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BANKING & FINANCIAL SERVICES

B.Com. II Semester

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Paper DSC 203: BANKING AND FINANCIAL SERVICES
(For B.Com. (General) Only)

Objective: *To familiarize with Fund-based and Non-fund-based Financial Services.*

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

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

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

UNIT–IV: INTRODUCTION TO FINANCIAL SERVICES:
Financial Services: Meaning – Functions – Classification - Scope - Fund Based Activities - Non-fund Based Activities - Modern Activities - Causes for Financial Innovation - New Financial Products and Services - Innovative Financial Instruments - Challenges Facing the Financial Service Sector - Present Scenario

UNIT–V: FINANCIAL SERVICES:
Definition - Services of Merchant Banks - Problems and Scope of Merchant Banking in India - Venture Capital: Meaning, Features, Scope, Importance - Leasing - Definition and Steps - Types of Lease - Financial Lease - Operating Lease - Leverage Lease - Sale and Lease Back - Discounting: Concept - Advantages of Bill Discounting -Factoring - Meaning and Nature - Parties in Factoring - Merits and Demerits of Factoring - Forfeiting - Parties to Forfeiting - Costs of Forfeiting - Benefits of Forfeiting for Exporters and Importers

SUGGESTED READINGS:

1. Banking Theory & Practices: Dr. P. K. Srivatsava, Himalaya Publishers
2. Banking Theory & Practices: K.C. Shekar, Vikas Publications
3. Banking and Financial Services: Santhi Vedula & Kavitha Krishna Himalaya Publishing House
4. Banking and Financial Services: Dr.Jayanthi, PBP.
5. Banking Theory, Law & Practices: R. R Paul, Kalyani Publishers
6. Money Banking and Financial Markets: Averbach, Rabort. D, MacMillan. Landon
7. Financial Markets and Services: Gordon and Natarajan, Himalaya Publishing House.
8. Financial Services: T. Siddaiah, Pearson Education.

UNIT-I: INTRODUCTION:

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FUNCTIONS OF COMMERCIAL BANKS:

Commercial banks are the most important components of the whole banking system. A commercial bank is a profit-based financial institution that grants loans, accepts deposits, and offers other financial services, such as overdraft facilities and electronic transfer of funds.

According to Culbertson, *"Commercial Banks are the institutions that make short make short term banks to business and in the process create money."*

In other words, commercial banks are financial institutions that accept demand deposits from the general public, transfer funds from the bank to another, and earn profit.
Commercial banks play a significant role in fulfilling the short-term and medium- term financial requirements of industries. They do not provide, long-term credit, so that liquidity of assets should be maintained. The funds of commercial banks belong to the general public and are withdrawn at a short notice; therefore, commercial banks prefers to provide credit for a short period of time backed by tangible and easily marketable securities. Commercial banks, while providing loans to businesses, consider various factors, such as nature and size of business, financial status and profitability of the business, and its ability to repay loans.

Commercial banks are of three types, which are as follows:

(a) Public Sector Banks: Refer to a type of commercial banks that are nationalized by the government of a country. In public sector banks, the major stake is held by the government. In India, public sector banks operate under the guidelines of Reserve Bank of India (RBI), which is the central bank. Some of the Indian public sector banks are State Bank of India (SBI), Corporation Bank, Bank of Baroda, Dena Bank, and Punjab National Bank.

(b) Private Sector Banks: Refer to a kind of commercial banks in which major part of share capital is held by private businesses and individuals. These banks are registered as companies with limited liability. Some of the Indian private sector banks are Vysya Bank, Industrial Credit and Investment Corporation of India (ICICI) Bank, and Housing Development Finance Corporation (HDFC) Bank.

(c) Foreign Banks: Refer to commercial banks that are headquartered in a foreign country, but operate branches in different countries. Some of the foreign banks operating in India are Hong Kong and Shanghai Banking Corporation (HSBC), Citibank, American Express Bank, Standard & Chartered Bank, and Grindlay's Bank. In India, since financial reforms of 1991, there is a rapid increase in the number of foreign banks. Commercial banks mark significant

importance in the economic development of a country as well as serving the financial requirements of the general public.

The most important functions of commercial banks are discussed below:

1. Accepting deposits:

The most significant and traditional function of commercial bank is accepting deposits from the public. The deposits may be of three types: Saving deposits, Current deposits and fixed deposits. In case of current account, people can withdraw deposits in part or in full at any time he likes without notice.

Usually no interest is paid on them, because the bank cannot utilise these short-term deposits. Savings deposits are payable on demand and money can be withdrawn by cheques. But there are certain restrictions imposed on the depositors of this account. Deposits in this account earn interest at nominal rates. Fixed deposits are made for a fixed period of time. A higher rate of interests is paid on the fixed deposits.

2. Providing loans:

The second important function of the commercial bank is to provide loans against suitable mortgages to the public to fulfill their needs of money. Loans can be granted in the form of cash credit, demand loans, short- term loan, overdraft, discounting of bills etc. Under cash credit system, borrower is sanctioned a credit limit up to which he can borrow from the bank. The interest payable by the borrower is calculated on the amount of credit limit actually drawn. Demand loans granted by a bank are those loans which can be recalled on demand by the bank any time.

Here, the interest is payable on the entire sum of demand loans granted. Short-term loans (like car loans, housing loans etc.) are given as personal loans against some security. The interest is payable on the entire sum of loan granted. In case of overdraft facility, an account holder is allowed to withdraw a sum of money in excess of the amount deposited with the bank.

Here, the borrower who has received this facility, has to pay interest on the amount overdrawn. Another important form of bank lending is through discounting or purchasing the bills of exchange. A bill of exchange is drawn by a creditor on the debtor specifying the amount of debt and also the date when it becomes payable. Such bills of exchange are normally issued for a period of 90 months.

3. Credit Creation:

This is an unique function performed by the commercial banks. A bank has sometimes been called a factory for the manufacture of credit. In the process of acceptance of deposits and granting of loans, commercial banks are able to create credit.

4. Transfer of funds:

Commercial banks are able to transfer funds of a customer to other customer's account through the cheques, draft, mail transfers, telegraphic transfers etc.

5. Agency functions:

In modern time, commercial banks also act as an agent of the customer. However, banks charge fee or commission for these functions.

Agency functions include:
(a) Collection of cheques, bills and drafts,
(b) Collection of interest, dividend etc.
(c) Payment of interest, installments of loans, insurance premium etc.
(d) Purchase and sale of securities
(e) Transfer of funds through demand drafts, mail transfer etc.

6. Other functions:

Apart from the above important and most popular functions, commercial banks also perform the following other functions:
(a) Payment of credit letters and travellers cheques, gift cheques, bank draft etc.
(b) Dealing in foreign exchange.
(c) Locker services.
(d) Provision of tax assistance and investment advice etc.
From the above analysis, it is clear that in a modern economy the commercial banks play an important role in various economic activities of the country.

EMERGING TRENDS IN COMMERCIAL BANKING IN INDIA:

E-Banking: Over the years, banking has drastically changed and has affected the lives of millions of individuals around the globe. E-banking or virtual banking, or net banking or internet banking is an electronic payment system wherein customers of a given bank can perform all their banking transactions.

In other words, e-banking refers to all the financial transactions undertaken by any financial institution over the internet.

From paying bills and transferring money into accounts to applying for loans, you can take advantage of all the facilities that a traditional bank offers – without even having to get off your comfy couch!

Advantages

1.Convenience: In this busy and hectic schedule it is difficult for an individual to make time to visit bank for checking their account balance, interest rates, successful transfer of money, and any other update. Banking system has developed virtual banking system for customer convenience where an individual can access their banking system anytime and anyplace. There are many scenarios when there is banking holiday due to which your money can’t be transferred. Online banking system has provides an ease by providing 24 hours and 365 days services. It resolves issues faced by the customers during traditional banking system. An individual don’t need to stand in queue for any money deport and transfer.

2.Transfer service: The virtual banking system provides convenience to transfer money 24 hours in 365 days. You don’t need to stick to perform any transaction within working hours as you can do as per your convenience in 24 hours.

3.Monitoring service: The customers can access their updated passbook anytime for monitor their transactions to manage their financial plans.

4.Online bills payment: You don't need to stand in queue for paying bills as it has feature to pay any kind of bill including electricity, water supply, telephone, and other bills.

5.Quality service: Internet banking has improved the quality of services by providing them convenience to perform their transactions anytime during the day. The consumers are able to apply for loan, insurance, and any other services without visiting the banks physically which shows that the quality of e-banking is fast and effective.

6.High liquidity: You can transfer money and utilize anytime which is the greatest advantage to access internet banking. You don't need to visit banks for transferring money which can be done from anywhere without visiting to the banks physically.

7.Low cost banking service: Internet banking reduce enable to reduce operational costs with better quality of services. It provides convenience with high customer service at lower rate. The Bank charges minimal amount for operations which reflect that the e-banking services are reasonable and efficient.

8.High interest rates: Internet banking provides low interest rate on mortgage loans than banks. The operational cost is also low which helps to saving amount that is beneficial for the customers. There are various other facilities such as no minimum balance account which helps to maintain account with zero balance. It increases total disposable income of the consumers without even worry about maintaining minimum balance.

Disadvantages

E-banking has various advantages which improves the banking system but there are disadvantages of using internet banking. These are as follows:

1.Security issues: Internet banking is completely insecure as there are many problems related to the website and data can be hacked by the hackers. It can leads to financial loss to the users. The financial information can also be stolen that can also create financial loss.

2.Lack of direct contact between customer and banking officer: Online banking requires effective customer service for handling issues faced by the user. But lack of customer support creates disappointment among the customers. There are some online payments which may not be reflected in the system due to technical issues. It also creates insecurity among the customers. Thus the lack of support from customer service executive is a barrier in online banking.

3.Transaction problem: During online banking there are various issues faced by the user such as transferred payment is not reflected, payment failed, and other issues due to technical support.

4.Long procedure to access e-banking: In some countries, government banks are providing internet banking by filling the internet banking form then after approval you can access security password to log in. An individual need to download the App of specific banking then all credentials needs to be filled for login successfully.

5.Training and development: The banks need to conduct training and development program for employees for providing quality online services which enhance the customer experience. It requires huge investment to train them for providing effective services.

MOBILE BANKING:

Mobile banking is a service provided by a bank or other financial institution that allows its customers to conduct financial transactions remotely using a mobile device such as a mobile phone or tablet. Transactions through mobile banking may include obtaining account balances and lists of latest transactions, electronic bill payments, and funds transfers between a customer's or another's accounts. In this paper, the author examines the dynamics of development, the current state and the role of mobile banking in the global payment system. There are both advantages and disadvantages of mobile banking some of which have been highlighted below.

Advantages

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

Disadvantages

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

CORE BANKING:

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

Now a days, most banks use core banking applications to support their operations where 'CORE' stands for "Centralized Online Real-time Environment". This basically means that all the bank's branches access applications from centralized data centres. It means that the deposits made are reflected immediately on the servers of bank and the customer can withdraw the deposited money from any of the branches of bank throughout the world.

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These applications now also have the capability to address the needs of corporate customers providing a comprehensive banking solution. Normal core banking functions will include deposit accounts, loans, mortgages and payments. Banks make these services available across multiple channels like ATMs, internet banking and branches.

Features of Core Banking

1. Customer relationship management features including a 360 degree customer view.
2. The ability to originate new products and customers.
3. Banking analytics including risk analysis, profitability analysis and provisions for capital reserve allocation and collateral management.
4. Banking finance including general ledger and reporting.
5. Banking channels such as teller systems, side counter applications, mobile banking and online banking solutions.
6. Best practice workflow process.
7. Content management facilities.
8. Governance and compliance capabilities such as internal controls management and auditing.
9. Security control and audit capabilities.
10. Core banking solutions to help maximize growth, increase productivity and mitigate risk.

Advantages of Core Banking

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

Disadvantages of core banking:

1. Excessive reliance on era
2. Any failure in pc structures can cause whole community to head down

3. If records isn't included nicely and if right care isn't always taken , hackers can advantage get admission to the data.

BANK ASSURANCE –

Bancassurance simply means **selling of insurance products** by banks. Bancassurance is used to describe the partnership or relationship between a bank and an insurance company whereby the **insurance company uses the bank sales channel** in order to sell insurance products.

In this arrangement, insurance companies and banks undergo a tie-up, thereby allowing banks to sell the insurance products to its customers. By selling insurance policies bank earns a revenue stream apart from interest. It is called as **fee-based income**. This income is purely **risk-free for the bank** since the bank simply plays the role of an intermediary for sourcing business to the insurance company. Insurers see it as a tool to increase penetration and market share and bankers use it to augment their fee income and to smoothen the volatility of interest income. Bancassurance is a package of banking and insurance services under one roof. The introduction of Bancassurance has broadened the scope of retail banking.

Advantages of Bancassurance:
Advantanges for the banks

- Revenue diversification
- Satisfaction of more financial needs under the same roof.
- Customer retention-Increase in customer loyalty
- More profitable resources utilization
- Enriched customer environment
- Establish sales oriented culture
- Advantage for the insurance companies
- Revenue and channel diversification
- Quality customer access
- Increase in volume and profit
- Improved brand equity
- The insurance company can establish itself more quickly in a new market, using a local existing bank channel.

Advantage for the consumers

- Enhanced conviniency
- One stop shop for all financial needs
- Innovative and better products range
- More credible solutions

Disadvantages of bancassurance

- Data management of an individual customer's identity and contact details may result in the insurance company utilizing the details to market their products, thus compromising on data security.
- There is a possibility of the conflict of interest between the other products of bank and insurance policies (like money back policy). This could confuse the customer regarding where he has to invest.
- Better approach and services provided by banks to the customer is a hope rather than a fact. This is because many banks in India are known for their bad customer service and this fact turns worse when they are responsible to sell insurance products. Work nature to market insurance products requires submissive attitude, which is a point that has to be worked on by many banks in India.

OMBUDSMAN:

Banking ombudsman, a quasi-judicial authority is formed with an intent to resolve the complaints of the customers of the Bank.

Section 35A of the Banking Regulation Act, 1949 deals with Banking Ombudsman Scheme. It came into effect in 1995 and presently the Banking Ombudsman Scheme 2006 is in operation.

The scheme covers not just scheduled Commercial Banks but also Regional Rural Banks and Scheduled Primary Co-operative Banks. Recently, RBI also extended the concept of Banking Ombudsman to NBFC's as well.

What complaints can one lodge with the Banking Ombudsman?

