange the cheques drawn on one another and to claim funds for the same. Such operations are called 'clearing operations'. Generally one bank is appointed as in-charge of the clearing operations. In the four metros and a few other major cities, however, RBI is looking after the operations of the clearing house.

The paper based clearing systems comprise: (a) MICR Clearing, (b) Non- MICR clearing and (c) High Value clearing. MICR stands for Magnetic Ink Character Recognition (MICR). MICR is a technology for processing cheques. This is done through information contained in the bottom strip of the cheque where the cheque number, city code, bank code and branch code are given.

Generally, if a cheque is to be paid within the same city (local cheque), it takes 2-3 days for the money to come to the beneficiary's account. In case of High Value Clearing, however, which is available only in some large cities, cheque clearing cycle is completed on the same day and the customer depositing the cheque is permitted to utilise the proceeds the next day morning.[36]

The introduction of 'Speed Clearing' in June 2008 for collection of outstation cheques has significantly brought down the time taken for realisation of outstation cheques from 10-14 days; now the funds are available to customers on T+1 (transaction day + 1 day) or T+2 (transaction day + 2 days) basis.

Cheque Truncation

Cheque Truncation is a system of cheque clearing and settlement between banks based on electronic data/ images or both without physical exchange of instrument. Cheque truncation has several advantages. First, the bank customers would get their cheques realised faster, as T+0 (local clearing) and T+1 (inter-city clearing) is possible in Cheque Truncation System (CTS). Second, faster realisation is accompanied by a reduction in costs for the customers and the banks. Third, it is also possible for banks to offer innovative products and services based on CTS. Finally, the banks have the additional advantage of reduced reconciliation and clearing frauds.

[36] To encourage customers to move from paper-based systems to electronic systems, which are more secure, faster and less costly, the banks were advised in April 2009 to increase the threshold amount of cheque eligible to be presented in High Value Clearing from Rs.1 lakh to Rs.10 lakhs and gradually discontinue the scheme in an undisruptive manner over a period of the next one year. However, the facility of MICR/ Non-MICR clearing will continue to be available for paper-based instruments.

Electronic Payment Systems

Payments can be made between two or more parties by means of electronic instructions without the use of cheques. Generally, the electronic payment systems are faster and safer than paper based systems. Different forms of electronic payment systems are listed below.[37]

Real Time Gross Settlement (RTGS) system, introduced in India in March 2004, is a system through which electronic instructions can be given by banks to transfer funds from their account to the account of another bank. The RTGS system is maintained and operated by RBI and provides a means of efficient and faster funds transfer among banks facilitating their financial operations. As the name suggests, funds transfer between banks takes place on a 'real time' basis. Therefore, money can reach the beneficiary instantaneously. The system which was operationalised with respect to settlement of transactions relating to inter-bank payments was extended to customer transactions later. Though the system is primarily designed for large value payments, bank customers have the choice of availing of the RTGS facility for their time-critical low value payments as well. More than 60,000 branches as at end-September 2009 are participants in the RTGS.

Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person/ company etc. can approach his bank and make cash payment or give instructions/ authorisation to transfer funds directly from his own account to the bank account of the receiver/ beneficiary. RBI is the service provider for EFT. The electronic payment systems comprise large value payment systems as well as retail payment mechanisms.

In addition, there are some electronic payment systems which are exclusively for retail payments. The retail payment system comprises Electronic Clearing Services (ECS), National Electronic Funds Transfer (NEFT) and card based payment systems including ATM network.

Electronic Clearing Service (ECS) is a retail payment system that can be used to make bulk payments/ receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make/ receive large volumes of payments rather than for funds transfers by individuals. The ECS facility is available at a large number of centres. The ECS is further divided into two types - ECS (Credit) to make bulk payments to individuals/ vendors and ECS (Debit) to receive bulk utility payments from individuals.

[37] In addition to these systems, some banks in India have begun to offer certain banking services through the Internet that facilitate transfer of funds electronically.

Under ECS (Credit), one entity/ company would make payments from its bank account to a number of recipients by direct credit to their bank accounts. For instance, companies make use of ECS (Credit) to make periodic dividend/ interest payments to their investors. Similarly, employers like banks, government departments, etc make monthly salary payments to their employees through ECS (Credit). Payments of repetitive nature to be made to vendors can also be made through this mode.

The payments are affected through a sponsor bank of the Company making the payment and such bank has to ensure that there are enough funds in its accounts on the settlement day to offset the total amount for which the payment is being made for that particular settlement. The sponsor bank is generally the bank with whom the company maintains its account.

ECS (Debit) is mostly used by utility companies like telephone companies, electricity companies etc. to receive the bill payments directly from the bank accounts of their customers. Instead of making electricity bill payment through cash or by means of cheque, a consumer (individuals as well as companies) can opt to make bill payments directly into the account of the electricity provider/ company/ board from his own bank account. For this purpose, the consumer has to give an application to the utility company (provided the company has opted for the ECS (Debit) scheme), providing details of the bank account from which the monthly/ bi-monthly bill amount can be directly deducted. Thereafter, the utility company would advise the consumer's bank to debit the bill amount to his account on the due date of the bill and transfer the amount to the company's own account. This is done by crediting the account of the sponsor bank, which again is generally the bank with whom the company receiving the payments, maintains the account. The actual bill would be sent to the consumer as usual at his address.

The settlement cycle under the ECS has been reduced to T+1 day from earlier T+3 days across the country. To widen the geographical coverage of ECS beyond the existing ECS centres and to have a centralised processing capability, the National Electronic Clearing Service (NECS) was operationalised with effect from September 29, 2008. The NECS is a nationwide system in which as many as 114 banks with 30,780 branches participated as at the end of September, 2009.

National Electronic Funds Transfer (NEFT) system, introduced in November 2005, is a nationwide funds transfer system to facilitate transfer of funds from any bank branch to any other bank branch. The beneficiary gets the credit on the same day or the next day depending on the time of settlement. Ninety one banks with over 61,000 branches participated in NEFT as at end of September 2009.

The banks generally charge some processing fees for electronic fund transfers, just as in the case of other services such as demand drafts, pay orders etc. The actual charges depend upon the amount and the banker-customer relationship. In a bid to encourage customers to move

from paper-based systems to electronic systems, RBI has rationalised and made transparent the charges the banks could levy on customers for electronic transactions. RBI on its part has extended the waiver of its processing charges for electronic modes of payment up to the end of March 2011.

In order not to be involved with day-to-day operations of the retail payment system, RBI has encouraged the setting up of National Payment Corporation of India (NPCI) to act as an umbrella organisation for operating the various retail payment systems in India. NPCI has since become functional and is in the process of setting up its roadmap. NPCI will be an authorised entity under the Payment & Settlement Systems Act and would, therefore, be subjected to regulation and supervision of RBI.

Credit/ Debit cards are widely used in the country as they provide a convenient form of making payments for goods and services without the use of cheques or cash. Issuance of credit card is a service where the customer is provided with credit facility for purchase of goods and services in shops, restaurants, hotels, railway bookings, petrol pumps, utility bill payments, etc. The merchant establishment who accepts credit card payments claims the amount subsequently from the customer's bank through his own bank. The card user is required to pay only on receipt of the bill and this payment can be either in full or partially in instalments.

Banks issuing credit cards earn revenue from their customers in a variety of ways such as joining fee, additional card fee, annual fee, replacement card fee, cash advance fee, charge slip/ statement retrieval fee, charges on over limit accounts and late payment fee, interest on delayed payment, interest on revolving credit, etc. The fees may vary based on the type of card and from bank to bank. Banks earn income not only as issuers of credit cards, but also as acquirers where the transaction occurs on a point of sale terminal installed by the bank.[38] As the Indian economy develops, it is expected that the retail market will increasingly seek short-term credit for personal uses, and to a large extent, this rising demand would be met by the issuance of credit cards.

Debit Card is a direct account access card. Unlike a credit card, in the case of a debit card, the entire amount transacted gets debited from the customer's account as soon as the debit card is used for purchase of goods and services. The amount permitted to be transacted in debit card is to the extent of the amount standing to the credit of the card user's account.

[38] A Point of Sale (POS) terminal is the instrument in which the credit card is swiped. The bank that installs POS terminal is called the acquirer bank. A more detailed discussion on the POS terminal is given in Section 8.1.3.

Automated Teller Machines (ATMs) are mainly used for cash withdrawals by customers. In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry and several other banking transactions which the banks owning the ATMs might want to offer.

6.1.4 NRI Remittances

NRI, as an individual, can remit funds into India through normal banking channels using the facilities provided by the overseas bank. Alternately, an NRI can also remit funds through authorised Money Transfer Agents (MTA). Further, a number of banks have launched their inward remittance products which facilitate funds transfer on the same day/ next day.

6.1.5 Cash Management Services and Remittances

Many banks have branches rendering cash management services (CMS) to corporate clients, for managing their receivables and payments across the country. Under cash management services, banks offer their corporate clients custom-made collection, payment and remittance services allowing them to reduce the time period between collections and remittances, thereby streamlining their cash flows. Cash management products include physical cheque-based clearing, electronic clearing services, central pooling of country-wide collections, dividend and interest remittance services and Internet-based payment products. Such services provide customers with enhanced liquidity and better cash management.

