PRINCIPLES & PRACTICES OF BANKING

INDIAN INSTITUTE OF BANKING & FINANCE
'THE ARCADE', WORLD TRADE CENTRE, CUFFE PARADE MUMBAI 400 005
Established on 30th April 1928
MISSION
- To develop professionally qualified and competent bankers and financial professionals primarily through a process of education, training, examination, consultancy/counseling and continuing professional development programs.

VISION
- To be the premier Institute for developing and nurturing competent professionals in banking and finance field.

OBJECTIVES

- To facilitate study of theory and practice of banking and finance.
- To test and certify attainment of competence in the profession of banking and finance.
- To collect, analyse and provide information needed by professionals in banking and finance.
- To promote continuous professional development.
- To promote and undertake research relating to Operations, Products, Instruments, Processes, etc., in banking and finance and to encourage innovation and creativity among finance professionals so that they could face competition and succeed.

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PRINCIPLES & PRACTICES OF BANKING
(For JAIIB/Diploma in Banking & Finance Examination)

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Originally prepared by A.M. Arundekar (Module A), O.P. Agarwal (Module B), Dr. Onkar Nath (Module C), P.S. Khandelwal (Module D) under the guidance of T.S. Radhakrishnan.
Revised and updated by D. Srinivasan (Module A), R. Malayarasan (Module B), V. Radhakrishnan & V. Suresh (Module C), Praveen Kumar & H.M. Prathiba (Module D) all faculty at IMAGE, Chennai under the guidance of N.C. Rao, Asst. General Manager, Indian Bank, Chennai & Dr. U.A. Balasubramanian, Faculty, IMAGE, Chennai.
Glossary prepared by Mr. B.S. Khubchandani; Former Chief Manager, Bank of India.

FOREWORD

The world of banking and finance is changing very fast and banks are leveraging knowledge and technology in offering newer services to the customers. Banks and technology are evolving so rapidly that bank staff must continually seek new skills that enable them not only to respond to change, but also to build competence in handling various queries raised by customers. Therefore, there is a need for today's bank employees to keep themselves updated with a new set of skills and knowledge.

The Institute, being the main provider of banking education, reviews the syllabus for its associate examinations, viz., JAIIB /CAIIB and various other examinations with the help of Expert Groups from time to time to make the contents relevant and contemporary in nature. The latest revision has been done by an expert group under the Chairmanship of Prof. Y.K. Bhushan. This book and the other two books mentioned below are the courseware for JAIIB which aims to impart up-to-date knowledge in the field of banking and finance with a view to equipping the bankers to face the emerging challenges of today and tomorrow.

As there is a growing demand for qualified manpower in the banking sector with accent on banking knowledge and skills, together with technology-familiarity, customer-orientation and hands-on application skills which will substantially reduce the training intervention at the bank level before/ immediately after they are employed, the institute has launched the Diploma in Banking & Finance (DBF) in 2007 for graduation-plus level candidates. Candidates to the course will get extensive and detailed knowledge on banking and finance and details of banking operations. The Diploma is offered in the distance learning mode with a mix of educational support services like provision of study kits, contact classes, etc. The key features of the Diploma is that it aims at exposing students to real-life banking environment and that it is equivalent to JAIIB.

The JAIIB and the Diploma in Banking & Finance has three papers, viz.

1. Principles & Practices of Banking
2. Accounting & Finance for Bankers

3. Legal & Regulatory Aspects of Banking

This book, the courseware for the first paper on Principles & Practices of Banking, starts with an overview of Indian financial system and covers deposit, remittances, collection and allied services with greater emphasis on day-to-day operations in addition to the law related thereto. Special focus is on retail banking which takes the participants through the concepts and processes of retail deposit and credit products in great detail. Marketing of Bank products have been covered in length. Aspects such as insurance, mutual funds, credit cards, etc., have also been covered. The flow of transactions in a centralised (computerised) operating environment and delivery of services through multiple channels have been given adequate coverage to make the participants aware of the latest banking environment and practices.

The Institute had constituted teams consisting of eminent bankers and academicians to prepare the reading material for all the subjects as self-instructional study kits obviating the need for the intervention of a teacher. This book represents the outcome of this endeavour to bring out self-contained comprehensive courseware/book on the subject. The Institute acknowledges with gratitude the valuable services rendered by the authors in preparing the courseware in a short period of time.

The team, who developed the book, have made all efforts to cover the entire syllabus prescribed for the subject. However, the candidates could still refer to a few standard textbooks to supplement this material which we are sure, will enhance the professional competence of the candidates to still a higher degree. We have no doubt that the study material will be found useful and will meet the needs of the candidates to prepare adequately for the examinations. In addition, we are sure that these books will also prove useful to practitioners, academicians, and other interested readers.

We welcome suggestions for improvement of the book.

Mumbai 3-7-2008

R. Bhaskaran

Chief Executive Officer

RECOMMENDED READING

The Institute has prepared comprehensive courseware in the form of study kits to facilitate preparation for the examination without intervention of the teacher. An attempt has heen made to cover fully the syllabus prescribed for each module/subject and the presentation of topics may not always be in the same sequence as given in the syllabus.

Candidates are also expected to take note of all the latest developments relating to the subject covered in the syllabus by referring to Financial Papers, Economic Journals, Latest Books and Publications

PAPER 1 - PRINCIPLES & PRACTICE OF

BANKING.

The candidates would be able to acquire an in-depth knowledge of the following:

- Various functions associated with banking.
- Practice and procedures relating to deposit and credit, documentation, monitoring and control.
- An insight into marketing of banking services and banking technology.

MODULE A - INDIAN FINANCIAL SYSTEM

Recent Developments in the Indian Financial System; Market Structure and Financial Innovation. RBI, SEBI, IRDA, etc. - their Major Functions. Role and Functions of Banks - Regulatory Provisions/ Enactments Governing Banks.

Retail Banking: Approach, Products, Marketing, etc.

Wholesale Banking; International Banking

Role and Functions of Capital Markets

Role and Functions of Mutual Funds

Role and Functions of Insurance Companies - Bancassurance

Importance of Risk Management in Banks - Types of Risk - Impact and Management

Factoring & Forfaiting

Alliances/Mergers/Consolidation

ADR/GDR/Off Balance Sheet Items

Participatory Notes

Credit Information Bureau (India) Ltd.

Fair Practices for Debt Collection

Basel II

Banking Codes and Standards Board

MODULE B - FUNCTIONS OF BANKS Deposits

Banker-Customer Relations - Know Your Customer [KYC] Guidelines - Different Deposit Products -Services Rendered by Banks - Mandate and Power of Attorney

Banker's Lien - Right of Set-off- Garnishee Order - Income Tax Attachment Order, etc.

Payment and Collection of Cheque - Duties and Responsibilities of Paying and Collecting Banker-Protection Available to Paying and Collecting Banker under NI Act - Endorsements - Forged Instruments - Bouncing of Cheques and their Implications

Opening of Accounts for Various Types of Customers - Minors - Joint Account Holders - HUF -Firms - Companies - Trusts - Societies - Govt. and Public Bodies
Importance of AML Credit
Principles of Lending - Various Credit Products/Facilities - Working Capital and Term Loans - Credit Appraisal Techniques - Approach to Lending-Credit Management - Credit Monitoring - NPA Management - Different Types of Documents; Documentation Procedures; Stamping of Documents
Securities - Different Modes of Charging - Types of Collaterals and their Characteristics
Priority Sector Lending - Sectors - Targets - Issues/Problems - Recent Developments - Financial Inclusion Agriculture/SMEs/SHGs/SSI/Tiny Sector Financing
New Products & Services - Factoring, Securitisation, Bancassurance, Mutual Funds, etc.
Credit Cards/Home Loans/Personal Loans/Consumer Loans - Brief Outline of Procedures and Practices
Ancillary Services: Remittances, Safe Deposit Lockers, etc.
MODULE C - BANKING TECHNOLOGY
Electronic Banking - Core Banking - Electronic Products
Banking Technology - Distribution Channels - Teller Machines at the Bank Counters - Cash Dispensers
- ATMs - Anywhere Anytime Banking - Home Banking (Corporate and Personal) - Electronic Payment
Systems
Online Banking - Online Enquiry and Update Facilities - Personal Identification Numbers and their Use in Conjunction with Magnetic Cards of Both Credit and Debit Cards, Smart Cards, Signature Storage and Display by Electronic Means, Cheque Truncation, Microfiche, Note and Coin Counting Devices
Electronic Funds Transfer Systems - Plain Messages (Telex or Data Communication) - Structured Messages (SWIFT, etc.) - RTGS
Information Technology - Current Trends - Banknet, RBI Net, Datanet, Nicnet, I-net, Internet, E-mail, etc. - Role and Uses of Technology Upgradation - Global Developments in Banking Technology -Information Technology in Finance and Service Delivery - Impact of Technology on Banks - Protecting the Confidentiality and Secrecy of Data - Effect on Customers and Service Quality - Computer Audit
- Information System Audit - Information System Security and Disaster Management
MODULE D - SUPPORT SERVICES - MARKETING OF BANKING SERVICES AND PRODUCTS
Marketing Management - Meaning, Importance and Functions - Marketing of Services - Product Research & Development - Test Marketing of Bank Products - Product Life Cycle - Product Modification - New Product Development - Packaging and Branding of Bank Products - Diversification
- Pricing of Bank Products and Services - Objectives! Strategies and Methods - Factors Influencing
the Pricing Decisions, Importance of Pricing. Distribution - Factors Influencing - Direct and Indirect
Channels of Bank Products - Physical Distribution - Channel Functions and Services - Promotion -
Promotion Mix and Role of Promotion in Marketing - Marketing Information Systems - Role of DSA/
DMA in Bank Marketing - Channel Management - Selling Function in a Bank - Portfolio and Wealth
Management - Tele Marketing/Mobile Phone Banking

CONTENTS

MODULE A: INDIAN FINANCIAL SYSTEM

INDIAN FINANCIAL SYSTEM

UNIT 1 An Overview

STRUCTURE

1.0 Objectives
1.1 What is a Financial System?
- 1.1.1 Roles and Functions in Brief of the Central Banking Authority
- 1.1.2 Commercial Banks
- 1.1.3 Non-Banking Financial Companies (NBFCs)
- 1.1.4 Primary Dealers (PDs)
- 1.1.5 Financial Institutions (FIs)
- 1.1.6 Cooperative Banks
- 1.1.7 Payment and Settlement System
- 1.1.8 Management of Government Debt
- 1.1.9 Bankers to Government

1.0 OBJECTIVES

This unit gives an overview about the financial system, its role and constituents of the system in the country.

1.1 WHAT IS A FINANCIAL SYSTEM?

A financial system means the structure that is available in an economy to mobilise the capital from various surplus sectors of the economy and allocate and distribute the same to the various needy sectors. The transformation of 'Savings' into 'Investments and Consumption' is facilitated by the active role played by the financial system. The process of transformation is aided by various types of financial assets suiting the individual needs and demands of both the 'investors' and 'spenders'. The offering of these diverse types of financial assets is supported by the role of 'financial intermediaries' who invariably intermediate between these two segments of investors and spenders. Examples of intermediaries are banks, financial institutions, mutual funds, etc. The place where these activities take place could be taken to connote the financial market.

Figure 1.1 represents the various segments of the financial market.

The financial system comprises a mixture of intermediaries, markets and instruments that are related to each other. It provides a system by which savings are transformed into investments. To simplify, the overall financial system can be presented diagrammatically as shown in Figure 1.2.

1.1.1 Roles and Functions in Brief of the Central Banking Authority

The Central Banking Authority (Reserve Bank of India) has two distinct roles; Monetary control including controlling inflation and bank supervision. All major central banks other countries too look after these two functions and carry the charge of ensuring that the overall financial health of banks is not impaired. This is ensured through off-site and on-site surveillance of banks. Monetary control is exercised through Cash Reserve Ratio and Statutory Liquidity Ratio mechanism and Bank and Repo rates - main instruments available to Central Banks to control Prime rates of leading banks. Central Banks do act as lenders of last resort to banking system and are responsible for ensuring an efficient payment and settlement system.

1. Monetary control
2. Supervision over
• Commercial Banks
•NBFCs
• Primary Dealers
• Financial Institutions
• Cooperative Banks
• Clearing and Settlement System

3. Management of government debt
4. Banker to government
5. Lender of last resort to banks
6. Regulating money markets through monetary instruments (CRR, SLR, BANK RATE, REPO RATE)
1. Equity market and debt market supervision and control.
2. Supervision over
• Stock exchanges
• Brokers
• Equity and debt raisers
• Investment bankers (merchant bankers)
• Foreign institutional investors
• Custodians
• Depositories
• Mutual funds
• Listed companies
• Service providers to capital markets like registrars
1. Regulatory framework including rules and regulations for running insurance business
2. Supervising all insurance companies both in general and life insurance business
3. Regulating pricing, investments and cost structure of insurance companies
4. Regulating insurance brokers including agencies both individuals and banks

PENSIONS
1. Framing rules for pension funds
2. Regulating all pension funds

Note. 77iis schematic diagram illustrates the various constituents in a financial system and the broad categories in. which they can be categorised on the basis of activities that they perform.

1.1.2 Commercial Banks

Commercial banks include public sector banks, foreign banks, and private sector banks. Acceptance of deposits from the public for the purpose of lending or investment is the main area of activity.

1.1.3 Non-Banking Financial Companies (NBFCs)

NBFCs are allowed to raise monies as deposits from the public and lend monies through various instruments including leasing, hire purchase and bill discounting etc. These are licensed and supervised by the Central Banking Authority. Central Bank prescribes that no NBFC can operate without a valid license from the Central Banking Authority.

1.1.4 Primary Dealers (PDs)

Primary dealers also known as PDs, deal in government securities and deal in both the primary and secondary markets. Their basic responsibility is to provide markets for government securities and strengthen the government securities market.

1.1.5 Financial Institutions (FIs)

FIs are development financial institutions which provide long-term funds for industry and agriculture. All these institutions are under off-site and on-site surveillance of the Central Banking Authority. FIs raise their resources through long-term bonds from the financial system and borrowings from international financial institutions.

1.1.6 Cooperative Banks

These are allowed to raise deposits and give advances from and to the public. Urban Cooperative Banks are controlled by State governments and RBI, while other cooperative banks are controlled by National Bank for Agriculture and Rural Development (NABARD) and State Governments. Except for certain exemptions in paying a higher interest on deposits, the Urban Cooperative Banks regulatory framework is similar to the other banks.

1.1.7 Payment and Settlement System

An efficient and effective Payment and Settlement System is a necessary condition for a well running Financial System. Maintenance of clearing houses at various centres, creation of currency holding chests in different geographical areas and creation of the mechanism for electronic transfer of funds are vital activities undertaken by the Central Banks.

1.1.8 Management of Government Debt

Most of the Central Banks manage the issue and servicing of government debt. This involves price discovery, volumes to be raised, tenure of debt and matching it with the overall cash management of the debt.

1.1.9 Bankers to Government

Most of the Central Banks maintain an account, Government deposit and carry out their cash management through the issue of Bonds and Treasury Bills.

1.1.10 Lender of Last Resort to Banks

The Central Bank provides liquidity support on a temporary basis through the facility of repurchase (REPO) of securities to banks to meet their short-term liquidity requirements.

1.1.11 Cash Reserve Ratio (CRR)

Cash Reserve Ratio (CRR) is the mandatory deposit to be held by Banks with the requisite monetary authority. It is a percentage of their Demand and Time liabilities. The increase or decrease can be effected by the Central Bank to pump in or soak liquidity in the banking system.

1.1.12 Statutory Liquidity Ratio (SLR)

Statutory Liquidity Ratio (SLR) is the prescribed percentage of Demand and Time liabilities of a bank to be held in prescribed securities, mostly government securities. The increase or decrease in the CRR & SLR, contracts and enhances credit creation.

1.2 EQUITY AND DEBT MARKET

Marketability of corporate securities, i.e. bonds, debentures, and convertible debentures, enables corporates to raise debt, while debenture holders enjoy very high liquidity. All securities quoted on stock exchanges and freely bought and sold on these exchanges can be issued only after obtaining approval of the capital market regulator viz., SEBI.

1.2.1 Stock Exchanges

A stock exchange is duly approved by the regulators to provide sale and purchase of securities on behalf of investors. The stock exchanges provide clearing house facilities for netting of payments and securities delivery. Clearing houses guarantee all payments and deliveries. Securities include equities, debt and derivatives.

1.2.2 Brokers

Only brokers approved by the capital market regulator can operate on the stock exchange. Brokers perform the job of intermediating between buyers and sellers of securities. They help build-up an order book, carry out price discovery and are responsible for brokers' contracts being honoured. The services are subject to brokerage.

1.2.3 Equity and Debt Raisers

Companies wishing to raise equity or debt through stock exchanges have to approach a capital market regulator with the prescribed applications and a *proforma prospectus for permission to raise equity and debt and to get them listed on a stock exchange.

1.2.4 Investment Bankers (Merchant Bankers)

Merchant banks undertake a number of activities such as undertaking the issue of stocks, fund raising and management. They also provide advisory services and counsel on mergers and acquisitions etc. They are licensed by the capital market regulators.

1.2.5 Foreign Institutional Investors (FIIs)

FIIs are foreign-based funds authorised by the Capital Market Regulator to invest in the Indian equity and debt market through stock exchanges.

1.2.6 Depositories

Depositories hold securities in demat form (as opposed to physical form), maintain accounts of depository participants who, in turn, maintain sub-accounts of their customers. On instructions of the stock exchange clearing house, supported by documentation, a depository transfers securities from the buyers to sellers accounts in electronic form.

1.2.7 Mutual Funds
A mutual fund is a form of Collective Investment that pools money from investors and invests in Stocks, Debt and other Securities. It is a less risky investment option for an individual investor. Mutual funds require the regulators approval to start an asset management company (the fund) and each scheme has to be approved by the regulator before it is launched.

1.2.8 Registrars
Registrars maintain a register of share and debenture holders and process share and debenture allocation, when issues are subscribed. Registrars too need regulators approval to do business.

1.3 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)
Regulator for Insurance business, both general and life assurance. Regulates all aspects of insurance business, including licensing of insurance companies, framing regulations about the conduct of business and supervising all insurance activities in the country etc.

1.4 LET US SUM UP
The financial system comprises a mixture of intermediaries, markets and instruments that are related to each other. It provides a system by which savings are transformed into investments. The RBI (Reserve Bank of India), being the Central Banking Authority, exercises monetary control and supervises the banking institutions. Different institutions such as Commercial Banks, Non-Banking Finance Companies, Mutual Funds, Insurance companies, primary dealers, brokers, depositories and insurance agents, also different markets such as the capital market and the money market are part of the financial system. The three regulatory authorities viz., RBI, SEBI and IRDA are controlling and supervising the banking, capital market and insurance sectors respectively.

ANNEXURES
FIGURE A1.1: Organisation Chart of a Public Sector Bank
FIGURE A1.3: Distribution Channels of a Branch

1.5 CHECK YOUR PROGRESS
1. State whether following statements are True or False.
False: SEBI: a) RBI has direct supervision over depositories and mutual funds.
True: b) Monetary control is exercised through Cash Reserve Ratio and Statutory Liquidity Ratio.
False: Government Securities: c) Primary dealers mainly deal in shares, mutual fund units etc.
False: RBI: d) Issue and servicing of government debt is managed by commercial banks.
False: increases: e) The decrease in Statutory Liquidity Ratio contracts the credit creation.
2. Choose the correct word(s) from the bracket and complete the sentence.
a) Depositories hold securities in-demat-form, (demat, physical)
b) Cash Reserve Ratio is the-mandetory-deposit to be held by Banks with RBI. (voluntary, mandatory)
c) The-stock exchanges-provide clearing house facilities for netting of payments and securities delivery, (primary dealers, stock exchanges).
d) Urban Cooperative Banks are controlled by-State Governments-and-RBI-. NABARD, State Governments, RBI, SEBI).
e) Leasing, hire purchase and bill discounting are the domain of-Non-BankingFinance Companies-(Non-BankingFinance Companies, mutual funds, commercial banks)
3. Terminal questions.

(a) Distinguish between Banks and Non-Banking Finance Companies.
(b) Write a short note on the Indian financial system.
(c) Elucidate the role of RBI.
(d) What services are provided by merchant bankers? Are investment bankers and merchant bankers the same?
(e) Write in brief the role of Insurance Regulatory and Development Authority (IRDA).