An unhappy customer can lodge a complaint with the Banking Ombudsman with respect to the following banking services

- Non-payment or unreasonable delay in the payment /collection/ issue of cheques, drafts, bills etc.;
- Non-acceptance, without sufficient cause, of small denomination notes and coins tendered for any purpose, and for charging of commission in respect thereof;
- Non-payment or delay in payment of inward remittances;
- Non-adherence to prescribed working hours;
- Delay/failure to provide any banking facility (other than loans and advances) which has been promised in writing by the Bank
- Delay/ non-credit of proceeds to the respective parties' accounts, non-payment of deposit or non-observance of the RBI directives, with respect to the rate of interest on bank deposits
- Complaints from NRIs having accounts in India in relation to their remittances from abroad, deposits and other bank related matters;
- Refusal to open deposit accounts without any valid reason for this refusal;
- Levying charges without adequate prior notice to the customer;
- Non-adherence to RBI instructions on ATM / Debit Card /Prepaid Card / Credit Card operations in India by the bank or its subsidiaries

- Non-adherence to RBI instruction with regard to Mobile Banking / Electronic Banking service in India.
- Non-disbursement or delay in disbursement of pension (to the extent the grievance can be attributed to the action on the part of the bank concerned, but not with regard to its employees);
- Refusal to accept or delay in accepting payment towards taxes, as asked by Reserve Bank/Government;
- Failure /Delay with regard to the issue, service or redemption of Government securities;
- Forced closure of deposit accounts without any notice or without giving sufficient reason;
- Refusal to close or delay in closing accounts;
- Not following the fair practices code as adopted by the bank;
- Non-observance of Reserve Bank guidelines on engagement of recovery agents by banks;
- Non-adherence to RBI guidelines on allied-banking activities like sale of insurance or mutual fund or other investment products by banks
- Any other matter relating to the violation of RBI directives

Regarding loans and advances, complaints with respect to the following areas can be lodged:

- Non-observance of Reserve Bank Directives on interest rates;
- Delays in sanction, disbursement or non-observance of prescribed time schedule for disposal of loan applications;
- Not accepting application for loans without furnishing valid reasons to the applicant; and
- Non-observance of any other direction or instruction given by the Reserve Bank as may be specified by the RBI for this purpose from time to time.

Can my complaint be rejected by the Ombudsman?

Yes, a complaint can be rejected by the ombudsman if:

1. The Bank has not been approached for redressal of the grievance.
2. No complaint has been made within one year from the date of receipt of the reply of the bank or if no reply is received, and, the complaint to Banking Ombudsman is made after the time period of one year and one month from the date of complaint to the bank.
3. The subject matter of the complaint is pending for disposal / has already been dealt with at another forum
4. Frivolous or vexatious complaints.
5. If the complaint has the same subject matter that was settled in the past through the office of the Banking Ombudsman in any proceedings.

What is the procedure for filing complaint with the Banking Ombudsman?

As the first point, there is no cost involved while filing a complaint with the Banking ombudsman

1. A complaint can be registered with the Banking Ombudsman online

- Visit the following address: https://secweb.rbi.org.in/BO/precompltindex.htm

1. Following questions will be asked:
2. Have you made a written complaint to the bank? YES/ NO
3. If yes, whether 30 days are over from the date of lodging the complaint? YES / NO
4. If the above two questions are answered YES, then the following details are required:
    - Bank Name
    - Account No
    - Complainant Name
    - Mobile No

Once the details are filled, the website is redirected to the complaint form.

The applicable Banking Ombudsman office under whose jurisdiction the case is applicable needs to be selected

There is also an option to upload documents as evidence against the concerned bank.

2. The complainant can be filed by an authorized representative (other than an advocate).

RESERVE BANK OF INDIA:

Introduction:

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

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

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

Origin of the Reserve Bank of India

Strategic efforts were made to establish a central bank in India. ***Warren Hastings*** made the earliest attempt, when he was acting as the Governor of Bengal in 1773. He recommended for the formation of "***General Bank in Bengal and Bihar***". The Chamberlin Commission report in 1913 also raised the issue of the founding of a central bank for the country. Based on this report, ***Professor J.M. Keynes*** formulated the first comprehensive plan for an Indian central bank. However, Keynes' plan did not come into effect, on account of the outbreak of the First World War.

The Imperial Bank of India was set up in 1921 by amalgamating three Presidency Banks, which performed a few central banking functions. However, primarily it remained as

a commercial bank. The Imperial Bank served as a banker to the Government and in some capacity as the bankers' bank till the establishment of the Reserve Bank of India.

The publication of a White Paper on Indian Constitutional reforms raised the issue of starting a central bank in India again. Accordingly a fresh bill to this effect was introduced in the Indian Legislative Assembly on September 8, 1933. The bill was passed and received the assent of the Governor-General on March 6, 1934 and became the RBI Act, 1934. In accordance with the Act, the Reserve Bank of India was constituted and it commenced operations from April 1, 1935.

Objectives of the Reserve Bank of India

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as:

to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.

Besides it has other objectives, which can be listed out as below.

1. To remain free from political influence and be in successful operation for maintaining financial stability and credit.
2. To discharge purely central banking functions in the Indian money market, such as acting as the note-issuing authority, bankers' bank and banker to Government, and to promote the growth of the economy.
3. To assist the planned process of development of the Indian economy.

Organization of the Reserve Bank of India

The Reserve Bank of India was originally established as a shareholders' bank with a share capital of Rs.5 crores, divided into 5 lakhs fully paid-up shares of Rs.100 each. When the bank was nationalized in 1949, the entire share capital was acquired by the Central Government by compensating the shareholders.

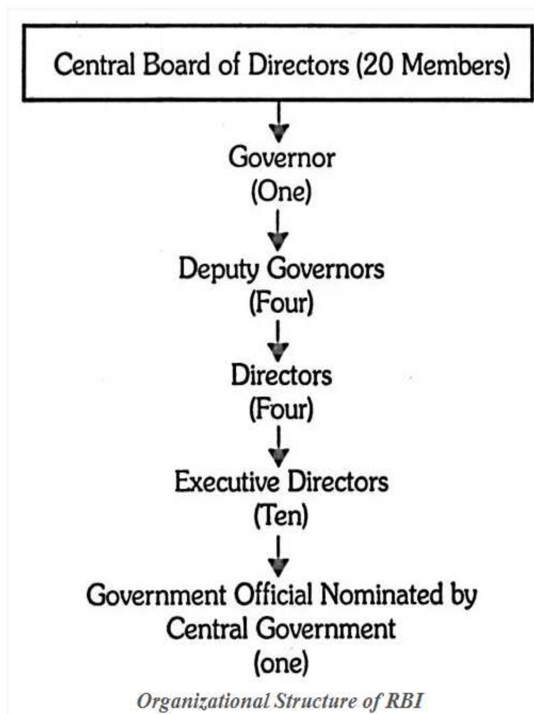
Management of the Reserve Bank of India

The general superintendence and direction of the affairs of the Reserve Bank of India are vested in the Central Board of Directors, which consists of 20 members as detailed below:

1. A Governor and Four Deputy Governors appointed by the Central Government,
2. Four Directors nominated by the Central Government,
3. Ten other Directors, and
4. One Government official nominated by the Central Government.

The organizational structure of the RBI can be pictorially represented in the image below .
Governor of the Reserve Bank of India acts as the Chairman of the Central Board of Directors of the Bank and its chief executive authority. The Governor can exercise all the powers, which can be exercised by the Bank under the Act. However, his powers subject to the regulations made by the Central Board of Directors from time to time. In the performance of his duties,

the Deputy Governors and the Executive Directors assist him. Each Deputy Governor is responsible for certain specific operations of the Bank. The Governor and the Deputy Governors are appointed by the Central Government for a period not exceeding 5 years. They are eligible for reappointment. They are full-time officers of the Bank.
The 10 directors who are nominated by the Central Government hold office for a period of 4 years. The Act provides for their retirement by rotation and every year two directors shall retire. However, the retiring director is eligible for re-election.



Organizational Structure of RBI

There are Local Boards for four regions of the country such as Western, Eastern, Northern and Southern regions. The head quarters of the Local Hoards are situated at Mumbai, Kolkatta, Chennai and New Delhi. Each Local Board consists of five members. All the members are appointed by the Central Government. The members should represent, as far as possible, territorial and economic interests and the interests of cooperative and indigenous banks.

The members of the Local Board are appointed for a period of four years. They are eligible for reappointment. They elect from among themselves one person as the Chairman of the Board.

The Central Board of Directors should meet at least six times in a year and not less than once in a quarter. Deputy Governors and the official director may attend the meetings of Board but they have no authority to vote. A Deputy Governor may exercise the right to vote, if he is authorized to do so when the Governor is absent. In the absence of the Governor, the Deputy Governor discharges the duties of the Governor and has the right of control over the affairs of the Bank. The Central Office of the Reserve Bank is located in Mumbai.

Functions of Reserve bank of India:

- **Monetary Authority**: Formulates, implements and monitors the monetary policy for A) maintaining price stability, keeping inflation in check ; B) ensuring adequate flow of credit to productive sectors.
- **Regulator and supervisor of the financial system:** lays out parameters of banking operations within which the country"s banking and financial system functions for- A) maintaining public confidence in the system, B) protecting depositors' interest ; C) providing cost-effective banking services to the general public.
- **Regulator and supervisor of the payment systems**: A) Authorises setting up of payment systems; B) Lays down standards for working of the payment system; C)lays down policies for encouraging the movement from paper-based payment systems to electronic modes of payments. D) Setting up of the regulatory framework of newer payment methods. E) Enhancement of customer convenience in payment systems. F) Improving security and efficiency in modes of payment.
- **Manager of Foreign Exchange**: RBI manages forex under the FEMA- Foreign Exchange Management Act, 1999. in order to A) facilitate external trade and payment B) promote the development of foreign exchange market in India.
- **Issuer of currency:** RBI issues and exchanges currency as well as destroys currency & coins not fit for circulation to ensure that the public has an adequate quantity of supplies of currency notes and in good quality.
- **Developmental role :** RBI performs a wide range of promotional functions to support national objectives. Under this it setup institutions like NABARD, IDBI, SIDBI, NHB, etc.
- **Banker to the Government:** performs merchant banking function for the central and the state governments; also acts as their banker.
- **Banker to banks:** An important role and function of RBI is to maintain the banking accounts of all scheduled banks and acts as the banker of last resort.
- An agent of Government of India in the IMF.

MONETARY POLICY

Monetary policy is an economic policy that manages the size and growth rate of the money supply in an economy. It is a powerful tool to regulate macroeconomic variables such as inflation and unemployment.

These policies are implemented through different tools, including the adjustment of the interest rates, purchase or sale of government securities, and changing the amount of cash circulating in the economy. The central bank or a similar regulatory organization is responsible for formulating these policies.

There are many definitions of monetary policy. A few of them are as under:

"Monetary policy involves the influence on the level and composition of aggregate demand by the manipulation of interest rates and the availability of credit"–D.C. Aston

The definition focuses on the role of monetary policy in influencing the level of demand/ consumption through interest rates to achieve stability in prices and ensuring adequate flow of credit in the economy to achieve stable growth.

Monetary Policy is "the management of the expansion and contraction of the volume of money in circulation for the explicit purpose of attaining a specific objective such as full employment." –Kent R.P.

The focus of this definition is on the role of monetary policy in attainment of full employment through expansion and contraction of money supply.

Objectives of Monetary Policy

The primary objectives of monetary policies are the management of inflation or unemployment, and maintenance of currency exchange rates.

Inflation

Monetary policies can target inflation levels. A low level of inflation is considered to be healthy for the economy. If inflation is high, a contractionary policy can address this issue.

Unemployment

Monetary policies can influence the level of unemployment in the economy. For example, an expansionary monetary policy generally decreases unemployment because the higher money supply stimulates business activities that lead to the expansion of the job market.

Currency exchange rates

Using its fiscal authority, a central bank can regulate the exchange rates between domestic and foreign currencies. For example, the central bank may increase the money supply by issuing more currency. In such a case, the domestic currency becomes cheaper relative to its foreign counterparts.

Tools of Monetary Policy

Central banks use various tools to implement monetary policies. The widely utilized policy tools include:

Interest rate adjustment

A central bank can influence interest rates by changing the discount rate. The discount rate (base rate) is an interest rate charged by a central bank to banks for short-term loans. For example, if a central bank increases the discount rate, the cost of borrowing for the banks increases. Subsequently, the banks will increase the interest rate they charge their customers. Thus, the cost of borrowing in the economy will increase, and the money supply will decrease.

Change reserve requirements

Central banks usually set up the minimum amount of reserves that must be held by a commercial bank. By changing the required amount, the central bank can influence the money supply in the economy. If monetary authorities increase the required reserve amount, commercial banks find less money available to lend to their clients and thus, money supply decreases.

Commercial banks can't use the reserves to make loans or fund investments into new businesses. Since it constitutes a lost opportunity for the commercial banks, central banks pay them interest on the reserves. The interest is known as IOR or IORR (interest on reserves or interest on required reserves).

Open market operations

The central bank can either purchase or sell securities issued by the government to affect the money supply. For example, central banks can purchase government bonds. As a result, banks will obtain more money to increase the lending and money supply in the economy.

Expansionary vs. Contractionary Monetary Policy

Depending on its objectives, monetary policies can be expansionary or contractionary.

Expansionary Monetary Policy

This is a monetary policy that aims to increase the money supply in the economy by decreasing interest rates, purchasing government securities by central banks, and lowering the reserve requirements for banks. An expansionary policy lowers unemployment and stimulates business activities and consumer spending. The overall goal of the expansionary monetary policy is to fuel economic growth. However, it can also possibly lead to higher inflation.

Contractionary Monetary Policy

The goal of a contractionary monetary policy is to decrease the money supply in the economy. It can be achieved by raising interest rates, selling government bonds, and increasing the reserve requirements for banks. The contractionary policy is utilized when the government wants to control inflation levels.

BRIEF DESCRIPTION ON VARIOUS TYPES OF BANKS:

Banking is no new term to anyone be it homemakers, salaried people, businessmen, farmers, students or any other profession. Especially the Indian homes are well connected with banks and banking. The banking industry takes care of the finances of a country which includes credit and cash.

Banks are the backbone of the economy in a country and hence strict rules and regulations are imposed on the modus-operandi of banks. The major transactions that happen at banks are granting credits and accepting deposits from various entities.

RBI is the apex body that governs and monitors bank across India. It is responsible for regulating the monetary policy in the country.

BANK CLASSIFICATION IN INDIA

There are two broad categories under which banks are classified in India- **SCHEDULED AND NON-SCHEDULED BANKS.**

The scheduled banks include **COMMERCIAL BANKS AND COOPERATIVE BANKS**. The commercial banks include **REGIONAL RURAL BANKS, SMALL FINANCE BANK, FOREIGN BANKS, PRIVATE SECTOR BANKS, and PUBLIC SECTOR BANKS.**

PAYMENTS BANK is a new introduction to the category. Cooperative banks include URBAN AND RURAL BANKS.

Let us understand the nomenclature better;

SCHEDULED BANKS are the banks which are covered under the second schedule of the Reserve Bank of India Act, 1934. To qualify for being a scheduled bank, a minimum of 5 lakh paid-up capital is required on the bank's behalf. The RBI lends loan to these banks at bank rate as and when required.

COMMERCIAL BANKS are regulated and managed under the Banking Regulation Act, 1949. These are profit making banks based on their business model. Granting loans to the government, general public, and corporate and accepting deposits counts as the primary function.

There are four types of commercial banks:

PUBLIC SECTOR BANKS: These banks for more than 75% of the total banking business in the nation. They are called nationalized banks. The government holds the majority stakes at these banks. Post-merger, SBI is the largest public sector banks by volume. It also ranks amongst the top 50 banks in the world.