6.2 Para-banking Activities

The Reserve Bank of India (RBI) has allowed the Scheduled Commercial Banks (SCBs) to undertake certain financial services or para-banking activities and has issued guidelines to SCBs for undertaking these businesses. The RBI has advised banks that they should adopt adequate safeguards so that para-banking activities undertaken by them are run on sound and prudent lines. Banks can undertake certain eligible financial services either departmentally or by setting up subsidiaries, with prior approval of RBI.

6.2.1 Primary Dealership Business

Primary Dealers can be referred to as Merchant Bankers to Government of India. In 1995, the Reserve Bank of India (RBI) introduced the system of Primary Dealers (PDs) in the Government Securities Market, which comprised independent entities undertaking Primary Dealer activity. In order to broad base the Primary Dealership system, banks were permitted to undertake Primary Dealership business in 2006-07. To do primary dealership business, it is necessary to have a license from the RBI.

The two primary objectives of the PD system are to:

- strengthen the infrastructure in the government securities market to make it vibrant, liquid and broad based.
- improve secondary market trading system, which would (a) contribute to price discovery, (b) enhance liquidity and turnover and (c) encourage voluntary holding of government securities.

A bank can do PD business either through a subsidiary or departmentally. A subsidiary of a scheduled commercial bank dedicated predominantly to the securities business (particularly, the government securities market) can apply for primary dealership. To do PD business departmentally, only banks which do not have a partly or wholly owned subsidiary undertaking PD business and fulfill the following criteria can apply:

- Minimum net owned funds (NOF) of Rs.1,000 crores
- Minimum CRAR of 9 per cent
- Net NPAs of less than 3 per cent and a profit making record for the last three years

6.2.2 Investment Banking/ Merchant Banking Services

Investment Banking is not one specific function or service but rather an umbrella term for a range of activities. These activities include issuing securities (underwriting) for companies, managing portfolios of financial assets, trading securities (stocks and bonds), helping investors purchase securities and providing financial advice and support services. It can be seen that all these services are capital market related services. These services are offered to governments, companies, non-profit institutions and individuals.

A number of commercial banks have formed subsidiaries to undertake investment banking services. Here, it is important to draw the distinction between Merchant Banking and Investment Banking.

As per the Securities and Exchange Board of India (SEBI) (Merchant Bankers) Rules, 1992 and SEBI (Merchant Bankers) Regulations, 1992, merchant banking service is any service provided in relation to issue management either by making arrangements regarding selling, buying or subscribing securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management. This, inter alia, consists of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of the subscription for debt/ equity issue management and acting as advisor, consultant, co-manager, underwriter and portfolio manager. In addition, merchant banking services also include advisory services on corporate restructuring, debt or equity restructuring, loan restructuring, etc. Fees are charged by the merchant banker for

rendering these services. Banks and Financial Institutions including Non Banking Finance Companies (NBFCs) providing merchant banking services are governed by the SEBI Rules and Regulations stated above.

On the other hand, the term 'Investment Banking' has a much wider connotation and has gradually come to refer to all types of capital market activity. Investment banking thus encompasses not merely merchant banking but other related capital market activities such as stock trading, market making, broking and asset management as well as a host of specialized corporate advisory services in the areas of mergers and acquisitions, project advisory and business and financial advisory.

Investment banking has a large number of players: Indian and foreign. The large foreign investment banks such as Goldman Sachs and Merrill Lynch (which are standalone investment banks) have entered India attracted by India's booming economy. However, the Indian investment banking firms (including investment banking arms of Indian commercial banks) have generally succeeded in holding their own as they are able to service both small and large customers. However, one area foreign banks still dominate is global mergers and acquisitions.

6.2.3 Mutual Fund Business

A number of banks, both in the private and public sectors have sponsored asset management companies to undertake mutual fund business. Banks have entered the mutual fund business, sometimes on their own (by setting up a subsidiary) and sometimes in joint venture with others. Other banks have entered into distribution agreements with mutual funds for the sale of the latter's mutual fund products, for which they receive fees. The advantage that banks enjoy in entering the mutual fund businesses is mainly on account of their wide distribution network.

Box 6.1: Bank Sponsored Mutual Funds

Indian banks which have sponsored mutual fund business so far include ICICI Bank, HDFC Bank and Kotak Mahindra Bank in the private sector, and State Bank of India in the public sector. As per AMFI (Association of Mutual Funds in India) data, total assets under management of all mutual funds in India amounted to Rs. 417, 300 crores as on March 31, 2009, of which bank sponsored mutual funds accounted for 15.5 percent.

Money Market Mutual Funds (MMMFs) come under the purview of SEBI regulations. Banks and Financial Institutions desirous of setting up MMMFs would, however, have to seek necessary clearance from RBI for undertaking this additional activity before approaching SEBI for registration.

6.2.4 Pension Funds Management (PFM) by banks

Consequent upon the issue of Government of India Notification dated May 24, 2007, banks

have been advised that they may now undertake Pension Funds Management (PFM) through their subsidiaries set up for the purpose. This would be subject to their satisfying the eligibility criteria prescribed by Pensions Fund Regulatory and Development Authority (PFRDA) for Pension Fund Managers. Banks intending to undertake PFM should obtain prior approval of RBI before engaging in such business.

The RBI has issued guidelines for banks acting as Pension Fund Managers. According to the guidelines, banks will be allowed to undertake PFM through their subsidiaries only, and not departmentally. Banks may lend their names/ abbreviations to their subsidiaries formed for PFM, for leveraging their brand names and associated benefits thereto, only subject to the banks maintaining 'arm's length' relationship with the subsidiary. In order to provide adequate safeguards against associated risks and ensure that only strong and credible banks enter into the business of PFM, the banks complying with the following eligibility criteria (as also the solvency margin prescribed by PFRDA) may approach the RBI for necessary permission:

- Net worth of the bank should be not less than Rs.500 crores.
- CRAR should be not less than 11% during the last three years.
- Bank should have made net profit for the last three consecutive years.
- Return on Assets (ROA) should be at least 0.6% or more.
- Level of net NPAs should be less than 3%.
- Performance of the bank's subsidiaries, if any, should be satisfactory.

Box 6.2: Pension Fund Business by Banks

Pension Fund Regulatory and Development Authority (PFRDA) had invited Expressions of Interest from public sector entities for sponsoring Pension Funds for Government employees on 11th May 2007. In response, Expressions of Interest were received from seven public sector entities. A committee constituted by the PFRDA has selected State Bank of India (SBI), UTI Asset Management Company (UTIAMC) and Life Insurance Corporation (LIC) to be the first sponsors of pension funds in the country under the new pension system (NPS) for government employees.

6.2.5 Depository Services

In the depository system, securities are held in depository accounts in dematerialized form. Transfer of securities is done through simple account transfers. The method does away with the risks and hassles normally associated with paperwork. The enactment of the Depositories Act, in August 1996, paved the way for the establishment of National Securities Depository Limited (NSDL) and later the Central Depository Services (India) Limited (CDSL). These two institutions have set up a national infrastructure of international standards that handles most of the securities held and settled in dematerialised form in the Indian capital markets.

As a depository participant of the National Securities Depository Limited (NSDL) or Central Depository Services (India) Limited (CDSL), a bank may offer depository services to clients and earn fees. Custodial depository services means safe keeping of securities of a client and providing services incidental thereto, and includes:

- maintaining accounts of securities of a client;
- collecting the benefit of rights accruing to the client in respect of the securities;
- keeping the client informed of the action taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client; and
- maintaining and reconciling records of the services referred to in sub-clause (a) to (c).

6.2.6 Wealth Management/ Portfolio Management Services[39]

A number of banks and financial institutions are seeking a share in the fast-growing wealth management services market. Currently, a high net worth individual can choose from among a number of private sector and public sector banks for wealth management services.[40] In addition to high net worth resident Indians, non-resident Indians (NRIs) form a major chunk of the customer base for personal wealth management industry in India.

Banks that do portfolio management on behalf of their clients are subject to several regulations. No bank should introduce any new portfolio management scheme (PMS) without obtaining specific prior approval of RBI. They are also to comply with the guidelines contained in the SEBI (Portfolio Managers) Rules and Regulations, 1993 and those issued from time to time.

The following conditions are to be strictly observed by the banks operating PMS or similar scheme:

- PMS should be entirely at the customer's risk, without guaranteeing, either directly or indirectly, a pre-determined return.
- Funds should not be accepted for portfolio management for a period less than one year.

---

[39] Portfolio management deals with only financial assets whereas wealth management covers both financial assets and non financial assets such as real estates.