1.6 ANSWERS TO 'CHECK YOUR PROGRESS'

1. True or false.
(a) False (Hint: SEBI) b) (True)
(c) False (Hint: Govt. Securities) (d) False (Hint: RBI)
(e) False (Hint: increases credit creation)
2. Choose the correct words,
(a) Demat
(b) Mandatory
(c) Stock Exchanges
(d) State Governments &RBI

UNIT 2 BANKING REGULATION

STRUCTURE

2.0 OBJECTIVES

After going through this unit, you should get an understanding of the various tools and techniques of banking regulation exercised by the Reserve Bank of India (RBI), which affect the functioning of commercial banks in India. This Unit would help you to better appreciate the basics of banking in India and would acquaint you with:

- Constitution and objectives of the RBI,
- Functions of the RBI as the regulator of the Indian Banking System,
- Monetary tools of the RBI and their effect on banks,
- Priority Sector Advances - their composition and rationale, and
- Regulatory Restrictions on Bank Lending.

2.1 INTRODUCTION

In Unit 1, you have observed that the banking system in India is regulated by the Reserve Bank of India as the central banking authority in the country. Banking regulation is not peculiar to India, as the banking system of every country is regulated by some authority in terms of the laws of the country concerned. Even in the United Kingdom, where banking has not been defined under any statute book, the banking system is regulated by the Bank of England as the central banking authority in terms of an enactment. In India too the banking system is regulated by the Reserve Bank of India, in terms of the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949.

A reasonable regulation of the banking system is essential to check the imprudence of the players, which can erode the confidence of the public in the banking system. The financial system deals with the people's money and it is necessary to generate, maintain and promote the confidence and trust of the people in the banking system at all times and with great care by preventing and curbing all possibilities of misuse and even imprudence by any of the players of the financial system. Thus, the rationale behind regulation of the financial/banking system is:

- To generate, maintain and promote confidence and trust of the public in the financial/banking system.
- To protect investor's interests by adequate/timely disclosure by the institutions and access to information by the investors.
- To ensure that the financial markets are both fair and efficient.
- To ensure that the participants measure up to the rules of the marketplace.

In India, which is a developing country, the role of the banking regulator (RBI), as also of the securities market regulator (Securities and Exchange Board of India - SEBI), is more crucial in achieving the aforesaid objectives of a stable banking/financial system. RBI has the added responsibility to smoothen and aid the process of economic development of the country via the banking system in tune with the national economic policies.

The foregoing objectives of the banking system with reference to the RBI would be discussed in this Unit. The RBI's statutory objectives and regulatory functions and tools would be explained in this Unit to enable you to better understand the various facets of banking that would be dealt with in the subsequent units.

2.2 RBI's CONSTITUTION AND OBJECTIVES

The Reserve Bank of India (RBI) was constituted under the Reserve Bank of India Act, 1934 and started functioning with effect from 1 April, 1935. RBI is the oldest among the central banks operating in developing countries, though it is much younger than the Bank of England and the Federal Reserve Board operating as the central banks in UK and USA respectively, being developed countries.

RBI is a state owned institution under the Reserve Bank (Transfer of Public Ownership) of India Act, 1948. This Act empowers the Union Government, in consultation with the Governor of the RBI, to issue such directions to RBI as considered necessary in public interest. The Governor and four Deputy Governors of RBI are appointed by the Union Government. The control of the RBI vests in the Central Board of Directors, that comprises the Governor, four Deputy Governors and 15 Directors nominated by the Union Government.

The RBI's internal management is based on functional specialisation and coordination amongst about 20 departments, with headquarters at Mumbai, which is the financial capital of the country.
The main objectives of the RBI are contained in the preamble of the RBI Act, 1934. It reads 'Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and 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'. The main objectives of RBI may be stated as follows in specific terms:

I. To maintain monetary stability such that the business and economic life of the country can deliver the welfare gains of a mixed economy,

II. To maintain financial stability and ensure sound financial institutions so that economic units can conduct their business with confidence,

III. To maintain stable payment systems, so that financial transactions can be safely and efficiently executed,

IV. To ensure that credit allocation by the financial system broadly reflects the national economic priorities and social concerns,

V. To regulate the overall volume of money and credit in the economy to ensure a reasonable degree of price stability,

VI. To promote the development of financial markets and systems to enable itself to operate/regulate efficiently.

2.3 RBI's MAIN FUNCTIONS

We will now discuss the essential functions of RBI that help it to achieve the objectives mentioned above. These are as follows:

2.3.1 Notes Issuance

RBI has the sole authority for the issuance of currency notes and putting them into circulation, withdrawing them or exchanging them. RBI has issued and put in circulation notes in the denomination of Rs. 2, 5, 10, 20, 50, 100, 500 and 1000, except Rs. 1 notes and all coins, which are issued by the Government of India, but put into circulation by RBI. The RBI has about seventeen Issue Offices and above 4,000 currency chests where new and reissuable notes are stored. The currency chests are kept by various banking groups as agents of RBI. The RBI Group has over 2,800 currency chests, Nationalised banks have about 800, Treasuries about 420 and private sector banks have about 20 currency chests. As a cover for the notes issue, RBI keeps a minimum value of gold coin, bullion and foreign securities as a part of the total approved assets.

2.3.2 Government's Banker

RBI acts as the banker to the Central and State Governments. As such, it provides them banking services of deposits, withdrawal of funds, making payments and receipts, collection and transfer of funds and management of public debt. Government deposits are received free of interest and RBI does not receive any remuneration for the routine banking business of the government. RBI also makes 'ways and means advance' to central and state governments, subject to certain rules and limits on the amount of overdrafts with a view to contain the fiscal deficit as decided by the central government. RBI charges a commission for managing the public debt and interest on overdrafts from the concerned governments.

2.3.3 Bankers' Bank

Every central bank acts as a bankers' bank and so does RBI. The commercial banks and state cooperative banks which are scheduled banks (appearing in the second schedule of the RBI Act) have to keep stipulated reserves in cash and in approved securities as a percentage of their Demand and Time Liabilities (DTL). These reserves, as discussed in a later section of this Unit, regulate the banks' ability to create credit and affect money supply in the economy.

RBI also changes its Bank Rate to regulate the cost of bank credit and thereby its volume indirectly. RBI also acts as a 'lender of the last resort' for banks by rediscounting bills and by refinance mechanism for certain kinds of credit, subject to the conditions laid down in its Credit Policy announced by annually.

2.3.4 Bank's Supervision

From November 1993, RBI's banking supervisory function has been separated from its traditional central banking functions. The Board of Financial Supervision (BFS) was set up in 1994 to oversee the Indian Financial System, comprising not only commercial banks, state cooperative banks, but also the All India Financial Institutions (AIFIs) and Non-Banking Finance Companies (NBFCs). The BFS has a full time vice-chairman and six other members, apart from the RBI Governor as its chairman.
RBI's supervisory powers over commercial banks are quite wide as mentioned below and their objective is to develop a sound banking system in the country:
i) To issue licences for new banks and new branches for the existing banks,
ii) To prescribe the minimum requirements for the paid-up capital and reserves, maintenance of cash reserves and other liquid assets,
iii) To inspect the working of the scheduled banks in India and abroad from all relevant angles to ensure their sound working.
iv) To conduct ad hoc investigations into complaints, irregularities and frauds pertaining to the banks.
v) To control appointments, reappointments, termination of Chairmen and CEOs of private banks.
vi) To approve or force amalgamation or merger of two banks. The recent example is the merger of Global Trust Bank with Oriental Bank of Commerce, after the RBI's moratorium (freezing) of the former in early 2004.

2.3.5 Development of the Financial System

This represents RBI's developmental role as against its regulatory and supervisory role over banks as mentioned above. RBI has created specialised financial institutions for:
i) Industrial finance: Industrial Development Bank of India (IDBI) in 1964, Small Industries Development Bank of India (SIDBI) in 1989.
ii) Agricultural credit: National Bank for Agriculture and Rural Development (NABARD) in 1981.
iii) Export-import finance: Export-Import Bank of India (EXIM Bank) in 1981.
iv) Deposits Insurance Corporation of India in 1961, which later became Deposit Insurance and Credit Guarantee Corporation of India (DICGC).
RBI has also initiated several schemes connected with various facets of banking which have significantly impacted the banking development in the country over the last five decades. Some of these are as follows:
i) Bill Market Scheme of 1952 and 1970.
ii) Lead Bank Scheme for backward districts development (1970s),
iii)P.L. Tandon Committee on Inventory norms for Bank Credit, 1974.*
iv) Credit Authorisation Scheme (1960s).*
v) Consortium Financing Scheme (1970s).*
vi) Priority Sector Advances Scheme (discussed later in this Unit).
Note: The schemes marked with an asterisk (*) have been discontinued after the liberalisation since 1991.
RBI has also tried to integrate the large unorganised financial sector (indigenous bankers, various kinds of non-banking finance companies etc.) into the organised financial system by regulating them to some extent. However, the task is so enormous and complex that it will take longer for RBI to have the desired integration of the two sectors, so as to work as a single financial system in the country.

2.3.6 Exchange Control

RBI is entrusted with the duty of maintaining the stability of the external value of the national Currency - Indian Rupee. It used to regulate the foreign exchange market in the country in terms of the Foreign Exchange Regulation Act (FERA), 1947 (amended and enlarged in 1973). The FERA, 1973 has been replaced by the Foreign Exchange Management Act, 1999 (FEMA) and RBI is now guided by the provisions of the new Act. The RBI performs the following tasks:

i) It administers foreign exchange control through its Exchange-Control Department. It authorizes the bank's specified branches and other dealers, called Authorised Dealers (ADs) to deal in the prescribed kinds of foreign exchange transactions and issues the AD series of circulars for regulating such transactions.

ii) It manages the exchange rate between the Indian Rupee and foreign currencies, by selling and buying foreign exchange to/from the Authorised Dealers and by other means,

iii) It manages the foreign exchange reserves of the country and maintains reserves in gold and foreign securities issued by foreign governments and international financial institutions.

2.3.7 Monetary Control

The RBI controls the money supply, volume of bank credit and also cost of bank credit (via the Bank Rate) and thereby the overall money supply in the economy. Money supply change is a technique of controlling inflationary or deflationary situations in the economy. The RBI issues monetary policy for the country as the Ministry of Finance issues fiscal policy and the Ministry of Commerce issues the EXIM policy of the country from time to time. All these policies are among the important macroeconomic policies that influence various businesses in the country. RBI issues monetary and credit policies annually.

2.4 TOOLS OF MONETARY CONTROL

RBI uses its monetary policy for controlling inflationary or deflationary situations in the economy by using one or more of the following tools of monetary control. These are discussed below.

2.4.1 Cash Reserve Ratio (CRR)

It refers to the cash that all banks (scheduled and non-scheduled) are required to maintain with RBI as a certain percentage of their demand and time liabilities (DTL). As you know, demand liabilities of a bank represent its deposits which are payable on demand of the depositors (viz., current and savings deposits) and time liabilities refer to its time deposits which are repayable on the specified maturities. In order to meet these liabilities in time (i.e. to keep liquidity), a bank has to keep a regulatory cash reserve with RBI (currently, it is 6.5 per cent for scheduled commercial banks). If a bank fails to maintain the prescribed CRR at prescribed intervals, it has to pay penal interest on the shortfall by adjustment from the interest receivable on the balances with RBI. A cut in the CRR enhances loanable funds with banks and reduces their dependence on the call and term money market. This will bring down the call rates. An increase in CRR will squeeze the liquidity in the banking system and reduce their lending operations and the call rate will tend to increase.

2.4.2 Statutory Liquidity Ratio (SLR)

It refers to the supplementary liquid reserve requirements of banks, in addition to CRR. SLR is maintained by all banks (scheduled and non-scheduled) in the form of cash in hand (exclusive of the minimum CRR), current account balances with SBI and other public sector commercial banks, unencumbered approved securities and gold. RBI can prescribe SLR from 0 per cent to 40 per cent of bank's DTL (presently it is 25 per cent). SLR has three objectives:

- To restrict expansion of banks' credit,
- To increase banks' investment in approved securities and
- To ensure solvency of banks.

The effect of an increase in SLR by RBI is the reduction in the lending capacity of banks by pre-empting (blocking) a certain portion of their DTL for government or other approved securities. It has therefore a deflationary impact on the economy, not only by reducing the supply of loanable funds of banks, but also by increasing the lending rates in the face of an increasing demand for bank credit. The reverse phenomena happens in case of a cut in SLR.

2.4.3 Bank Rate

Bank Rate is the standard rate at which RBI is prepared to buy or rediscount bills of exchange or other eligible commercial paper from banks. It is the basic cost of rediscounting and refinance facilities from RBI. The Bank Rate is therefore used by RBI to affect the cost and availability of refinance and to change the loanable resources of banks and other financial institutions. Change in the Bank Rate by RBI affects the interest rates on loans and deposits in the banking system across the board in the same direction, if not to the same extent. After deregulation and banking reforms since 1991, RBI has gradually loosened its direct regulation of deposit and lending rates and these are left to banks to decide through their boards, with only a few exceptions. However, RBI can still affect the interest rates via changes in its Bank Rate, whenever the situation of the economy warrants it.

2.4.4 Open Market Operations (OMOs)

This refers to sale or purchase of government securities (of Central or State governments or both) by RBI in the open market with a view to increase or decrease the liquidity in the banking system and thereby affect the loanable funds with banks. RBI can also alter the interest rate structure through its pricing policy for open market sale/purchase.

2.4.5 Selective Credit Control (SCC)

The RBI issues directives, under Sections 21 and 35A of the Banking Regulation Act, stipulating certain restrictions on bank advances against specified sensitive commodities as follows:

Pulses, other food grains (viz., coarse grains), oilseeds, oils including vanaspati, all imported oil seeds and oils, sugar including imported sugar (excepting buffer stocks and unreleased stock of sugar with sugar mills), Gur and Khandsari, Cotton and Kapas, Paddy/Rice and Wheat.

RBI's objective in issuing Selective Credit Control (SCC) directives is to prevent speculative holding of essential commodities and the resultant rise in their prices. RBI's general guidelines on SCC are:

(i) anks should not allow customers dealing in SCC commodities any credit facilities including against book debts/receivables or even collateral securities like insurance policies, shares, stocks and real estate) that would directly or indirectly defeat the purpose of the SCC directives,

(ii) Credit limits against each commodity covered by SCC directives should be segregated and the SCC restrictions be applied to each of such segregated limits.

Presently, only buffer stocks of sugar, unreleased stocks of sugar with sugar mills representing free sale sugar and levy sugar are covered by SCC directives.

2.5 OTHER TOOLS

RBI has used other tools of regulation in the past. However, after the liberalisation policy of 1991, most of these tools have since been discontinued and are no longer used by RBI. These tools are:

- Credit Rationing/Allocation
- Credit Authorisation Scheme
- Credit Planning
- Inventory and Credit Norms

2.6 REGULATORY RESTRICTIONS ON LENDING

There are certain regulatory restrictions on lending by banks in terms of RBI directives or the Banking Regulation Act, 1949 (BRA) as follows:
i) No advance or loan can be granted against the security of the bank's own shares or partly paid shares of a company,
ii) No bank can hold shares in a company:
a) As pledgee or mortgagee in excess of the limit of 30 per cent of the Paid-up capital of that company or 30 per cent of the Bank's Paid-up capital and Reserves, whichever is less (Sec. 19(ii) of BRA).
b) in the management of which Managing Director or Manager of the Bank is interested (Sec. 19(iii) of BRA).
iii) Bank's aggregate investment in shares, Certificate of Deposits (CDs), bonds, etc., should not exceed the limit of 40 per cent of Bank's net owned funds as at the end of the previous year,
iv) No bank should grant loans against:
a) CDs
b) FDs issued by other banks
c) Money Market Mutual Funds
(v) Bank should adhere to the RBI guidelines relating to the level of credit, margin and interest rate etc. for loans against the security of commodities covered by the Selective Credit Control Directives of RBI. No loan should be granted by banks to:
• The Bank's directors or firms in which a director is interested as a partner/manager/employee/guarantor (certain exemptions allowed).
• Relatives of other bank's directors ('relatives' defined by RBI) - Such loans can be sanctioned by higher authorities or the Bank's Board as per RBI guidelines.
vi) Banks should not sanction a new or additional facility to borrowers appearing in RBI's list of "Willful Defaulters" for a period of 5 years from the date of publication of the list by RBI.

2.7 LET US SUM UP

Reserve Bank of India is the central banking authority and regulator of the Indian Banking System, like the Federal Reserve Board in USA and Bank of England in UK. RBI was constituted under the Reserve Bank of India Act, 1934 and it draws its regulatory powers from this Act and also the Banking Regulation Act. RBI's main objectives are to maintain financial solvency and liquidity in the banking system,
stability in the exchange rate and internal value of the Rupee, to regulate the volume and flow of bank credit in tune with the national priorities and to develop financial institutions on sound lines.
RBI performs multifarious functions to achieve the above said objectives. Its main functions include Notes Issuance, Government's Banker, Bankers' Bank, Banks' Supervision, Development of the Financial System, Exchange Control, and Monetary Control.
RBI's main tools of Monetary Control are Cash Reserve Ratio, Statutory Liquidity Ratio, Open Market Operations, Bank Rate and Selective Credit Control. RBI uses these tools singly or in combination to control and rectify specific monetary situations in the economy or banking system from time to time. These measures affect the volume and cost of bank credit, besides maintaining the stability of the financial system.
In accordance with the government policy of poverty alleviation and improving the economic condition of the disadvantaged sections of the society, RBI has directed banks to lend to the specified Priority Sector with a minimum target of 40 per cent of their Net bank credit, with specified sub-targets for agriculture, weaker sections and the very poor sections of the society. Certain concessions in the lending terms and operations have also been prescribed by RBI for Priority Sector Advances.
There are also certain regulatory restrictions prescribed by RBI on lending by banks in terms of the Banking Regulation Act and also on grounds of prudence and to prevent abuse of bank credit.

2.8 CHECK YOUR PROGRESS

1. State whether each of the following statements are 'True' or 'False'.

T: a) RBI is the regulator of banks and the securities market in India.

T: b) RBI started functioning from 1934 and onwards.

T: c) RBI maintains the financial stability of financial institutions in India.

F: (d) Notes in the denomination from Rupee 1 to Rupees 1000 are issued by RBI.

F: e) RBI appoints the CEOs of private sector banks.

F: f) RBI has no power to amalgamate weaker banks with strong banks.

F: g) Credit Authorisation and Consortium of Finance schemes of RBI are still mandatory for commercial banks in India.

F: h) RBI currently draws its powers of regulating exchange control from FERA, 1973.

F: i) All scheduled bank branches can handle foreign exchange transactions.

F: j) SLR is lower than CRR.

*(k) As there is no sub-target for the SSI sector, it does not comprise the Priority Sector.

2. Fill in the blanks in the following sentences with appropriate word(s).

a) The Indian Banking System is regulated in terms of the provisions of ,
Act, 1934 and Act, 1949.

b) In USA and UK, the banking regulators are
And respectively.

c) RBI is a owned institution.

d) The Central Board of Directors of RBI comprises one ------------, four and fifteen -------------.

e) New and reissuable notes are stored in -------- ----------- maintained by banks as of RBI.

(f) RBI acts as the to the Central and Governments.

(g) In the Indian Banking System, RBI acts as the bank and also as lender of the ---------- ----------------.

(h) A decrease in the Bank Rate is likely to lead to a ----- in interest rates of banks.

(i) Monetary and Credit policy is issued by ------ each year ---- times.

(j) A decrease in CRR will -------. the liquidity in the banking system.

(k) To control inflationary situation in the economy, RBI can increase one or more of these monetary tool ---- or/ and ----- or / and -------.

3. Write the full form of the following acronyms.

ADs DTL PSA

(a) FERA	(b) FEMA	(c)
(d) CRR	(e) SLR	(f)
(g) OMO	(h) SCC	(i)
(j) SSI	(k) DRI	

4. Terminal Questions.

(a) Explain precisely the various reasons for regulating the banking system in a country.

(b) Enumerate the main supervisory powers of RBI over commercial banks.

(c) Explain the effect of an increase in the CRR and SLR on the banking system. Can RBI use
both of these monetary tools simultaneously?

(d) Does RBI have the power to control or influence directly or indirectly the interest rates of
banks in India and if so, in what manner and to what extent?

(e) Give at least eight examples of the Priority Sector. Also explain the rationale of PSA.

2.9 ANSWERS TO CHECK YOUR PROGRESS'

(a) False

(d) False
(g) False
(j) False
1. (a) Reserve Bank of India; Banking Regulation

(b) Federal Reserve Board; Bank of England
(c) State
(d) Governor; Deputy Governors; Directors
(e) Currency Chests; agents (f) Banker; State
(g) Bankers'; last resort (h) Decrease
(i) RBI; two (j) Improve
(k) CRR; SLR; Bank Rate

3. (a) Foreign Exchange Regulation Act (c) Authorised Dealers (e) Statutory Liquidity Ratio
(g) Open Market Operations (i) Priority Sector Advances (k) Differential Rate of Interest
(b) False
(e) True
(h) False
(k) False

(b) Foreign Exchange Management Act
(d) Cash Reserve Ratio
(f) Demand and Time Liabilities
(h) Selective Credit Control
(j) Small Scale Industries
(c) True
(f) False
(i) False

(b) Foreign Exchange Management Act
(d) Cash Reserve Ratio
(f) Demand and Time Liabilities
(h) Selective Credit Control
(j) Small Scale Industries

2.10 KEYWORDS

Monetary Stability, Payment System, Board of Financial Supervision, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Bank Rate, Open Market Operations (OMO), Priority Sector, Exchange Control.