PRIVATE SECTOR BANKS: Private shareholders hold majority stakes in private sector banks. Reserve Bank of India lays down all the rules and regulations.

FOREIGN BANKS: A bank operating as a private entity in India but headquartered in a Foreign country is a foreign bank. They are governed by both the country they are located in as well the country they have headquarters in.

REGIONAL RURAL BANKS: These banks were established mainly to support the weaker and lesser fortunate section of the society like marginal farmers, laborers, small enterprises etc. they mainly operate at regional levels at different states and may have branches in urban areas as well. Their main features are:

1. Supporting rural and semi-urban region financially
2. Pension distribution and Wage disbursement of MGNREGA workers
3. Added banking facilities like locker, cards-debit, and credit

SMALL FINANCE BANKS: These banks cater to a niche segment in the society and help with financial inclusion of sections which are not taken care of by other leading banks. They look after micro industries, unorganized sector, small farmers etc. RBI and FEMA are the governing bodies of these banks.

COOPERATIVE BANKS: Run by the elected members of a managing committee and registered under the Cooperative Societies Act, 1912 are the cooperative banks. These are no-profit, no-loss banks and mainly serve entrepreneurs, industries, small businesses, and self-employment.

PAYMENTS BANK: This is a new and upcoming model of banking in India. It has been conceptualized and signed-off by RBI with restricted operations. Maximum of Rs. One Lakh is acceptable per customer by these banks. Like other banks, they also offer para-banking services like ATM cards, Debit- Credit cards, net-banking, mobile banking etc.

District Cooperative Central Bank

- Cooperative banks that are operating at the district level in various parts of India are known as **District Cooperative Central Banks (DCCB)**.
- It was established with the main of providing banking facilities to the rural livelihoods especially in the agriculture sector.
- Therefore, the branches were primarily established in the **rural** and **semi-urban** areas.

  The District Cooperative Central Bank (DCCB's) have three primary sources of funds:
  - DCCBs own share capital and reserves,
  - Deposits from the public, and
  - DCCBs loans from the state co-operative banks.

Banking Model:

- The Banking model typically consists of a district central bank to be established in each district of every Indian state.
- Collectively, these banks shall be represented by a **State Apex Central Cooperative Bank** that is established for each state. This shall act as an apex body for the DCCBs.
- The President of the DCCB is elected by its members and elected directors who represent a multitude of professional cooperative bodies. The bodies include; **milk unions**, **rural cooperatives**, **urban cooperatives**, **agricultural** and **non-agricultural cooperatives**.
- Trends from the past few years reveal that the **local politicians** get elected as the president. They hold sway over the cooperatives and getting elected help to nurture their political ambitions.
- Besides, the banks have a few private individuals who provide finance and management.

Functions of DCCB:

DCCBs meet the credit requirements of member societies.

- They shall also perform the banking business and provide facilities relating to it.
- DCCBs act as a balancing center for **Primary Agricultural Credit Societies (PACS)**. This is done by diverting the surplus funds of some societies to those who face shortages of funds.
- DCCBs can also perform non-credit activities.

- DCCBs maintain close and continuous contact with the PACS. This means they shall provide leadership and guidance to them.
- Further, DCCBs supervise and inspect PACS such that a safe place is provided for the investment of the PACS resources.

Board of DCCB:

The Board of District Cooperative Central Bank comprises of:

Elected Chairman of the PACS,

Representatives of the State Government, and

Representatives of the State Cooperative Bank.

The board periodically reviews the performance of the bank. This is essential for the board to provide a policy.

DCCBS performs its functions under the administrative control of the Registrar of the cooperative societies. Therefore, the government is an important stakeholder.

Inspection

- All DCCBs are registered under the Banking Regulations Act. DCCBs are expected to follow relevant provisions of the Act.
- The regulatory control of DCCBs is held by the **Reserve Bank of India (RBI)**.
- DCCBs are subjected to the periodical supervision. This ensures that they shall function following the provision of the law and with prudence.

Loans & Advances:

1. Short Term Production Loans: These loans are extended for raising the crops and are routed through PACS.

- The Government of India has introduced the subvention scheme. Under this scheme loans up to **INR 3 lakhs** are granted.
- These loans are extended to farmers at an interest rate of **7 percent**.
- The government of India provides an interest subsidy of **2 percent** to the banks also.

2. Kisan Credit Card: This is an innovation brought about in the banking system.

Short-term credit is made easy, convenient, and flexible for the farmers.

- It requires only one-time documentation.
- There is a single limit for whole years requirement.
- Users are granted any number of drawls and repayments.
- If the account is regular, there is a facility of automatic renewal.
- Besides, there are additional features like personal accident insurance. This is provided through collaboration with insurance companies.

3. Term Loans: The term loans are offered by the cooperatives to the farmers.

- The term loans are delivered either through the **PACS** or directly to the farmers by DCCBs.

- Higher lending agencies like **NABARD** offer DCCBs an option to refinance. These higher lending agencies can channelize these funds through the State Cooperative Banks.
- Term loans can be granted for numerous purposes like excavation of wells, purchase of **pump sets**, **horticulture**, **rural transport**, **animal husbandry**, and other **farming equipment**.

REGIONAL RURAL BANKS (RRBS):

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

These Regional Rural Banks (RRBs) have been receiving a high degree of importance and attention in the rural credit system.

Considering the gross absence of banking facilities in the rural areas of the country, the Reserve Bank of India in consultation with the Central Government, State Governments and some major nationalized sponsored banks had set up some Regional Rural Banks in the late 1970s with a view to elevate the economic status of the rural poor as well as to inculcate a habit of saving among the rural masses.

As per the recommendations of the Working Group on Rural Banks, the regional rural banks were established in 1975 for supplementing the commercial banks and co-operatives in supplying rural credit. The main objective of regional rural banks in India is to advance credit and other facilities, especially to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in order to develop agriculture, trade, commerce, industry and other usual productive activities in different rural areas of the country.

At the initial stage, five regional rural banks were established on October 2, 1975 at Gorakhpur and Moradabad in Uttar Pradesh, Jaipur in Rajasthan, Bhiwani in Haryana and Malda in West Bengal under the sponsorship of State Bank of India, the Syndicate Bank, United Commercial Bank, Punjab National Bank and United Bank of India respectively.

All these five RRBs have an authorised capital of Rs 1 crore and paid-up capital of Rs 25 lakh. The share capital of RRB is subscribed in the following manner—as the Central Government—50 per cent, the State Government concerned—15 per cent and the sponsoring commercial bank—35 per cent.

The regional rural banks are maintaining its special charter it their of operation is very much limited to a definite region, grant direct loan to rural people at concessional rates and receive subsidies and concessions from the Reserve Bank and the sponsoring bank.

The Objectives of Regional Rural Banks:

In view of the above preamble of the Act the objects and activities of RRBs can be briefed as under:

1) Bridging the credit gaps in rural areas.

2) To develop such measures which could restrict the outflow of rural deposits to urban areas.

3) To reduce regional imbalances and increase rural employment generation activities.
For achieving its objectives the RRBs provide financial assistance to different segments of rural population engaged in rural activities.

Area of Functioning of Regional Rural Banks:

The Regional Rural Banks are required to function within a limited area for which they are established. Usually the functional area of Each RRB is confined to a few districts of the state in which they are set up. The area of functioning of RRBs is decided by central government in consultation with NABARD and the Sponsor Banks by way of a notification issued in this regard.

It is therefore necessary for RRBs to establish their Head Office in central place of their notified area of functioning because they are also authorized to open their branches or appoint agency within their specified areas.

Sponsorship of Regional Rural Banks:

Each Regional Rural Bank is sponsored by a Public Sector Bank. A sponsor bank in relation to a Regional Rural Bank is a Bank by which such a RRB is sponsored. It is duty of a sponsor bank to aid and assist the RRB sponsored by it.

A sponsor bank helps RRB by:

a) Subscribing to the share capital.
b) Training personnel of Regional Rural Bank.
c) Providing managerial and financial assistance to RRB.

A sponsor bank provides such managerial (staff) and financial assistance during the first 5 years of its functioning. The central government may, either on its own motion or on the recommendations of NABARD extend such period of 5 years for such further period(not exceeding 5 years at a time) as may be deemed fit.
The authorized capital of Regional Rural Banks is Rs. 5 crores which is contributed by Central Government, State Government and the Sponsor Bank in ration of 50:15:35.

Functions of Regional Rural Banks:

All the Regional Rural Banks are authorized to carry on to transact the business of a banking as defined in the Banking Regulation Act 1949. RRBs grant loans to small and marginal farmers, Agricultural labourers, Co-operative societies and to individuals including artisans, small entrepreneurs and persons of small means.

In brief RRBs do all such functions as are done by domestic banks like accepting deposits from public, providing credit, remittance services etc. They can also invest in Government securities and deposit schemes of Banks and Financial Institutions.

Regional Rural Banks may also seek refinance facilities provided by NABARD for the loans sanctioned and disbursed by them.

All the RRBs are covered under DICGC scheme and they are also required to observe the RBI stipulations for Cash Reserve Ratio and Statutory Liquidity Ratio.

The Reserve bank of India has brought all the RRBs under the ambit of Priority Sector lending w.e.f April 1997. Like all other commercial banks RRB are bound to provide 40% of their Net Bank Credit to Priority Sector. Out of which 25% of PS advances or 10 % of Net Bank Credit is to be given to weaker sectors.

NABARD:

NABARD is a development bank established under statutory provisions. Let us briefly go through important characteristics of this development bank to get a clear understanding of its role and functions.

Role and Functions of NABARD

The National Bank for Agriculture And Rural Development is popularly referred to as NABARD.

NABARD is designated as an apex development bank in the country.This national bank was established in 1982 by a Special Act of the Parliament, with a manadate to uplift rural India by facilitating credit flow in agriculture, cottage and village industries, handicrafts and small-scale industries. It is also required to support non-farm sector while promoting other allied economic activities in rural areas. NABARD functions to promote sustainable rural development for attaining prosperity of rural areas in India.
It is basically concerned with "matters concerning policy, as well as planning and operations in the field of credit for agriculture and other economic activities in rural areas in India". It is worth noting with refernce to NABARD that RBI has sold its own stake to the Government of India. Therefore, Government of India holds 99% stake in NABARD.

Role of NABARD:

- It is an apex institution which has power to deal with all matters concerning policy, planning as well as operations in giving credit for agriculture and other economic activities in the rural areas.
- it is a refinancing agency for those institutions that provide investment and production credit for promoting the several developmental programs for rural development.
- It is improving the absorptive capacity of the credit delivery system in India, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, and training of personnel.
- It co-ordinates the rural credit financing activities of all sorts of institutions engaged in developmental work at the field level while maintaining liaison with Government of India, and State Governments, and also RBI and other national level institutions that are concerned with policy formulation.
- It prepares rural credit plans, annually, for all districts in the country.
- It also promotes research in rural banking, and the field of agriculture and rural development.

Functions of NABARD:

- NABARD gives high priority to projects formed under IRDP.
- It provides refinance for IRDP accounts in order to give highest share for the support for poverty alleviation programs run by IRDP.
- Other than the activities included under IRDP, it also makes the service area plan, to provide backward and forward linkages and also infrastructural support.
- NABARD also prepares guidelines for promotion of group activities under its programs and provides 100% refinance support for them.
- It is making efforts to establish linkages between Self-help Group(SHG) that are organized by voluntary agencies for poor and needy in rural areas and other official credit agencies.
- It refinances to the complete extent for those projects that are taken under the 'National Watershed Development Programme' and the 'National Mission of Wasteland Development'.
- It also has a system of District Oriented Monitoring Studies, under which, study is conducted for a cross section of schemes that are sanctioned in a district to various banks, to ascertain their performance and to identify the constraints in their implementation, It also initiates appropriate action to remedy them.
- It also supports Vikas volunteer Vahini programs which offer credit and development activities to poor farmers.
- It also inspects and supervises the cooperative banks and RRBs to periodically ensure the development of the rural financing and farmers' welfare.
- NABARAD also recommends about licensing for RRBs and Cooperative banks to RBI.
- NABARD also provides assistance and support for the training and development of the staff of various other credit institutions, that are engaged in credit distributions.
- It also runs programs for agriculture and rural development.
- It is engaged in regulations of the cooperative banks and the RRB's, and manages their talent acquisition through IBPS CWE conducted across the country.

SIDBI:

The SIDBI (Small Industries Development Bank of India) is a wholly owned subsidiary of IDBI (Industrial Development Bank of India), established under the special Act of the Parliament 1988 which became operative from April 2, 1990.

SIDBI was made responsible for administering Small Industries Development Fund and National Equity Fund that were administered by IDBI before. SIDBI is the Primary Financial Institution for promoting, developing and financing MSME (Micro, Small and Medium Enterprise) sector.

Besides focussing on the development of the Micro, Small and Medium Enterprise sector, SIDBI also promotes cleaner production and energy efficiency. SIDBI helps MSMEs in acquiring the funds they require to grow, market, develop and commercialize their technologies and innovative products. The bank provides several schemes and also offers financial services and products for meeting the individual's requirement of various businesses.

Finance Facilities Offered by SIDBI

Small Industries Development Bank of India, offers the following facilities to its customers:

1. Direct Finance

SIDBI offers Working Capital Assistance, Term Loan Assistance, Foreign Currency Loan, Support against Receivables, equity support, Energy Saving scheme for the MSME sector, etc.

2. Indirect Finance

SIDBI offers indirect assistance by providing Refinance to PLIs (Primary Lending Institutions), comprising of banks, State Level Financial Institutions, etc. with an extensive branch network across the country. The key objective of the refinancing scheme is to raise the resource position of Primary Lending Institutions that would ultimately enable the flow of credit to the MSME sector.

3. Micro Finance

Small Industries Development Bank of India offers microfinance to small businessmen and entrepreneurs for establishing their business.

Functions of SIDBI (Small Industries Development Bank of India)

1. Small Industries Development Bank of India refinances loans that are extended by the PLIs to the small-scale industrial units and also offers resources assistance to them
2. It discounts and rediscounts bills
3. It also helps in expanding marketing channels for the products of SSI (Small Scale Industries) sector both in the domestic as well as international markets
4. It offers services like factoring, leasing etc. to the industrial concerns in the small-scale sector
5. It promotes employment oriented industries particularly in semi-urban areas for creating employment opportunities and thus checking relocation of people to the urban areas
6. It also initiates steps for modernisation and technological up-gradation of current units
7. It also enables the timely flow of credit for working capital as well as term loans to Small Scale Industries in cooperation with commercial banks
8. It also co-promotes state level venture funds

Benefits of SIDBI

1. Custom-made

SIDBI policies loans as per the requirements of your businesses. If your requirement doesn't fall into the ordinary and usual category, Small Industries Development Bank of India would assist funding you in the right way.

2. Dedicated Size

Credit and loans are modified as per the size of the business. So, MSMEs could avail different types of loans custom-made for suiting their business requirement.

3. Attractive Interest Rates

It has a tie-up with several banks and financial institutions world over and could offer concessional interest rates. The SIDBI has tie-ups with World Bank and the Japan International Cooperation Agency.

4. Assistance

It not just give provides a loan, it also offers assistance and much-required advice. It's relationship managers assist entrepreneurs in making the right decisions and offering assistance till loan process ends.