[40] HSBC Private Bank in Asia, for example, provides the full spectrum of private banking solutions for affluent individuals and their families. Their services include investment services, family wealth advisory services, private wealth solutions such as wealth planning and protection, and traditional banking services. (Source: HSBC website)

- Portfolio funds should not be deployed for lending in call/ notice money; inter-bank term deposits and bills rediscounting markets and lending to/ placement with corporate bodies.
- Banks should maintain clientwise account/ record of funds accepted for management and investments made and the portfolio clients should be entitled to get a statement of account.
- Banks' own investments and investments belonging to PMS clients should be kept distinct from each other, and any transactions between the bank's investment account and client's portfolio account should be strictly at market rates.
- PMS clients' accounts should be subjected by banks to a separate audit by external auditors.

6.2.7 Bancassurance

With the issuance of Government of India Notification dated August 3, 2000, specifying 'Insurance' as a permissible form of business that could be undertaken by banks under Section 6(1) (o) of the BR Act, banks were advised to undertake insurance business with a prior approval of the RBI. However, insurance business will not be permitted to be undertaken departmentally by the banks.

A number of banks (both in public and private sectors) have entered into joint venture partnerships with foreign insurance companies for both life and non-life insurance business. At present, Indian partners (either alone or jointly) hold at least 74% of Indian insurance joint ventures. This is because the maximum holding by foreign companies put together cannot exceed 26% of the equity of Indian insurance ventures. Laws and regulations governing insurance companies currently provide that each promoter should eventually reduce its stake to 26% following the completion of 10 years from the commencement of business by the concerned insurance company.

The advantage that banks have in entering the insurance business is mainly on account of their wide distribution network. Banks are able to leverage their corporate and retail customer base for cross selling insurance products. Banks collect fees from these subsidiaries for generating leads and providing referrals that are converted into policies.

Box 6.3: Insurance Joint Ventures Promoted by Banks

Some of the insurance joint ventures promoted by banks have become leaders in the insurance business. ICICI Bank and HDFC Bank have promoted joint ventures in both life and non-life business, while State Bank of India (SBI) has promoted a successful joint venture in life business.

In addition, some banks distribute Third Party Insurance Products. With a view to provide "one stop banking" to their customers, banks distribute life insurance products and general insurance products through their branches. Banks have entered into agency agreements with life and non-life companies to distribute their various insurance products, for which they are paid a commission. The personnel involved in selling these insurance products have to be authorised by the IRDA regulations to act as specified persons for selling insurance products.

Box 6.4: Life Insurance Policies Sold by Banks

According to IRDA Annual Report, 2007-08, out of the total new life insurance business premium acquired by all the life insurance companies during 2007-08, new business sold through banks accounted for 7.28% of total new life insurance premium, with Life Insurance Corporation of India being able to distribute only 1.15% of its total new business premium through banks, while the other new life insurance ventures were able to sell 18.20% of their new business premium through banks.

Source: IRDA Annual Report, 2007-08

CHAPTER 7: Relationship between Bank and Customer

In India, banks face a challenge of providing services to a broad range of customers, varying from highly rated corporates and high net worth individuals to low-end depositors and borrowers. Banks usually place their customers into certain categories so that they are able to (a) develop suitable products according to customer requirements and (b) service customers efficiently. The bank-customer relationship is influenced by several dimensions, notably:

- While banks are competing with each other to attract the most profitable businesses, financial inclusion is increasingly becoming part of their agenda. An important issue in India is that a large number of people, nearly half of the adult population, still do not have bank accounts. 'Financial Inclusion' would imply bringing this large segment of the population into the banking fold.
- Second, banks have started using innovative methods in approaching the customers; technology is an important component of such efforts.
- Finally, on account of security threats as well as black money circulating in the system, care has to be taken to identify the customers properly, know the sources of their funds and prevent money laundering.

7.1 Strategy for expanding customer base

Driven by competition, banks are increasingly making their services customer-friendly. There are three key components of strategies to expand and retain the customer base:

- Product life cycle strategy
- Appropriate targeting
- Expanding product portfolio

7.1.1 Product Life Cycle Strategy

Product life cycle strategy means addressing the concerns of the customers throughout the life cycle of the banking products. The product life-cycle strategy of a banking product (such as bank loans) comprises:

- Identifying target markets;
- Developing and designing suitable products;
- Marketing the products;
- Sales and advice processes;
- After-sales service; and
- Complaint handling.

7.1.2 Appropriate targeting[41]

Banks focus on customer profiles and offer differentiated deposit and credit products to various categories of customers depending on their income category, age group and background. For example, banks may segment various categories of customers to offer targeted products, such as Private Banking for high net worth individuals, Defence Banking Services for defence personnel, and Special Savings Accounts for trusts.

Banks use multiple channels to target specific segments of population. Banks deliver their products and services through a variety of channels, ranging from traditional bank branches, extension counters and satellite offices, to ATMs, call centres and the Internet. Some private banks also appoint direct marketing agents or associates, who deliver retail credit products. These agents help banks achieve deeper penetration by offering doorstep service to the customer.

7.1.3 Expanding product portfolio

To ensure that their customers get 'one-stop solution', a key component of banks' customer strategy is to offer an expanded set of products and services. Through their distribution network, banks may offer Government of India savings bonds, insurance policies, a variety of mutual fund products, and distribute public offerings of equity shares by Indian companies. As a depository participant of the National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL), a bank may offer depository share accounts to settle securities transactions in a dematerialized mode and so on.

7.2 Services to different Customer Groups

Developing and properly categorising a customer data base forms part of the core strategy of a bank. A typical bank with a widespread network of branches aims at serving the following broad customer groups.

- retail customers;
- corporate customers;
- international customers;
- rural customers.

A bank formulates its overall customer strategy to increase profitable business keeping in mind its strengths and weaknesses. The key strategy components and trends in each of these customer groups are briefly discussed below.

---

[41] This aspect is described in detail under 7.2

7.2.1 Retail Customers

With growing household incomes, the Indian retail financial services market has high growth potential. The key dimensions of the retail strategy of a bank include customer focus, a wide range of products, customer convenience, widespread distribution, strong processes and prudent risk management.

The fee income that banks earn while extending commercial banking services to retail customers includes retail loan processing fees, credit card and debit card fees, transaction banking fees and fees from distribution of third party products. Cross selling of the entire range of credit and investment products and banking services to customers is often a key aspect of the retail strategy.

Retail Lending Activities

There is widespread acceptance by the average consumer of using credit to finance purchases. Given this background, retail credit has emerged as a rapidly growing opportunity for banks. Banks also focus on growth in retail deposit base which would include low cost current account and savings bank deposits. Retail deposits are usually more stable than corporate bulk deposits or wholesale deposits.

Banks offer a range of retail products, including home loans, automobile loans, commercial vehicle loans, two wheeler loans, personal loans, credit cards, loans against time deposits and loans against shares. Banks also fund dealers who sell automobiles, two wheelers, consumer durables and commercial vehicles. A few banks have set up home finance subsidiaries in order to concentrate on this business in a more focused manner.

Personal loans are unsecured loans provided to customers who use these funds for various purposes such as higher education, medical expenses, social events and holidays. Personal loans include micro-banking loans, which are relatively small value loans to lower income customers in urban and rural areas.

Credit cards have become an important component of lending to the retail segment in the case of a number of banks. As the Indian economy develops, it is expected that the retail market will seek short-term credit for personal uses, and the use of credit cards will facilitate further extension of banks' retail credit business.

Box 7.1: Share of retail loans in total loans

The share of retail loans in total loans and advances of Scheduled Commercial Banks (SCBs) was 21.3% at end-March 2009. The maximum share was accounted for by housing loans followed by 'other personal loans', auto loans, credit card receivables, loans for commercial durables, in that order.

Source: Report on Trends and Progress of Banking in India, 2008-09, RBI.

Lending to small and medium enterprises

Most of the private and foreign banks have integrated the strategy with regard to small and medium enterprises with their strategy for retail products and services. Hence, the retail focus includes meeting the working capital requirements, servicing deposit accounts and providing other banking products and services required by small and medium enterprises. Of late, public sector banks are also very active in lending to this business segment. Banks often adopt a cluster or community based approach to financing of small enterprises, that is, identifying small enterprises that have a homogeneous profile such as apparel manufacturers or jewellery exporters.

7.2.2 Corporate Customers

Corporate business covers project finance including infrastructure finance, cross border finance, working capital loans, non-fund based working capital products and other fee-based services. Banks often have to make special efforts to get the business of highly rated corporations.

The recent emphasis on infrastructure in India, including projects being built on private-public partnership basis, is leading to profitable business opportunities in this area. Further, Indian companies are also going global, and making large acquisitions abroad. This trend is likely to pick up momentum in future and banks which gear themselves up to meet such requirements from their customers will gain.

There is also a growing demand for foreign exchange services from the corporate customers. Banks offer fee-based products and services including foreign exchange products, documentary credits (such as letter of credit or LC) and guarantees to business enterprises. Corporate customers are also increasingly demanding products and services such as forward contracts and interest rate and currency swaps.

7.2.3 International Presence

Indian banks while expanding business abroad have usually been leveraging home country links. The emphasis has been on supporting Indian companies in raising corporate and project finance overseas for their investments in India and abroad (including financing of overseas acquisitions by Indian companies), and extending trade finance and personal financial services (including remittance and deposit products) for non-resident Indians.