Unit 3 RETAIL BANKING, WHOLESALE AND INTERNATIONAL BANKING, ADR, GDR AND PARTICIPATORY NOTES

STRUCTURE

3.0 OBJECTIVES

A study of this unit will help you to:

- know the concept, products, drivers of growth and opportunities of retail banking.
- have a glimpse of various products under wholesale banking.
- understand the meaning of international banking and different products.
- know about the financial instruments called ADRs and GDRs and its working.
- familiarise with participatory notes.

3.1 RETAIL BANKING

3.1.1Introduction to Retail Banking in India

Commercial Banks deal with different types of customers like individuals, sole proprietor/partnership firms, clubs, associations, trusts, schools, private limited companies and public limited companies etc. Until the late 1990s, banks have been mobilising deposits from all these customers but were lending mainly to the trade and industry only. In fact, the approach of the Government and the Reserve Bank of India was focussed at ensuring that the nation's scarce resources were directed towards production-oriented economic activities and bank financing to consumption expenses was discouraged. As a result, banks were reluctant to finance individuals for their consumption needs. However, under priority sector lending, banks were liberally financing individuals for agriculture and allied activities and also under various government sponsored schemes for their economic and financial upliftment. Hence, individual customers as a separate market segment were not thought of by bankers.

With the ushering in of economic reforms in India during the early 1990s, the banking sector was opened up to the private sector and the entire sector has been deregulated gradually. This resulted in operational flexibility and functional autonomy for the banks but competition also became very keen amongst the players. With liberalisation, the Indian economy also started growing fast and helped by the huge flow of foreign direct investments and foreign institutional investments into India, the liquidity in the banking system has improved a lot. The retail lending, especially, in emerging economies, showed a remarkable growth in the 1990s mainly due to rapid advances in information technology, the evolving macroeconomic environment, financial market reform and several micro-level demand and supply-side factors. With world-class technology, the private sector banks became very aggressive in business and to keep pace with them and to effectively counter competition, the public sector banks also followed them.

Liberalisation of the Indian economy, which has a young population, has led to increased incomes, and purchasing power, aspirations for a better lifestyle and expectations of higher quality products and services (a result of increasing influence of international trends and preference for international brands). The average Indian, who had a strong aversion to credit, is now in favour of credit for convenience in shopping, for financing housing, automobiles and consumer durables and even holidays. The stigma attached to debt has declined substantially. Consumerism is growing and the credit culture is here to stay.

3.1.2What is Retail Banking?

The banks also were in desperate need for augmenting their lending portfolio and also to diversify their portfolio risk. Banks took this opportunity to cater to the multiple banking requirements of the individuals by segmenting the individuals as a separate business market and called it by the name of 'Retail Banking'. Thus, we can define Retail Banking as doing banking business with individual customers.

Retail banking is, however, quite broad in nature - it refers to the dealing of commercial banks with individual customers, both on liabilities and assets sides of the balance sheet. Fixed, current/savings accounts on the liabilities side; and personal loans, housing, auto loans, and educational loans on the assets side, are the important products offered by banks. Related ancillary services include credit cards, debit cards and depository services. Today's retail banking sector is characterised by three basic features:

1. Multiple products (deposits, credit cards, insurance, investments and securities).
2. Multiple channels of distribution (call centre, branch, Internet and kiosk); and
3. Multiple customer groups (consumer, small business, and corporate).

Retail Products

The typical products offered in the Indian retail banking segment are:

Retail Deposit Products

- Savings Bank Account

- Recurring Deposit
- Recurring Deposit Account
- Current Deposit Account
- Term Deposit Account
- Zero Balance Account for salaried class people
- No Frills Account for the common man
- Senior Citizen Deposit Accounts, etc.

Retail Loan Products

• Home Loans to resident Indians for purchase of land and construction of residential house/purchase of ready built house/for repairs and renovation of an existing house.

- Home Loans to Non-Resident Indians
- Auto Loans - for purchase of new/used four-wheelers and two-wheelers
- Consumer Loans - for purchase of white goods and durables
- Personal loans - for purchase of jewels, for meeting domestic consumption etc.
- Educational Loans - for pursuing higher education both in India and abroad
- Trade related advances to individuals - for setting up business, retail trade etc.
- Crop loans to agricultural farmers
- Credit Cards etc.

Retail Services

- Safe Deposit Lockers
- Depository Services
- Bancassurance Products etc.

In the recent years, retail lending has turned out to be a key profit driver for banks with a retail portfolio constituting 21.5 per cent of the total outstanding advances, as on March 2004. It is reported that the overall impairment of the retail loan portfolio worked out much less than the Gross NPA ratio for the entire loan portfolio. Within the retail segment, the housing loans had the least gross asset impairment. In fact, retailing makes ample business sense in the banking sector.

3.1.4Drivers of Retail Business in India

1. The economic prosperity and the consequent increase in purchasing power has given a fillip to a consumer boom. During the fourteen years after 1992, India's economy grew at an average rate of 6.8 per cent and continues to grow at a higher rate - which is unique in the world.
2. Changing consumer demographics indicate vast potential for growth in consumption both qualitatively and quantitatively. India is one of the countries having highest proportion (70 percent) of the population below thirty-five years of age (young population). The report of Goldman Sachs for Brazil, Russia, India and China (BRIC), has predicted a bright future for India because of this demographic advantage.
3. Convenience banking in the form of debit cards, internet and phone banking, anywhere and anytime banking has attracted many new customers into the banking field. Technological innovations relating to increasing use of credit/debit cards, ATMs, direct debits and phone banking has contributed to the growth of retail banking in India.
4. The interest rate in the economy which was hovering at 12 per cent plus in the 1990s, suddenly started declining from 2000 onwards to as low as 5 to 6 per cent in 2004. Initially, this falling interest rate contributed to the growth of retail credit by generating the demand for such credit. The lowering of interest rates coupled with a robust growth in the economy resulted in many of the corporates posting higher profits and this resulted in a slow down in the offtake of credit by them.
5. After the liberalisation of the economy, the Indian banks adopted the best international practices of accounting and integrated risk management systems. The growth in the Retail Loans Portfolio also provided banks the opportunity to diversify their risks.

6. Further the delinquency rate, i.e. defaults in respect of retail advances was comfortably on the lower side when compared to the overall bank loans and advances and retail loans have put comparatively less of a provisioning burden on banks apart from diversifying their income streams.

Within the retail segment, the housing loans had the least gross asset impairment.

3.1.5 Opportunities of Retail Banking in India

Retail banking has immense opportunities in a growing economy like India. The rise of the Indian middle class is an important contributory factor in this regard. With the tremendous growth experienced by the Indian industries, in particular the software industry and the retailing sector, the percentage of middle to high-income Indian households is expected to continue rising. The combination of the above factors promises substantial growth in the retail sector. Finally, retail banking does not refer to lending only. One should not forget the role played by retail depositors. The homemaker, the retail shopkeeper, the pensioners, the self-employed and those employed in the unorganised sector - all need to get a place in the banks. In recent days, the Reserve Bank of India and the Government of India are very particular about 'Financial Inclusion' and the entire banking industry is viewing this as an emerging business opportunity.

On the other hand, rising indebtedness could turn out to be a cause for concern in the future. Sharing of information about the credit history of households is extremely important as far as retail banking is concerned. The Credit Information Bureau (India) Limited (CIBIL), incorporated in 2000, aims at fulfilling the need of credit granting institutions for comprehensive credit information by collecting, collating and disseminating credit information pertaining to both commercial and consumer borrowers.

3.2 WHOLESALE BANKING AND INTERNATIONAL BANKING

3.2.1 What is Wholesale Banking?'

Wholesale Banking refers to doing banking business with industrial and business entities - mostly corporates and trading houses, including multinationals, domestic business houses and prime public sector companies. Banks in India have been doing this type of business traditionally and this segment , of business is also called Corporate Banking/Commercial Banking. With competition open to even multinational banks, in servicing this segment of customers, banks are vying with each other in providing a wide array of commercial, transactional and electronic banking products. Banks achieve this through innovative product development and a well-integrated approach to relationship management. Every bank promises to provide superior product delivery, industry benchmark service levels and strong customer orientation. The product offerings are suitably structured taking into account a client's risk profile and specific needs.

3.2.2 Products

The products offered can be classified into four major groups, viz., Fund Based Services, Non-Fund Based Services, Value-Added Services and Internet Banking Services. To understand this better, a bouquet of products offered by one of the leading private sector banks is mentioned below.

1. Fund-based Services

a. Term Lending

b. short Term Finance

c. Working Capital finance

d. Bill Discounting

e. Structured Finance

f. Export Credit

2. Non-fund-based Services
a) Bank Guarantees b) Letter of Credit
c) Collection of Bills and Documents

3. Value-added Services
a) Cash Management Services
c) Vendor Financing
e) Corporate Salary Accounts
g) Forex Desk
i) Derivatives Desk
k) Tax Collection
b) Channel Financing
d) Real Time Gross Settlement
f) Syndication Services
h) Money Market Desk
) Employees Trusts
I) Bankers to Right/Public Issue

4. Internet Banking Services
a) Payment Gateway Services
c) Supply Chain Management
b) corporate Internet banking
d) Supply chain partners
All the banks have exclusive product structured to meet the requirements of the Government Sector. Banks have products to suit other banks in areas like Clearing sub-membership, DD/cheques payable at par, RTGS - Sub-membership, Cheque Collection, Funds Transfer, ATM tie-ups, etc. They also cater to the Financial Institutions by offering products like Cash Management Services and to Mutual Funds by offering products in the areas of Collection Services, Payment Services, Custodial Services and Funds Transfer. Banks also cater to the requirements of Stock Brokers like Clearing Settlement Bankers on Equity and Derivatives Segment, Professional Clearing Member of NSE Derivatives, Bank Guarantees etc.

3.3 INTERNATIONAL BANKING ,

3.3.1 Introduction

Every country manufactures certain goods and services beyond its requirements and they need to sell (export) this surplus production to other countries. Similarly, no country is self-reliant with regard to all its requirements and hence it needs to buy (import) certain goods and services from other countries in order to bridge the demand and supply in its economy. Further, in a liberalised free trade economy, the government and people of one country may invest capital and labour in another country and in turn may earn income in the form of profits, dividends, interest, royalty, etc. The foreign exchange market is the place where each country/people can pay for their requirements and receive their entitlements in their own home currency. Banks are amongst the active members of the foreign exchange market and they provide certain types of services to their customers called International banking services. Banking services catering to cross-border transactions is called International Banking. Banks have been traditionally offering various services to the international business people. These services can be broadly grouped into the following.

3.3.2 Needs of Exporters

1. Export Packing Credit: Banks provide preshipment finance in the form of Export Packing Credit (EPC) both in rupees as well as in foreign currencies to assist the exporters for manufacturing or packing the goods for export from India.

2. Export Bill Negotiation: Banks negotiate export bills drawn under Letter of Credit (LC), if the documents are found to be strictly in terms with the LC conditions and payment of the bills to the exporter is made even before the bills are realised from the importers.
3. Export Bill Purchase and Discounting: Even when the exports are not covered under Letter of Credit, banks sanction credit limits and pay the value of the invoice, immediately on shipment to the exporter at a discount. The export documents are presented and the proceeds will be credited to the advance account on realisation.
4. Export Bill Collection Sennces: The export documents are sent in collection by the exporter through his banker for payment by the overseas buyer on their presentation. Such payments received against the delivery of documents by the buyer's bank are remitted to the collecting bank and proceeds credited to his account after deducting commission and other charges, if any.
5. Bank Guarantees: Banks also issue Guarantees in foreign currency on behalf of exporters for approved purposes as defined under FEMA, subject to availability of credit limits or against 100 per cent cash margin.
6. Rupee Advance against Export Bills: If an exporter expects the currency of his invoicing to appreciate further and does not want to surrender the export value of forex, before the due date, banks offer rupee advance against export bills up to the due date of the receivables, subject to limit availability and RBI rules.
7. Export LC Advising: With a correspondent banking relationship with the leading banks across the world, Letter of Credit is advised through Banks.
8. Export LC Confirmation: When the exporter does not have confidence in the credit standing of an LC opening bank or if the political climate or credit risk of the buyer's country is not satisfactory, banks offer LC confirmation services.
9. Suppliers Credit: This facility enables Indian exporters to extend term credit to importers (overseas) of eligible goods at the post-shipment stage.

3.3.3 Requirements of Importers

1. Import Collection Bill *Services: Documentary Collections are a common and flexible method of payment for goods purchased from abroad. Although relatively simple in principle, they require careful and accurate attention to bills of exchange, stamping requirements on bill of exchange, bills of lading and other documents. Banks handle the Import collection documents meticulously and help the importers to remit the import value.
2. Direct Import Bills: FEMA allows importers to receive import documents directly from the overseas supplier subject to certain conditions and banks help importers to settle payments against the direct imports.
3. Advance Payment towards Imports: Whenever any advance payment to an overseas supplier is required to be made, banks provide advisory services and also assist in faster remittance to the suppliers.
4. Import Letters of Credit: Banks issue Import Letters of Credit on behalf of importers.
5. Arranging for Buyer's and Supplier's Credit: Banks offer a wide range of offshore financing options to importers and take care of their working capital requirements. Banks also arrange for financing import requirements of importers by way of Suppliers' credit and Buyers' credit.
6. Bank Guarantees: Banks issue Bank Guarantees in foreign currency on behalf of Importers for all approved purposes as defined under FEMA, against 100 percent cash margin or under regular limits.

3.3.4 Remittance Services

1. EEFC Account Services: Banks provide facilities to maintain an Exchange Earners Foreign Currency a/c (EEFC a/c) in all permitted currencies.
2. Receipt of Foreign Inward Remittances Services: Banks receive from abroad and credit them to the Indian beneficiaries accounts.

3. Payment Services to Abroad (Outward Remittances): Banks as Authorised Dealers in Foreign Exchange provide remittance facilities in foreign currency to any country for any permitted purpose up to the limits permitted by RBI.

3.4 UNIVERSAL BANKING

Universal banking means offering all types of financial products like banking, insurance, mutual funds, capital market related products including share broking, commodity broking, investment type products like sale of gold/bullion, government/corporate bonds, providing advisory services and Merchant Banking Activities, etc., - all at one place. The banking products would include all types of deposit (liability) products and also loan (asset) products like short-, medium- and long-term loans (project finance). The insurance products would cover both life and non-life insurance products including health insurance products. In other words, universal banking refers to a Super Financial Hub for marketing of all the financial products sold by the private / public/ government bodies under one roof. The main advantage of universal banking lies in the ability of banks to cross sell their products to a vast clientele of customers and thereby earn both fee based and a non-fee based income. The customer is equally benefited as it saves for him/her a lot of time and travel and helps him/her in getting speedy delivery of the products at one place.

3.4.1 Progress of Universal Banking in India

In the Indian Banking scenario, the first major step towards universal banking started in the year 2000 with the Government of India, notifying changes in the Banking Regulation Act allowing banks to venture into the insurance business, either with risk participation or without risk participation as corporate distribution agents of insurance companies. Further with the opening up of the insurance sector to private investments, most of the banks have either started their own insurance companies or entered into a strategic alliance with the insurance companies under the name of bancassurance for distribution of insurance products across their wide network of delivery channels. With more and more liberalisation of the economy, mutual funds have also tied-up with commercial banks to market their products and today banks are selling the products of different mutual funds under suitable tie-up arrangements. Another step towards universal banking was the merger of ICICI with ICICI Bank and the merger of *IDBI with *IDBI Bank and the resultant entity renamed as *IDBI Ltd. continuing as a commercial scheduled bank. Thus, the two mighty development finance institutions were merged into commercial banks and many commercial banks have started funding infrastructure projects. With the refinance institutions like SIDBI and NABARD also jumping into direct financing, many of the banks have tied-up with these institutions for joint appraisal and business sharing under the name of co-financing. With more and more freedom being given to banks and RBI gradually turning into a pure supervisor of banks, the distinction between the development finance institutions and commercial banks has greatly disappeared. In 2002, the RBI permitted participation of retail investors in the Government Securities market and some of the banks are offering customers the opportunity to invest directly in the debt market also. With prior approval of RBI, most of the banks in India sell imported Gold Coins of 999.9 purity (investment grade pure gold) by entering into tie-up arrangements with reputed mints abroad. Banks in India have become directly or through their subsidiaries, depository participants either with NSDL or CDSL and are offering demat services to investors. Banks also offer their customers internet-based e-broking services directly or through tie-up arrangements with SEBI registered brokers to even trade in the capital market. Some of the banks are also offering portfolio investment schemes to their residential NRI customers. Thus, banks in India have been progressively marching towards universal banking.

3.5 AMERICAN DEPOSITORY RECEIPTS (ADRs) AND GLOBAL DEPOSITORY RECEIPTS (GDRs)

A Depository Receipt (DR) is a type of negotiable (transferable) financial instrument that is traded on a local stock exchange of a country but represents a security, usually in the form of equity that is issued by a foreign publicly listed company. The Deposit Receipt, which is a physical certificate, allows investors to hold shares in equity of other countries. One of the most common types of Deposit Receipts is the American Depository Receipt (ADR), which has been offering companies, investors and traders global investment opportunities since the 1920s.
Since then, Deposit Receipts have spread to other parts of the globe in the form of Global Depository Receipts (GDRs) (the other most common type of Deposit Receipt), European DRs and International DRs. ADRs are typically traded on a US national stock exchange, such as the New York Stock Exchange (NYSE) or the American Stock Exchange, while GDRs are commonly listed on European stock exchanges such as the London Stock Exchange. Both ADRs and GDRs are usually denominated in US dollars, but can also be denominated in euros.

3.5.1 Deposit Receipt Mechanism

A Deposit Receipt is created when a foreign company wishes to list its already publicly traded shares or debt securities on a foreign stock exchange. Before it can be listed to a particular stock exchange, the company in question will have to meet certain requirements put forth by the exchange. Initial public offerings, however, can also take the form of Deposit Receipt. Deposit receipts can be traded publicly or over the counter.
Example
A Software company in India has fulfilled the requirements for DR listing and now wants to list its publicly traded shares on the NYSE in the form of an ADR. Before the software company's shares are traded freely on the exchange, a US broker, through an international office or a local brokerage house in India, would purchase the domestic shares from the Indian market and then have them delivered to the local (Indian) custodian bank of the depository bank. The depository bank is the American institution that issues the ADRs in America. In this example, let us take the depository bank as the Bank of New York. Once the Bank of New York's local custodian bank in India receives the shares, this custodian bank verifies the delivery of the shares by informing the Bank of New York that the shares can now be issued in the United States. The Bank of New York then delivers the ADRs to the broker who initially purchased them. Based on a determined ADR ratio, each ADR may be issued as representing one or more of the Indian local shares and the price of each ADR would be stated in US dollars converted from the equivalent Indian price of the shares being held by the depository bank. The ADRs now represent the local Indian shares held by the depository and can now be freely traded equity on the NYSE.
After the process whereby the new ADR of the Indian software company is issued, the ADR can be traded freely among the investors and transferred from the buyer to the seller on the NYSE, through a procedure known as intra-market trading. All ADR transactions of the Indian software company will now take place in US dollars and are settled like any other US transaction on the NYSE. The ADR investor holds privileges like those granted to shareholders of ordinary shares, such as voting rights and cash dividends. The rights of the ADR holder are stated on the ADR certificate.

3.5.2 The Benefits of Depository Receipts

The DR functions as a means to increase the global trade, which in turn can help increase not only volumes on local and foreign markets but also the exchange of information, technology, regulatory procedures as well as market transparency. Thus, instead of being faced with impediments to foreign investment, as is often the case in many emerging markets, the DR investor and company can both benefit from investment abroad. Let us take a closer look at the benefits.
TABLE 3.1 Benefits of Depository Receipts

- For the Company

A company may opt to issue a DR to obtain greater exposure and raise capital in the world market. Issuing DRs has the added benefit of increasing the share's liquidity while boosting the company's prestige in its local market (the company is traded internationally). Depository receipts encourage an international shareholder base and provide expatriates living abroad with an easier opportunity to invest in their home countries. Moreover, in many countries, especially those with emerging markets, obstacles often prevent foreign investors from entering the local market. By issuing a DR, a company can still encourage investment from abroad without having to worry about barriers to entry that a foreign investor might face.