5. Security Free

Businesspersons could get up to INR 100 lakhs without providing security.

6. Capital Growth

Without tempering the ownership of a company, the entrepreneurs could acquire adequate capital for meeting their growth requirements.

7. Equity and Venture Funding

It has a subsidiary known as SIDBI Venture Capital Limited which is wholly owned that offers growth capital as equity through the venture capital funds which focusses on MSMEs.

8. Subsidies

SIDBI offers various schemes which have concessional interest rates and comfortable terms. SIDBI has an in-depth knowledge and a wider understanding of schemes and loans available and could help enterprises in making the best decision for their businesses.

9. Transparency

Its processes and the rate structure are transparent. There aren't any hidden charges.

DEVELOPMENT BANKS

Development banks are specialized financial institutions. They provide medium and long-term finance to the industrial and agricultural sector. They provide finance to both private and public sector. Development banks are multipurpose financial institutions. They do term lending, investment in securities and other activities. They even promote saving and investment habit in the public.

Definition of Development Banks

The definition of the term 'development banks' can be stated as follows,

1. In **General** sense,

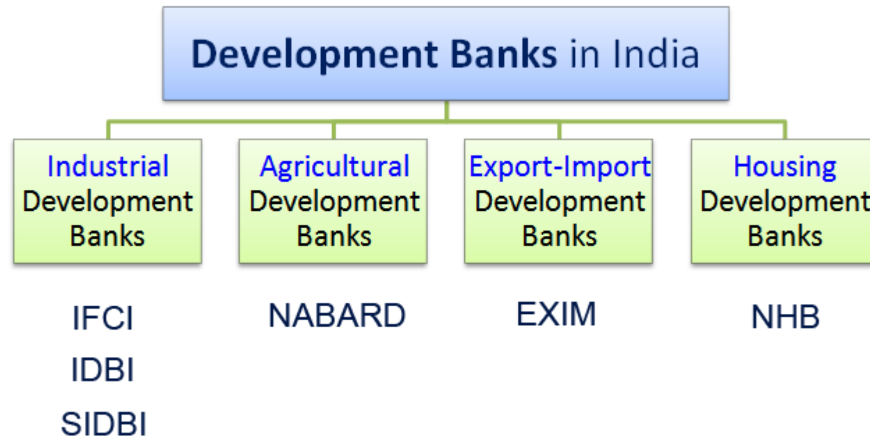
"Development banks are those financial institutions whose prime goal (motive) is to finance the primary (basic) needs of the society. Such funding results in the growth and development of social and economic sectors of the nation. However, needs of the society vary from region to region due to differences seen in its communal structure, economy and other aspects."

2. As per **Banking** subject (mainly in Indian context),

"Development banks are financial institutions established to lend (loan) finance (money) on subsidized interest rate. Such lending is sanctioned to promote and develop important sectors like agriculture, industry, import-export, housing and allied activities."

Development Banks in India

Development banking was started after the World War II. It provided finance to reconstruct the buildings and industries which were destroyed in the war.
In India, development banking was started immediately after independence.
The arrangement of development banks in India is depicted below.



Development banks in India are classified into following four groups:

1. **Industrial Development Banks** : It includes, for example, Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), and Small Industries Development Bank of India (SIDBI).
2. **Agricultural Development Banks** : It includes, for example, National Bank for Agriculture & Rural Development (NABARD).
3. **Export-Import Development Banks** : It includes, for example, Export-Import Bank of India (EXIM Bank).
4. **Housing Development Banks** : It includes, for example, National Housing Bank (NHB).

Industrial Finance Corporation of India (IFCI) is the first development bank in India. It started in 1948 to provide finance to medium and large-scale industries in India.

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UNIT-II: BANKER AND CUSTOMER RELATIONSHIP:

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

BANKER

The term banking may define as accepting of deposit of money from the public for the purpose of lending or investing investment of that money which are repayable on demand or otherwise and with a draw by cheque, draft or order.

CUSTOMER

A person who has a bank account in his name and for whom the banker undertakes to provide the facilities as a banker is considered to be a customer.

To constitute a customer the following requirements must be fulfilled;

1. The bank account may be savings, current or fixed deposit must be operated in his name by making a necessary deposit of money.
2. The dealing between the banker and customer must be of the nature of the banking business.

The general relationship between banker and customer:

Banker-Customer Relationship

The relationship between banker and customer is mainly that of a debtor and creditor. However, they also share other relationships.

Some of the important relationships they share are depicted below.

The banker-customer relationship is that of a:

1. Debtor and Creditor,
2. Pledger and Pledgee,
3. Licensor and Licensee,

4. Bailor and Bailee,
5. Hypothecator and Hypothecatee,
6. Trustee and Beneficiary,
7. Agent and Principal,
8. Advisor and Client, and
9. Other miscellaneous relationships.

Discussed below are important banker-customer relationships.

1. Relationship of Debtor and Creditor

When a customer opens an account with a bank and if the account has a credit balance, then the relationship is that of debtor (banker / bank) and creditor (customer).
In case of savings / fixed deposit / current account (with credit balance), the banker is the debtor, and the customer is the creditor. This is because the banker owes money to the customer. The customer has the right to demand back his money whenever he wants it from the banker, and the banker must repay the balance to the customer.

In case of loan / advance accounts, banker is the creditor, and the customer is the debtor because the customer owes money to the banker. The banker can demand the repayment of loan / advance on the due date, and the customer has to repay the debt.

A customer remains a creditor until there is credit balance in his account with the banker. A customer (creditor) does not get any charge over the assets of the banker (debtor). The customer's status is that of an unsecured creditor of the banker.

The debtor-creditor relationship of banker and customer differs from other commercial debts in the following ways:

1. The creditor (the customer) must demand payment. On his own, the debtor (banker) will not repay the debt. However, in case of fixed deposits, the bank must inform a customer about maturity.
2. The creditor must demand the payment at the right time and place. The depositor or creditor must demand the payment at the branch of the bank, where he has opened the account. However, today, some banks allow payment at all their branches and ATM centres. The depositor must demand the payment at the right time (during the working hours) and on the date of maturity in the case of fixed deposits. Today, banks also allow pre-mature withdrawals.
3. The creditor must make the demand for payment in a proper manner. The demand must be in form of cheques; withdrawal slips, or pay order. Now-a-days, banks allow e-banking, ATM, mobile-banking, etc.

2. Relationship of Pledger and Pledgee

The relationship between customer and banker can be that of Pledger and Pledgee. This happens when customer pledges (promises) certain assets or security with the bank in order to get a loan. In this case, the customer becomes the Pledger, and the bank becomes the Pledgee. Under this agreement, the assets or security will remain with the bank until a customer repays the loan.

3. Relationship of Licensor and Licensee

The relationship between banker and customer can be that of a Licensor and Licensee. This happens when the banker gives a sale deposit locker to the customer. So, the banker will become the Licensor, and the customer will become the Licensee.

4. Relationship of Bailor and Bailee

The relationship between banker and customer can be that of Bailor and Bailee.

1. **Bailment** is a contract for delivering goods by one party to another to be held in trust for a specific period and returned when the purpose is ended.
2. **Bailor** is the party that delivers property to another.
3. **Bailee** is the party to whom the property is delivered.

So, when a customer gives a sealed box to the bank for safe keeping, the customer became the bailor, and the bank became the bailee.

5. Relationship of Hypothecator and Hypothecatee

The relationship between customer and banker can be that of Hypothecator and Hypotheatee. This happens when the customer hypothecates (pledges) certain movable or non-movable property or assets with the banker in order to get a loan. In this case, the customer became the Hypothecator, and the Banker became the Hypothecatee.

6. Relationship of Trustee and Beneficiary

A trustee holds property for the beneficiary, and the profit earned from this property belongs to the beneficiary. If the customer deposits securities or valuables with the banker for safe custody, banker becomes a trustee of his customer. The customer is the beneficiary so the ownership remains with the customer.

7. Relationship of Agent and Principal

The banker acts as an agent of the customer (principal) by providing the following agency services:

- Buying and selling securities on his behalf,
- Collection of cheques, dividends, bills or promissory notes on his behalf, and
- Acting as a trustee, attorney, executor, correspondent or representative of a customer.

Banker as an agent performs many other functions such as payment of insurance premium, electricity and gas bills, handling tax problems, etc.

8. Relationship of Advisor and Client

When a customer invests in securities, the banker acts as an advisor. The advice can be given officially or unofficially. While giving advice the banker has to take maximum care and caution. Here, the banker is an Advisor, and the customer is a Client.

9. Other Relationships

Other miscellaneous banker-customer relationships are as follows:

- **Obligation to honour cheques** : As long as there is sufficient balance in the account of the customer, the banker must honour all his cheques. The cheques must be complete and in proper order. They must be presented within six months from the date of issue. However, the banker can refuse to honour the cheques only in certain cases.
- **Secrecy of customer's account** : When a customer opens an account in a bank, the banker must not give information about the customer's account to others.
- **Banker's right to claim incidental charges** : A banker has a right to charge a commission, interest or other charges for the various services given by him to the customer. For e.g. an overdraft facility.
- **Law of limitation on bank deposits** : Under the law of limitation, generally, a customer gives up the right to recover the amount due at a banker if he has not operated his account since last 10 years.

So, these were some important banker-customer relationships.

KNOW YOUR CUSTOMER (KYC)

- KYC means "Know Your Customer". It is a process by which banks obtain information about the identity and address of the customers.
- This process helps to ensure that banks' services are not misused. The KYC procedure is to be completed by the banks while opening accounts.
- Banks are also required to periodically update their customers' KYC details.
- KYC guidelines were introduced in year 2002 by RBI and all banks were asked to make all accounts KYC compliant by 31 December 2005.
- These guidelines are issued under Section 35 A of the Banking Regulation Act, 1949.

KYC Documents:

These are the documents used to establish customer's identity. Banks need two types of document one for identity another for address along with a recent photograph.

'Officially Valid Documents' (OVDs)

The Government of India has notified six documents as '**Officially Valid Documents' (OVDs)** for the purpose of producing proof of identity. These are Passport, Driving Licence, Voters' Identity Card, PAN Card, Aadhaar Card and NREGA Job Card. If the document submitted by you for proof of identity does not contain address details, then you will have to submit another officially valid document which contains address details.

E-KYC

e-KYC refers to electronic KYC. e-KYC is possible only for those who have Aadhaar numbers. While using e-KYC service, you have to authorise the Unique Identification Authority of India (UIDAI), by explicit consent, to release your identity/address through biometric authentication to the bank branches/business correspondent (BC).

The UIDAI then transfers your data comprising your name, age, gender, and photograph electronically to the bank.

Information thus provided through e-KYC process is permitted to be treated as an 'Officially Valid Document' under PML(Prevention of Money Laundering) Rules and is a valid process for KYC verification.

TYPES OF BANK ACCOUNTS:

Bank Accounts are classified into four different types. They are,

1) Current Account

2) Savings Account

3) Recurring Deposit Account

4) Fixed Deposit Account

What is Current Account?

Current account is mainly for business persons, firms, companies, public enterprises etc and are never used for the purpose of investment or savings.These deposits are the most liquid deposits and there are no limits for number of transactions or the amount of transactions in a day. While, there is no interest paid on amount held in the account, banks charges certain service charges, on such accounts. The current accounts do not have any fixed maturity as these are on continuous basis accounts.

What is Savings Account?

Savings Account is meant for saving purposes. Any individual either single or jointly can open a savings account. Most of the salaried persons, pensioners and students use Savings Account. The advantage of having Savings Account is Banks pay interest for the savings. The saving account holder is allowed to withdraw money from the account as and when required. The rate of interest ranges between 4% to 6% per annum in India. There is no restriction on the number and amount of deposits. But withdrawals are subjected to certain restrictions. Some banks recommend to maintain a minimum amount to keep it functioning.

What is Recurring Deposit Account?

Recurring deposit account or RD account is opened by those who want to save certain amount of money regularly for a certain period of time and earn a higher interest rate. In RD account a fixed amount is deposited every month for a specified period and the total amount is repaid with interest at the end of the particular fixed period.

The period of deposit is minimum six months and maximum ten years. The interest rates vary for different plans based on the amount one saves and the period of time and also on banks. No withdrawals are allowed from the RD account. However, the bank may allow to close the account before the maturity period.

These accounts can be opened in single or joint names. Banks are also providing the Nomination facility to the RD account holders.

What is Fixed Deposit Account?

In **Fixed Deposit Account** (also known as **FD Account**), a particular sum of money is deposited in a bank for specific period of time. It's one time deposit and one time take away

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(withdraw) account. The money deposited in this account can not be withdrawn before the expiry of period.
However, in case of need, the depositor can ask for closing the fixed deposit prematurely by paying a penalty. The penalty amount varies with banks.
A high interest rate is paid on fixed deposits. The rate of interest paid for fixed deposit vary according to amount, period and also from bank to bank.

Opening of an Account:
Steps to open a bank account
1. Decide what kind of account you need
Choose a savings account if you're looking for a place to save money over a short period of time, but still keep it readily accessible. Choose a chequing account to keep money that you plan to use for day-to-day spending or to pay bills over the short term. You'll earn less interest than with a savings account.
2. Look for an account with the services you'll use most
In particular, think about how you're likely to put money in and take it out:

- branch – make deposits and withdrawals using a teller or ATM
- debit card – buy something or get cash at a store
- cheques – pay bills
- direct debit – pay bills automatically from your account each month
- direct deposit – have your pay put into your account
- Internet or telephone banking – for a range of transactions

3. Shop around to compare rates and fees
Understand the service fees you can be charged before you open an account. Look for accounts that charge the lowest fees for the services you need. And compare interest rates. They will vary across financial institutions.
4. Choose a financial institution and location
Choose one that has branches or bank machines located close to where you live or work.
5. Open your account
You'll have to give personal information such as your address, date of birth, social insurance number, job title and phone numbers when you complete the account application. You'll also need to show 2 pieces of acceptable identification. One of them must be from the government. Then make your first deposit.

SPECIAL TYPES OF CUSTOMERS:

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

Minor, Married Women, Partnership Firms, Companies, Clubs and other Non-Trading Institutions

1. Minors

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

2. Lunatics

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

3. Illiterate persons

An illiterate person means a person who can't sign his name. While opening of an account of such a person is unavoidable, the banker should obtain (1) Left thumb impression on the account opening form and specimen signature card in the presence of an authorized bank official (2) Details of identification marks should be noted on the account opening form and specimen signature card (3) At least two copies of photograph duly attested by any account holder/authorized bank official.

4. Married women

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

5. Executors and administrators:

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

7. Trustees

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

8. Joint accounts

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

9. Partnership firm

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

10. Joint stock companies

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

11. Societies and other non- trading institutions

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

12. Customer's attorneys

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

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UNIT-III: NEGOTIABLE INSTRUMENTS:

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

Introduction:

Negotiable Instruments are written contracts whose benefit could be passed on from its original holder to a new holder. In other words, negotiable instruments are documents which promise payment to the assignee (the person whom it is assigned to/given to) or a specified person. These instruments are transferable signed documents which promises to pay the bearer/holder the sum of money when demanded or at any time in the future.