7.2.4 Rural Banking Customers

Over 70% of India's citizens live in rural areas. Hence, there is a need for banks to formulate strategies for rural banking, which have to include products targeted at various customer segments operating in rural areas. These customer segments include corporates, small and medium enterprises and finally the individual farmers and traders. Primary credit products for the rural retail segment include farmer financing, micro-finance loans, working capital financing for agro-enterprises, farm equipment financing, and commodity based financing. Other financial services such as savings, investment and insurance products customised for the rural segment are also offered by banks.

7.3 Competition amongst Banks for Customers

Banks seek to gain advantage over their competitors by offering innovative products and services, use of technology, building customer relationships and developing a team of highly motivated and skilled employees. The relative strengths and weaknesses of different classes of banks-such as public sector banks, new private sector banks, old private sector banks and foreign banks-are described below.

7.3.1 Competition for Retail Products and Services

In the retail markets, competition is intense among all categories of banks. However, even though foreign banks have product and delivery capabilities, they are constrained by limited branch network. Over the last decade, because of their stronger technology and marketing capabilities, the new private sector banks have been gaining market share at the expense of public sector banks. They are slowly moving towards the Tier II cities to tap potential business.

7.3.2 Competition for Corporate Products and Services

In the case of corporate business, public sector banks and the new private sector banks have developed strong capabilities in delivering working capital products and services. Public sector banks have built extensive branch networks that have enabled them to raise low cost deposits and, as a result, price their loans and fee-based services very competitively. Their wide geographical reach facilitates the delivery of banking products to their corporate customers located all over the country.

Traditionally, foreign banks in India have been active in providing trade finance, fee-based services and other short-term financing products to highly rated Indian corporations. A few Indian public sector and private sector banks effectively compete with foreign banks in these areas. The larger Indian commercial banks also compete with foreign banks in foreign currency lending and syndication business. However, foreign banks are at an advantage due to their larger balance sheets and global presence.

In project finance, a few large Indian commercial banks have entered the infrastructure finance space. ICICI Bank and IDBI Bank have an advantage in this area as they were already in this business in their previous avatar. However, given their strong deposit base, the larger commercial banks have decided to expand their presence in this market. In project finance, foreign banks have an advantage where foreign currency loans are involved.

7.3.3 Competition for International Banking

Indian commercial banks have limited access to foreign currency resources, and hence, face difficulty in participating in global takeovers and acquisitions being undertaken by Indian companies, although some leading Indian banks are participating in financing such cases in a limited manner.

In delivering sophisticated foreign exchange products like derivatives, a few Indian banks in the private sector are competing with their foreign counterparts.

For products and services targeted at non-resident Indians and Indian businesses, there is intense competition among a large number of banks, both Indian and foreign.

7.3.4 Competition for Rural Customers

In the agriculture and priority segments, the principal competitors are the large public sector banks, regional rural banks (RRBs) and cooperative banks. This is due to the extensive physical presence of public sector banks and RRBs throughout India via their large branch networks and their focus on agriculture and priority sectors.

7.4 Customer Relationship Management

Over the years, the RBI has taken a number of initiatives to improve the quality of customer service. These steps include grievance redress through the Banking Ombudsman Scheme[42] and setting up a Customer Service Department within RBI.

RBI has set up a full-fledged Customer Service Department with a view to making banks more customer-friendly and has taken a number of steps to disseminate instructions/ guidelines relating to customer service and grievance redressal by banks by placing all customer related notifications and press releases on its multi-lingual Internet site. Customers of commercial banks can also approach the RBI with their grievances.

In February 2006, RBI set up the Banking Codes and Standards Board of India (BCSBI) as an independent autonomous watchdog to ensure that customers get fair treatment in their dealings

[42] Discussed under section 7.5.

with banks. The BCSBI has published the "Code of Banks' Commitments to Customers "(the Code)" which sets minimum standards of banking practice and benchmarks in customer service for banks to follow. Commercial banks have become members of the BCSBI and have adopted the Code as their Fair Practice Code in dealings with customers.

The main RBI directives on customer services include the following.[43]

7.4.1 Committees on Customer Service

Banks are required to constitute a Customer Service Committee of their respective Boards and include experts and representatives of customers as invitees to enable improvements in the quality of customer service.

Further, banks have to establish Customer Service Committee at branch level. Each bank is also expected to have a nodal department / official for customer service in the Head Office and each controlling office whom customers with grievances can approach in the first instance and with whom the Banking Ombudsman and RBI can liaise.

7.4.2 Board-approved Policies on Customer Service

Customer service is projected as a priority objective of banks along with profit, growth and fulfilment of social obligations. Banks need to have a board approved policy for the following:

- Comprehensive Deposit Policy
- Cheque Collection Policy
- Customer Compensation Policy in areas such as erroneous debits, payment of interest in case of delays in collection, etc.[44] and
- Customer Grievance Redressal Policy

Banks should provide a complaints/ suggestions box at each of their offices. Further, at every office of the bank, a notice requesting the customers to meet the branch manager may be displayed regarding grievances, if the grievances remain unattended. A complaint book with perforated copies in each set may be introduced, so designed as to instantly provide an acknowledgement to the customers and intimation to the controlling office.

[43] However, the banking system cannot depend only on regulatory steps to improve customer service. Market based solutions are also necessary.

[44] According to RBI guidelines, in the case of delays in collection of bills, the concerned bank should pay interest to the aggrieved party for the delayed period in respect of collection of bills at the rate of 2% per annum above the rate of interest payable on balances of Savings Bank accounts.

7.4.3 Giving Publicity to the Policies

Banks should ensure that wide publicity is given to the customer policies formulated by them by placing them prominently on their web-site and also disseminating the policies through notice board in their branches, issuing booklets/ brochures, etc.

7.4.4 Operations of Accounts by Special Category of Customers

Banks should develop policies for special categories of customers including sick/ old/ incapacitated persons, persons with disabilities, visually impaired persons, etc. Such a customer may require identification through the customer's thumb or toe impression by two independent witnesses known to the bank, one of whom should be a responsible bank official.

7.4.5 Customer Confidentiality Obligations

The scope of the secrecy law in India has generally followed the common law principles based on implied contract. Bankers' obligation to maintain secrecy about customers' accounts arises out of the contractual relationship between the banker and customer, and as such no information should be divulged to third parties except under circumstances which are well defined. The following exceptions are normally accepted, where:

- disclosure is under compulsion of law
- there is duty to the public to disclose
- interest of bank requires disclosure, and
- disclosure is made with the express or implied consent of the customer.

Box 7.2: Collecting Information from Customers for Cross-selling Purposes

At the time of opening of accounts of the customers, banks are required to collect certain information; but they also collect a lot of additional personal information, which can be potentially used for cross selling various financial services by the banks, their subsidiaries and affiliates. Sometimes, such information is also provided to other agencies. RBI has advised banks that the information provided by the customer for Know Your Customer (KYC) compliance (see Section 7.5) while opening an account is confidential and divulging any details thereof for cross selling or any other purpose would be in breach of customer confidentiality obligations.

Wherever banks desire to collect any information about the customer for a purpose other than KYC requirements, it should not form part of the account opening form. Such information may be collected separately, purely on a voluntary basis, after explaining the objectives to the customer and taking his express approval for the specific uses to which such information could be put.

Source: RBI Guidelines

7.4.6 National Do Not Call Registry

With a view to reducing the number of unsolicited marketing calls received by customers, the RBI has advised banks that all telemarketers, viz., direct selling agents/ direct marketing agents engaged by them should be registered with the Department of Telecommunications (DoT).

7.5 Banking Ombudsman Scheme

The Banking Ombudsman Scheme makes available an expeditious and inexpensive forum to bank customers for resolution of complaints relating to certain services rendered by banks. The Banking Ombudsman Scheme was introduced under Section 35 A of the Banking Regulation Act (BR Act), 1949 with effect from 1995.

All Scheduled Commercial Banks, Regional Rural Banks and Scheduled Primary Co-operative Banks are covered under the Scheme.

7.5.1 Appointment of Banking Ombudsman

The Banking Ombudsman is a senior official appointed by the RBI to receive and redress customer complaints against deficiency in certain banking services (including Internet banking and loans and advances). At present, fifteen Banking Ombudsmen have been appointed, with their offices located mostly in state capitals.

7.5.2 Filing a Complaint to the Banking Ombudsman

One can file a complaint before the Banking Ombudsman if (a) the reply to the representation made by the customer to his bank is not received from the concerned bank within a period of one month after the bank has received the representation, or (b) the bank rejects the complaint, or (c) if the complainant is not satisfied with the reply given by the bank. The Banking Ombudsman does not charge any fee for filing and resolving customers' complaints.

7.5.3 Limit on the Amount of Compensation as Specified in an Award

The amount, if any, to be paid by the bank to the complainant by way of compensation for any loss suffered by the complainant is limited to the amount arising directly out of the act or omission of the bank or Rs 10 lakhs, whichever is lower.