- For the Investor

Buying into a DR immediately turns an investors' portfolio into a global one. Investors gain the benefits of diversification, while trading in their own market under familiar settlement and clearance conditions. More importantly, DR investors will be able to reap the benefits of these usually higher risk, higher return equities, without having to endure the added risks of going directly into foreign markets, which may pose lack of transparency or instability resulting from changing regulatory procedures. It is important to remember that an investor will still bear some foreign exchange risk, stemming from uncertainties in emerging economies and societies. On the other hand, the investor can also benefit from competitive rates the US dollar and euro have with respect to most foreign currencies.

Thus, an issue of ADR/GDR by a company in an overseas market gives people the opportunity to add the benefits of foreign investment while bypassing the unnecessary risks of investing outside their own borders, by adding these securities to their portfolio. As with any security, however, investing in ADRs requires an understanding of why they are used and how they are issued and traded.

3.6 PARTICIPATORY NOTES

Foreigners or non-residents (i.e. people living outside India other than Non-Resident Indians and Persons of Indian Origin) are not allowed to invest directly in the Indian stock market. Their involvement in the Indian capital market has to be carried out through a foreign institution, which in turn is required to register itself with Securities and Exchange Board of India (SEBI) as a foreign institutional investor (FII).

Participatory notes are like contract notes. These are issued by Foreign Institutional Investors (FIIs) to entities that want to invest in the Indian stock market but do not want to register themselves with the SEBI. FIIs registered with the SEBI and their sub-accounts can issue, deal or hold Participatory Notes.

The underlying security against these notes would be listed or proposed to be listed securities on any Indian stock exchange. FIIs issue these notes to investors abroad with details of scrips that can be bought and expected returns over specific periods of time. If the client agrees, they deposit the funds with the overseas branch of the FII. Then, the Indian arm of the FII proceeds with the transaction, buying the scrips in the Indian market and settling it on its own account. The details of the ultimate investor are not revealed at all in the Indian market or to the SEBI. In respect of participatory notes, the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIIs registered with a financial regulator.

On recommendation by the Lahiri Committee, in 2004, SEBI passed a regulation that derivative instruments like Participatory Notes against underlying Indian securities can be issued only to regulated entities and further transfers, if any, can also be to other regulated entities only. FIIs issuing such derivative instruments are therefore required to exercise due diligence and maintain complete details of investors, based strictly on 'know your client' principles. In the words of SEBI, 'A Foreign Institutional Investor or sub-account may issue, deal in or hold, offshore derivative instruments such as Participatory Notes, Equity Linked Notes or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only in favour of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation or establishment, subject to compliance of "know your client" requirement'.

FIIs are not allowed to issue Participatory Notes to Indian nationals, persons of Indian origin or overseas corporate bodies (which are majority owned or controlled by NRIs). This is done to ensure that the Participatory Note route is not used for money laundering purposes.
FIIs are required to report to the SEBI on a monthly basis if they issue, renew, cancel, or redeem Participatory Notes. The SEBI also seeks some quarterly reports about investing in Participatory Notes.

3.7 CHECK YOUR PROGRESS

1. The loan values (amount of loan) under retail lending normally range between
True: a) Rs. 20,000 to Rs. 100 lakh
(b) Rs. 100 lakh to Rs. 10 crore (c) More than Rs. 10 crore (d) None.
2. The Retail loans given by commercial banks are generally for duration of
True: a) five to seven years with housing loans granted for a longer duration of 15-20 years
(b)less than 5 years only.
(c)less than 1 year only.
(d) none.
3. The experience of banks in India in recent years under retail lending has shown that the following loans had the least level of impairment (defaults).
True: a) home loans portfolio
(b) consumer loans portfolio (c) vehicle loans portfolio (d) none
4. Wholesale banking refers to doing banking business with
(a) individuals
True: (b)industrial and business entities - including government and public sector companies.
(c) only companies registered under the Companies Act.
(d)large borrowers irrespective of their category
5. A Depository Receipt (DR) is a type of
True: a) negotiable (transferable) financial instrument that is traded on a local stock exchange of a country but represents a security, usually in the form of equity that is issued by a foreign publicly listed company.
(b) negotiable (transferable) financial instrument that is traded on a stock exchange of a foreign country but represents a security, usually in the form of equity that is issued by a foreign publicly listed company.
(c) negotiable (transferable) financial instrument that is traded on a local stock exchange of a country but represents a security, usually in the form of equity that is issued by a local publicly listed company.
(d) Receipt given by a depository participant of a depository.
6. 'Overseas Depository Bank' means
True: a) a bank authorised by the issuing company to issue Global Depository receipts against issue of Foreign Currency Convertible Bonds or ordinary shares of the issuing company;
(b) a bank authorised by the government to issue Global Depository receipts against issue of Foreign Currency Convertible Bonds or ordinary shares of the issuing company;
(c) a bank authorised by the issuing company to issue Global Depository Receipts against receipt of foreign currency;
(d) a bank where deposits in foreign currencies can be made.
7. Participatory notes are like contract notes issued by
True: a) Foreign Institutional Investors (FIIs) to entities that want to invest in the Indian stock market but do not want to register themselves with the SEBI.
(b) Commercial banks to their investors.
(c) Government of India to banks
(d) None.
8. On recommendation from Lahiri Committee, in 2004, SEBI passed a regulation that derivative, instruments like Participatory Notes against underlying Indian securities can be issued.

True: a) Only to regulated entities and further transfers, if any, can also be to other regulated entities only.
(b) Only to foreign banks
(c) Only to FIIs registered with SEBI
(d) None.

3.8 ANSWERS TO 'CHECK YOUR PROGRESS'

(a), 2. (a), 3. (a), 4. (b), 5. (a), 6. (a), 7. (a), 8. (a).
3.9 KEYWORDS
Retail Banking, Wholesale Banking, International Banking, Depository Receipts. Participatory notes.

Unit 4 ROLE AND FUNCTIONS OF CAPITAL MARKET, SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

STRUCTURE

4.0 OBJECTIVES

On reading this unit, the reader will be able to understand:
the structure of capital markets in India, and
the role and functions of Securities and Exchange Board of India (SEBI).

4.1 CAPITAL MARKETS Introduction

For starting any business, an entrepreneur needs investment in the form of capital. Depending on the size of the project, the requirement of capital will vary. In most cases, the entrepreneur may not be able to bring in the required capital from his own money. The entrepreneur may have to borrow the money from banks/financial institutions, friends or relatives. Borrowing has a cost in the form of 'interest' and this may prove to be a severe burden on the profitability of the business, particularly, in case of projects with long gestation (developments) periods. At the same time, interest cost has some tax advantage. The promoters will have to decide the financing aspect of the project, taking into consideration the various costs involved. Since the banks/financial institutions may demand a security for their loan in the form of collaterals, the promoters may choose to raise a major part of their requirement of capital money from the public by offering to the later, certain instruments like equity shares, debentures, bonds, and so on. In order to raise money from the public, SEBI has prescribed certain rules and regulations and by complying with the same, the promoters can raise their financial requirement in a market known as the capital market.

Capital market is a market for long-term debt and equity shares. In this market, capital funds comprising both equity and debt are issued and traded. This also includes private placement sources of debt and equity as well as organised markets like stock exchanges. Capital market can be further divided into the primary and secondary markets.

4.1.1Primary Market

In the primary market, securities (shares/bonds/debentures) are offered to the public for subscription, for the purpose of raising capital or fund. The issue of securities, shares or bonds in the primary market is subject to the fulfilment of a number of pre-issue guidelines by SEBI and compliance to various provisions of the Company Act. The primary market is classified into 'public issue' market and 'private placement' market. There are a number of intermediaries in the primary market such as merchant banker, issue manager, lead arranger, etc.

Banks participate in the market for subscription to issues as also bring banker to the Issue, arrange, handwritten, etc.

4.1.2Secondary Market

Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Secondary market comprises equity markets and debt markets. Secondary market is the trading avenue in which already existing/preissued securities are traded amongst investors. Secondary market could be either an auction or a dealer market. While stock exchange is the part of an auction market, Over the Counter (OTC) market is a part of the dealer market.

For the general investors, the secondary market provides an efficient platform for trading of securities and price discovery. For the managers of the company, secondary (equity) markets serve as a monitoring and control conduit (means) — by facilitating value enhancing control activities, enabling implementation of incentive-based management contracts and aggregating information (via price discovery) that guides management decisions. Banks facilitate secondary market transactions by opening direct trading and demat accounts to individuals and companies. Banks also extend credit against securities. They may also act as clearing house banks.

4.1.3Stock Exchanges in India

There are 22 recognised stock exchanges in India. In terms of legal structure, the stock exchanges in India could be segregated into two broad groups - nineteen stock exchanges which were set up as companies, either limited by guarantees or by shares, and the 3 stock exchanges which were Associations of Persons (AOPs), viz. Bombay Stock Exchange (BSE), Ahmedabad Stock Exchange (ASE) and Madhya Pradesh Stock Exchange (MPSE). The nineteen stock exchanges which have been functioning as companies include: the Stock Exchanges of Bangalore, Bhubaneswar, Calcutta, Cochin, Coimbatore, Delhi, Guwahati, Hyderabad, Interconnected SE, Jaipur, Ludhiana, Madras, Magadh, Pune, Saurashtra-Kutch, Uttar Pradesh, Vadodara, National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI). Apart from NSE, all stock exchanges, whether established as corporate bodies or as AOPs, were non-profit making organisations.

To improve the efficiency of the exchanges, it is necessary to corporatise them. Corporatisation is the process of converting the organisational structure of the stock exchange from a non-corporate to a corporate structure. Traditionally, some of the stock exchanges in India were established as AOPs, e.g. BSE, ASE and MPSE. Corporatisation of such exchanges is the process of converting them into incorporated companies.

4.1.4Demutualisation of Stock Exchanges

Demutualisation refers to the transition process of an exchange from a 'mutually owned' association to a 'shareholders-owned' company. In other words, transforming the legal structure of an exchange from a mutual form to a business corporation form is referred to as demutualisation. The above in effect means that after demutualisation the ownership, the management, and the trading rights at the exchange are segregated from one another.

In a mutual exchange, the three functions of ownership, management and trading are intertwined into a single group. Here, the broker members of the exchange are both the owners and the traders on the exchange and they further manage the exchange as well. A demutualised exchange, on the other hand, has all these three functions clearly segregated, i.e. the ownership, management and trading are in separate hands.

The BSE, NSE and OTCEI are not only corporatised but also demutualised with the segregation of ownership and trading rights of members.

The NSE was started in 1992 by banks and financial institutions including Industrial Financial Corporation of India (IFCI), IL&FS, Industrial Credit and Investment Corporation of India (ICICI), Punjab National Bank (PNB) and General Insurance Corporation. Foreign institutional investors can now invest up to 49 per cent in stock exchanges in India. There is, however, a limit of 5 per cent, beyond which no single investor either directly or indirectly, can hold shares in an Indian stock exchange. NSE, already has an enabling provision allowing a Foreign Institutional Investment (FII) up to 26 per cent and a Foreign Direct Investment (FDI) limit of 23 per cent of its paid-up capital. The paid-up capital of NSE is at present Rs. 45 crore. In January 2007, four select foreign investors, viz., the New York Stock Exchange Group, Goldman Sachs, General Atlantic and Japan's Softbank Asia Infrastructure Fund have picked up 5 per cent each, of the capital of NSE for a consideration of Rs. 2250-2500 crore.

4.1.5 Stock Brokers

A broker is a member of a recognized stock exchange, who is permitted to do trading on the screen-based trading system of different stock exchanges. He is enrolled as a member with the concerned exchange and is registered with SEBI.

A sub-broker is affiliated to a member of a recognised stock exchange and is a person who is registered with SEBI.

4.1.6 Financial Products/Instruments Dealt with in the Secondary Market

The following are the main financial products/instruments dealt in the secondary market:

Equity: Equity is the ownership interest in a company of holders of its common and preferred stocks. The various kinds of equity shares are as follows:

Equity Shares: An equity share is commonly referred to as an ordinary share. It represents the form of fractional ownership in which a shareholder, as a fractional owner, undertakes the entrepreneurial risk associated with a business venture. The holders of equity shares are

members of the company and have voting rights. A company may issue such shares with differential rights for voting, payment of dividend, etc.
Rights Issue/Rights Shares: This refers to the issue of new securities to the existing shareholders, at a ratio to those shares already held.Bonus Shares: These shares are issued by the companies to their shareholders free of cost by capitalisation of accumulated reserves from the profits earned in the earlier years or out of the share premium account.
Preferred Stock/Preference Shares: These shares do not offer voting rights. Owners of these shares are entitled to a fixed dividend or a dividend calculated at a fixed rate to be paid regularly before any dividend can be paid in respect of equity share. These shareholders also enjoy priority over the equity shareholders in the payment of surplus. In the event of liquidation, their claims rank below the claims of the company's creditors, bondholders/debenture holders, etc., but above the claims of the equity shareholders.
Cumulative Preference Shares: This is a type of preference share on which dividend accumulates if it remains unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.
Cumulative Convertible Preference Shares: This is a type of preference share where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.
Participating Preference Share: This refers to the right of certain preference shareholders to participate in profits, after a specified fixed dividend contracted for is paid. Participation right is linked with the quantum of dividend paid on the equity shares over and above a particular specified level.
Security Receipts: Security receipts mean receipts or other securities, issued by a securitisation company or a reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial assets involved in securitisation.
Government Securities (G-Secs): These are sovereign (credit risk free) coupon-bearing instruments which are issued by the Reserve Bank of India on behalf of the Government of India, in lieu of the Central Government's market borrowing programme. These securities have a fixed coupon that is paid on specific dates on a half-yearly basis. These securities are available in a wide range of maturity dates, from short-dated (less than one year) to long-dated (up to thirty years). The Government issues zero coupon bonds/securities too.
Debentures: Debentures are bonds issued by a company bearing a fixed rate of interest usually payable half-yearly, on specific dates and the principal amount repayable on a particular date on redemption of

the debentures. Debentures are normally secured/charged against the asset of the company in favour of the debenture holder.
Bond: A bond is a negotiable certificate evidencing indebtedness. It is normally unsecured. A Bond (debt security) security is generally issued by a company, municipality or a government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the loan. The various types of bonds are as follows:
1. Coupon Bonds: These are normal bonds on which the issuer pays the investor/holder interest at the
predetermined rate (known as coupon) at agreed intervals, normally twice a year. The maturity of the bond is known by the period for which it is issued. In the secondary market, since the interest
income is fixed to the face value, these bonds are traded at yield to maturity (YTM) based on market rates of interest.

2. Zero Coupon Bond: A bond issued at a discount and repaid at a face value is called a Zero Coupon Bond. No periodic interest is paid in this case. The difference between the issue price and redemption price represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond.

3. Convertible Bond: A bond giving the investor the option to convert the bond into equity at a fixed conversion price is referred to as a Convertible Bond.

Commercial Paper: Commercial papers are borrowings of a company from the market. They take the shape of short-term promises to repay fixed amounts. They are placed on the market either directly or through specialised intermediaries. Commercial papers are usually issued by companies with a high credit standing in the form of promissory notes, redeemable at par, to the holder on maturity and, therefore, does not require any guarantee. Commercial papers are money market instruments issued normally for a tenure of ninety days.

Treasury Bills: These are short-term (up to ninety-one days) bearer discount security, issued by the Government (through the Reserve Bank of India) as a means of meeting its cash requirements.

4.1.7 Regulatory Requirements Specified by SEBI for Corporate Debt Securities

All securities issued by a public issue must be listed in one or more stock exchanges. The issue of debt securities having a maturity period of more than 365 days by companies including listed companies (i.e. which have any of their securities, either as equity or debt, offered through an offer document and listed on a recognised stock exchange and also includes public sector undertakings whose securities are listed on a recognised stock exchange) on a private placement basis must comply with the conditions prescribed by SEBI from time to time for getting them listed on the stock exchanges. Further, unlisted companies/statutory corporations/other entities, if they so desire, may get their privately placed debt securities listed on the stock exchanges by complying with the relevant conditions. The debt securities shall carry a credit rating from a credit rating agency registered with SEBI. The debt securities shall be issued and traded in the demat form.

4.1.8 Commonly Used Terms in the Capital Market

Securities Transaction Tax (STT): Securities Transaction Tax (STT) is a tax being levied on all transactions done on the stock exchanges at rates prescribed by the Central Government from time to time. Pursuant to the enactment of the Finance (No. 2) Act, 2004, the Government of India notified the Securities Transaction Tax Rules, 2004 and STT came into effect from 1 October, 2004.

Rolling Settlement: In a Rolling Settlement, trades executed during the day are settled, based on the nett obligations for the day. Presently, the trades pertaining to the rolling settlement are settled on a T+2 day basis, where T stands for the trade day. Trades executed on a Monday, hence, are typically settled

on Wednesday (considering 2 working days from the trade day). The funds and securities pay-in and pay-out are carried out on T+2 day.

Pay-in Day and Pay-out Day: Pay-in day is the day when the brokers make payments or delivery of securities to the exchange. Pay-out day is the day when the exchange makes payment or delivery of securities to the broker. Settlement cycle is on a T+2 rolling settlement basis w.e.f. 1 April, 2003. The exchanges have to ensure that the pay-out of funds and securities to the clients is done by the broker within twenty-four hours of the pay-out. The exchanges will have to issue a press release immediately after the pay-out.

Auction: It is the main function of the exchange that both legs of a transaction namely the cash and security are available for settlement and there are no bad deliveries. In case of failure of delivery by a member, the exchange purchases the requisite quantity in the auction market and gives them to the buying or trading member. The shortages are met through an auction process and the difference in price indicated in the contract note and price received

through the auction is paid by the member to the exchange, which is then liable to be recovered from the client.
Securities Lending Scheme: Securities Lending and Borrowing is a scheme which enables lending of idle securities by the investors to the clearing corporation and earning a return through the same. For securities borrowing and lending system, clearing corporations of the stock exchange would be the nodal agency and be registered as the 'Approved Intermediaries' (AIs). The clearing corporation can borrow, on behalf of the members, securities for the purpose of meeting shortfalls. The defaulting selling broker may make the delivery within the period specified by the clearing corporation. In the event of the defaulted selling broker failing to make the delivery within the specified period, the clearing corporation has to buy the securities from the open market and return the same to the lender within seven trading days. In case of an inability to purchase the securities from the market, the transaction shall be closed out.

4.1.9 Types of Capital Issues in the Primary Market

In the primary market, issues can be classified as a public, rights or preferential issues (also known as private placements). While public and rights issues involve a detailed procedure, private placements or preferential issues are relatively simpler.

Public issues can be further classified into Initial Public Offerings (IPO) and Further Public Offerings (FPOs). In a public offering, the issuer makes an offer for the new investors to enter its shareholding family. The issuer company makes detailed disclosures as per the Disclosure and Investor Protection (DIP) guidelines in its offer document and offers it for subscription.

An IPO is the offering that is made when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves way for listing and trading of the issuer's securities.

An FPO is made when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document. An offer for sale in such a scenario is allowed only if it is made to satisfy listing or continuous listing obligations.

Rights Issue (RI) is when a listed company proposes to issue fresh securities to its existing shareholders as on a recorded date. The rights are normally offered in a particular ratio to the number of securities held prior to the issue. This route is best suited for companies who would like to raise capital without diluting the stake of its existing shareholders, unless they do not intend to subscribe to their entitlements.

A private placement is an issue of shares or of convertible securities by a company to a select group of persons under Section 81 of the Companies Act, 1956, which is neither a rights issue nor a public issue. This is a faster way for a company to raise equity capital.

A Qualified Institutional Placement (QIP) is a private placement of equity shares or securitiesconvertible into equity shares by a listed company to Qualified institutional buyers (QIB)only,in terms of provisions of chapter XIIIA of SEBI (DIP) guidelines.

4.1.10 Eligibility Norms for Making Capital Issues

SEBI has laid down eligibility norms for entities accessing the primary market through public issues. There are no eligibility norms for a listed company that is making a rights issue as it is an offer made to the existing shareholders who are expected to know their company. There are also no eligibility norms for a listed company making a preferential issue. However for a QIP, only those companies whose shares are listed in NSE or BSE and those who are having a minimum public float as required in terms of the listing agreement, are eligible.

Any company making a public issue or a listed company making a rights issue of a value of more than Rs. 50 lakh is required to file a draft offer document with SEBI for its observations. The validity period of SEBFs observation letter is only three months, i.e. the company has to open its issue within a period of three months. There is no requirement of filing any offer document/notice to SEBI in the case of preferential allotment and QIP. In

QIP, the merchant banker handling the issue has to file a copy of the placement document with SEBI post-allotment, for record purposes.

The merchant banks are the specialised intermediaries who are required to display due diligence and ensure that all the requirements of DIP are complied with, while submitting the draft offer document to SEBI. Any non-compliance on their part attracts penal action from SEBI, in terms of SEBI (Merchant Bankers) Regulations. The draft offer document filed by the merchant banker is also placed on the website for public comments. Officials of SEBI, at various levels, examine the compliance with DIP guidelines and ensure that all necessary material information is disclosed in the draft offer documents.