As mentioned above, these instruments are transferable. The final holder takes the funds and can use them as per his requirements. That means, once an instrument is transferred, holder of such instrument obtains a full legal title to such instrument.

Types of Negotiable Instruments

Promissory notes

A promissory note refers to a written promise to its holder by an entity or an individual to pay a certain sum of money by a pre-decided date. In other words, Promissory notes show the amount which someone owes to you or you owe to someone together with the interest rate and also the date of payment.

For example, A purchases from B INR 10,000 worth of goods. In case A is not able to pay for the purchases in cash, or doesn't want to do so, he could give B a promissory note. It is A's promise to pay B either on a specified date or on demand. In another possibility, A might have a promissory note which is issued by C. He could endorse this note and give it to B and clear of his dues this way.

However, the seller isn't bound to accept the promissory note. The reputation of a buyer is of great importance to a seller in deciding whether to accept the promissory note or not

Bill of exchange

Bills of exchange refer to a legally binding, written document which instructs a party to pay a predetermined sum of money to the second (another) party. Some of the bills might state that money is due on a specified date in the future, or they might state that the payment is due on demand.

A bill of exchange is used in transactions pertaining to goods as well as services. It is signed by a party who owes money (called the payer) and given to a party entitled to receive money (called the payee or seller), and thus, this could be used for fulfilling the contract for payment. However, a seller could also endorse a bill of exchange and give it to someone else, thus passing such payment to some other party.

It is to be noted that when the bill of exchange is issued by the financial institutions, it's usually referred to as a bank draft. And if it is issued by an individual, it is usually referred to as a trade draft.

A bill of exchange primarily acts as a promissory note in the international trade; the exporter or seller, in the transaction addresses a bill of exchange to an importer or buyer. A third party, usually the banks, is a party to several bills of exchange acting as a guarantee for these payments. It helps in reducing any risk which is part and parcel of any transaction.

Cheques

A cheque refers to an instrument in writing which contains an unconditional order, addressed to a banker and is signed by a person who has deposited his money with the banker. This order, requires the banker to pay a certain sum of money on demand only to to the bearer of cheque (person holding the cheque) or to any other person who is specifically to be paid as per instructions given.

Cheques could be a good way of paying different kinds of bills. Although the usage of cheques is declining over the years due to online banking, individuals still use cheques for paying for loans, college fees, car EMIs, etc. Cheques are also a good way of keeping track of all the transactions on paper. On the other side, cheques are comparatively a slow method of payment and might take some time to be processed.

COLLECTING BANKER:

A Collecting Banker is one who undertakes to collect various types of instruments representing money in favour of his customer or his own behalf from the drawers of these instruments; some are negotiable instruments as provided for in the negotiable instruments Act. 1881 and some are quasi negotiable instruments.

DUTIES & RESPONSIBILITIES OF COLLECTING BANKERS:

Acting as agent: While collecting an instrument, whether for credit to customer's account or for himself, the Bankers works as agent of his customer. As an agent he has generally to take such steps & precautions to protect the interest or his customer as a man of ordinary prudence would take to safe-guard his own interest.

Scrutinizing the instruments: Name of the holder, Branch name, date, amount in world and figure, any cutting without signature, material alteration of any to be checked carefully.

Checking the endorsement: Bankers has to check the instrument whether it has been endorsed properly.

Presenting the instrument in due time: It is the responsibility of the collecting bank to present the instrument in due time to the paying bank.

Collecting the proceeds in the payee's account: It is the duty of collecting banks to collect and credit the proceed of the instruments to the proper/correct account.

Notice of dishonor and returning the instruments: If any instrument is dishonored by the paying bank it should be informed to the customer on the business day following the receipt of the unpaid instruments.

PAYING BANKERS DUTIES & RESPONSIBILITIES.

A banker on whom the cheque is drawn should pay the cheque, when it is presented for payment. It is his obligation by section 31 of the NI Act. A banker is bound to honour his customers cheque to the extent of the fund available & the existence of no legal bar for payment. The paying banker should use reasonable care and diligence in paying a cheque so as to abstain from any action likely to damage his customers credit.

At the time of making payment of he should observe the following very carefully:

- Verification of signature of the drawer.
- Verification of the genuineness of he instrument.
- Payment not stopped by the A/c holder.
- Holders title on the cheque is valid.
- A/c is not dormant one.
- A/c holder is not bankrupt, deceased and insanse.
- A/c is not under subject of liquidation process.
- No. 'Guernsey Order' is issued by count.
- Properly endorsed.
- Cheque is not drawn beyond limit fixed by the drawer is respect of amount.
- Instrument being presented is crossed.
- Instrument is not state or post dated.
- No material alteration is made.
- Sufficient balance in the A/c

Circumstances when a banker refuse payment of Cheque

1. When the customer has countermanded payment.
2. When the banker has received a garnishee order.
3. When the customer has died.
4. When the customer has become insolvent or insane.
5. Where the banker has received a notice of assignment.
6. When the customer has lost the instrument.
7. When the banker has come to know of any defect in the title.
8. Where the instrument has been materially altered.
9. When the account is closed.

They are briefly discussed as follows

When the customer has countermanded payment:

If a customer countermands payment, i.e., issues instructions to his/her banker not to pay or honor, i.e.,'stop payment' of a particular cheque issued by him/her, the banker is bound to comply with such instruction. It is important to note that the customer must duly sign the countermand notice, which should contain correct particulars of the cheques and give to the banker in sufficient time, i.e., before the banker makes the payment of the cheque that is desired for 'stop payment'. However, it is not necessary that such a notice be given in writing always. An oral countermand is equally effective.

When the banker has received a Garnishee order:

Garnishee order implies a prohibiting order by a court of law attaching the funds in the customer's account. On receipt of such order, the banker must refuse the payment of the customer's cheque. If the banker by mistake makes payment of any cheque after receipt of such order, it will have to bear the loss itself. In this case it cannot recover from the payee who gets payment of an otherwise valid cheque.

When the customer has died:

If the banker receives notice of a customer's death, it must dishonor the cheque presented to it after the notice of death. However, a banker is justified in making payment if such payment is made before receiving the notice of death and the payment so made is valid.

When the customer has become insolvent or insane:

A banker must also refuse payment of cheques when its customer has been **adjudged insolvent or has become insane** since in such cases its original authority to pay on behalf of the customer ceases to exist. A fresh authority is required on those accounts. If a banker makes any payment even after receiving a due notice as regards insolvency or insanity of the account holder, such payment is not good against the drawer and in such a case the banker cannot get a refund from the payee, who gets payment of an otherwise valid cheque.

Where the banker has received a Notice of Assignment:

When the banker receives notice of assignment from the customer about his credit balance, it must refuse payment of the cheque(s) drawn by that customer.

When the customer has lost the instrument:

When the customer has lost the cheque and has informed the banker about the loss of the instrument, the bank must, in turn, dishonor the cheque.

When the banker has come to know of any defect in the Title:

When the banker comes across any defect in the title of the person presenting the cheque, it must refuse to honor the cheque. Even the holder of a bearer cheque is subject to this rule and the banker should insist on identification of the presenter in the event of any suspicion or doubt about the integrity of the possessor of the instrument.

Where the instrument has been materially altered:

When there is a material alteration on the instrument or where the signature of the drawer does not match with the specimen signature kept by the banker, the latter must dishonor such cheques. However, in case of payment by mistake, the banker is entitled to a refund from the wrong payee if traceable, failing which the banker will have to bear the loss itself.

When the account is closed:

When the customer gives notice to the banker for closing his account, the banker must not pay the customer's cheques after that date, i.e., the date of closing of the account.

Consequences of Wrongful Dishonors

(i) Wrongful dishonour of the customer's cheque makes the Bank liable to compensate the customer on contractual obligations as well as for injury to his creditworthiness. A return of a cheque would cause injury to the drawer's reputation.

(ii) Quantum of Damages is not limited to the actual pecuniary loss sustained by reason of such dishonour. When the customer is a trader he is entitled to claim substantial damages even if he had suffered no actual pecuniary loss sustained by such dishonour, if he can show that his creditworthiness had suffered by the dishonour of the cheque.

(iii) A non-trader is not entitled to recover substantial damages unless the damage he has suffered is alleged and proved as special damages, otherwise he would be entitled to nominal damages.

(iv) The Plaintiff's evidence on the transaction was vague, ill-defined and indeterminate and further he had not proved any actual or special damages, unless special damages are claimed and proved nominal damages will be awarded.

Precautions to be taken while Advancing Loans Against Securities:

Goods:

The bank should keep in mind the following points while advancing money on the security of goods.

Selection of the borrower

The banker should satisfy himself regarding the character, capacity, and capital of the borrower. Since in ease of goods, chances of fraud are more, this is all the more important.

Selection of the commodities

Commodities should be such which have fairly stable prices.

The head office should prepare a list of such commodities and in case a branch wants to lend money on the security of a commodity which is outside this list, the branch should take permission of the head office.

In the case of lending, some principles should be followed by banker against goods. Some advisability of Sending by a banker against goods is stated below:

1. ***Quality of goods:*** Generally, the bank should accept goods which could be marketed easily, quickly and standard quality in nature. Because there exists a greater risk if the goods are not a good quality which is taken as security.
2. ***Marketability:*** Goods are tangible securities and are better than guarantee and bill of exchange. If a borrower makes a default, the banker can realize his duties by disposing of the goods in the market.
3. ***Price:*** Banker should take those goods which have a ready market. They can be sold off easily than another kind of securities. The existence of a ready market makes the goods reliable and safe security.
4. ***Short period:*** Normally, advances against goods are for short periods because of seasonal character. Therefore, there is no necessity' to lock up funds for long period.
5. ***Stability:*** Generally, banks accept goods which are necessaries of life such as rice, Wheat, sugar, cotton etc. The price of such goods does not fluctuate widely.
6. ***Evaluate:*** It is easy to evaluate the prices of goods such as wheat, rice, grains, pulses etc. Market trends and reports are available in respect of almost all commodities in newspapers. So banker should take these types of goods as security.
7. ***Margin:*** In the case of goods, demand and nature determine the margin. Depending upon the quality and risk the margin is prescribed.

Charging the security

Goods can be deposited by way of security either in the form of a pledge or hypothecation.

In the case of hypothecation, the borrower must be dependable since the banker has little control over the movement of goods.

The banker must also obtain a declaration from the borrower stating that (i) the borrower is the owner of the goods hypothecated, and (ii) he shall not charge the same goods to any other person without the prior consent of the bank.

Legal requirements

Under its selective credit control scheme, the central bank issues from time to time directives regarding granting of loans against selective commodities. The banker should abide by these directives.

Storage of goods

The following points should be taken into account while storing the goods offered by way of security:

1. The godown must be safe from water, fire, etc. and situated in a good locality.
2. In case of hypothecation of goods, the borrower should give an undertaking that he will allow inspection of godown and stock books as and when desired by the bank's officials.
3. In case of the pledge, the godown should have a bank lock with the bank's name engraved on it. Some nameplates declaring that the goods are pledged should be prominently displayed in the godown.

4. In the case of payment of the loan in installments, it should be seen that the goods released are in proportion to the amount paid by the borrower.
5. The goods should be insured for full value so that the bank may not have to suffer on account of 'average clause' in case of under insurance.

Conduct of the account

1. No loan should be granted before the bank obtains either actual or constructive delivery of goods. In case the bank permits the borrower to process the raw materials hypothecated into a finished product, an appropriate nameplate that the goods are hypothecated with the bank should be prominently displayed.
2. The balance in the borrower's account should not be allowed to exceed the drawing limit.
3. The drawing limit should be fixed by taking into account the value of the goods (calculated on the basis of market price or cost whichever is lower) and appropriate margin in respect of those goods. While valuing the goods both quantity and quality of goods should be considered.
4. The borrower should clear the old debt before the commencement of the next season. In case he has not done so, a necessary explanation should be called for.
5. The advances should be made for genuine trade needs and not for speculative activities.

ADVANCES AGAINST LIFE INSURANCE POLICIES

Life insurance policies are considered as one of best securities available for bank advances and are readily accepted as collateral security. Need based advance is also granted against life insurance policies on a restricted basis. A life insurance policy has three different values attached to it as under:

1. Insured value: The face value of the policy equivalent to the sum assured.
2. Paid- value: The value which has been already paid by the assured against the policy.
3. Surrender value: The value which Life Insurance Corporation will be prepared to pay should the policy be surrendered to it and the contract of insurance under the policy is cancelled.

The surrender value may thus be considered as the market value of a life policy and it usually depends on the period for which the policy has already run and is fixed as a percentage of paid up value. Life Insurance Corporation has issued priced manual giving detailed instructions for calculation of surrender value under its different schemes. The general terms and conditions of advances against life policies are as under

Maximum Amount of Advance: 90% of the surrender value. Rate of interest
Rate of interest: Rate of interest differs from bank to bank.
Form of advance: Demand loan or overdraft.

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Securities and documents:

1. Life insurance policies are to be assigned in favour of the bank granting the advance. The assignment is in the form of legal assignment for which a notice in the prescribed form will be given to LIC by the assured. The original policy along with the notice of assignment will be sent by the bank to LIC for registration of assignment. The original policy after necessary assignment will be retained by the bank.
2. Other documents as per bank's policy.

Other terms and conditions: Life policies issued under Section 6 of the Married Women's Property Act, 1874 are not acceptable as security.

- In case of default the bank may surrender the policy to LIC after giving reasonable notice to the assured.
- On repayment of loan the policy should be reassigned by the bank in favour of the assured and notice of reassignment must also be got issued from the bank.

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UNIT–IV: INTRODUCTION TO FINANCIAL SERVICES:

Financial Services: Meaning – Functions – Classification - Scope - Fund Based Activities - Non-fund Based Activities - Modern Activities - Causes for Financial Innovation - New Financial Products and Services - Innovative Financial Instruments - Challenges Facing the Financial Service Sector - Present Scenario

Introduction:

Financial service is part of financial system that provides different types of finance through various credit instruments, financial products and services.

Definition of Financial Services:

Financial services refer to services provided by the finance industry. The finance industry encompasses a broad range of organizations that deal with the management of money. Among these organizations are banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds, and some government-sponsored enterprises.

Functions of Financial Services:

The following functions of financial services below are;

- Facilitating transactions (exchange of goods and services) in the economy.
- Mobilizing savings (for which the outlets would otherwise be much more limited).
- Allocating capital funds (notably to finance productive investment).
- Monitoring managers (so that the funds allocated will spend as envisaged).
- Transforming risk (reducing it through aggregation and enabling it to carry by those more willing to bear it).

Scope of Financial Services:

The following scope of Financial services, and cover a wide range of activities. They can broadly classify into two, namely:

Traditional Activities:

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can group under two heads, viz.

- Fund based activities and
- Non-fund based activities.

A. Fund based activities:

The traditional services which come under fund based activities are the following:

- Underwriting or investment in shares, debentures, bonds, etc. of new issues (primary market activities).
- Dealing with secondary market activities.
- Participating in money market instruments like commercial papers, certificates of deposits, treasury bills, discounting of bills, etc.