Further, the Banking Ombudsman may award compensation not exceeding Rs 1 lakh to the complainant only in the case of complaints relating to credit card operations for mental agony and harassment. The Banking Ombudsman will take into account the loss of the complainant's time, expenses incurred by the complainant and harassment and mental anguish suffered by the complainant while passing such award.

7.5.4 Further recourse available

If a customer is not satisfied with the decision passed by the Banking Ombudsman, he can approach the Appellate Authority against the Banking Ombudsman's decision. Appellate Authority is vested with a Deputy Governor of RBI. He can also explore any other recourse available to him as per the law. The bank also has the option to file an appeal before the appellate authority under the scheme.

7.6 Know Your Customer (KYC) norms

Banks are required to follow Know Your Customer (KYC) guidelines. These guidelines are meant to weed out and to protect the good ones and the banks. With the growth in organized crime, KYC has assumed great significance for banks. The RBI guidelines on KYC aim at preventing banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. They also enable banks to have better knowledge and understanding of their customers and their financial dealings. This in turn helps banks to manage their risks better. The RBI expects all banks to have comprehensive KYC policies, which need to be approved by their respective boards.

Banks should frame their KYC policies incorporating the following four key elements:

a) Customer Acceptance Policy;

b) Customer Identification Procedures;

c) Monitoring of Transactions; and

d) Risk Management.

7.6.1 Customer Acceptance Policy

Every bank should develop a clear Customer Acceptance Policy laying down explicit criteria for acceptance of customers. The usual elements of this policy should include the following. Banks, for example, should not open an account in anonymous or fictitious/ benami name(s). Nor should any account be opened where the bank's due diligence exercises relating to identity has not been carried out. Banks have to ensure that the identity of the new or existing customers does not match with any person with known criminal background. If a customer wants to act on behalf of another, the reasons for the same must be looked into.

However, the adoption of customer acceptance policy and its implementation should not become too restrictive and should not result in denial of banking services to general public, especially to those who are financially or socially disadvantaged.

7.6.2 Customer Identification Procedures

Customer identification means identifying the customer and verifying his/her identity by using reliable, independent source documents, data or information. For individual customers, banks should obtain sufficient identification data to verify the identity of the customer, his address and a recent photograph. The usual documents required for opening deposit accounts are given in Box 7.3. For customers who are legal persons, banks should scrutinize their legal status through relevant documents, examine the ownership structures and determine the natural persons who control the entity.

Box 7.3: Documents for opening deposit accounts under KYC guidelines

The Customer identification will be done on the basis of documents provided by the prospective customer as under:

a) Passport or Voter ID card or Pension Payment Orders (Govt./PSUs) alone, whereon the address is the same as mentioned in account opening form.

b) Any one document for proof of identity and proof of address, from each of the under noted items:

Proof of Identity

i) Passport, if the address differs from the one mentioned in the account opening form

ii) Voter ID card, if the address differs from the one mentioned in the account opening form

iii) PAN Card

iv) Govt./ Defence ID card

v) ID cards of reputed employers

vi) Driving License

vii) Pension Payment Orders (Govt./PSUs), if the address differs from the one mentioned in the account opening form

viii) Photo ID card issued by Post Offices

viii) Photo ID card issued to bonafide students of Universities/ Institutes approved by UGC/ AICTE

Proof of address

i) Credit card statement

ii) Salary slip

iii) Income tax/ wealth tax assessment

iv) Electricity bill

v) Telephone bill

vi) Bank account statement

vii) Letter from a reputed employer

viii) Letter from any recognized public authority

ix) Ration card

x) Copies of registered leave & license agreement/ Sale Deed/ Lease Agreement may be accepted as proof of address

xi) Certificate issued by hostel and also, proof of residence incorporating local address, as well as permanent address issued by respective hostel warden of aforesaid University/ institute where the student resides, duly countersigned by the Registrar/ Principal/ Dean of Student Welfare. Such accounts should be closed on completion of education/ leaving the University/ Institute.

xii) For students residing with relatives, address proof of relatives along with their identity proof, can also be accepted provided declaration is given by the relative that the student is related to him and is staying with him.

Source: State Bank of India website

7.6.3 Monitoring of Transactions

Ongoing monitoring is an essential element of effective KYC procedures. Banks can effectively control and reduce their risk only if they have an understanding of the normal and reasonable activity of the customer so that they have the means of identifying the transactions that fall outside the regular pattern of activity. Banks should pay special attention to all complex, unusually large transactions and all unusual patterns which have no apparent economic or visible lawful purpose. Banks may prescribe threshold limits for a particular category of accounts and pay particular attention to the transactions which exceed these limits.

Banks should ensure that any remittance of funds by way of demand draft/ mail/ telegraphic transfer or any other mode and issue of travellers' cheques for value of Rs 50,000 and above is effected by debit to the customer's account or against cheques and not against cash payment.

Banks should further ensure that the provisions of Foreign Contribution (Regulation) Act, 1976 as amended from time to time, wherever applicable, are strictly adhered to.

7.6.4 Risk Management

Banks should, in consultation with their boards, devise procedures for creating risk profiles of their existing and new customers and apply various anti-money laundering measures keeping in view the risks involved in a transaction, account or banking/ business relationship.

Banks should prepare a profile for each new customer based on risk categorisation. The customer profile may contain information relating to customer's identity, social/ financial status, nature of business activity, information about his clients' business and their location etc. Customers may be categorised into low, medium and high risk. For example, individuals (other than high net worth individuals) and entities whose identities and sources of wealth can be easily identified and transactions in whose accounts by and large conform to the known transaction profile of that kind of customers may be categorised as low risk. Salaried employees, government owned companies, regulators etc fall in this category. For this category of customers, it is sufficient to meet just the basic requirements of verifying identity.

There are other customers who belong to medium to high risk category. Banks need to apply intensive due diligence for higher risk customers, especially those for whom the sources of funds are not clear. Examples of customers requiring higher due diligence include (a) non-resident customers; (b) high net worth individuals; (c) trusts, charities, NGOs and organizations receiving donations; (d) companies having close family shareholding or beneficial ownership; (e) firms with 'sleeping partners'; (f) politically exposed persons (PEPs) of foreign origin; (g) non-face-to-face customers and (h) those with dubious reputation as per public information available etc.

Banks' internal audit and compliance functions have an important role in evaluating and ensuring adherence to the KYC policies and procedures. Concurrent/ Internal Auditors should specifically check and verify the application of KYC procedures at the branches and comment on the lapses observed in this regard.

7.7 Prevention of Money Laundering Act (PMLA), 2002

The PMLA, 2002 casts certain obligations on the banking companies in regard to maintenance and reporting of the following types of transactions:

a) all cash transactions of the value of more than Rs 10 lakh or its equivalent in foreign currency;

b) all series of cash transactions integrally connected to each other which have been valued below Rs 10 Lakh or its equivalent in foreign currency where such series of transactions have taken place within a month and the aggregate value of such transactions exceeds Rs 10 Lakh;

c) all cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine and where any forgery of a valuable security or a document has taken place facilitating the transaction; and

d) all suspicious transactions whether or not made in cash

CHAPTER 8: Evolving Trends in Modern Banking

There are a number of trends evolving in modern banking, the most important of which relate to (a) technology, (b) outsourcing of services and (c) financial inclusion

8.1 Technology

Banks in India have started using technology in a proactive manner. The huge number of bank customers and their myriad needs are being met in increasingly sophisticated ways. In a number of areas, the foreign banks and the new private sector banks have been the first movers in the application of technology, but public sector banks are also catching up. One major advantage that Indian banks have is the availability of major IT companies in India who are the world leaders in IT applications.

8.1.1 Internet Banking

Through its website, a bank may offer its customers online access to account information and payment and fund transfer facilities. The range of services offered differs from bank to bank depending mainly on the type and size of the bank. Internet banking is changing the banking industry and affecting banking relationships in a major way (see box 8.1).

Box 8.1: Examples of Online Payment Services offered by some banks

Shopping Online: One can shop securely online with the existing debit/credit card. This can also be done without revealing the customer's card number.

Prepaid Mobile Refill: A bank's account holder can recharge his prepaid mobile phone with this service.

Bill Pay: A customer can pay his telephone, electricity and mobile phone bills through the Internet, ATMs, mobile phone and telephone.

Register & Pay: One can view and pay various mobile, telephone, electricity bills and insurance premiums on-line. After registering, customers can get sms and e-mail alerts every time a bill is received.

RTGS Fund Transfer: RTGS is an inter-bank funds transfer system, where funds are transferred as and when the transactions are triggered (i.e. real time).

Online Payment of Taxes: A customer can pay various taxes online including Excise and Service Tax, Direct Tax etc.

8.1.2 Mobile Banking Transactions

Some banks have started offering mobile banking and telebanking to customers. The expansion in the use and geographical reach of mobile phones has created new opportunities for banks to use this mode for banking transactions and also provide an opportunity to extend banking facilities to the hitherto excluded sections of the society.