Offer Document means prospectus in case of a public issue, or offer for sale and Letter of Offer in case of a rights issue which are filed with Registrar of Companies (ROC) and stock exchanges. An offer document covers all the relevant information to help an investor to make his/her investment decision.

A Draft Offer Document means the offer document in a draft stage. The draft offer documents are filed with SEBI, at least twenty-one days prior to the filing of the offer document with ROC/SEs. SEBI may specify changes, if any, in the draft offer document and the issuer or the lead merchant banker (LM) shall carry out such changes in the draft offer document before filing the offer document with ROC/ SEs. The draft offer document will be available on the SEBI website for public comments for a period of twenty-one days from the filing of the draft offer document with SEBI.

Red Herring Prospectus (RHP) is a prospectus which does not have details of either price of number of shares being offered or the amount of issue. This means that in case the price is not disclosed, the number of shares and the upper and lower price bands are disclosed. On the other hand, an issuer can state the issue size, and the number of shares are determined later. An RHP for an FPO can be filed with the ROC without the price band. In such a case, the floor price or the price band will be notified by way of an advertisement one day prior to the opening of the issue. In the case of book-built issues, it is a process of price discovery and the price cannot be determined until the bidding process is completed. Such details are thus not shown in the RHP filed with ROC in terms of the provisions of the Companies Act. Only on completion of the bidding process, the details of the final price are included in the offer document. The offer document filed thereafter with ROC is called a prospectus.

Pricing of the Issue

Indian primary market ushered in an era of free pricing in 1992. Following this, the guidelines have provided that the issuer, in consultation with the merchant banker shall decide the price. There is no price formula stipulated by SEBI. SEBI does not play any role in the price fixation. The company and

merchant banker are however required to give full disclosures of the parameters which they had considered while deciding the issue price. There are two types of issues, one where company and LM fix a price (called fixed price) and other, where the company and LM stipulate a floor price or a price
band and leave it to market forces to determine the final price (price discovery through book building process).

An issuer company is allowed to freely price the issue. The basis of issue price is disclosed in the offer document where the issuer discloses in detail about the qualitative and quantitative factors justifying the issue price. The issuer company can mention a price band of 20 per cent (cap in the price band should not be more than 20 per cent of the floor price) in the draft offer documents filed with SEBI and actual price can be determined at a later date before filing of the final offer document with SEBI/ROCs. Book Building means a process undertaken, by which a demand for the securities proposed to be issued by a corporate body is elicited and built-up and the price for the securities is assessed on the basis of the bids obtained for the quantum of securities offered for subscription by the issuer. This method provides an opportunity to the market to discover the price for securities.

In a book built issue allocation, Retail Individual Investors (RIIs), Non-Institutional Investors (Nils) and QIBs are in the ratio of 35:15:50 respectively. In case the book built issues are made pursuant to the requirement of mandatory allocation of 60 per cent to QIBs in terms of Rule 19(2)(b) of SCRR, the respective figures are 30 per cent for RIIs and 10 per cent for Nils. Retail Individual Investor means an investor who apples or bids for securities of or for a value not more than Rs. 1,00,000.

4.1.11 Intermediaries in an ISSUE in the Primary Market.

Merchant bankers to the issue or Book Running Lead Managers (BRLM), syndicate members, registrars to the issue, bankers to the issue, auditors of the company, underwriters to the issue, solicitors, etc., are the intermediaries to an issue in the primary market.

Book Running Lead Managers (BRLM): A merchant banker possessing a valid SEBI registration in accordance with the SEBI (Merchant Bankers) Regulations, 1992 is eligible to act as a BRLM to an issue.

Safety Net: Any safety net scheme or buy-back arrangements of the shares proposed in any public issue shall be finalised by an issuer company with the lead merchant banker in advance and disclosed in the prospectus. Such a buy-back or safety net arrangement shall be made available only to original resident individual allottees limited to a maximum of 1000 shares per allottee and the offer is kept open for a period of six months from the last date of dispatch of securities.

Cut Off Price: In a book-building issue, the issuer is required to indicate either the price band or a floor price in the RHP. The actual discovered issue price can be any price in the price band or any price above the floor price. This issue price is called the Cut Off Price. This is decided by the issuer and LM after considering the 'book and investors' appetite for the stock. SEBI (DIP) guidelines permit only retail individual investors to have an option of applying at the cut off price.

4.2 THE SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI) The Government of India enacted the SEBI Act, 1992, on 4 April 1992 to provide for the establishment of a board, called the Securities and Exchange Board of India (SEBI) to protect the interests of investors in securities and to promote the development of and to regulate, the securities market and for matters connected therewith or incidental thereto (Prior to the formation of SEBI, some of the control functions were carried on by the controller of Capital Issues and the Company Law Board.).

4.2.1 Functions of the Board

1. Subject to the provisions of this Act, it shall be the duty of the board to protect the interests of in¬ vestors in securities and to promote the development of and to regulate the securities market, by:

(a) regulating the business in stock exchanges and any other securities markets;

(b)(i) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with the securities market in any manner;

(ii) registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies.

(c) registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds;

(d) promoting and regulating self-regulatory organisations;

(e) prohibiting fraudulent and unfair trade practices relating to the securities markets;

(f) promoting investors' education and training of intermediaries of security markets;

(g) prohibiting insider trading in securities;

(h) regulating substantial acquisition of shares and takeover of companies; (i) calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisations in the securities market;

(j) (i) calling for information and records from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities, which is under investigation or inquiry by the Board;
(ii) performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), as may be delegated to it by the Central Government;
(k) levying fees or other charges for carrying out the purposes of this section; (1) conducting research for the above purposes;
(i) calling fromor furnishing to any such agencies, as may be specified by the board, such information as may be considered necessary by it for the efficient discharge of its functions;
(m) performing such other functions as may be prescribed.
2. The board may take measures to undertake inspection of any book, or register or other document
or record of any listed public company or a public company (not being intermediaries), which intends to get its securities listed on any recognised stock exchange, where the board has reasonable
grounds to believe that such a company has been indulging in insider trading or fraudulent and
unfair trade practices relating to the securities market.
3. The board shall have the same powers as are vested in a civil court under the Code of Civil
Procedure, 1908 (5 of 1908), while trying a suit in respect of the following matters, namely:

(a) the discovery and production of books of account and other documents, at such a place and
time as may be specified by the board;
(b) summoning and enforcing the attendance of persons and examining them on oath;
(c) inspection of any books, registers and other documents of any person at any place;
(d) inspection of any book or register, or other documents or record of the company;
(e) issuing commissions for the examination of witnesses or documents.
4. The board may, by an order, for reasons to be recorded in writing, in the interests of investors or
the securities market, take any of the following measures, either pending investigation or inquiry
or on completion of such investigation or inquiry, namely:

suspend the trading of any security in a recognised stock exchange;
restrain persons from accessing the securities market and prohibit any person associated with the securities market to buy, sell or deal in securities;
suspend any office bearer of any stock exchange or self-regulatory organisation from holding such position;impound and retain the proceeds or securities in respect of any transaction which is under investigation; attach, after passing of an order on an application made for approval by the Judicial Magistrate of the first class having jurisdiction, for a period not exceeding one month, one or more bank
account or accounts of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of this Act or the rules or the regulations made thereunder. This provided that only the bank account or accounts or any transaction entered therein, so far as it relates to the proceeds actually involved in violation of any of the provisions of this Act, or the rules or the regulations made thereunder shall be allowed to be attached;

(a) direct any intermediary or any person associated with the securities market in any manner not
to dispose of or alienate an asset, forming part of any transaction which is under investigation.
Powers of SEBI to Regulate or Prohibit Issue of Prospectus, Offer Document or Advertisement Soliciting Money for Issue of Securities: Without prejudice to the provisions of the Companies Act, 1956, (1 of 1956), SEBI may, for the protection of investors,
(a) specify, by regulations:
(i) the matters relating to issue of capital, transfer of securities and other matters incidental thereto; and (ii) the manner in which such matters shall be disclosed by the companies;
(b) by general or special orders:
(i) prohibit any company from issuing prospectus, any offer document or advertisement soliciting
money from the public for the issue of securities;
(ii) specify the conditions subject to which, the prospectus, such offer document or advertisement, if not prohibited, may be issued.
Without prejudice to the provisions of Section 21 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), SEBI may specify the requirements for listing and transfer of securities and other matters incidental thereto.
4.2.2 Power to Investigate
When SEBI has reasonable ground to believe that:
the transactions in securities are being dealt with in a manner detrimental to the investors or the
securities market; or
any intermediary or any person associated with the securities market has violated any of the provisions
of this Act or the rules or the regulations made or directions issued by SEBI thereunder,
it may, at any time by order in writing, direct any person (specified in the order to investigate the affairs of such intermediary or persons associated with the securities market) to report thereon to the board, for taking suitable action.
4.2.3 Cease and Desist Proceedings
If SEBI finds, after causing an inquiry to be made, that any person has violated, or is likely to violate, any provisions of this Act, or any rules or regulations made thereunder, it may pass an order requiring such person(s) to cease and desist from committing or causing such violation.

4.3 REGISTRATION OF STOCK BROKERS, SUB-BROKERS, SHARE TRANSFER AGENTS, ETC.

1. No stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with the securities market shall buy, sell or deal in securities except under and in accordance with, the conditions of a certificate of registration obtained from SEBI in accordance with the regulations made under this Act.
2. No depository, participant, custodian of securities, foreign institutional investor, credit rating agency or any other intermediary associated with the securities market as the Board may, by notification in this behalf specify, shall buy or sell or deal in securities except under and in accordance with the conditions of a certificate of registration obtained from SEBI in accordance with the regulations made under this Act.
3. No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or collective investment schemes including mutual funds, unless he obtains a f registration from SEBI in accordance with the regulations.

4. Every application for registration shall be in such a manner and on payment of such fees as may be determined by the regulations.

5. SEBI may, by order, suspend or cancel a certificate of registration in such manner as may be determined by regulations.

Provided that no order under this sub-section shall be made unless the person concerned has been given a reasonable opportunity of being heard.

4.4 QUALIFIED INSTITUTIONAL BUYERS (QIBs)

Qualified Institutional Buyers (QIBs) are those institutional investors who are generally perceived to possess an expertise and the financial muscle to evaluate and invest in the capital markets. In terms of Clause 2.2.2B (v) of DIP guidelines, a 'Qualified Institutional Buyer' shall mean:

(a) public financial institution as defined in section 4A of the Companies Act, 1956;
(b) scheduled commercial banks;
(c) mutual funds;
(d) foreign institutional investor registered with SEBI;
(e) multilateral and bilateral development financial institutions;
(f) venture capital funds registered with SEBI;
(g)foreign venture capital investors registered with SEBI;
(h)State Industrial Development Corporations;
(i) Insurance Companies registered with the Insurance Regulatory and Development Authority (IRDA); (j) Provident Funds with a minimum corpus of Rs. 25 crore; (k) Pension Funds with minimum corpus of Rs. 25 crore.

These entities are not required to be registered with SEBI as QIBs. Any entity falling under the categories specified above is considered as a QIB for the purpose of participating in the primary issuance process.

4.5 CHECK YOUR PROGRESS

1. The main function of SEBI is:
to protect the interests of investors in securities
to promote the development of the securities market
to regulate securities market (d) all the above.

2. SEBI in respect of certain matters, has the same powers:
(a) as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit,
(b) as are vested in a criminal court under the Criminal Procedure Code while trying a suit
(c) as the Company Law Board
(d) none.

3. One of the following categories of investors need not obtain a certificate of registration from SEBI in order to buy, sell or deal in securities:
(a) stock broker (b) portfolio manager
(c) investment adviser (d) retail investor.

4. The ownership, management and trading functions of a stock exchange are clearly segregated in respect of
(a) Demutualised exchange (b) Corporatised exchange
(c) Any stock exchange (d) None.

5. The issue of new securities to existing shareholders at a ratio to those already held is known as:
(a) Rights Issue/Rights Shares (b) Bonus Issue
(c) Preference Issue (d) None.

6. Initial Public Offering (IPO) means that an unlisted company makes to the public for the first time:
(a) a fresh issue of securities (b) offers its existing securities for sale
(c) both the above (d) none.

7. As per SEBI guidelines, in a Book Building process the cap in the price band
(a)should be at least 10 per cent of the floor price
(b) should not be more than 20 per cent of the floor price
(c) no limits (d) None.
8. 'Retail individual investor' means an investor who applies or bids
(a) for securities of or for a value of not more than Rs. 1,00,000
(b) for securities of face value of not more than Rs. 1,00,000
for securities of 1000 units (d) none.
9. As per SEBI guidelines, safety net arrangements can be made available only to:
(a) all original resident individual allottees limited up to a maximum of 1000 shares per allottee
(b) all original allottees limited up to a maximum of 1000 shares per allottee
(c) all shareholders limited up to a maximum of 1000 shares per shareholder
(d) none.
10. Red Herring Prospectus is a prospectus
(a) which is issued in red colour
(b) which contains some clauses in red colour
(c)which does not have details of either price or number of shares being offered or the amount of issue
(d) none.

4.6 ANSWERS TO 'CHECK YOUR PROGRESS

'1. (d), 2. (a), 3. (d) 4. (a), 5. (a), 6. (c), 7. (b), 8. (a), 9. (a), 10. (c).

4.7 KEYWORDS

Collective investment scheme, Equity shares, Rolling settlement, Offer document, Safety net.

ROLE AND FUNCTIONS OF MUTUAL FUNDS

STRUCTURE

5.0 OBJECTIVES

On reading this unit, you will be able to
understand the concept of mutual funds in India,
know about the regulatory requirements regarding a mutual fund,
know about different types of mutual fund schemes,
understand the role of intermediaries/distributors in the functioning of mutual funds, and
understand the concept of universal banking.

5.1 WHAT IS A MUTUAL FUND?

Mutual fund is a mechanism for pooling resources from the public by issuing units to them and investing the funds, so collected in securities in accordance with objectives as disclosed in an offer document. Mutual fund issues units to investors in accordance with the quantum of money invested by them. Investors of mutual funds are known as unit holders. The profits or losses of fund/plan are shared by the investors in proportion to their investments. A mutual fund is required to be registered with SEBI, which regulates the securities markets before it can collect funds from the public. SEBI formulates the policies and regulates the mutual funds to protect the interest of the investors.

5.2 MANAGEMENT OF MUTUAL FUNDS

A mutual fund is set up in the form of a trust, which has sponsors, trustees, Asset Management Companies (AMCs) and custodians. The trust is established by a sponsor or more than one sponsor. A sponsor is like a promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders. An AMC approved by SEBI manages the funds by making investments in various types of securities. A custodian, who is also registered with SEBI, holds the securities of the various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over the AMC. They monitor the performance and compliance of SEBI regulations by the mutual fund.

SEBI regulations require that at least two-thirds of the directors of the trustee company or board of trustees must be independent, i.e. they should not be associated with the sponsors. Also, 50 per cent of the directors of the AMC must be independent.

The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV). The NAV per unit is the market value of securities of a scheme, less the expenses incurred on the scheme, divided by the total number of units of the scheme on any particular date. NAV is required to be dis¬closed by the mutual funds on a regular basis - daily or weekly - depending upon the type of scheme.

5.3 DIFFERENT TYPES OF MUTUAL FUND SCHEMES

A mutual fund scheme can be classified into an open-ended fund or a close-ended fund depending on its maturity period. A scheme can also be classified as a Growth Fund, Income Fund, or Balanced Fund considering its investment objective.

Open-ended Scheme/Plan: An open-ended scheme/plan is one that is available for subscription and repurchase on a continuous basis. These schemes do not have fixed maturity periods. Investors can conveniently buy and sell units at NAV related prices which are declared on a daily basis. The mutual fund buys and sells units regularly. The key feature of the open-ended schemes is liquidity.

Close-ended Scheme/Plan: A close-ended scheme/plan has a stipulated maturity period, e.g. 3-10 years. The fund is open for subscription only during a specified period at the time of launch of the scheme. Investors can invest in the scheme at the time of the initial public offer and thereafter they can

buy or sell the units of the scheme on the stock exchanges in case the units are listed in a recognised stock exchange. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. SEBI regulations stipulate that at least one of the two exit routes be provided to the investor, i.e. either repurchase facility or through listing on stock exchanges. These mutual fund schemes disclose NAV generally on a weekly basis.

Growth Scheme/Equity Oriented Scheme: The aim of growth funds is to provide capital appreciation over medium- to long-term period. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively higher risks. These schemes provide different options to the investors like dividend option, capital appreciation etc. and the investors may choose an option depending on their preferences.

Income Scheme/Debt Oriented Scheme: The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected by fluctuations in equity markets. Opportunities of capital appreciation, however, are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country.

If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice-versa.
Balanced Plan/Scheme: Balanced plans are used to provide both growth and regular income, as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. They generally invest 40-60 per cent in equity and debt instruments. These funds are also affected by fluctuations in share prices in the stock markets. NAVs of such funds are however likely to be less volatile as compared to pure equity funds.
Money Market or Liquid Fund: These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and to ensure a moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter bank call money, government securities etc. Returns on these schemes fluctuate much less compared to other funds.
Gilt Fund: These funds invest exclusively in government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.
Index Funds: Index funds replicate the portfolio of a particular index such as the BSE sensitive index, S&P NSE 50 index (Nifty), etc. These schemes invest in the securities in the same weightage comprising an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factors known as 'tracking error' in technical terms.
There are also exchange traded index funds launched by the mutual funds which are traded on the stock exchanges.
Sector Specific Funds: These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents, e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to the diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time. They may also seek the advice of an expert.
Tax Saving Schemes: These schemes offer tax rebates to the investors under specific provisions of the

Income Tax Act, 1961, as the Government offers tax incentives for investment in specified avenues, e.g. Equity Linked Savings Scheme (ELSS). Pension schemes, launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest predominantly in equities. Their growth opportunities and the risks associated are like any equity oriented scheme.
Fund of Funds (FoF): A scheme that invests primarily in other schemes of the same mutual fund or other mutual funds is known as a Fund of Funds (FoF) scheme. An FoF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe.

5.3.1 Repurchase or Redemption Price

Repurchase or redemption price is the price or NAV at which an open-ended scheme purchases or redeems its units from the unit holders. Subject to provisions in each scheme or fund it is generally seen that fund houses stipulate an exit load. Thus, an investor getting out of a scheme will get an amount equal to NAV minus exit load, if any.
Assured Return Scheme: Assured return schemes are those schemes that assure a specific return to the unit holders irrespective of performance of the scheme.
A scheme cannot promise returns unless such returns are fully guaranteed by the sponsor or AMC and this is required to be disclosed in the offer document.

5.4 ROLE OF MUTUAL FUNDS IN THE CAPITAL MARKET

Mutual funds are emerging as an important financial intermediary for the investing public in India. Conceptually and operationally they are different from banks. The key channel in

bringing the mutual funds to a large number of investors all over the country is the network of intermediaries/distributors. These intermediaries/distributors have to take on the role of financial advisors to investors.
SEBI has made it mandatory for any entity/person engaged in marketing and selling of mutual fund products to pass the Association of Mutual Funds in India (AMFI) certification test (Advisors Module) and obtain a registration number from AMFI. Firms and corporates will have to obtain certificate of registration from AMFI and all employees of corporate distributors engaged in selling and marketing of mutual fund products have to pass the AMFI certification test (Advisors Module) and obtain registration with AMFI before canvassing the business of mutual funds.
These days, banks also enroll themselves as corporate distributors and have started marketing mutual fund products by using their large branch networks and the existing infrastructure. Since mutual funds pay around 1.5 to 2.5 per cent of the business canvassed, as brokerage/commission to the distributors, the banks also get an additional avenue for earning fee-based income. Further, the mutual fund products also suit their bouquet of financial products which could be sold under one roof as a financial supermarket.

5.5 CHECK YOUR PROGRESS

1.A mutual fund is set up in the form of:
(a) a trust
(b) a Company incorporated under the Indian Companies Act
(c) by an Act of Parliament
(d) none.

2.A mutual fund has, apart from its sponsors:
(a) Trustees (b) Asset Management Company
(c) Custodian (d) All of the above.

3. The main function of an Asset Management Company is to:
(a) hold the securities of various schemes
(b) manage the funds by making investments in various types of securities
(c) hold its property for the benefit of the unit holders
(d) all the above.

4. NAV is required to be disclosed by the mutual funds on a ---- on -----basis:
(a) daily (b) weekly
(c) depending on the type of scheme (d) none.

5. A Fund of Funds is a scheme that invests primarily:
(a) in money market instruments
(b) in other schemes of the same mutual fund or other mutual funds
(c) in the bullion market
(d) only in primary market.

6. The aim of balanced funds is to provide:
(a) growth (capital appreciation) (b) regular income
(c) both growth and regular income (d) none.