- Involving in equipment leasing, hire purchase, venture capital, seed capital, etc.
- Dealing in foreign exchange market activities. Non-fund based activities

B. Non-fund based activities:

Financial intermediaries provide services-based on non-fund activities also. This can calls "fee-based" activity. Today customers, whether individual or corporate, not satisfy mere provisions of finance. They expect more from their companies. Hence a wide variety of services, are being provided under this head. They include:

- Managing the capital issue i.e. management of pre-issue and post-issue activities relating to the capital issued by the SEBI guidelines and thus enabling the promoters to market their issue.
- Making arrangements for the placement of capital and debt instruments with investment institutions.
- The arrangement of funds from financial institutions for the client's project cost or his working capital requirements.
- Assisting in the process of getting all Government and other clearances.

Modern Activities:

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are like the non-fund based activities. Because of the importance, these activities have been in brief under the head "New-financial-products-and-services". However, some of the modern services provided by them are given in brief hereunder:

1. Rendering project advisory services right from the preparation of the project report until the raising of funds for starting the project with necessary Government approvals.
2. Planning for M&A and assisting with their smooth carry out.
3. Guiding corporate customers in capital restructuring.
4. Acting as trustees to the debenture holders.
5. Recommending suitable changes in the management structure and management style to achieve better results.
6. Structuring the financial collaborations/joint ventures by identifying suitable joint venture partners and preparing joint venture agreements.
7. Rehabilitating and restructuring sick companies through an appropriate scheme of reconstruction and facilitating the implementation of the scheme.

More things…

1. Hedging of risks due to exchange rate risk, interest rate risk, economic risk, and political risk by using swaps and other derivative products.
2. Managing in-portfolio of large Public Sector Corporations.
3. Undertaking risk management services like insurance services, buy-back options, etc.

4. Advising the clients on the questions of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period, etc.
5. Guiding the clients in the minimization of the cost of debt and the determination of the optimum debt-equity mix.
6. Promoting credit rating agencies for rating companies that want to go public by the issue of the debt instrument.
7. Undertaking services relating to the capital market, such as 1) Clearing services, 2) Registration and transfers, 3) Safe custody of securities, 4) Collection of income on securities.

Causes for Financial Innovation

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain market place. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons:

i. **Low profitability :** The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.
ii. **Keen competition :** The entry of many financial intermediaries in the financial sector market has led to severe competition amount themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.
iii. **Economic Liberalisation :** Reform of the financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.
iv. **Improved communication technology :** The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.
v. **Customer Service :** Now-a-days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations thus help them in soliciting new business.
vi. **Global impact :** Many of the providers and users of capital have changed their roles all over the world. Financial intermediaries have come out of their traditional

approach and they are ready to assume more credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

vii. **Investor awareness :** With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

Financial Engineering

Thus, the growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. Financial engineering is the lifeblood of any financial ability. "Financial engineering is the design, the development and the implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance".

New Financial Products and Services

Today, the importance of financial services is gaining momentum all over the world. In these days of complex finance, people expect a Financial Service Company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the injection of the economic liberation policy into our economy and the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporates and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial service company to innovate new products and service so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are discussed below :

(i) Merchant Banking : A merchant banker is a financial intermediary who helps to transfer capital from those who posses it to those who need it. Merchant banking includes a wide range of activities such as management of customers securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporates and thus promotes industrial development in the country.

(ii) Loan Syndication : This is more or less similar to 'consortium financing'. But, this work is taken up by the merchant banker as a lead-manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

(iii) Leasing : A lease is an agreement under which a company or a firm, acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called "rental charges". The lessee cannot acquire any ownership to the asset, but he can use it and have full control over it. he is expected to pay for all maintenance charges and repairing and operating costs. In countries like the U.S.A., the U.K. and Japan equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business. Commercial banks have also been permitted to carry on this business by forming subsidiary companies.

(iv) Mutual Funds : A mutual fund refers to a find raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing risk. The fund provides investment avenue for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capital appreciation in the long run.

(v) Factoring : Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book debts passes on to the factor. His services can be compared to a *del credre agent* who undertakes to collect debts. But, a factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus, he provides a number of services apart from financing.

(vi) Forfeiting : Forfeiting is a technique by which a forfeitor (financing agency) discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills. The forfeitor does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.

(vii) Venture Capital : A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

(viii) Custodial Services : It is another line of activity which has gained importance, of late. Under this, a financial intermediary mainly provides services to clients, particularly to foreign investors, for a prescribed fee. Custodial services provide agency services like safe keeping of shares and debentures, collection of interest and dividend and reporting of matters on corporate developments and corporate securities to foreign investors.

(ix) Corporate Advisory Service : Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers to that they can transact some of their important banking transactions by sitting in their own office. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

(x) Securitisation : Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable. A financial institution might have a lot of its assets blocked up in assets like real estate, machinery etc. which are long term in nature and which are non-negotiable. In such cases, securitisation would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public. Like any other security, they can be traded in the market. it is best suited to housing finance companies whose loans are always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

(xi) Derivative Security : A derivative security is a security whose value depends upon the values of other basic variables backing the security. In most cases, these variables are nothing but the prices of traded securities. A derivative security is basically used as a risk management tool and it is resorted to cover the risk due to price fluctuations by the investments manager. Just like a forward contract which is a derivative of a spot contract, a derivative security is derived from other trading securities backing it. Naturally the value of a derivative security depends upon the values of the backing securities. Derivative helps to break the risks into various components such as credit risk, interest rates risk, exchange rates risk and so on. It enables the various risk components to be identified precisely and priced them and even traded them if necessary. Financial intermediaries can go for derivatives since they will have greater importance in the near future. In India some forms of derivatives are in operation.

(xii) New Products in Forex Market : New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them, the following are the important ones :

(a) Forward Contracts : A forward transaction is one where the delivery of a foreign currency takes place at a specified future date for a specified price. It may have a fixed maturity for e.g. 31st May or a flexible maturity for e.g. 1st to 31st May. There is an obligation to honour this contract at any cost, failing which, there will be some penalty. Forward contracts are permitted only for genuine business transactions. It can be extended to other transactions like interest payments.

(b) Options : As the very name implies, it is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his option. There is no obligation to buy or sell, but it is completely left to his option. Options may be of

two types namely call options and put options. Under call options, the customer has an option to buy and it is the option to sell under put options. Options trading would lead to speculation and hence there are much restrictions in India.

(c) Futures : It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange. Unlike options, there is an obligation to buy or sell foreign exchange on a future date at a specified rate. it can be dealt only in a stock exchange. **(d) Swaps :** A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates-say, for instance, purchase of spot and sale of forward or vice versa with different maturities. Thus swaps would result in simultaneous buying and selling of the same foreign currency of the same value for different maturities to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any, between two countries. It can also be used in the interest rate market also.

(xiii) Lines of Credit (LOC) : It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of financing institution/bank of one country with another institution/bank/agent to support the export of goods and services to as to enable the importers to import no deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

Innovative Financial Instruments –

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have come into the financial market in recent times. Some of them have been discussed hereunder :

- **Commercial Paper :** A paper is a short-term negotiable money market instrument. It has the character of an unsecured promissory note with a fixed maturity of 3 to 6 months. Banking and non-banking companies can issue this for raising their short term debt. It also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value. Since its denomination is very high, it is suitable only to institutional investors and companies.
- **Treasury Bill :** A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the

Government has come out with short term treasury bills of 182-days bills and 364-days bills.

- **Certificate of Deposit :** The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.
- **Inter-bank Participations (IBPs) :** The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days and 180 days. This may be 'with risk' participation or 'without risk' participation. However, only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per cent per annum. This is also a money market instrument.
- **Zero Interest Convertible Debenture/Bonds :** As the very name suggests, these instruments carry no interest till the time of conversion. These instruments are converted into equity shares after a period of time.
- **Deep Discount Bonds :** There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs.2,00,000 was issued at a deep discounted price of Rs.5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.
- **Index-Linked Guilt Bonds :** These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation-free instruments.
- **Option Bonds :** These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically. This option has to be exercised by the prospective investor at the time of investment.
- **Secured Premium Notes :** These are instruments which carry no interest of three years. In other words, their interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.
- **Medium Term Debentures :** Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany. **(xi)**
- **Variable Rate Debentures :** Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula as we adopt in the case of Dearness Allowance calculations.

- **Non-Convertible Debentures with Equity Warrants :** Generally debentures are redeemed on the date of maturity. but, these debentures are redeemed in full at a premium in instalments as in the case of anticipated insurance policies. The instalments may be paid at the end of 5th, 6th, 7th and 8th year from the date of allotment.
- **Equity with 100% Safety Net :** Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs.40/- per share (nominal value of Rs.10/- per share), the company is ready to get it back at Rs.40/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs.30/- there is 100% safety net and hence the company will get it back at Rs.40/-.
- **Cumulative convertible Preference Shares :** These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.
- **Convertible Bonds :** A convertible bond is one which can be converted into equity shares at a per-determined timing neither fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.
- **Debentures with 'Call' and 'Put' Feature :** Sometimes debentures may be issued with 'Call' and 'Put' feature. In the case of debentures with 'Call feature', the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with 'Put features', the company gives the holder the right to seek redemption at specified times at predetermined prices.
- **Easy Exit Bond :** As the name indicates, this bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paving a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years. Recently the IDBI has issued this type of bond with a face value of Rs.5000 per bond.
- **Retirement Bond :** This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. No payment will be made during the 'wait period'. The longer the wait period, the higher will be the monthly income. Besides these, the investor will also get a lump sum amount on maturity. For example, the IDBI has issued Retirement Bond '96 assuring a fixed monthly income for 10 years after the expiry of the wait period. This bond can be gifted to any person.
- **Regular Income Bond :** This bond offers an attractive rate of interest payable half yearly with the facility of early redemption. The investor is assured of regular and fixed income. For example, the IDBI has issued Regular Income Bond '96 carrying

16% interest p.a. It is redeemable at the end of every year from the expiry of 3 years from the date of allotment.

- **Infrastructure Bond :** It is a kind of debt instrument issued with a view to giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under Sec.88, Sec.54 EA and Sec.54EB of the Income Tax Act. HUDCO has issued for the first time such bonds. Its face value is Rs.1000 each carrying an interest rate of 15% per annum payable semi annually. This bond will also be listed in important stock exchanges.
- **Carrot and Stick bonds :** Carrot bonds have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.
- **Convertible Bonds with a Premium put :** These are bonds issued at face value with a put, which means that the bond holder can redeem the bonds for more than their face value.
- **Debt with Equity Warrant :** Sometimes bonds are issued with warrants for the purchase of shares. These warrants are separately tradable.
- **Dual Currency Bonds :** Bonds that are denominated and pay interest in one currency and are redeemable in another currency come under this category. They facilitate interest rate arbitrage between two markets.
- **ECU Bonds (European Currency Unit Bonds) :** These bonds are denominated in a basket of currencies of the 10 countries that constitute the European community. They pay principal and interest in ECUs or in any of the 10 currencies at the option of the holder.
- **Yankee Bonds :** If bonds are raised in U.S.A., they are called Yankee bonds and if they are raised in Japan, they are called Samurai Bonds.
- **Flip-Flop Notes :** It is a kind of debt instrument which permits investors to switch between two types of securities e.g. to switch over from a long term bond to a short term fixed-rate note.
- **Floating Rate Notes (FRNs) :** These are debt instruments which facilitate periodic interest rate adjustments. **(xxix) Loyalty Coupons :** These are entitlements to the holder of debt for two to three years to exchange into equity shares at discount prices. To get this facility, the original subscriber must hold the debt instruments for the said period.
- **Global Depository Receipt (GDR) :** A global depository receipt is a dollar denominated instrument traded on a stock exchange in Europe or the U.S.A./ or both. It represents a certain number of underlying equity shares. Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees. The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs.

Challenges Facing the Financial Service Sector:

However, the financial service sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are reported hereunder:

- **Lack of qualified personnel :** The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence, it is very vital that a proper and comprehensive training must be given to the various financial intermediaries.
- **Lack of investor awareness :** The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/users of the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even through audio-visual aids.
- **Lack of transparency :** The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency. In other words, the disclosure requirements and the accounting practices have to be in line with the international standards.
- **Lack of specialization :** In the Indian scene, each financial intermediary seems to deal in different financial service lines without specializing in one or two areas. In other words, each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments. In other countries, financial intermediaries like Newtons, Solomon Brothers etc. specialize in one or two areas only. This helps them to achieve high levels of efficiency and excellence. Hence, in India also, financial intermediaries can go for specialization.
- **Lack of recent data :** Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'. Moreover, a proper data base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.
- **Lack of efficient risk management system :** With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the financial intermediaries as in the West, they would not be in a position to fulfil the growing requirements of their customers. Hence, it is absolutely essential that they should introduce Futures, Options, Swaps and other derivative products which are necessary for an efficient risk management system.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

PRESENT SCENARIO

The present scenario of financial service sector is :

(i) Conservatism to dynamism:

At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. As a result, we have recently witnessed phenomenal changes in the money market, securities market, capital market, debt market and the foreign exchange market. In this changed context, the role of financial services has assumed greater significance in our county. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one.

(ii) Emergence of Primary Equity Market:

Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish, have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 24 in 2004. The aggregate funds raised by the industries in the primary markets have gone from up. The number of companies listed on the stock exchange have also gone up from 2265 in 1980 to over 10000 in 2004. Thus, the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

(iii) Concept of Credit Rating

There is every possibility of introducing equity grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The three major credit rating agencies functioning in India are:

(i) Credit Rating Information Services of India Ltd. (CRISIL)

(ii) Credit Analysis and Research ltd. (CARE) and

(iii) Investment Information and Credit Rating Agency (ICRA)

(iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

Their activities have been mainly confined to debt instruments only.

(iv) Process of Globalisation

Again, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentiabilities for the introduction of innovative international financial products in India are very great. Moreover, India is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

(v) Process of Liberalisation

Realizing all these factors, the Government of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing of issues from pricing issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. The Securities Exchange Board of India has liberalized many stringent conditions so as to boost the capital and money markets. In this changed context, the financial service industry in India has to play a very position and dynamic role in the years to come by offering many innovative products to suit to the varied requirements of the millions of prospective investors spread throughout the country.

UNIT–V: FINANCIAL SERVICES:

Definition - Services of Merchant Banks - Problems and Scope of Merchant Banking in India - Venture Capital: Meaning, Features, Scope, Importance - Leasing - Definition and Steps - Types of Lease - Financial Lease - Operating Lease - Leverage Lease - Sale and Lease Back - Discounting: Concept - Advantages of Bill Discounting -Factoring - Meaning and Nature - Parties in Factoring - Merits and Demerits of Factoring - Forfeiting - Parties to Forfeiting - Costs of Forfeiting - Benefits of Forfeiting for Exporters and Importers

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Merchant Banking

Definition: Merchant banking can be defined as a skill-oriented professional service provided by merchant banks to their clients, concerning their financial needs, for adequate consideration, in the form of fee.

Merchant banks are a specialist in international trade and thus, excel in transacting with large enterprises.