The RBI has adopted Bank Led Model in which mobile phone banking is promoted through business correspondents of banks.[45] The operative guidelines for banks on Mobile Banking Transactions in India were issued on October 8, 2008. Only banks who have received one-time approval from the RBI are permitted to provide this facility to customers.

Box 8.2: Mobile Banking in India

Till June 30, 2009, 32 banks had been granted permission to operate Mobile Banking in India, of which 7 belonged to the State Bank Group, 12 to nationalised banks and 13 to private/ foreign banks.

Source: Report on Trends and Progress of Banking in India 2008-09, RBI.

8.1.3 Point of Sale (PoS) Terminals

To use smart cards/debit cards/credit cards for the purchase of an item or for payment of a service at a merchant's store, the card has to be swiped in a terminal (known as Point of Sale or POS terminal) kept at the merchant's store. As soon as the card is put on the terminal, the details of the card are transmitted through dial-up or leased lines to a host computer. On verification of the genuineness of the card, the transaction is authorised and concluded. It is thus a means to 'check out' whether the cardholder is authorized to make a transaction using the card. POS terminal is a relatively new concept.

A Point of Sale (PoS) terminal is an integrated PC-based device, with a monitor (CRT), PoS keyboard, PoS printer, Customer Display, Magnetic Swipe Reader and an electronic cash drawer all rolled into one. More generally, the POS terminal refers to the hardware and software used for checkouts.

In recent years, banks are making efforts to acquire Point of Sale (PoS) terminals at the premises of merchants across the country as a relatively new source of income. 'Acquiring' a POS terminal means installing a POS terminal at the merchant premises. The installer of the

[45] For more details on Business Correspondents of banks, please see 8.3.1

PoS terminals is the acquirer of the terminal and the merchants are required to hold an account (merchant account) with the acquirer bank. The acquirer bank levies each transaction with a charge, say 1% of the transaction value. This amount is payable by the merchant. Most merchants do not mind absorbing this cost, because such facilities expand their sales. Some merchants, however, pass on the cost to the customer. This business is known as merchant acquisition business.

Banks are vying with one another for PoS machine acquisition, since it offers a huge opportunity to generate additional income by increasing the card base and encouraging card holders to use them for their merchant transactions. Leading banks--both in the public and private sectors--are planning to install hundreds of thousands of these terminals across the country. Some banks are planning joint ventures with global companies who have experience and expertise in this area.

PoS terminals are predominantly used for sale and purchase transactions. The PoS terminals have proved to be very effective in combating fraudulent transaction by on-line verification of cards. Also, the RBI is expected to permit cash withdrawal transactions to cardholders from PoS terminals installed with shopkeepers, mall stores, etc.

PoS terminals, having gained significant acceptance in metros, need to become more popular in tier-2 and tier-3 cities. Public sector banks appear to be more interested in targeting the smaller towns and cities where they have strong branch presence. The challenges of setting up a widespread PoS network will be primarily (a) operational costs and (b) viability in smaller towns and cities. Experts feel that once the technology stabilises and costs per unit comes down, PoS terminals will become popular all over India.

8.2 Outsourcing of Non-core Activities

Outsourcing can enable banks to stay ahead of competition. Growing competition in the banking sector has forced banks to outsource some of their activities to maintain their competitive edge. Decision to outsource could be on cost considerations as well as lack of expertise in banks in delivering certain services. Banks typically outsource their non-core functions so that they can concentrate on their core functions.

However, there are risks involved in the process of outsourcing to a third party. These risks include non-compliance with regulations, loss of control over business, leakage of customer data, lack of expertise of the third party, poor service from third party, etc.

The key driving force behind outsourcing activities by any firm, irrespective of the nature of its business, is cost saving. Initially, foreign banks were involved in outsourcing their activities in order to leverage India's significant cost advantages. Organisations such as American Express, Citibank, Standard Chartered Bank, ANZ Grindlays, HSBC, and ABN Amro have been outsourcing

their Information Technology Outsourcing (ITO)/Business Process Outsourcing (BPO) requirements to leading Indian IT companies.

Outsourcing Activities of Indian Banks

During the recent years, Indian banks also have started outsourcing their non-core activities. The outsourced services may include software application support, maintenance of hardware and software, hosting services, managing data centres, managing ATM networks across the country, and disaster management. Further, banks are also giving contracts to third parties in order to manage other support services such as call-support services, help-desk support, credit card processing, cheque processing and clearing, ATM cash replenishment, cheque clearing and collection, loan servicing, data processing, etc. The two main reasons for Indian banks outsourcing non-core activities are similar to the overseas banks, i.e. cost consideration and lack of expertise in certain areas. Through outsourcing, banks can also benefit from the domain expertise of the service providers.

Outsourcing helps banks not only to focus on their core activities, but also in certain cases to reduce the capital investment in developing the required infrastructure. Further, in-house provision of services may be more expensive because they do not enjoy any economy of scale. Service providers on the other hand may enjoy economies of scale because they cater to the outsourcing requirements of a number of banks and companies and pass on some of the benefits of scale to the outsourcing banks. It is not only the small banks who have started outsourcing non-core activities; large public sector banks are also outsourcing their non-core services.

Certain precautions need to be taken while outsourcing non-core functions. The legal contract entered into with the vendors should be approved only after the quantification of benefits through a thorough analysis. The vendor's domain knowledge is important for delivering the services as per contract; for example customizing the bank's IT requirements. It is therefore important for banks to verify whether the vendors have the required domain knowledge.

While outsourcing, the major concern for banks relates to security. There have been case instances where the employees of vendors have leaked confidential information of clients. For banks, such leakage of customer's account details can be disastrous, with huge fallout in terms of monetary losses as well as severe damage to the bank's reputation.

To cope with the challenges, the RBI has proposed that the board of directors of a bank should be responsible for the outsourcing policy as well as approving such activities undertaken by a bank. In addition, the Information Technology Act, 2000 aims at tackling some aspects of cyber crimes such as leakage of confidential information by vendors. As part of internal inspection/audit, internal inspectors/ auditors in banks look into security related aspects of outsourcing.

Going forward, it is expected that outsourcing in the banking sector in India will increase as competition in the industry grows and support services increasingly becomes more sophisticated and expensive.

8.3 Financial Inclusion

Despite the expansion of the banking network in India since independence, a sizeable proportion of the households, especially in rural areas, still do not have a bank account. Considerable efforts have to be made to reach these unbanked regions and population. Financial Inclusion implies providing financial services viz., access to payments and remittance facilities, savings, loans and insurance services at affordable cost to those who are excluded from the formal financial system. Box 8.3 gives indications of the low access to banking services in India.

Box 8.3: Financial Inclusion Statistics

National Sample Survey Organisation (NSSO) data reveal that 45.9 million farmer households in the country (or 51.4% of the total) do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources; of which one-third also borrow from informal sources. Farm households not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively. Thus, apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.

Source: Report of the Committee on Financial Inclusion, January 2008

8.3.1 Initiatives taken by the RBI

The Lead Bank Scheme introduced by the RBI in 1969 is the earliest attempt by the RBI to foster financial inclusion. Under the scheme, designated banks are made key instruments for local development and entrusted with the responsibility of identifying growth centres, assessing deposit potential and credit gaps and evolving a coordinated approach for credit deployment in each district, in concert with other banks and other agencies. As at March 2009, there were 26 banks, mostly in the public sector, which have been assigned lead responsibility in 622 districts of the country.

The RBI's recent measures to promote financial inclusion includes: advising banks to open 'no frills' accounts, introduction of Business Correspondent (BC)/ Business Facilitator (BF) model and adoption of Information and Communication Technology (ICT) solutions for achieving greater outreach.

Basic banking 'no-frills' account

To achieve the objective of greater financial inclusion, all banks have been advised by the RBI to make available a basic banking 'no-frills' account either with 'nil' or very low minimum balances. They have also been advised to keep the transaction charges low, which would make such accounts accessible to vast sections of population. The nature and number of transactions in such accounts could be restricted by the banks, but such restrictions must be made known to the customer in advance in a transparent manner. The growth of such deposits should be encouraged with affordable infrastructure and low operational costs through the use of appropriate technology.

Box 8.4: No-frill accounts

Scheduled Commercial Banks (SCBs) are making considerable efforts towards opening no-frills accounts. The number of no-frills accounts opened by SCBs during 2006-07, 2007-08, and 2008-09 were 6.73 million, 15.79 million and 33.02 million respectively.

Source: Report on Trends and Progress of Banking in India, 2008-09, RBI.

Use of Business Facilitators and Correspondents

With the objective of ensuring a greater financial inclusion and increasing the outreach of the banking sector, the RBI has introduced business facilitators and business correspondent models to enable banks to use the services of NGOs, Self Help Groups (SHGs) and micro finance institutions as intermediaries in providing financial and banking services. These intermediaries serve as the facilitators /correspondents of the banks.

In the business facilitator model, these intermediaries help the banks facilitate services such as identification of borrowers, collection and preliminary processing of loan applications, creating awareness about savings and other products, processing and submission of applications to banks and post-sanction monitoring.