7. As per SEBI guidelines, any entity/person engaged in the marketing and selling of mutual fund products is required to pass a certification test and obtain a registration number from:
(a) SEBI (b) AMFI
(c) NSE (d) None.

5.6 ANSWERS TO CHECK YOUR PROGRESS'

1. (a), 2. (d), 3. (b), 4. (c), 5. (b), 6. (c), 7. (b).

5.7 KEYWORDS

Custodian, Asset Management Company (AMC), Net Asset Value (NAV), Universal Banking.

ROLE AND FUNCTIONS OF INSURANCE COMPANIES, BANCASSURANCE AND INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

STRUCTURE

OBJECTIVES

Reading through this unit will enable the reader to.

(a) understand the historical background of the insurance industry in India.
(b)know the regulatory requirements of the industry,
(c)know the different types of insurance policies and the new products introduced,
(d)know about bancassurance and its models,
(e) know about Insurance Regulatory and Development Authority and its functions and powers,
(f)know the role of intermediaries/agents in the industry and their licensing requirements.

6.1 THE ROLE AND FUNCTION OF INSURANCE COMPANIES

6.1.1 Introduction

The Indian Insurance Industry is as old as it is in any other part of the world. The first insurance company in India was started in 1818 in Kolkata. We had a number of foreign and Indian insurers operating in the Indian market till the nationalisation of the industry took place. The reasons for the nationalisation of the industry are concerned mostly with the unethical practices adopted by some of the players against the interests of the insurance consumers. Nationalisation has lent the industry solidity, growth and outreach, which is unparalleled. Along with these achievements there however also grew a feeling of insensitivity to the needs of the market, tardiness in the adoption of modern practices to upgrade technical skills coupled with a sense of lethargy, which probably led to a feeling amongst the public that the insurance industry was not fully responsive to customer needs. The committee on reforms in the insurance sector went into the question of reforms in the insurance sector recommended in 1994, opening the sector to private participation to induce a spirit of competition amongst the various insurers and to provide a choice to the consumers. It was also the hope of the Committee that such a broad-basing of the industry will ensure a better penetration of the insurance market of the country in terms of the Gross Domestic Product (GDP), which remains at very low levels in comparison to some of the developing countries in the Asian region.

6.1.2 Players in the Indian Insurance Market

The insurance industry, till the year 1999-2000, comprised mainly of two players. In the life insurance segment, Life Insurance Corporation (LIC) of India Ltd. was the sole player and in the general insurance segment, General Insurance Corporation of India (GIC) was the player with its four subsidiaries, namely,

(a) The Oriental Insurance Company Limited.
(b) The New India Assurance Company Limited.
(c) National Insurance Company Limited.
(d) United India Insurance Company Limited

GIC has been converted into a National reinsurer and these four subsidiaries have been delinked from the parent company and made into an independent insurance company (with effect from December 2000).

6.1.3 Opening Up of the Insurance Sector

The insurance sector was opened up in the year 1999, facilitating entry of private players into the industry. The entry level capital requirements were kept sufficiently high at Rs. 1 crore to deter corporates other than those who had sufficiently long-term interests and which had the capability to continuously raise funds through equity contributions from the promoters till such time as the operations stabilise. The regulatory framework, which was designed for the operation of insurance companies, laid down the ground rules for insurers and is equally applicable to both the state-owned and the private insurers.

The new environment has facilitated competitive conditions and the industry has exhibited a healthy growth trend, in both the life and non-life segments. The new players not only succeeded in establishing themselves, but also captured a healthy market share. The existing insurers have also been able to show growth in the premium underwritten by them.

Currently, as per IRDA's annual report, 2005-06, there are fourteen life and fourteen non-life insurance companies. Out of the non-life insurance companies, two are specialised insurance companies, viz., Agricultural Insurance Company, which handles crop insurance business and Export Credit Guarantee Corporation, which only transacts export credit insurance.

Number of Registered Insurers in India

TABLE 6.1: Registered Insurers in India

Types of Business Public Sector Private Sector Total
Life Insurance
General Insurance Reinsurance 1
6
1 13
8
0 14
14
1
Total 8 21 29

6.1.4 Regulatory Requirements of the Industry

In the year 2000, the IRDA was constituted as an autonomous body to regulate and develop the business of insurance and reinsurance in the country in terms of the Insurance Regulatory & Development Authority Act, 1999. The Authority has been entrusted with the requisite regulations in the areas of registration of insurers, their conduct of business, solvency margins, conduct of reinsurance business, licensing and code of conduct of intermediaries, etc. The Indian insurance market is thus run and regulated on globally acceptable standards.

6.1.5 Types of Insurance Business

Insurance business is divided into four classes:

(a) Life Insurance

(c) Marine Insurance

(b) Fire Insurance

(d) Miscellaneous Insurance.

Life Insurers transact life insurance business; General Insurers transact the rest. No composites are permitted as per the law.

Legislation: Insurance is a federal subject in India. The primary legislations that deal with the insurance business in India are:

- Insurance Act, 1938, and
- Insurance Regulatory & Development Authority Act, 1999.

6.1.6 Insurance Products

Life Insurance

Popular Products: Endowment Assurance (Participating), Money Back (Participating) and Term Assurance (Non-Participating) Policies. More than 80 per cent of the life insurance business is from these products.

General Insurance

Fire and miscellaneous insurance businesses are predominant in this category. Motor vehicle insurance is compulsory.

The Tariff Advisory Committee (TAC) lays down tariff rates for some of the general insurance products.

Several new products have been launched by life insurers. These include the Unit Linked Insurance Products (ULIP).

Contract of Insurance

A contract of insurance is a contract of utmost good faith, technically known as uberrima fides. The doctrine of disclosing all material facts is embodied in this important principle, which applies to all forms of insurance.

At the time of buying a policy, the policyholder should ensure that all questions in the proposal form are correctly answered. Any misrepresentation, non-disclosure or fraud in any document, leading to the acceptance of the risk would render the insurance contract null and void.

6.1.7 Life Insurance

Life insurance is a contract that pledges payment of an amount to the person assured (or his nominee) on the occurrence of the event insured against.

The contract is valid for payment of the insured amount during:

- the date of maturity, or
- specified dates at periodic intervals, or
- unfortunate death, if it occurs earlier.

Among other things, the contract also provides for the payment of a premium periodically to the insurer by the policyholder. Life insurance is universally acknowledged to be a mechanism, which eliminates 'risk', substituting certainty for uncertainty and comes to the timely aid of the family in the unfortunate event of death of the breadwinner.

By and large, life insurance is civilisation's partial solution to the problems caused by death. Life insurance, in short, is concerned with two hazards that stand across the life path of every person:

1. Premature death and leaving a dependent family to fend for itself.
2. Living till old age without a visible means of support.

6.1.8 Advantages of Life Insurance: Financial Protection

Savings through life insurance guarantee protection against the risk of death of the saver. Moreover, in case of demise, life insurance assures payment of the entire amount assured (with bonuses wherever applicable) whereas in other saving schemes, only the amount saved (with interest) is payable.

Aid to Thrift: Life insurance encourages 'thrift'. It allows long-term savings since payments can be made effortlessly because of the 'easy instalment' facility built into the scheme (premium payment for insurance could be monthly, quarterly, half-yearly or yearly).

For example: The Salary Saving Scheme, popularly known as SSS, provides a convenient method of paying the premium each month by deducting the amount from one's salary.

In this case, the employer directly pays the deducted premium to the insurer.

Liquidity: It is easy to acquire loans on the sole security of any policy that has acquired a loan value. Besides, a life insurance policy is also generally accepted as security, even for a commercial loan.

Tax Relief: Life insurance is the best way to enjoy tax deductions on income tax and wealth tax. Tax rebates/concessions are available for amounts paid, by way of premium for life insurance. In such cases the assured, in effect, pays a lower premium for insurance than otherwise.

Money when You Need It: A policy that has a suitable insurance plan or a combination of different plans can be effectively used to meet certain financial needs that may arise from time to time such as children's education or marriage provision or even periodical needs for cash over a stretch of time can be made less stressful through life insurance.

Alternatively, policy money can be made available at the time of one's retirement from service and used for any specific purpose, such as, purchase of a house or for other investments. Loans are also granted to policyholders for house building or for purchase of flats (subject to certain conditions).

Medical and Non-Medical Schemes: Life insurance is normally offered after a medical examination of the life to be assured. However, to facilitate greater spread of insurance and also to avoid inconvenience, insurance companies extend insurance cover without any medical examination, subject to certain conditions.

With Profit and Without Profit Plans: An insurance policy can be 'with' or 'without' profit. In the former, bonuses disclosed, if any, after periodical valuations, are allotted to the policy and are payable along with the contracted amount.

In 'without' profit plan, the contracted amount is paid without any addition. The premium rate charged for a 'with' profit policy is therefore higher than for a 'without' profit policy.

Keyman Insurance: Keyman insurance is taken by a business firm on the life of key employee(s) to protect the firm against financial losses, which may occur due to the premature demise of the Keyman.

6.1.9 Group Insurance Schemes

Group insurance is a plan of insurance which provides life cover to a number of persons under a single policy called the 'Master Policy'. Under the single contract, many persons are covered. It becomes possible to give a cover to the group at a low cost, on account of savings in the administrative and medical examination expenses. One important feature is with regard to selection and underwriting of lives, Individual lives are not assessed. The selection is of the group. Group selection is aimed at forming a group, which will show an average rate of mortality.

Introduction of New Products

The opening up of the sector has resulted in introduction of new products, particularly the unit linked products, which offer both capital appreciation and insurance cover and have attracted the attention of the insured. Today, a wider choice is available to the customer, with products being tailor-made to suit the needs of the insured. Availability of riders, particularly health riders, has been a positive development. The insurers are putting in efforts to develop products, both in the life and non-life segments. In the non-life segment, a private insurer first launched weather insurance in the country. Other products launched by non-life insurers include mutual fund package policy, pollution liability package policy and export credit (short-term) policy — initiatives which the new players have taken. Additional covers have also been launched by Export Credit Guarantee Corporation (ECGC) in the area of credit insurance.

6.1.10 Agents and Insurance Intermediaries

Agents and corporate agents are key distribution channels to any insurer. Development of these agencies must be on the best professional lines. Towards this, the IRDA has prescribed, minimum educational qualifications at the point of entry and practical training followed by an examination. To aid the growth of insurance selling in rural and non-urban centres, compulsory targets which individual insurers are required to fulfil have been prescribed. IRDA has also lowered the required minimum educational qualification for rural agents to a pass in the tenth standard examination. It has also encouraged the Insurance Institute of India, to conduct the qualifying examination for the agents and to bring out books and training material in various vernacular languages.

Customer Protection

The insurance industry has ombudsmen in 12 cities. Each ombudsman is empowered to redress customer grievances in respect of insurance contracts on personal lives, where the insured amount is less than Rs. 20 lakh, in accordance with the ombudsman scheme.

Role of Insurance Industry in the Indian Economy

The insurance sector is a major contributor to the financial savings of the household sector in the country, which are further channelised into various investment avenues. As per preliminary estimates, contribution of insurance funds to the financial savings was 14.9 per cent in 2003-04, viz., 2.2 per cent of the GDP at current market prices. Life insurance funds, postal insurance and state insurance contributed 14.5 per cent, 0.1 per cent and 0.3 per cent, respectively. The percentage of life insurance funds to the GDP at current market prices increased from 2.1 per cent in the previous year. Significantly, the contribution of provident and pension funds to financial savings decreased to 13 per cent as against 14.3 per cent in the previous year. The overall growth in the insurance industry has been positive.

Global players have exhibited an interest in the huge market that India offers. Given that 42.9 per cent of the financial savings are parked with the banking sector, there is a vast potential for the insurance sector to grow. Today, India accounts for only 0.59 per cent of the US$ 2,940.67 billion global insurance market. Many international studies have estimated that the insurance industry in India can grow by over 125 per cent in the next ten years. In fact, India has been identified as one of the two fastest growing insurance markets. The growth in the life segment is expected to be faster, as against the non-life segment. In the environment that has been created subsequent to the opening up of the insurance sector, the players in the industry are expected to create additional markets by enhancing the level of risk awareness amongst the uninsured public, thereby spreading both the message and the associated benefits of insurance across a wider cross-section. The liberalised environment is also expected to improve the levels of customer satisfaction. New products are also expected to be introduced to take care of the unattended risk exposures.

6.2 BANCASSURANCE

Bancassurance is an arrangement whereby branches of commercial banks act as corporate agents and distribute insurance products developed by insurance companies to their customers. It is nothing but a convergence of banking and insurance.

6.2.1 Bancassurance in India

The banking industry in India has been experiencing, since the early nineties, shrinkage in their interest income subsequent to migrating to the adoption of international best practices and standards of accoun¬ting. With the opening up of the banking sector to private and international players due to liberalisation, competition has become much severe and intense, resulting in a further shrinkage of margins in the industry. In order to augment their income from other sources, the banks were keenly waiting for an opportunity. Realising the changes, the Government of India, during August 2000, issued a notification specifying 'Insurance' as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949. The RBI, in its 'Monetary and Credit Policy for the year 2000-01' announced its intention to allow banks' entry into insurance business and issued detailed guidelines in August 2000. Accordingly, any bank intending to undertake insurance business in the manner set out below should obtain prior approval of RBI before engaging in such business:

1. Any scheduled commercial bank would be permitted to undertake insurance business as an agent of insurance companies on a fee basis, without any risk participation. The subsidiaries of banks will also be allowed to undertake distribution of insurance products on an agency basis.
2. Banks that satisfy certain eligibility criteria will be permitted to set up a joint venture company for
undertaking insurance business with risk participation, subject to safeguards.

As the banks in India have a vast network of branches spread across the country and huge manpower strength, this convergence of banking and insurance came as a boon to the insurance industry. Insurance companies find bancassurance profitable due to a quicker reach to untapped market, economies of scale in administrative cost and opportunity to introduce new hybrid products. This prompted the insurance companies to reshape their distribution channels and utilise the banks' large network in acquiring their customers at low cost.

6.2.2 Convergence of Banking and Insurance

The advantages to banks are many, viz., improved customer retention, overall customer satisfaction, provision of a very good avenue for earning risk free non-interest income by means of commission over a long period, improvement in bottom lines, higher employee productivity and also improved return on assets (RoA), as they utilise only the existing infrastructure and available manpower. There is no requirement of additional capital as bancassurance is totally risk free.

6.2.3 Bancassurance Models

Internationally, four models of Bancassurance are in vogue. They are:

(a) Corporate agency model or distribution alliance model.
(b) Joint venture model, where an insurance company and a bank share the equity capital of their joint venture, subject to local government regulations.
(c) Merger between a bank and an insurer.
(d) Build or buy own insurance operation.

In India, only the first two models have been adopted. Though a couple of years ago, LIC of India acquired a strategic and significant stake in the equity capital of Corporation Bank and Oriental Bank of Commerce, they too follow the first model only.

Apart from distributing their conventional insurance products, both life and non-life, through bancassurance, some insurance companies have designed innovative, across the counter products under group insurance, which can be marketed easily to a large section of the bank's customers. Even the Government of India has also utilised the bancassurance model to design and deliver certain insurance products to the people living below the poverty line as a part of its social upliftment programme (Jana Shree Bima Yojana and Universal Health Care Policies).

6.3 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

The Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the business of insurance and reinsurance in the country in terms of the IRDA Act, 1999. The Authority was constituted on 19 April 2000 vide

Government of India's notification no. 277. The key objective of the IRDA is to promote market efficiency and ensure consumer protection.

6.3.1 Duties, Powers and Functions of IRDA

The IRDA shall have the duty to regulate, promote and ensure an orderly growth of the insurance business and reinsurance business.

The powers and functions of the IRDA shall include:

(a) issuing to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel
such registration;

(b) protection of the interests of the policy holders in matters concerning assigning of policy, nomination
by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

(c) specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents;

(d) specifying the code of conduct for surveyors and loss assessors; (ej promoting efficiency in the conduct of insurance business;

(e) promoting and regulating professional organisations connected with the insurance and reinsurance business;

(f) levying fees and other charges for carrying out the purposes of this Act;

(h) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organizations connected with the insurance business;

(i) control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the TAC under Section 64U of the Insurance Act, 1938 (4 of 1938);

(j) specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

(k) regulating investment of funds by insurance companies;

(1) regulating maintenance of the margin of solvency;

(m) adjudication of disputes between insurers and intermediaries or insurance intermediaries;

(n) supervising the functioning of the TAC; (o) specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f); (p) specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and

(o) exercising such other powers as may be prescribed.

6.4 CHECK YOUR PROGRESS

1. The first insurance company was started in India in 1818 at:

(a) Kolkata (b) Chennai (c) Mumbai (d) New Delhi.

2. The entry level capital requirement for a new Insurance Company in India is:

(a) Rs.lOOcrore (b) Rs. 50 crore (c) Rs. 500 crore (d) None.

3. As on 31 March 2006, the total number of insurance companies in the life insurance business is:

(a) 15 (b) 14 (c) 1 (d) None.

4. The primary legislation that deals with insurance business in India is:

(a) Insurance Act, 1938 (b) Insurance Regulatory and Development Authority Act, 1999

(c) Both Insurance Act, 1938 and IRDA Act, 1999

(d) LIC of India Act.

5. Bancassurance is an arrangement whereby:

(a) branches of commercial banks distribute to their customers as corporate agents, insurance products developed by the insurance companies

(b) branches of Insurance companies distribute to their customers as corporate agents, banking products developed by banks

(c) both (a) and (b) (d) none.

6.5 ANSWERS TO 'CHECK YOUR PROGRESS'

1. ((a) , 2. (a), 3. (b), 4. (c), 5. (a).

6.6 KEYWORDS

Life insurance, Fire insurance, Marine insurance, Bancassurance, Keyman insurance, Group insurance.

FACTORING, FORFAITING SERVICES AND OFF-BALANCE ITEMS

STRUCTURE

7.0 OBJECTIVES

By reading this unit, you will be able to:

- Understand factoring services, difference between bill discounting and factoring services and its advantages,
- Learn about the 'Forfaiting' services and its advantages to the exporting community,
- Familiarise with the items appearing as off-balance items.

7.1 FACTORING

7.1.1 Introduction

Factoring is a service that is concerned with the financing and collection of account receivables in domestic and international trade. It is an ongoing arrangement between the client and factor (usually a bank or a financial institution), where invoices raised on open account sales of goods and services are regularly assigned to 'the factor' for financing, collection and sales ledger administration. The buyer and the seller usually have long-term relationships. The client sells invoiced receivables at a discount to the factor to raise finance for working capital requirement. The factor may or may not accept the incumbent credit risk. Factoring enables companies to sell their outstanding book debts for cash.

7.1.2 Types of Factoring

There are two types of factoring services, recourse factoring (with recourse) and non-recourse factoring (without recourse). In recourse factoring, in the case of non-payment of invoices by customers, the factor will recover the amount advanced from the client. In non-recourse

factoring, the factor provides both finance and credit protection. In case of non-payment of invoices by customers, the factor will bear the risk of bad debts.
The factor operates by buying from the selling company, their invoiced debts. These are purchased usually with credit protection by the factor, 'who' then will be responsible for all credit control, collection and sales accounting work. The management of the company may thus concentrate on production and sales and need not concern itself with non-profitable control and sales accounting matters.
Domestic Factoring
Under domestic factoring, receivables arising only out of domestic trade shall be considered for factoring. The supplier/borrower shall draw bills of exchange for goods supplied and the purchaser shall accept that. After acceptance of bills of exchange, the factor shall make a prepayment of about 80 per cent of invoice value after deducting its discount charges at normal interest rates for the period of bill of exchange to the supplier. The balance payment (20 per cent of the invoice value) shall be made after collecting the payment from the purchaser. If the purchaser fails to pay the due amount on due dates, the supplier shall make good the payment. The borrower/supplier shall submit the bill of exchange along with the invoice and LR/RR receipts.
The maximum debt period normally permitted under factoring is one hundred and fifty days inclusive of a maximum grace period of sixty days.
Various Management Information System (MIS) reports such as Debtors Ageing Analysis, Weekly Statement of Accounts, Sales Analysis and Statement of Outstanding Invoices are given to the seller by the factor. To be eligible for factoring, suppliers must have a minimum track record of certain years of existence in business with consistent profitability and a positive minimum net worth.
Usually, before providing advance payments to the supplier, an agreement is entered with the supplier for assigning the debts of the purchaser to the factor and the later makes advances only against invoices drawn on this particular purchaser. Sub-limit of each purchaser is fixed and sum of these sub-limit is the overall limit of the supplier. Usually, the purchaser should have been dealing with the supplier for a certain minimum period to be eligible for factoring. The limit for factoring is usually fixed on the basis of the projected receivables on credit sales of the company and deducting existing bills/book debts limits enjoyed by the company from their bank.
Normally, the charges for factoring will consist of (i) Finance charge for purchase of receivables (the finance charge moves in tandem with the market interest rates and is determined on the basis of credit rating), (ii) Service charges for collection, follow-up, administration, etc. (The service charge varies from 0.1 per cent to 2.0 per cent of the invoice value and is determined on the basis of value of invoices submitted to the factors.)
International Factoring
In international factoring, there are usually two factors. The export factor looks at financing the exporter and sales administration (presenting invoices at the right time and collecting payments being the key tasks). The import factor is interested in evaluating the buyer, collecting the money on time at the same time ensuring that he is protected against default. International factoring encompasses all the four services, i.e. pre-payments, sales ledger administration, credit protection and collections.
Let us understand the important steps involved in international factoring. The importer places the order for purchase of goods with the exporter.
The exporter requests the export factor for limit approval on the importer. The export factor, in turn, forwards this request to an import factor in the Importer's country. The import factor evaluates the importer and conveys its approval to the export factor who in turn conveys commencement of the factoring arrangement to the exporter. The exporter delivers the goods to the importer. The exporter produces the documents to the export factor.
The export factor disburses funds to the exporter up to the prepayment amount decided and at the same time forwards the documents to the import factor.