Services offered by Merchant Banks

Merchant Banks offers a range of financial and consultancy services, to the customers, which are related to:

- Marketing and underwriting of the new issue.
- Merger and acquisition related services.
- Advisory services, for raising funds.
- Management of customer security.
- Project promotion and project finance.
- Investment banking
- Portfolio Services
- Insurance Services.

Merchant banking helps in reinforcing the economic development of the country, by acting as a source of funds and information to the business entities.

Problems of Merchant Banking:

1) Restriction of merchant banking activities: SEBI guidelines have authorized merchant bankers to undertake issue related activities and made them restrict their activities or think of separating these activities from present one and float new subsidiary and enlarge the scope of its activities.

2) Minimum net worth of Rs.1 crore: SEBI guidelines stipulate that a minimum net worth of Rs.1 crore for authorization of merchant bankers.

3) Non co-operation of issuing companies: Non co-operation of the issuing companies in timely allotment of securities and refund of application money is another problem faced by merchant bankers.

4) Merchant Banker's Commission: Maximum :- 0.5% Project appraisal fees

Lead Manager :- 0.5% up to Rs.25 crores - 0.2% more in excess of Rs.25 crores

Underwriting fees & Brokerage commission :- 1.5%

Other expenses :- Advertising - Printing – Registrar's expenses - Stamp duty

In spite of problems popping up, merchant banking in India has vast scope to develop because of lot of domestic as well as foreign businesses booming here. Indian economy provides an amicable environment for these firms to set up, flourish and expand here.

Scope for Merchant Banking in India

- **Growth of New Issues Market:** The growth of new issue market is unprecedented since 1990-1991. Merchant banking can help with the further sophistication and penetration of the new issues market.
- **Entry of Foreign Investors:** Foreign institutional investors were allowed to invest in the primary and secondary market in 1992 and also, Indian companies were allowed to directly tap foreign capital through euro issues. Further, foreign direct investment by NRIs has risen considerably due to number of incentives offered to them. They need the services of merchant bankers to advise them for their investment in India. The increasing number of joint ventures abroad by Indian companies also requires expert services of merchant bankers.
- **Changing Policy of Financial Institutions:** The policy of decentralization, increase in demand for technical and financial services and encouragement of small and medium industries, requires the services of merchant bankers.
- **Development of Debt Market:** The development of debt market will offer tremendous opportunity to Merchant Bankers.
- **Innovations in Financial Instruments:** The Indian capital market has witnessed innovations in the introduction of financial instruments. This has further extended the role of merchant bankers as market makers for these instruments.
- **Corporate Restructuring:** Due to liberalization and globalization, competition in the corporate sector is becoming intense. To survive and thrive, companies need new strategies, structures and methods of functioning. This has led to corporate restructuring including mergers, acquisitions, etc. These developments offer a good opportunity to merchant bankers to extend their area of operations.
- **Disinvestment:** The government of India has raised Rs. 2000 crores through disinvestment of equity shares of selected public sector undertakings in 93-94. Merchant Bankers can help in the disinvestment process.

Merchant Banker

Any person, indulged in issue management business by making arrangements with respect to trade and subscription of securities or by playing the role of manager/consultant or by providing advisory services, is known as a merchant banker. The activities carried out by merchant bankers are:

- Private placement of securities.
- Managing public issue of securities
- Satellite dealership of government securities
- Management of international offerings like Depository Receipts, bonds, etc.
- Syndication of rupee term loans

- Stock broking
- International financial advisory services.

In India, the functions of the merchant bankers are governed by the Securities and Exchange Board of India (SEBI) Regulations, 1992.

Functions of Merchant Banking Organization

1. **Portfolio Management**: Merchant banks provides advisory services to the institutional investors, on account of investment decisions. They trade in securities, on behalf of the clients, with the aim of providing them with portfolio management services.
2. **Raising funds for clients**: Merchant banking organisation assist the clients in raising funds from the domestic and international market, by issuing securities like shares, debentures, etc., which can be deployed for starting a new project or business or expansion activities.
3. **Promotional Activities**: One of the most important activities of merchant banking is the promotion of business enterprise, during its initial stage, right from conceiving the idea to obtaining government approval. There is some organisation, which even provide financial and technical assistance to the business enterprise.
4. **Loan Syndication**: Loan Syndication means service provided by the merchant bankers, in raising credit from banks and financial institutions, to finance the project cost or working capital of the client's project, also termed as project finance service.
5. **Leasing Services**: Merchant Banking organisations renders leasing services to their customers. There are some banks which maintain venture capital funds to help entrepreneurs.

Merchant Banking helps in coordinating the operations of intermediaries, with respect to the issue of shares like registrar, advertising agency, bankers, underwriters, brokers, printers and so on. Further, it ensures compliance with the rules and regulations, of the capital market.

Venture Capital: Meaning

It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk

associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Features of Venture Capital:

The main features of venture capital can be summarised as follows:

(i) High Degrees of Risk: Venture capital represents financial investment in a highly risk project with the objective of earning a high rate of return.

(ii) Equity Participation: Venture capital financing is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable.

(iii) Long Term Investment: Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.

(iv) Participation in Management: In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender of banker.

It is also different from that of a ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one."

Scope of Venture Capital

The scope of venture capital may briefly be explained as follows:

1. Promotion of Enterprise

The entrepreneurs promote or establish the enterprise, after assessing the business opportunities. **Venture capital is required** for gaining knowledge about these opportunities, making forecasts, determining the objectives, deciding the location, preparing plant layout, registration of the enterprise and completion of other formalities.

The capital sows the seeds of the enterprise. Hence, it will not be an exaggeration to term it as "seed capital".

2. Formulation of Firm

The capital venture is also required for the formation of the firm after the practical shape is given to the idea of the entrepreneur. **In other words,** the form of the organization, single, partnership, company or any other form will be decided whether less or more capital is required? *The volume of capital will also depend upon the scale of production.*

Venture capital is used for registration of the firm, contracts, incorporation certificate, business transaction certificate, etc. If the scale of production is small, less capital is required and if the scale is large, **more capital is required**.

3. Production of the Product

For the production of any product, the firm has to face not only Complex problems but has to arrange adequate capital. **Without that**, it will not be possible to give returns to the sources deployed for production. In that case, the production of the product will be getting blocked.

4. Management, Organisation, and Control

Venture capital is required to appoint the employees, officers, and subordinates to continuously have a watch on the quality of the product and to see that the organization is working properly according to the objectives and also see that performance is in consonance with the determined targets.

5. Marketing Stage

After the production of goods by the enterprise, the next stages of marketing. **Here**, it is to remember that if the gap between the production and the marketing stage is short, the requirement of venture capital will be low on the contrary, if the gap between production and marketing stage is more, the requirement of venture capital will be high. Its reason is that the parties to whom payments are to be made will not care, whether the firm has the capital or not. They will not wait for the receipt of capital.

6. Development Expansion and Diversification

The timely inflow of the capital with the requirements helps in ensuring the sound footing of the firm in the market. The sound footing necessitates **additional capital requirements**, as it leads to the emergence of ideas for diversification and hence feelings for the need for more capital starts. All these results in large profits and the stability of the firm go on increasing.

7. Listing of Company at Stock Exchange

It is better to have the firm registered at the stock exchange, for its permanent existence and Goodwill. But, it is not easy. **For it**, stocks security (Regulation) Act and directions of SEBI are to be complied with. It also requires venture capital.

8. Other Areas

Besides the aforesaid **scope of venture capital**, it is also required for the search of additional new opportunities, participation in development programs, contribution to social development and future of the Enterprise.

Importance of Venture Capital Financing

The following are the importance of **venture capital financing.**

1. **Promotes Entrepreneurs**: Just as a scientist brings out his laboratory findings to reality and makes it commercially successful, similarly, an entrepreneur converts his technical know-how to a commercially viable project with the assistance of venture capital institutions.
2. **Promotes products**: New products with modern technology become commercially feasible mainly due to the financial assistance of venture capital institutions.
3. **Encourages customers**: The financial institutions provide **venture capital** to their customers not as a mere financial assistance but more as a package deal which includes assistance in management, marketing, technical and others.

Example: Hot mail dot com. It was a project invented by an young Indian graduate from Bangalore, by name Sabir Bhatia. This project was developed by him due to the financial assistance provided by the venture capital firms in Silicon Valley, U.S.A. His project was later on purchased by Microsoft company, U.S.A. The Chairman of the company, Mr. Bill Gates offered 400 Million US Dollars in hot cash.

4. **Brings out latent talent**: While funding entrepreneurs, the venture capital institutions give more thrust to potential talent of the borrower which helps in the growth of the borrowing concern.
5. **Promotes exports**: The Venture capital institution encourages export oriented units because of which there is more foreign exchange earnings of the country.
6. **As Catalyst**: A venture capital institution acts as more as a catalyst in improving the financial and managerial talents of the borrowing concern. The borrowing concerns will be more keen to become self dependent and will take necessary measures to repay the loan.
7. **Creates more employment opportunities**: By promoting entrepreneurship, venture capital institutions are encouraging self employment and this will motivate more educated unemployed to take up new ventures which have not been attempted so far.
8. **Brings financial viability**: Through their assistance, the venture capital institutions not only improve the borrowing concern but create a situation whereby they can raise their own capital through the capital market. In the process they strengthen the capital market also.
9. **Helps technological growth**: Modern technology will be put to use in the country when financial institutions encourage business ventures with new technology.
10. **Helps sick companies**: Many sick companies are able to turn around after getting proper nursing from the venture capital institutions.
11. **Helps development of Backward areas**: By promoting industries in backward areas, venture capital institutions are responsible for the development of the backward regions and human resources.
12. **Helps growth of economy**: By promoting new entrepreneurs and by reviving sick units, a fillip is given to the economic growth. There will be increase in the production of consumer goods which improves the standard of living of the people.

LEASING (LEASE FINANCING)

Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee. The periodical payment made by the lessee to the lessor is known as lease rental. Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

Steps in leasing transactions

The important steps involved in a leasing transaction can be summarized as follows:

Firstly, the lessee has to take a decision about the asset required and determine the manufacturer or the supplier. He also decides about his other requirements, viz., the design specification, the price, warranties, terms of delivery, installation and servicing.

The lessee then enters into a lease agreement with the lessor. He specifies to him his requirements as determined above. The lease agreement contains the obligations of the lessor and the lessee as:

(i) The basic lease period during which the lease is irrevocable;

(ii) The timing and amount of periodical rental payments during the basic lease period;

(iii) Details of any option to renew the lease or to purchase the asset at the end of the basic lease period. In the case of absence of any such option to the lessee, the lessor takes possession of the asset and is entitled to any residual value associated with it; and

(iv) Details regarding the responsibility for payment of cost of maintenance and repairs, taxes, insurance and other expenses. In case of a ―Net lease agreement‖, the lessee pays all these costs. However, in case of a ―Maintenance lease agreement‖, the lessor maintains the asset and also pays for the insurance.

After the lease agreement is signed, the lessor contacts, the manufacturer or supplier to supply the asset to the lessee. The lessor makes payment to the manufacturer or the supplier after the asset has been delivered, tested and accepted by the lessee.

Types of Lease

Depending upon the transfer of risk and rewards to the lessee, the period of lease and the number of parties to the transaction, lease financing can be classified into two categories. Finance lease and operating lease.

Finance Lease

It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals. In other words, it puts the lessee in the same condition as he/she would have been if he/she had purchased the asset. Finance lease has two phases: The first one is called primary period. This is non-cancellable period and in this period, the lessor recovers his total investment through
lease rental. The primary period may last for indefinite period of time. The lease rental for the secondary period is much smaller than that of primary period.

Features of Finance Lease

From the above discussion, following features can be derived for finance lease:

a) A finance lease is a device that gives the lessee a right to use an asset.

b) The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.

c) The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.

d) Lessee is responsible for the maintenance of asset.

e) No asset-based risk and rewards is taken by lessor.

f) Such type of lease is non-cancellable; the lessor's investment is assured.

Operating Lease / Service Lease

Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee. The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why this type of lease is also known as service lease.

Features of Operating/Service Lease

a) The lease term is much lower than the economic life of the asset.
b) The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.
c) The lessor provides the technical knowhow of the leased asset to the lessee.
d) Risks and rewards incidental to the ownership of asset are borne by the lessor.
e) Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.

Leverage Lease:

In a leveraged lease, the lessor invests some money from his pocket to purchase the asset and arranges for the rest of the money required from a lender in the market. The leveraged lease is a lease in which three parties are involved: Lessor, Lessee, and the Lender. Here, the lender is the third party but enjoys the benefit of the interest in the asset acquired.
In this type of arrangement, the lender will have a secured interest in the asset since he is investing money to acquire the asset. When the assets are taken on lease, the lesser will be obliged to make the payments to the lender of the leased asset. The lease agreement is actually assigned to the lender of the leased asset in this type of arrangement. The leveraged lease is also a tax advantage for the lessor since the lessor takes a loan from the lender to purchase the asset while the payment from the lessee will directly go to the lender. Thus they are saving tax in this entire process. This type of arrangement is mostly seen while purchasing high-value assets.

Characteristics of Leveraged Lease

Characteristics of Leveraged Lease are given below:

- In the leveraged lease, the finance provider which is lender is without recourse to the lessor.
- The lender holds the asset since it carries the payment obligation.
- The lessor will be free from the obligation of the payments to the lender the payment is directly done to the lender by the lessee but in case of default, the lessor will be obliged to pay the dues.
- The small portion of the fund is arranged by the lessor and the majority portion of the fund which is required to obtain the asset is borrowed by the lender.

- The lender will have more rights in regard to the sale or resale of the asset in comparison to the lessor.
- One of the typical characteristics of this type of vehicle is that the lender can check the financial position of the lessee that whether the lessee will be in a position to pay the rentals or not and if not the lenders will opt for recourse loan payment where the lessor will be obliged to make the payments.
- The leveraged lease is generally used when any company wants to purchase some high-value assets.
- In this type of method of leasing the lessor will be the one who will get benefitted by tax also. It will receive some tax-related benefit of ownership of the asset. Although the rights are also lying with the lender of the asset according to lessee agreement.

Sale and Lease Back:

Definition:

Sale and Leaseback is a simple financial transaction which allows a person to lease an asset to himself after selling it. Under the transaction, an asset previously owned by the seller is sold to someone else and is leased back to the first owner for a long term. The transaction thus allows a person to be able to use the asset and not own it. One usually makes a leaseback transaction for high value fixed assets such as real estate and goods like airplanes and trains. Sale and leaseback is shortly called as leaseback.

For example, X owns a land. Under the leaseback transaction, X will sell the land to Y and will get a lease on the same land from Y for a long term.

A company usually enters a leaseback transaction for accounting and taxation purposes. For example, a company may transfer its asset to the holding company but still will be able to use it. Also, transferring to holding company will allow the parent company to track the assets' worth and profitability. Another example is, that in case of financial distress or when a company needs money for some purpose, instead of getting a loan or raising money from outside, a company can sell the asset. The buyer of the asset is someone who is only interested in a securing a long term investment and will lease the asset back to the company. This way the company gets the cash influx and will still be able to use the asset.

Sale and Leaseback transactions are common in the Real estate investment trusts (REITs) and Aviation industry.

The person who buys the assets and lets out on lease is called the investor or landlord. The seller of the asset is also the lessee.