In addition to activities which the intermediaries can engage in the business facilitator model, the scope of activities under the business correspondent's models include disbursal of small value credit, recovery of principal/collection of interest, collection of small value deposits, receipt and delivery of small value remittances etc.

As the engagement of intermediaries as business facilitators/correspondents involves a significant reputational, legal and operational risks, banks need to give due consideration to those risks. The bank's arrangement with the business correspondents should:

- Specify the suitable limits on cash holding by intermediaries, as also limits on individual customer payments and receipts.

- Require that the transactions are accounted for and reflected in the bank's books by the end of the day or next working day.
- Require all agreements/contracts with the customer to clearly specify that the bank is responsible to the customer for acts of omission and commission of the business facilitator / correspondent.

Banks pay reasonable commission/ fees to the Business Facilitators/ Correspondents. The banks' agreement with them however should specifically prohibit them from charging any fees to the customers for the services rendered by them on behalf of the banks.

Adoption of technology

To give an impetus to financial inclusion, the RBI has formulated a scheme to accelerate the pace of adoption of the biometric access/ smart card based Electronic Benefit Transfer (EBT) mechanism by the banks and roll out the EBT system in the States that are ready to adopt the scheme. As per the scheme, RBI would partially reimburse the banks, for a limited period, the cost of opening accounts with biometric access/ smart cards. Through these accounts, payment of social security benefits, National Rural Employment Guarantee Act (NREGA) payments and payments under other government benefit programmes would be routed.

The potential of information technology (IT) in extending banking services to under-served markets in rural and semi-urban areas is enormous. The use of Smart Card technology, mobile ATMs, coverage of rural post offices under electronic payments networks - all could contribute to providing financial services to more people and thereby serve financial inclusion.

India is experiencing an explosion in the use of mobile communication technology, and this could be exploited by the financial sector for spreading the banking habit. Mobile phone users belong to all strata of society, spread across urban, semi-urban and rural areas. However, while encouraging the spread of cost-effective banking through mobile communications, it has to be ensured that essential security features are maintained.

8.3.2 Micro Credit

Micro Credit is defined as provision of credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels. Micro Credit Institutions (MCIs) are those which provide these facilities.

Banks are allowed to devise appropriate loan and savings products and the related terms and conditions including size of the loan, unit cost, unit size, maturity period, grace period, margins, etc. Such credit covers not only consumption and production loans for various farm and non-farm activities of the poor but also includes their other credit needs such as housing and shelter improvements.

Self-Help Groups (SHGs)

As stated earlier, despite the expansion of the banking sector, the rural poor--particularly the marginal farmers and landless labourers--depend to a very large degree on the moneylenders for credit. Several studies have shown that Self Help Savings and Credit Groups have the potential to bring together the banks and the rural poor.

A Self-Help Group (SHG) is a registered or unregistered group of 15-20 people who voluntarily join together to save small amounts regularly. These pooled savings are used to make interest bearing loans to group members. In addition to inculcating the habit of thrift, SHG activity develops among its members the capacity to handle resources. When the group matures and stabilizes, it gets linked to the banks under a SHG-banks linkage program and banks start providing credit to SHGs. Note that banks provides credit to SHGs and not to individuals belonging to the SHG. It is the SHGs who pass on the loans to the individuals. Thus, the SHGs become responsible for repayment to the banks.

The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment thereof. Peer pressure acts as an effective substitute for collaterals. Box 8.6 gives an indication of the financial inclusion through the self-help groups.

Box 8.5: Self Help Groups

Under the SHGs-Bank Linkage Programme (SBLP) Approach, as on March 31, 2009, 4.2 million SHGs had outstanding loans of Rs.22, 680 crores from commercial banks, regional rural banks and co-operative banks together. The share of commercial banks in total outstanding loans is 71 per cent. Further, as on March 31, 2009, the number of SHGs maintaining savings bank accounts with the banking sector was 6.1 million with outstanding savings of Rs. 5,546 crores.

Source: Report on Trends and Progress of Banking in India, 2008-09, RBI.

What are the advantages of financing through SHGs? An economically poor individual gains strength as part of a group. Besides, financing through SHGs reduces transaction costs for both lenders and borrowers. While lenders have to handle only a single SHG account instead of a large number of small-sized individual accounts, borrowers as part of a SHG cut down expenses on travel for completing paper work and on the loss of workdays in availing loans.

Since 1991-92, the National Bank for Agriculture and Rural Development (NABARD) has been encouraging banks to extend micro credit loans to SHGs. The scheme was then extended to RRBs and co-operative banks. More than 90 per cent of the groups linked with banks are exclusive women's groups.

While the SHG-bank linkage programme has emerged as the dominant micro finance dispensation model in India, other models too have evolved. For example, micro finance delivery through microfinance institutions (MFIs) has also emerged as an important delivery channel.

References

1. Indian Financial System, by Bharati V Pathak, (Pearson Education)

2. Management of Banking & Financial Services, by Justin Paul & Padmalatha Suresh, (Pearson Education)

3. Commercial Banking, The Management of Risk, Benton E Gup & James W Kolari, (Wiley Student Edition)

4. Modern Banking, Theory & Practice, D.Muraleedharan, PHI, (Eastern Economy Edition)

5. Laws & Practices of Banking, The Indian Institute of Bankers, (Macmillan)

6. Banking Regulation Act, 1949

7. The Reserve Bank of India Act, 1934

8. Annual Report of the Reserve Bank of India for the Year 2008-09

9. Report on Trend and Progress of Banking in India 2008-09

10. Reserve Bank of India Master Circulars

11. Report on Currency and Finance 2006-08, "The Banking Sector in India: Emerging Issues and Challenges", RBI.

MODEL TEST PAPER

COMMERCIAL BANKING IN INDIA: A BEGINNER'S MODULE

Q.1 RBI controls the commercial banks through [2 Marks]

(a) periodic inspection of banks
(b) follow up action
(c) calling for returns and other information
(d) All of the above

Q.2 The Lead Bank scheme was introduced by the RBI in: [2 Marks]

(a) 1969
(b) 1973
(c) 1971
(d) 1967

Q.3 Under the new system, the RBI acts as the banker to Central Government only, not banker to State Governments. [2 Marks]

(a) FALSE
(b) TRUE

Q.4 In a 'no frills' savings bank account, banks usually waive minimum balances condition. [2 Marks]

(a) FALSE
(b) TRUE

Q.5 Hindu Undivided Families (HUFs) are not allowed to open current accounts. [1 Mark]

(a) FALSE
(b) TRUE

Q.6 While private sector banks and foreign banks earn fees for undertaking government related business, public sector banks have to offer these services for free to government departments. [2 Marks]

(a) TRUE
(b) FALSE

Q.7 The three main types of deposit accounts collected by banks are savings bank, certificates of deposit and term deposits. [1 Mark]

(a) TRUE
(b) FALSE

Q.8 ______ and _____ are two major companies in the mortgage business and provide stiff competion to the commercial banks in the disbursal of housing loans. [2 Marks]

(a) NEDFI, HDFC

(b) NEDFI, HUDCO

(c) HDFC, HUDCO

(d) LIC, HUDCO

Q.9 In case a depositor wishes to withdraw his deposits prematurely, banks [2 Marks]

(a) do not allow the same till maturity of the deposits

(b) charge a penalty for the same

(c) do not charge any penalty and allow the same

(d) do not allow premature withdrawal

Q.10 What percentage of India's population lives in rural areas? [1 Mark]

(a) 50% to less than 55%

(b) 65% to less than 70%

(c) 70% to less than 75%.

(d) 60% to less than 65%

(e) 55% to less than 60%

Q.11 For filing and resolving customer complaints, the Banking Ombudsman [1 Mark]

(a) charges a fee of Rs. 500/-

(b) does not charge any fee

(c) charges a fee of Rs. 1500/-

(d) charges a fee of Rs. 1000/-

Q.12 Term deposits are meant for individuals and small businesses, and not for large companies. [1 Mark]

(a) TRUE

(b) FALSE

Q.13 Foreign banks can be involved in all segments of personal loans, except in household consumer finance. [2 Marks]

(a) FALSE

(b) TRUE

Q.14 In case a depositor is a sole proprietor and holds deposits in the name of the proprietory concern as well as in the individual capacity, the maximum insurance cover is available upto. [1 Mark]

(a) Rs. 1,00,000/-
(b) Rs. 2,00,000/-
(c) Rs. 5,00,000/-
(d) None of the above

Q.15 Banks give contracts to third parties in order to manage support services like [2 Marks]

(a) help desk support
(b) credit card processing
(c) call support service
(d) All of the above

Q.16 In case of FCNR(B) Scheme, the period for fixed deposits is [2 Marks]

(a) as applicable to resident accounts
(b) for terms not less than 1 year and not more than 5 years
(c) for terms not less than 2 years and not more than 6 years
(d) at the discretion of the Bank

Q.17 To create a strong and competitive banking system, reform measures were initiated in early 1990s. The thrust of these reforms was on [2 Marks]

(a) increasing operation efficiency
(b) strengthening supervision over banks
(c) developing technological and institutional infrastructure
(d) All of the above