The importer, on the due date of the invoice, pays the import factor, who in turn remits this payment to the export factor. The export factor applies the received funds to the outstanding amount of the advance against the invoice. The exporter receives the balance payment.

7.1.3 Advantages of Factoring

Factoring replaces high cost market credit and enables purchases on cash basis for availing cash discounts.

(a)The customer gets instant finance against each invoice.

(b)Low margin (up to 20 per cent) thereby improving cash flow.

(c) The customer gets large credit/grace period.

(d)Each invoice is followed up for payment by the factor on the due date and thereafter.

(e) MIS reports and sales ledger administration is totally taken care of by the factor.

(f)Factoring accelerates receivables turnover, and improves operating cycle, resulting in more production, larger sales, higher profits and increased ROI.

7.2 FORFAITING SERVICES

7.2.1 Forfaiting – Definition

Forfeiting is a means of finance (credit) an exporter of goods avails from an intermediary called the forfaiter against the export receivables but without the obligation to repay the credit. Forfeiting is used for international trade transactions. In fact, it is the discounting of trade receivables such as drafts drawn under letters of credit, bills of exchange, promissory notes, or other freely negotiable instruments on a 'no recourse' basis, (i.e. without recourse to the exporter in case the importer fails to pay on the due date). It is a highly flexible technique that allows an exporter to grant attractive credit terms to foreign buyers, without sacrificing his cash flow and without the risks of possible late payment or default by the importer. Simultaneously, the exporter is fully protected against interest and/or currency rates moving unfavourably during the credit period as the entire risk is passed on to the forfaiter. Forfeiting is thus a highly effective sales tool, which simultaneously improves cash flow and eliminates risk for the exporter.

Some bankers define forfaiting as medium-term capital goods financing, by means of selling a bill of exchange, at a discount, to a third party who is the forfaiter. This third party collects the payment from an essentially overseas customer, through a collateral bank(s), thus, assuming the underlying responsibility of exporters and simultaneously providing trade finance for importers by converting a short-term loan to a medium-term one.

7.2.2 Mechanism of Forfaiting

The exporter identifies his importer and signs with him a contract for sale of his goods at a price negotiated between them, giving the importer adequate credit period to pay for the imports. The exporter will also inform the importer that the exporter would discount the sales receivable with a forfaiter and assign the receivables to the forfaiter. The importer arranges with his banker for issue of a letter of credit in favour of the exporter. The exporter enters into a forfaiting contract with the forfaiter. Then the actual export takes place. The debt instruments are drawn by the exporter (seller), accepted by the importer (buyer), and will be backed by the unconditional standby letter of credit (guarantee) of the importer's bank. The forfaiter sends these documents to the importer's bank, which in turn notifies receipt to the forfaiter. The forfaiter makes payment to the exporter (100 per cent of the value of exports), after deducting his discount and other incidental charges as per the contract. In exchange for the payment, the forfaiter then takes over responsibility for claiming the debt from the importer. The forfaiter either holds the notes till full maturity (as an investment), or sells them to another investor on a non-recourse basis. The holder of the notes then presents each receivable to the bank at which they are payable as they fall due.

The letter of credit does not have to be transferable or confirmed by the advising bank in the exporter's country; but it must be subject to the Uniform Customs and Practice for Documentary Credits (UCPDC) of the International Chamber of Commerce, Paris (UCP 500). Promissory notes or bills of exchange/ drafts are actually the most commonly forfaited debt instruments. Under a forfaiting agreement, a promissory note or bill of exchange/draft is issued for each installment of the supplier's credit, thus documenting the existence of a claim of the exporter on the importer that is totally abstract, i.e. it is unconditional, irrevocable and divorced from the underlying trade transaction.

Normally, the documents required by the forfaiter from the exporter will be as follows:

(a)Copy of supply contract or of its payment terms.

(b) Letter of credit or guarantee, which is the forfaiters' preferred form of security of payment of a bill or note. For a LC/Guarantee to be acceptable, the issuing bank must be internationally reputed and credit-worthy. The most important point to remember is that any LC/guarantee should be irrevocable, unconditional, divisible and assignable.

(c) Copy of signed commercial invoice.

Copy of shipping documents including certificates of receipt, railway bill, airway bill, bill of lading or equivalent documents

(e) Letter of assignment and notification to the guarantor.

7.2.3 Advantages of Forfaiting

Forfeiting provides a flexible, creative alternative to traditional international trade financing methods and is particularly useful for transactions with buyers in developing nations. The following are the advantages of forfaiting to the exporters:

(a) Forfaiting provides 100 per cent financing - without recourse and not occupying exporter's credit line. That is to say once the exporter obtains the financed fund, he will be exempted from the responsibility to repay the debt.

(b) Forfaiting improves cash flow of the exporter - by converting receivables into current cash inflow and it is beneficial to the exporter to improve his liquidity and his ability to improve further the fund raising capability.

(c) Forfaiting saves administration cost - by using forfaiting, the exporter will be freed from the management of the receivables. The relative costs, as a result, will be reduced greatly.

(d) Forfaiting increases trade opportunity - with forfaiting, the exporter is able to grant credit to his buyer freely and thus, be more competitive in the market.

(e) Forfaiting also helps to realise price transfer - the exporter can also transfer the corresponding financing cost into the sale price.

(f) Forfaiting enables the exporter to avoid various risks, i.e. forfaiting business enables the exporter to transfer various risks, resulting from deferred payment, such as interest-rate risk, currency risk, credit risk and political risk.

7.3 OFF-BALANCE SHEET ITEMS

Off-Balance Sheet Items are those items in the books of a bank, which are not mentioned in the balance sheet of the bank. These items are not assets or liabilities to be reported in the balance sheet as on the date of balance sheet, but may get converted into an asset or liability at a later date, depending on the happening of a certain event. These items are contingent upon certain breach of commitments and are also called contingent liabilities. These contingent liabilities have to be disclosed as 'Notes to the Balance Sheet'. But once these commitments crystallise, these also become part of the assets or liabilities of the bank and have to be shown in the balance sheet. These items include:

(a) Direct credit substitutes, e.g. general guarantees of indebtedness (including standby LCs serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptance).

(b) Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby LCs related to particular transactions).

(c) Short-term self-liquidating trade-related contingencies (such as documentary credits coUateralised by the underlying shipments).

(d) Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank.

(e) Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown.

(f) Note issuance facilities and revolving underwriting facilities.

(g) Aggregate outstanding foreign exchange contracts.

(h) Take-out finance in the books of taking over institution (i) Unconditional take-out finance (ii) Conditional take-out finance (iii) Non-funded exposures to commercial real estate.

(i) Guarantees issued on behalf of stockbrokers and market makers.

(j) Commitment to provide liquidity facility for securitisation of standard asset transactions.

(k) Foreign exchange open position.

(1) Open position in gold.

(m) forward Rate agreement (FRA)/Interest Rate Swap (IRS).

Banks classify their off-balance sheet exposures into three broad categories - full risk (credit substitutes) - standby letters of credit, money guarantees, etc.; medium risk (not direct credit substitutes, which do not support existing financial obligations) - bid bonds, letters of credit, indemnities and warranties; and low risk - reverse repos, currency swaps, options, futures, etc. Let us study about some of these items in detail.

7.3.1 Guarantees

Bank guarantee is one of the facilities that banks extend to their customers. A contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default. There are three persons in a contract of guarantee; the person giving the guarantee is called the Guarantor or Surety, the person on whose behalf the guarantee is given is called the Principal Debtor and the person in favour of whom the guarantee is given is called the Creditor or Beneficiary.

The issuance of guarantee does not result in outlay of funds. The Bank's liability arises only when the customer fails to perform the act for which the guarantee has been issued and the bank is required to part with any money to the beneficiary of the guarantee. This is the main reason for guarantee limits being classified as non-fund based limits. The guarantees are classified as contingent liability.

Guarantees can be broadly classified as:

(a) Performance Guarantees; (b) Financial Guarantees;

(c) Deferred Payment Guarantees.

Performance Guarantees

These are guarantees issued in respect of performance of a contract or obligation. In the event of non-performance or short performance of the obligations, the bank will be called upon to make good the monetary loss arising out of the non-fulfilment of the guarantee obligation, within the amount guaranteed. This is a guarantee confirming the performance competency of the person, on whose behalf, the guarantee is issued. Liability is however reduced to money terms.

The following guarantees can be treated as performance guarantees.

Guarantee in lieu of tender money/Earnest Money Deposit (EMD), guarantee in lieu of security deposit and shipping guarantee.

Financial Guarantees

In certain contracts entered into by the bank customer with a government department/quasi-government department/large companies, there is a provision for payment of certain amount of money-in advance-against the bank guarantee to enable the customer to start the work under the contract and begin performing the contracted job/work/project. The advance enables the performance of the contract. The amount which is guaranteed (it is possible that the guarantee may be less than the contact or a percentage of the contract amount) is made available to the customer in advance and the guarantee terms, inter-alia, include that the amount will be paid by the bank in case the customer does not fulfil the terms of the contract within the period stated in the contract. In this case, the entire amount of money is received by the customer and such guarantees are known as money guarantees.

The following are the examples of financial/money guarantee:

(a) Bank guarantee for supply of goods on credit basis,

(b) Guarantees in favour of customs authorities,

(c) Bank guarantees in favour of tax authorities.

Deferred Payment Guarantees

These guarantees normally arise in the case of purchase of machinery or such other capital equipment by customers (from suppliers in India or outside). The manufacturer of the machinery supplies the machinery against a cash payment of say, 10 per cent or 15 per cent and gets accepted bills for the balance amount by the purchaser's bank or alternatively, for the balance amount, the seller of the machinery gets guarantees issued. Such guarantees are known as Deferred Payment Guarantees.

7.3.2 Letter of Credit

A letter of credit may be explained as an undertaking given by the buyer's bank on behalf of the buyer to the seller, stipulating that if specified documents are presented within a stipulated date, the bank establishing the credit will pay the amount of the bill drawn in terms of such LC.

Parties to a Letter of Credit

A letter of credit has essentially the following parties to if. Buyer: Also known as purchaser or one who applies for an LC.

Opening Branch/Bank: The branch/bank, which opens an LC and adds its credit standing to that of the buyer.

Seller: Is also known as the shipper and is the beneficiary under the credit.

Negotiating Branch or Bank: Is a branch/bank other than the opening branch or another bank at which the beneficiary may negotiate the drafts drawn under an LC.

Types of Credit

Irrevocable - Without Recourse Letter of Credit: This type of LC cannot be cancelled by the buyer on whose behalf it is opened or be revoked by the bank, which has opened it without the consent of the beneficiary/seller. Once a credit of the above type is opened and the beneficiary is advised, the drafts drawn under the credit, together with documents thereunder, if found to be in conformity with the terms of the credit, will have to be paid by the opening bank. As this is a 'without recourse'LC , when once such bills are paid, no recourse can be had against the beneficiary.

1. Revocable - Without Recourse Letter of Credit: These are not legally binding undertakings between banks and beneficiaries. Such credits may be modified or cancelled at any moment without notice to the beneficiary. Bill/bills paid, negotiated or accepted by the negotiating branch/bank, prior to the receipt of cancellation or modification of such credit will have to be honoured by the opening branch/bank. This type of credit is not normally in use nowadays.

2. Revolving Letter of Credit: A revolving letter of credit is one which also provides that the amount of drawing stipulated in it will be available to the beneficiary again and again, as may be agreed between the buyer and the seller, within a stipulated period. Provision can also be made in this to control the frequency of the drawing and limit the total extent that could be thus drawn within the due date.

However, banks insist that a protective clause, normally known as reinstatement clause is incorporated in revolving LC.

7.3.3 Forward Exchange Contract

A forward exchange contract is a firm contract between the bank and its customers for the purchase / sale of a specified quantity of a stated foreign currency at a pre-determined exchange rate. On the due date when the contract is executed, the transaction will be put through at the contracted rate of exchange, irrespective of the spot rate then prevailing. Forward exchange contract is a method of protecting oneself against exchange rate fluctuations. Foreign exchange contracts are the most common means of hedging transactions in foreign currencies.

7.3.4 Forward Rate Agreement (FRA) and interest Rate Swap (IRS)

Forward Rate Agreement (FRA) and Interest Rate Swap (IRS) are such instruments that can provide effective hedge against interest rate risks. An FRA or an IRS provides means for hedging the interest rate risk arising on account of lendings or borrowings made at fixed/variable interest rates.

An FRA is a financial contract between two parties to exchange interest payments for a 'notional principal' amount on the settlement date for a specified period from start date to maturity date. Accordingly, on the settlement date, cash payments based on contract (fixed) and the settlement rate are made by the parties to one another. The settlement rate is the agreed benchmark/reference rate prevailing on the settlement date.

An IRS is a financial contract between two parties exchanging or swapping a stream of interest payments for a 'notional principal' amount on multiple occasions during a specified period. Such contracts generally involve exchange of 'fixed to floating' or 'floating to floating' rates of interest. Accordingly, on each payment date - that occurs during the swap period - cash payments based on fixed/floating and floating rates are made by the parties to one another.

7.4 CHECK YOUR PROGRESS

1. Factoring service means:
(a) Collection of bills (b) Discounting of bills
(c) Maintenance of account books (d) All of the above.

2. The type of arrangement under which a bank pays the seller the value of the bill and later collects it from the buyer on the due date is called:
(a) Bill discounting (b) Factoring
(c) Forfeiting (d) None.

3. The type of factoring under which the factor collects back from the seller the amount paid by him in case of non-payment of the bills on the due date is called:
(a) Recourse factoring(b) Non-recourse factoring
(c) Bills discounting (d) Bills purchased.

4.Under domestic factoring, the payment of the bills that the seller gets from the factor is:
(a)100 per cent of the value of the bills immediately on submission.
(b) nearly 80 per cent of the bill amount upon tendering the bill and the balance on due date.
(c)nearly 80 per cent of the bill amount upon tendering the bill and the balance on due date after collecting it from the buyer.
(d)100 per cent of the value of the bill only after collection from the buyer.

5. In international factoring, the number of factors will be:
(a) 2 (b) 1
(c) 1 (d) more than 2

6. Forfaiting provides finance against the export receivables to an exporter:
(a) with recourse to the exporter (b) without recourse to the exporter
(c) both (d) either one

7. Forfaiter is:
(a) an intermediary between an exporter and importer
(b) an exporter (c) an importer

(d) a bank.
8. Forfaiting provides to the exporter against receivables:
(a) 100 per cent financing
(b) 80 per cent financing
(c) depending on the contract with the forfaiter
(d) none.
9. Forfaiting enables the exporter to avoid the following risks:
(a) interest-rate risk (b) currency risk
(c) credit risk and political risk (d) all.
10. Bank Guarantees are issued by:
(a) any bank
(b) only specified banks
(c) only banks permitted to do this type of business
(d) none.
11. In a bank guarantee, the number of parties involved in the agreement are:
(a) three (b) two
(c) many (d) one.
12. Letter of Credit is defined in the:
(a) Indian Contract Act (b) Negotiable Instruments Act
(c) Transfer of Property Act (d) None.
13.A revolving Letter of Credit is one which provides that the amount of drawing stipulated in it will be available to the beneficiary:again and again as may be agreed between the buyer and the seller within a stipulated period.
(a) Any number of times
(b) Only one once
(c) None
14. A forward exchange contract is a firm contract for the purchase/sale of a specified quantity of a stated foreign currency at a pre-determined exchange rate between the bank and its:
(a) exporters (b) importers
(c) both (d) none
7.5 ANSWERS TO CHECK YOUR PROGRESS'
1. (d), 2. (a), 3. (a), 4. (c), 5. (a), 6. (b), 7. (a), 8. (a), 9. (d), 10. (a), 11. (a), 12. (d), 13. (a), 14. (c).
7.6 KEYWORDS Factoring, Forfaiting, Guarantees, Letter of Credit, Forward contracts, Forward Rate Agreements, Interest Rate Swaps.

UNIT
8
RISK MANAGEMENT AND BASEL II
An Overview

STRUCTURE

70

8.0 OBJECTIVES

An in-depth study of this unit should make you understand:

- the various types of risks faced by a bank and their effective management, and
- the nuances of Basel II in strengthening of the banking system.

8.1 INTRODUCTION - RISK MANAGEMENT

Banks, in the process of financial intermediation, are confronted with various kinds of financial and non-financial risks, viz., credit risk, interest rate risk, foreign exchange rate risk, liquidity risk, equity price risk, commodity price risk, legal risk, regulatory risk, reputation risk, operational risk, etc. These risks are highly independent/interdependent events that affect the bank/financial institution. One area of risk can have ramifications for a range of other risk categories. In view of this, banks are required to identify, measure, monitor and control the overall level of risks undertaken by them.

8.1.1 Risk Management Function

The broad parameters of risk management function should cover:

(a) Organisational structure

(b) Comprehensive risk measurement approach

(c) Risk management policies approved by the board, which should be consistent with the broader business strategies, capital strength, management expertise and overall willingness to assume risk

(d) Guidelines and other parameters used to govern risk taking, including detailed structure of prudential limits

(e) Strong MIS for reporting, monitoring and controlling risks

(f) Well laid out procedures, effective control and comprehensive risk reporting framework

(g) Separate risk management organisation/framework independent of operational departments and with clear delineation of levels of responsibility for management of risk

(h) Periodical review and evaluation.

8.1.2 Risk Management Structure

Each bank should set risk limits after assessing its risks and the risk-bearing capacity. At organisational level, the task of overall risk management is assigned to an independent Risk Management Committee. The purpose of this top level committee is to empower one group with full responsibility of evaluating overall risks faced by the bank and determining the level of risks which will be in the best interest of the bank. The functions of Risk Management Committee are essentially to identify, monitor and measure the risk profile of the bank. The committee also develops policies and procedures, verifies the models that are used for pricing complex products, reviews the risk models as development takes place in the markets and also identifies new risks.

8.1.3 Loan Review Mechanism (LRM)

It is an effective tool for constant evaluation of the quality of loan book and for bringing about qualitative improvements in credit administration. Banks have, therefore, used Loan Review Mechanism (LRM) for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc. The main objectives of LRM could be to:

(a) promptly identify loans which develop credit weaknesses and initiate timely corrective action,
(b) evaluate portfolio quality and isolate potential problem areas,
(cj provide information for determining adequacy of loan loss provision,

1

(d) assess the adequacy of and adherence to loan policies and procedures, and to monitor compliance
with relevant laws and regulations,
(e) provide top management with information on credit administration, including credit sanction process,
risk evaluation and post-sanction follow-up.

Accurate and timely credit grading is one of the basic components of an effective LRM. Credit grading involves assessment of credit quality, identification of problem loans, and assignment of risk ratings. A proper Credit Grading System should support evaluating the portfolio quality and establishing loan loss provisions.

8.1.4 Credit Risk

Credit risk is defined as the possibility of losses associated with diminution in the credit quality of borrowers or counterparties. In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively, losses result from reduction in portfolio value arising from actual or perceived deterioration in credit quality. Credit risk emanates from a bank's dealings with an individual, corporate, bank, financial institution or a sovereign.

Credit risk may take the following forms:

(a) Direct lending: Principal and/or interest amount may not be repaid.
(b) Guarantees or letters of credit: Funds may not be forthcoming from the constituents upon
crystallisation of the liability.
(c) Treasury operations: The payment or series of payments due from the counter parties under the
respective contracts may not be forthcoming or ceases.
(d) Securities trading businesses: Funds/securities settlement may not be effected.
(e) Cross-border exposure: The availability and free transfer of foreign currency funds may either cease or restrictions may be imposed by the sovereign.

In this backdrop, it is imperative that banks have a robust credit risk management system which is sensitive and responsive to these factors. The effective management of credit risk is a critical component of comprehensive risk management and is essential for the long-term success of any banking organisation. Credit risk management encompasses identification, Measurement, monitoring and control of the credit risk exposures.