Example of Sale And Leaseback

A safe deposit vault given by banks is the classic example to quote. Here banks which initially are the owners of the vaults, sell the vaults to a leasing company at market price which is substantially higher than the book value. Subsequently, the leasing company will offer back these vaults to the same banks on long term basis. The banks will then sub-lease these vaults to its customers.

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Advantages to the Lessee

Enables Expansion of the Business

If a company doesn't have funds to own the asset, it can purchase the asset and enter a leaseback transaction. This way the company can get back 100% of the investment and still be able to use the asset. Similarly, in case when a company already owns an asset but wants some cash for expansion or even regular business use, the leaseback agreement will allow the company to get cash influx. This will also enable the company the to use the asset as before, by paying rent under the lease agreement.

Improve Company's Balance Sheet

An asset purchased on debt affects the company's balance sheet. The company can reduce its debt and improve balance sheet health by entering a leaseback transaction. This will improve the balance sheet in three ways. First, the liability on the balance sheet will reduce. Second, there will be an increase in current assets in the form of cash and lease agreement. Third, the asset turnover of the company will improve. The asset turnover will improve as the fixed assets will reduce but the revenue generating capability of the asset will still be in the hands of the company.

Reduction in Tax Liability

This works in two ways, the company which has now sold the asset and has it on lease, does not have to pay tax on any appreciation of the asset and also the rent outlet will reduce the profit in the profit and loss (p&l) account which will in-turn reduce the tax liability. Depreciationcharge on the asset would has a similar impact on the p&l account. However, the depreciation amount will be lower than the lease amount. Also, there is no depreciation is charge on real estate assets like land.

One can avoid paying tax on the sale of asset, by re-investing the sale proceeds in the business or by buying another asset.

Limited Risk

Once sold, the company is free from volatility risks of the asset that has to be borne in case of cyclical market variations.

ADVANTAGES TO THE INVESTOR

Fair Return on Investment

The investor is buying an asset which the seller will be using in the future. The buyer's interest will ensure that the asset is a fair investment which will provide a decent return on the investment.

Regular Stream of Income

The buyer does not have to worry about the return, as they have a reliable tenant for a long term. This ensures that the investment earns a fixed return on the property and has a continuous stream of cash flow.

Discounting: Concept

Bill or invoice discounting is a trade activity in which the seller gets amount in advance at discounted rates from the lender. This makes buyers contribute in the form of interest rate in increasing the revenue of the financial institutions, banks or NBFCs in form of interest paid and from monthly fee.

For example: You have sold goods to Mr. X, he has given you letter of credit from bank of 30 days, if you want to get money from bank before 30 days, the bank will charge some interest rate from you, which in return will be called as discount for the seller. Let's assume if the amount which you were supposed to get was Rs. 1 lakh on or after 30 days, by bank's discount or interest rate of Rs. 50,000 you now get Rs. 95,000 in return form the bank. The buyer will anyhow deposit Rs. 1 lakh to the respective bank on 30th day only.

This trading or financial process is termed as bill discounting or invoice discounting.

Bills that come under bill discounting are termed as 'bills of exchange'. Bill discounting feature can be used to avail loans up to approximately 90% of the raised invoices. The credit period majorly depends on the buyer's creditworthiness. Once the bank is convinced, it provides discount on the amount that is required to be paid at the end of credit period.

Bill Discounting Process

The Process of Bill Discounting is as follows;

1. An invoice is raised by the seller after he has sold the goods on credit. The buyer accepts the invoice. By acquiring, the buyer acknowledges paying on the due date.
2. It is discounted after the seller approaches the financing company. The legitimacy of the bill and creditworthiness of the buyer is assured by the financing company.
3. After deducting appropriate margin, discount and fee as per the norms, the financing company avails the fund to the seller Funds are given to the seller for further use in business.
4. The financial intermediary or the seller collects the money from the buyer on the due date. 'Who collects the money' depends on the agreement between the seller and financing institution.

Advantages of Bill Discounting

Credit Evaluation: Before sanctioning any invoice or bill discounting, the bank will surely consider the reputation of the seller by checking the past repayment history, financial stability and creditworthiness of the buyer as they do not want to be at risk if the buyer defaults to repay the amount.

Availability of Instant Cash: Instant cash is available at disposal for enterprises or businesses that helps to improve the momentum of the businesses; moreover, it provides the option to entrepreneurs to do business without funds. It works the similar way as bank overdraft but it is not the same, as the customer is required to pay interest on the used amount.

Banking Partner Preferred: A reputed bank is always the first preference before the bill discounting is offered to the buyer. This makes sure that the buyer's bank (paying entity) is

reliable and trustworthy. Agreement between reputable companies or banks is required for discounting purpose.

Bill Usage: Also known as 'Usance Period', bill usage is a period in which bill has to be valid within the date of time permitted by customers for the bill date and its payment. This time period can vary from 3 weeks to 3 months.

Additional benefits

- Effortless withdrawals
- Flexible repayment tenure
- Strengthened cash flow
- Interest to be paid only on used amount
- Easy authentication
- Quick processing with hassle free documentation

In bill discounting process, the interest amount is charged in advance by the bank from the buyers. Being it an agreement between buyer and seller, the bill amount is paid as per the end of credit period.

FACTORING

Factoring refers to the service of purchasing the accounts receivables of a business undertaking at a discount. In other words, factoring is the activity of undertaking the responsibility of debt collection on behalf of a third party. Under this, the sales ledger of a business undertaking is managed by a financial institution and the risk of debt collection is assumed by them. Factoring involves three parties, viz., the creditor (also called as client of the factoring institution), the debtor and the factor (factoring institution).

Creditor is the person who has sold goods and has Bills Receivable against the same. Debtor is the person who has purchased the goods on credit and is liable to pay the bills. Factor is the person who purchases from the creditor the Bills Receivables at a discount and later on collects the money from the debtor. Bills Receivable is essentially a financial asset associated with the debtor's liability to pay money to the seller (Creditor). Generally, the debtor will be informed of the discounting (sale) of Bills Receivable to the factor.

Under factoring, at least two of the following services are provided by the factor.

a) Financing
b) Maintenance of debts (Maintenance of Sales Ledger)
c) Collection of debts
d) Protection against credit risk

In India, factoring is undertaken by different institutions like SBI Factors & Commercial Services Private Ltd., Canara Bank Factors Ltd., etc.

Mechanism of factoring

The activity of factoring involves the following steps:

a) The client (seller/creditor) gets order from the debtors (customers) for goods and services to be provided on credit and makes an invoice.

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b) The invoice made by the client is then assigned to the factor (factoring institution) and also sends the invoice to the customer in the usual way with a notification that the invoice is assigned to the factor and the payment must be made to the factor
c) The client then submits copies of invoices to the factors with a schedule of offer accompanied by the receipt, delivery challan, or any other document which is a proof of dispatch
d) The factor makes prepayment of cash to the client upto 80% of the value of invoice and sends periodical statements
e) The debtors (customers) make payments to the factor as and when due
f) The factor makes payment of cash to the extent of the balance 20% on realization of full payment from the debtors

It is important to note that the factoring institution provides prepayment upto 80% of the invoice value to the client and also follows up with the customers for realization of payments due. The factoring institution also sends a monthly statement of accounts to the client showing the details about factored invoices and payments made. The balance 20% payment is made to the client only after the full payment is received from the customers.

Features (Characteristics) of factoring
a) Factoring is a short term borrowing source to the sellers
b) The cost of factoring services is high when compared to borrowing other short term loans. It varies from 1.5% to 3% per month depending upon the financial strength of the debtors (customers)
c) The period of each factoring ranges from 90 days to 150 days and the factoring services is provided even on invoices as low as Rs. 1,000

Advantages of factoring
Immediate Cash Inflow: This type of finance shortens the cash collection cycle. It provides swift realization of cash by selling the receivables to a factor. Availability of liquid cash sometimes becomes a deciding factor for grabbing an opportunity or losing it. The cash boost provided by factoring is readily available for capital expenditures, securing a new order or meeting an unforeseen condition.
Attention towards Business Operations and Growth: By selling off invoices, business managers can feel stress-free of the task of collection from the customers. Resources employed in the receivables department can be directed towards business operations, financial planning, and future growth.
Evasion of Bad Debts: Factoring is of two types – with recourse and without recourse. Under without recourse factoring, in case of bad debts, the loss is borne by the factor. Hence, the seller is under no obligation to the factor once it sells off its receivables.
Speedy Arrangement of Finance: Factors provide funds more rapidly than banking companies. Factoring companies offer quicker application, lesser documentation and swifter realization of funds as compared to other financial institutions.

No Requirement of Collateral: The advances are extended on the basis of the strength of accounts receivables and their credit healthiness. Unlike cash credit & overdraft, factors do not require any collateral security to be pledged/hypothecated. New businesses, startups can easily avail the advances provided they have strong receivables.
Sale not Loan: Factoring transaction is a transaction of sale, not a loan. Unlike other types of finances, factoring does not result in an increase in liabilities of the business. Hence, there are no adverse impacts on the financial ratios as well. It just involves the conversion of book debts into liquid cash.
Customer Analysis: Factors provide valuable advice and insights to the seller regarding the credit strength of the party from whom receivables are pending. It helps in negotiating better terms between the parties in future contracts.

Disadvantages of Factoring:
Reduction of Profit: The factor deducts a certain discount from the value of accounts receivable as fees for the services offered. Moreover, in certain cases, the factor also charges interest on the advance made. Consequently, profit of an entity is reduced by a significant margin.
Reliability of Customer's Credit: The factor assesses and evaluates credit wellness of the party who owes bills receivables. This is a critical factor which is outside the control of the seller. A factor may refuse to extend advances due to poor credit ratings of the concerned party.
Exhausting of Collateral Security: Factoring exhaust bills receivables of an entity as the entity is no longer entitled to receive payments from them. The seller is no longer holding any control over the book debts. Hence, they can not be provided as collateral security while obtaining any other type of finance.
Presence of Contingent Liability: The liability of the seller is not completely waived in case of with recourse factoring. If a party fails to pay its debts to the factor, the factor is legally entitled to recover it from the seller. Thus, the seller is contingently liable to the factor for paying the debts in future in case of default. This situation would impact business operations and financial plans which are under execution.
Higher Finance Charges: Factors usually deduct 2% to 4% of the total amount involved as their fees for the duration of 45-60 days. Computing it annually, the cost of finance turns out to be around 18% to 24% p.a. which is very higher than other sources of finance.

Parties in Factoring:
There are basically three parties involved in a factoring transaction.
1. The buyer of the goods.
2. The seller of the goods
3. The factor i.e. financial institution.

The three parties interact with each other during the purchase/ sale of goods. The possible procedure that may be followed is summarised below.

The Buyer

1. The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit.
2. He takes the delivery of goods along with the invoice bill and instructions from the seller to make payment to the factor on due date.
3. Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

The Seller

1. The seller enters into contract for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions.
2. Sells goods to the buyer as per the contract.
3. Sends copies of invoice, delivery challan along with the goods to the buyer and gives instructions to the buyer to make payment on due date.
4. The seller sells the receivables received from the buyer to a factor and receives 80% or more payment in advance.
5. The seller receives the balance payment from the factor after paying the service charges.

The Factor

1. The factor enters into an agreement with the seller for rendering factor services i.e. collection of receivables/debts.
2. The factor pays 80% or more of the amount of receivables copies of sale documents.
3. The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.

FORFEITING:

Forfeiting in French means to give up one's right. Thus, in Forfeiting the exporter hands over the entire export bill with the forfaiter and obtains payments. The exporter has given up his right on the importer which is now taken by the forfaiter. By doing so, the exporter is benefited as he gets immediate finance for his exports. The risk of his exports is now borne by the forfaiter. In case if the importer fails to pay, recourse cannot be made on the exporter.

Commercial banks act a forfaiters by purchasing account receivables from the exporter. There is not much risk involved for the forfaiter as the export is done against the L/C (Letter of credit), issued by importer's bank.

Forfeiting process or Parties involved in Forfeiting

1. Before resorting to Forfeiting, the exporter approaches the Forfeiting company with the details of his export and the details of the importer and the importing country.

2. On approval by the forfaiter, along with the terms and conditions, a sale contract is entered into between the exporter and importer.

3. On execution of the export, the exporter submits the bill to the forfaiter and obtains payment. In this way, the three parties involved in the Forfeiting process are the exporter, the importer and the forfaiter.
4. If the exports are done against Document Acceptance Bill, it has to be signed by the importer and since the importer's bank has guaranteed through the L/C, it will be easy for the forfaiter to collect payment.
5. All the trade documents, connected with exports, are handed over by the exporter to his bank which in turn hands over the documents to the importer's bank.
6. The proof of all these documents will be submitted by the exporter to the forfaiter who will make payment for the export.
7. The cost of Forfeiting is included in the bill. The exporter may not lose much as the interest will be included in the invoice and recovered from the importer. However, the forfaiter is exposed to the risk of fluctuations in the exchange rate, interest rate and commercial risk, and to cover these risks, he charges suitably.

Advantages of Forfeiting

The following are some of the advantages of Forfeiting.
1. It provides immediate funds to the exporter who is saved from the risk of the defaulting importer.
2. It is an earning to commercial banks who by taking the bills of highly valued currencies can gain on the appreciation of currencies.
3. The forfaiter can also discount these bills in the foreign market to meet more demands of the exporters.
4. There is very little risk for the forfaiter as both importer's bank and exporter's banks are involved.
5. Letter of Credit plays a major role for the forfaiter. Moreover, he enters into an agreement with the exporter on his terms and conditions and covers his risks by separate charges.
6. As Forfeiting provides 100% finance to exporter against his exports, he can concentrate on his other exports.

Disadvantages or Drawbacks of Forfeiting

The following are some of the disadvantages of Forfeiting.
1. Forfeiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.
2. There is discrimination between Western countries and the countries in the Southern Hemisphere which are mostly underdeveloped (countries in South Asia, Africa and Latin America).
3. There is no International Credit Agency which can guarantee for Forfeiting companies which affects long-term Forfeiting.
4. Only selected currencies are taken for Forfeiting as they alone enjoy international liquidity.

Costs of Forfeiting

A forfeiting transaction typically has 3 cost involved

1. Commitment Fees
2. Discount Fees
3. Documentation Fees

1). Commitment Fees:

A commitment fee is a banking term used to describe a fee charged by a lender to a borrower to compensate the lender for its commitment to lend. Commitment fees are typically associated with unused credit lines or undisbursed loans. The lender is compensated for providing access to a potential loan through a commitment fee since it has set aside the funds for the borrower and cannot yet charge interest.

- Ranges between 0.5% to 1.5% of the amount.
- The commitment fee is payable regardless of whether the export contract is executed or not.
- It is payable by the exporter to the forfaiter.

2) Discount Fees:

- It is the interest cost payable by the exporter for the entire period of the credit involved
- It is deducted by the forfaiter from the amount paid to the exporter against the avalised promissory notes or bills of exchange
- The interest cost is based on LIBOR + Premium.

3) Documentation Fees:

- Generally, no documentation fee is incurred in a straight forward transaction.
- If extensive documentation is involved & a legal framework is necessary, documentation may be changed.

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