Q.18 The past due debt collection policy of banks generally emphasizes on __________ at the time of recovery [2 Marks]

(a) respect to customers
(b) appropriate letter authorising agents to collect recovery
(c) due notice to customers
(d) All of the above

Q.19 Bank sponsored mutual funds dominate the mutual fund industry [2 Marks]

(a) TRUE
(b) FALSE

Q.20 According to the risk diversification principle of bank lending, diversification should be in terms of [2 Marks]

(a) customer base

(b) geographic location

(c) nature of business

(d) All of the above

Q.21 A Bank's aggregate exposure to the capital market, including both fund based and non-fund based exposure to capital market, in all forms should not exceed 50% of its net worth as on March 31 of the previous year. [2 Marks]

(a) TRUE

(b) FALSE

Q.22 Which of the following aspects are outlined by the loan policy of a bank? [2 Marks]

(a) rating standards

(b) lending procedures

(c) financial covenants

(d) All of the above

Q.23 Public sector banks are not allowed to enter the mutual fund business. [2 Marks]

(a) TRUE

(b) FALSE

Q.24 The RBI has adopted _____ Model in which mobile banking and is promoted through business correspondents of banks [1 Mark]

(a) Bank Led

(b) Band Mobile

(c) Mobile

(d) All of the above

Q.25 Services offered to government departments include all the above except: [1 Mark]

(a) payments of salaries and pensions

(b) distributing RBI bonds to government departments

(c) direct and indirect tax collections

(d) remittance facilities

Q.26 In case of FCNR(B) Scheme, the period for fixed deposits is [2 Marks]

(a) for terms not less than 1 year and not more than 5 years

(b) for terms not less than 1 year and not more than 6 years

(c) for terms not less than 2 years and not more than 6 years

(d) for terms not less than 2 years and not more than 5 years

Q.27 The main advantage that banks have in entering the insurance ventures is the strong capital base of banks. [1 Mark]

(a) FALSE

(b) TRUE

Q.28 While spreading the message of promotion of financial inclusion banks can make use of Business Correspondents to facilitate the opening of 'no frills' accounts. [2 Marks]

(a) FALSE

(b) TRUE

Q.29 Savers from the household sector prefer

(i) assured income

(ii) liquidity

(iii) safety of funds [1 Mark]

(a) only (i)

(b) only (ii)

(c) only (iii)

(d) (i), (ii), (iii)

Q.30 At present both IDBI and IDBI Bank operate as separate companies in the fields of term lending and commercial banking businesses respectively. [2 Marks]

(a) FALSE

(b) TRUE

Q.31 The concept of base rate to be introduced with effect from July 1, 2010 would include [2 Marks]

(a) product-specific operating cost

(b) credit risk premium

(c) tenor premium

(d) All of the above

Q.32 Credit appraisal can be done on a simplified basis by banks while carrying out credit appraisal of smaller units. [2 Marks]

(a) TRUE

(b) FALSE

Q.33 BCSBI stands for [1 Mark]

(a) Banking Codes and Standards Board of India

(b) Banking Credit and Standards Board of India

(c) Banking Codes and Service Board of India

(d) Banking Credit and Service Board of India

Q.34 While bulk of the forex treasury operations is on behalf of the clients, the major portion of domestic treasury operations consists of proprietary trading [2 Marks]

(a) FALSE

(b) TRUE

Q.35 Banks have to ensure that underwriting commitments taken up by them in respect of primary issue of shares or convertible debentures or units of equity-oriented mutual funds comply with the ceiling prescribed for the banks' exposure to the capital markets. [1 Mark]

(a) FALSE

(b) TRUE

Q.36 The concept of limited liablity introduced in Indian banking resulted in establishment of [2 Marks]

(a) joint stock banks

(b) urban banks

(c) rural banks

(d) none of the above

Q.37 Derivative products like swaps cover only foreign exchange risks and not interest rate risks. [1 Mark]

(a) FALSE

(b) TRUE

Q.38 Which of the following types of account fall under the time deposit category?

(i) Current account

(ii) Term deposit account [1 Mark]

(a) only (ii)

(b) only (i)

(c) (i) and (ii)

(d) None of the above

Q.39 An efficient financial intermediation process has which of the following components:

(i) effective mobilisation of savings

(ii) their allocation to the most productive uses [1 Mark]

(a) only (i)

(b) only (ii)

(c) (i) and (ii)

(d) None of the above

Q.40 A Nostro account is an account which an exporter maintains with a bank abroad [2 Marks]

(a) FALSE
(b) TRUE

Q.41 The main function of a commercial bank can be segregated into:

(i) payment system
(ii) Financial intermediation
(iii) Financial Services [1 Mark]

(a) (i), (ii), (iii)
(b) (i), (iii)
(c) (i), (ii)
(d) (ii), (iii)

Q.42 Self-Help Groups are set up to basically borrow from banks without making any savings contribution. [2 Marks]

(a) FALSE
(b) TRUE

Q.43 A commercial paper issue made by a corporate is a non-SLR instrument [2 Marks]

(a) FALSE
(b) TRUE

Q.44 As at end-June 2008, the number of bank branches in the country was: [2 Marks]

(a) Between 75,000 to 80,000
(b) Between 70,000 to 75,000
(c) Between 80,000 to 85,000
(d) Between 65,000 to 70,000

Q.45 Loss assets comprise assets where a loss has been identified by [2 Marks]

(a) RBI
(b) Bank
(c) a and b
(d) None of the above

Q.46 RBI acts as the issuer of currency in India, but only the Central Government has the right to destroy currency notes. [2 Marks]

(a) FALSE
(b) TRUE

Q. 47 No bank may hold shares in any company other than a subsidiary, exceeding 20.0% of the paid up share capital of that company. [2 Marks]

(a) TRUE

(b) FALSE

Q.48 The deposits of regional rural banks are not covered by the DICGC [1 Mark]

(a) FALSE

(b) TRUE

Q.49 Normally, the following types of customers require higher due diligence under KYC norms, except: [1 Mark]

(a) politically exposed persons (PEPs) of foreign origin.

(b) non-resident customers;

(c) farmers with land holding over 10 acres;

(d) high net worth individuals;

Q.50 The Banking Ombudsman is a senior official appointed by the RBI. [1 Mark]

(a) TRUE

(b) FALSE

Q.51 The RBI has prescribed that all SCBs should maintain their SLRs in [2 Marks]

(a) dated securities notified by RBI

(b) T-Bills of Government of India

(c) State Development Loans

(d) All the above

Q.52 What does EBT stand for? [1 Mark]

(a) Electronic Belated Transfer

(b) Electric Beginners transaction

(c) Electronic Benefit Transfer

(d) Electronic Beginning Transaction

Q.53 With growing savings among households in India, the need for retail credit is declining. [1 Mark]

(a) TRUE

(b) FALSE

Q.54 In India, the RBI prescribes the minimum SLR level for Scheduled Commercial Banks in India in specified assets as a percentage of Bank's ______ [3 Marks]

(a) Net Demand and Time Liabilities

(b) Demand Liabilities

(c) Time Liability

(d) None of the above

Q.55 If the beneficiary of a cheque has lost the cheque, he can instruct the paying bank to stop payment of the cheque without waiting for the account holder's instructions. [2 Marks]

(a) TRUE

(b) FALSE

Q.56 The CRR refer to the share of ______ that banks have to maintain with RBI of their net demand and time liabilities. [2 Marks]

(a) illiquid cash

(b) forex reserves

(c) gold

(d) liquid cash

Q.57 While outsourcing, the only consideration should be cost savings [2 Marks]

(a) TRUE

(b) FALSE

Q.58 Lord Krishna Bank Ltd. is a [2 Marks]

(a) new private sector bank

(b) old private sector bank

(c) public sector bank

(d) regional rural bank

Q.59 Government securities issued by the Central Government are considered to be part of SLR securities, but not securities issued by State Governments. [2 Marks]

(a) FALSE

(b) TRUE

Q.60 Under the Banking Regulation Act insurance is not included in the list of permissible businesses. However, Ministry of Finance provides special permission to banks to enter the insurance business. [2 Marks]

(a) FALSE

(b) TRUE

Correct Answers :

Question No.	Answers	Question No.	Answers
1	(d)	31	(d)
2	(a)	32	(a)
3	(a)	33	(a)
4	(b)	34	(b)
5	(a)	35	(b)
6	(b)	36	(a)
7	(b)	37	(a)
8	(c)	38	(a)
9	(b)	39	(c)
10	(c)	40	(a)
11	(b)	41	(a)
12	(b)	42	(a)
13	(a)	43	(b)
14	(a)	44	(a)
15	(d)	45	(c)
16	(b)	46	(a)
17	(d)	47	(a)
18	(d)	48	(a)
19	(b)	49	(c)
20	(d)	50	(a)
21	(b)	51	(d)
22	(d)	52	(c)
23	(b)	53	(b)
24	(a)	54	(a)
25	(b)	55	(b)
26	(a)	56	(d)
27	(a)	57	(b)
28	(b)	58	(b)
29	(d)	59	(a)
30	(a)	60	(a)