8.1.5 Market Risk

Traditionally, credit risk management was the primary challenge for banks. With progressive deregulation, market risk arising from adverse changes in market variables, such as interest rate, foreign exchange rate, equity price and commodity price has become relatively more important. Even a small change in market variables causes substantial changes in income and economic value of banks. Market risk takes the form of:

(a) Liquidity risk (b) Interest rate risk
(c) Foreign exchange rate (forex) risk (d) Commodity price risk
(e) Equity price risk

8.1.6 Operational Risk

Managing operational risk is becoming an important feature of sound risk management practices in modern financial markets in the wake of phenomenal increase in the volume of transactions, high degree of structural changes and complex support systems. The most important type of operational risk involves breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial loss through error, fraud, or failure to perform in a timely manner or cause the interest of the

Generally, operational risk is defined as any risk, which is not categorised as market or credit risk or the risk of loss arising from various types of human or technical error. It is also synonymous with settlement or payments risk and business interruption, administrative and legal risks. Operational risk has some form of link between credit and market risks. An operational problem with a business transaction could trigger a credit or market risk.

8.2 INTRODUCTION - BASEL II

The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of a group of ten countries in 1985. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States of America. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located.

8.2.1 Basel I Accord

The BCBS first came out with 1988 Capital Accord for banks, taking into account the elements of risk in various types of assets in the balance sheet as well as off-balance sheet business. Essentially, under the above system, the balance sheet assets, non-funded items and other off-balance sheet exposures are assigned weights according to the prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio, on the aggregate of the risk weighted assets and other exposures, on an ongoing basis. Under the Basel I Accord, only the credit risk element was considered and the minimum requirement of capital funds was fixed at 8 per cent of the total risk weighted assets. Risk adjusted assets would mean weighted aggregate of funded and non-funded items. Degrees of credit risk expressed as percentage weightings have been assigned to balance sheet assets and conversion factors to off-balance sheet items.

In India, however, banks are required to maintain a minimum Capital-To-Risk-Weighted Asset Ratio (CRAR) of 9 per cent on an ongoing basis.

The banks' overall minimum capital requirement will be the sum of the following:

(a) capital requirement for credit risk on all credit exposures excluding items comprising trading book
and including counterparty credit risk on all OTC derivatives on the basis of the risk weights; and

(b) capital requirement for market risks in the trading book.

The value of each asset/item shall be multiplied by the relevant weights to produce risk adjusted values of assets and off-balance sheet items. The aggregate will be taken into account for reckoning the minimum capital ratio.

8.2.2 Basel II Accord

BCBS brought out a report titled 'International Convergence of Capital Measurement and Capital Standards - A Revised Framework 2004' (also commonly called Basel Report II). The report presents the outcome of the Basel Committee on Banking Supervision's work over recent years to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks. Following the publication of the committee's first round of proposals for revising the capital adequacy framework in June 1999, many valuable improvements have been made to the original proposals. The report sets out the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the committee will propose for adoption in their respective countries. The committee expects its members to move forward with the appropriate adoption procedures in their respective countries and these, therefore, will be available for implementation by the end of the year 2008.

The fundamental objective of the committee's work towards revision of the 1988 accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks. The committee believes that the revised framework will promote the adoption of stronger risk management practices by the banking industry and views this as one of its major benefits.
In developing the revised framework, the committee has sought to arrive at significantly more risk-sensitive capital requirements that are conceptually sound and at the same time pay due regard to particular features of the present supervisory and accounting systems in individual member countries. The committee is also retaining key elements of the 1988 capital adequacy framework, including the general requirement for banks to hold total capital equivalent to at least 8 per cent of their risk-weighted assets; the basic structure of the 1996 Market Risk Amendment regarding the treatment of market risk; and the definition of eligible capital.
A significant innovation of the revised framework is the greater use of assessments of risk provided by banks' internal systems as inputs to capital calculations.
The revised framework is more risk sensitive than the 1988 Accord, but countries where risks in the local banking market are relatively high, nonetheless need to consider if banks should be required to hold additional capital over and above the Basel minimum. This is particularly the case with the more broad brush standardised approach. Even in the case of the internal ratings-based (IRB) approach, however, the risk of major loss events may be higher than is normally allowed for in this framework.
Three Pillars of Basel II
The Basel Committee's revised framework is based on the following three pillars:
The First Pillar: Minimum capital requirements
(a) Calculation of minimum capital requirements and constituents of capital
(b) Credit Risk
- Standardised Approach
- Internal Ratings-based Approach
- Securitisation Framework
(c) Operational Risk
(d) Market Risk.
The Second Pillar: Supervisory review process.
The Third Pillar: Market discipline.
The committee has also highlighted the need for banks and supervisors to give appropriate attention to the second (supervisory review) and third (market discipline) pillars of the revised framework. It is critical that the minimum capital requirements of the first pillar be accompanied by a robust implementation of the second, including efforts by banks to assess their capital adequacy and by supervisors to review such assessments. In addition, the disclosures provided under the third pillar of this framework will be essential in ensuring that market discipline is an effective complement to the other two pillars.
The First Pillar - Minimum Capital Requirements
The capital base of the bank consists of the following three types of capital elements: Tier 1, Tier 2, and Tier 3 capital. The sum of Tier 1, Tier 2, and Tier 3 elements will be eligible for inclusion in the capital base, subject to the following limits:

(a) The total of Tier 2 (supplementary) elements will be limited to a maximum of 100 per cent of the
total of Tier 1 elements.
(b) Subordinated term debt will be limited to a maximum of 50 per cent of Tier 1 elements.
(c) Tier 3 capital will be limited to 250 per cent of a bank's Tier 1 capital that is required to support
market risks.
(d) Where general provisions/general loan-loss reserves include amounts reflecting lower valuations

(e) of asset or latent but unidentified losses present in the balance sheet, the amount of such
(f) provisions
or reserves will be limited to a maximum of 1.25 percentage points.
(g) Asset revaluation reserves, which take the form of latent gains on unrealised securities, will be
subject to a discount of 55 per cent.

Definition of Capital Elements

(i) Tier 1: Includes only permanent shareholders' equity (issued and fully paid ordinary shares/ common stock and perpetual non-cumulative preference shares) and disclosed reserves (created or increased by appropriations of retained earnings or other surplus, e.g.: share premiums, retained profit, general reserves and legal reserves).

(ii) Tier 2:

(a) Undisclosed reserves are eligible for inclusion within supplementary elements, provided these
reserves are accepted by the supervisor. Such reserves consist of that part of the accumulated after-tax surplus of retained profits, which banks in some countries may be permitted to maintain as an undisclosed reserve. Apart from the fact that the reserve is not identified in the published balance sheet, it should have the same high quality and character as a disclosed capital reserve. As such, it should not be encumbered by any provision or other known liability,
but should be freely and immediately available to meet unforeseen future losses. This definition
of undisclosed reserves excludes hidden values arising from holdings of securities in the balance sheet that are below current market prices.
(b) Revaluation reserves are included in Tier 2, and could arise in two ways. First, in some
countries, banks (and other commercial companies) are permitted to revalue fixed assets, normally their own premises, from time to time in line with the change in market values. In some of these countries, the amount of such revaluations is determined by law. Revaluations of this kind are reflected on the face of the balance sheet as a revaluation reserve. Second, hidden values of 'latent' revaluation reserves may be present as a result of long-term holdings of equity securities valued in the balance sheet at the historic cost of acquisition. Both types of revaluation reserves may be included in Tier 2, provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale. In the case of 'latent' revaluation reserves, a discount of 55 per cent will be applied to the difference between
historic cost book value and market value to reflect the potential volatility of this form of unrealised capital and the notional tax charge on it.
(c) General provisions/general loan - loss reserves (for banks using the standardised approach
for credit risk): These are provisions or loan-loss reserves held against the future. Presently, unidentified losses are freely available to meet losses, which subsequently materialise and,

therefore, qualify for inclusion within supplementary elements. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped should be excluded. Furthermore, general provisions/general loan-loss reserves, eligible for inclusion in Tier 2, will be limited to a maximum of 1.25 percentage points of weighted risk assets.

(d) Hybrid (debt/equity) capital instruments: This includes a range of instruments which combine characteristics of equity capital and of debt. Their precise specifications differ from country to country, but they should meet the following requirements:

(i) Unsecured, subordinated and fully paid-up (ii) Not redeemable at the initiative of the holder or without the prior consent sf the supervisory authority; (iii) Available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt);

(iv) Although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), it should allow service obligations to be deferred (as with cumulative preference shares), where the profitability of the bank would not support payment.

Cumulative preference shares, having these characteristics, would be eligible for inclusion in this category.

(e) Subordinated term debt: Includes conventional, unsecured, subordinated debt capital instruments, with a minimum original fixed term to maturity of over five years and limited life redeemable preference shares. During the last five years to maturity, a cumulative discount (or amortisation) factor of 20 per cent per year will be applied to reflect the diminishing value of these instruments as a continuing source of strength. Unlike the hybrid debt instruments, these instruments are not normally available to participate in the losses of a bank that continues trading. For this reason, these instruments will be limited to a maximum of 50 per cent of Tier 1.

(iii) Tier 3: Short-Term Subordinated Debt Covering Market Risk: The principal form of eligible capital to cover market risks consists of shareholders' equity and retained earnings (Tier 1 capital) and supplementary capital (Tier 2 capital) as defined in the above paragraphs. But banks may also, at the discretion of their national authority, employ a third tier of capital (Tier 3), consisting of short-term subordinated debt for the sole purpose of meeting a proportion of the capital requirements for market risks, which is subject to the following conditions:

(a) Banks will be entitled to use Tier 3 capital solely to support market risks.

(b) Tier 3 capital will be limited to 250 per cent of a bank's Tier 1 capital that is required to support market risks. This means that a minimum of about 28.5 per cent of market risks needs to be supported by Tier 1 capital that is not required to support risks in the remainder of the book. Tier 2 elements may be substituted for Tier 3 up to the same limit of 250 per cent insofar as the overall limits are not breached, that is to say the eligible Tier 2 capital may not exceed the total Tier 1 capital, and long-term subordinated debt may not exceed 50 per cent of Tier 1 capital.

(c) The national authorities will have the discretion to refuse the use of short-term subordinated debt for individual banks or for their banking systems generally. In addition, it is a matter for national discretion, whether or not to apply the principle in the present framework that Tier 1 capital should represent at least half of the total eligible capital, i.e. that the sum of the total of Tier 2 and Tier 3 capital should not exceed the total of Tier 1 capital.

For short-term subordinated debt to be eligible as Tier 3 capital, it needs, if circumstances demand, to be capable of becoming part of a bank's permanent capital and thus be available to absorb losses in the event of insolvency. It must, therefore, at a minimum:
(a) be unsecured, subordinated and fully paid-up;
(b) have an original maturity of at least two years;
(c) not be repayable before the agreed repayment date unless the supervisory authority agrees;
(d) be subject to a lock-in clause, which stipulates that neither interest nor principal may be paid (even at maturity), if such payment means that the bank falls below or remains below its minimum capital requirement.

Deductions from the Capital Base
From Tier 1: Goodwill and increase in equity capital, resulting from a securitisation exposure, will be deducted.
The following elements will be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capitals:
(a) Investments in unconsolidated banking and financial subsidiary companies.
N.B.: The presumption is that this framework would be applied on a consolidated basis to banking groups.
(b) Investments in the capital of other banks and financial institutions (at the discretion of national
authorities).
(c) Significant minority investments in other financial entities. Where no deduction is applied, banks'
holdings of other banks' capital instruments will bear a weight of 100 per cent.
8.2.3 The Second Pillar - Supervisory Review Process
This section discusses the key principles of supervisory review, risk management guidance and supervisory transparency and accountability, produced by the committee with respect to banking risks. This includes guidance relating to, among other things, the treatment of interest rate risk in the banking book, credit risk (stress testing, definition of default, residual risk and credit concentration risk), operational risk, enhanced cross-border communication and cooperation and securitisation.
importance of Supervisory Review
The supervisory review process of the framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.
The supervisory review process recognises the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment. In the framework, bank management continues to bear the responsibility for ensuring that the bank has adequate capital to support its risks beyond the core minimum requirements.
Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. This interaction is intended to foster an active dialogue between banks and supervisors such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital. Accordingly, supervisors may wish to adopt an approach to focus more intensely on those banks with risk profiles or operational experience that warrants such attention.
The committee recognises the relationship that exists between the amount of capital held by the bank against its risks and the strength and effectiveness of the bank's risk management and internal control processes. Increased capital should however not be viewed as the only option for addressing increased risks confronting the bank. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves and improving internal controls, must also be considered.

Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

There are three main areas that might be particularly suited to treatment under Pillar 2. These are: risks considered under Pillar 1 that are not fully captured by the Pillar 1 process (e.g. credit concentration risk); factors that are not taken into account by the Pillar 1 process (e.g. Interest rate risk in the banking book, business and strategic risk); and factors external to the bank (e.g. business cycle effects). Another important aspect of Pillar 2 is the assessment of compliance with the minimum standards and disclosure

requirements of the more advanced methods in Pillar 1, in particular the IRB framework for credit risk and the advanced measurement approaches for operational risk. Supervisors must ensure that these requirements are being met, both as qualifying criteria and on a continuing basis.

Four Key Principles of Supervisory Review

The committee has identified four key principles of supervisory review, which complement those outlined in the extensive supervisory guidance that has been developed by the committee. The keystone of which is the core principles for effective banking supervision and the core principles methodology. A list of the specific guidance relating to the management of banking risks is also provided by the committee.

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Specific Issues to be Addressed Under the Supervisory Review Process

The committee has identified a number of important issues that banks and supervisors should particularly focus on while carrying out the supervisory review process. These issues include some key risks which are not directly addressed under Pillar 1 and important assessments that supervisors should make to ensure the proper functioning of certain aspects of Pillar 1.

8.2.4 The Third Pillar - Market Discipline Disclosure Requirements

The committee believes that the rationale for Pillar 3 is sufficiently strong to warrant the introduction of disclosure requirements for banks using the framework. Supervisors have an array of measures that they can use to require banks to make such disclosures. Some of these disclosures will be the qualifying criteria for the use of particular methodologies or the recognition of particular instruments and transactions.

Guiding Principles

The purpose of Pillar 3, market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence, the capital adequacy of the institution. The committee believes that such disclosures have particular relevance under the framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.

In principle, banks' disclosures should be consistent with how senior management and the Board of Directors assess and manage the risks of the bank. Under Pillar 1, banks use specified approaches/ methodologies for measuring the various risks they face and the resulting capital requirements. The

committee believes that providing disclosures, that are based on this common framework, is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and understandable disclosure framework that enhances comparability.

Achieving Appropriate Disclosure

The committee is of the opinion that supervisors have different powers available to them to achieve the disclosure requirements. Market discipline can contribute to a safe and sound banking environment and supervisors require firms to operate in a safe and sound manner. Under safety and soundness grounds, supervisors could require banks to disclose information. Alternatively, supervisors have the authority to require banks to provide information in regulatory reports. Some supervisors could make some or all the information in these reports publicly available. Further, there are a number of existing mechanisms by which supervisors may enforce requirements. These vary from country to country and range from 'moral suasion' through dialogue with the bank's management (in order to change the latter's behaviour), to reprimands or financial penalties. The nature of the exact measures used will depend on the legal powers of the supervisor and the seriousness of the disclosure deficiency. It is, however, not intended that direct additional capital requirements would be a response to non-disclosure, except as indicated below:

In addition to the general intervention measures outlined above, this framework also anticipates a role for specific measures. Where disclosure is a qualifying criterion under Pillar 1 to obtain lower risk weightings and/or to apply specific methodologies, there would be a direct sanction (not being allowed to apply the lower weighting or the specific methodology).

8.3 CHECK YOUR PROGRESS

Choose the correct option:

A.I. One of the following forms may not result in credit risk:

(a) in the case of direct lending: principal and/or interest amount may not be repaid;

(b) in the case of guarantees or letters of credit: funds may not be forthcoming from the constituents upon crystallisation of the liability;

(c) in the case of securities trading businesses: funds/securities settlement may not be effected;

(d) none.

2. Operational risk is the risk of loss arising from various types of:

(a) human error

(b) failed systems and procedures in the bank

(c) breakdown in internal controls

(d) all of the above.

B.I. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by:

(a) the central bank governors of the Group of ten countries

(b) European countries

(c) India

(d) USA.

2. Under the Basel I Accord, BCBS fixed the minimum requirement of capital funds for banks at:

(a) 8 per cent of the total risk weighted assets

(b) 9 per cent of the total risk weighted assets

(c) 10 per cent of the total risk weighted assets

(d) 1000 crore.

3. On how many pillars is the Basel I Framework based?

(a) 4 (b) 3
(c) 2 (d) 1
4. The risks considered for capital requirements under Basel II are:

(a) credit risk, market risk and operational risk
(b) credit risk, interest rate risk and foreign exchange risk
(c) credit risk, political risk and country risk
(d) None.
5. The first pillar under Basel II talks about:
(a) minimum capital requirements (b) supervisory review
(c) market discipline (d) disclosure norms
6. As per Basel II Framework, the total of Tier 2 capital is permitted up to a maximum of:
(a) 100 per cent of Tier 1 capital
(b) 250 per cent of Tier 1 capital
(c) 80 per cent of Tier 1 capital
(d) 50 per cent of Tier 1 and Tier 3 capital
7. Tier I capital of a bank consists of its:
(a) paid-up equity capital
(b) issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference
shares and disclosed reserves
(c) authorised capital (d) none.
8. Subordinated term debt will be limited to a maximum of:
(a) 50 per cent of Tier 1 elements . (b) 100 per cent of Tier 1 elements
(c) 85 per cent of Tier 1 elements (d) none.
9. Tier 3 capital will be limited to:
(a) 250 per cent of a bank's Tier 1 capital that is required to support market risks
(b) 100 per cent of a bank's Tier 1 Capital
(c) 250 per cent of a bank's Tier 1 capital
(d) none.
8.4 ANSWERS TO 'CHECK YOUR PROGRESS'
. A. 1. (d), 2. (d).
B. 1. (a), 2. (a), 3. (b), 4. (a), 5. (a), 6. (a), 7. (b), 8. (a), 9. (a).8.5
KEYWORDS
Liquidity Risk, Interest Rate Risk, Foreign Exchange Rate (Forex) Risk, Commodity Price Risk, Equity Price Risk, The Basel Committee on Banking Supervision, Capital Funds, Credit Risk, Operational Risk, Market Risk, Securitisation, Undisclosed Reserves, Risk-weighted Assets.

UNIT
9
ALLIANCES/MERGERS/ CONSOLIDATION
STRUCTURE

9.0 OBJECTIVES

This unit will enable you to:

- know the meaning of alliances, mergers and acquisitions and consolidation;
- study the objectives of merger/consolidation;
- know the advantages and disadvantages of alliances and mergers;
- study the progress and prospects of mergers and alliances in respect of the Indian banking industry.

Before proceeding further, let us understand clearly the meaning of the terms like alliance, merger, consolidation, take-over, acquisition, etc.

9.1 ALLIANCES

A strategic alliance is a formal and 'mutually agreed to' commercial collaboration between companies. The partners pool, exchange, or integrate specific business resources for mutual gain, yet they remain separate businesses. It is a synergistic arrangement whereby two or more organisations agree to cooperate in the operation of a business activity, where each involved company brings different strengths and capabilities to the arrangement. Alliances can be either equity or non-equity based and typically start with one cooperative agreement that evolves into a portfolio of arrangements built overtime.

9.1.1 Why Alliances?

Alliance contagious is an excellent vehicle to obtain market growth amid the rapidly changing market conditions. Alliances can also help construct broader business systems by linking a company's internal core competencies with the best of breed capabilities of its allies. But not all alliances succeed. Almost one in two fails. 'Problematic alliances can be the result of many factors, including industry dynamics, (for example, regulatory changes), new technologies, new entrants or economic cycles'.

The ability to weather external forces as well as maximise internal alliance potential is heavily driven by establishing a solid alliance foundation that includes experience, mutual trust, strong relationships and sound business rational. Alliances that are managed well can create tremendous value. Strategic alliances and collaborative approach, as an alternative to mergers and acquisitions, could be attempted to reduce transaction costs through outsourcing, leverage synergies in operations and thus avoid problems related to cultural integration. If merger/consolidation is difficult to achieve, this alternative could be tried. Further, rapid expansion in foreign markets without sufficient knowledge of local economic conditions could increase vulnerability of individual banks and hence, a strategic alliance with a local player could be a better solution.

One of the example of alliance is the coming together of three mid-size public sector banks - Indian Bank, Corporation Bank and Oriental Bank of Commerce - which have entered into a 'strategic alliance' in October 2006. The alliance, intended to help the banks leverage their combined balance sheet strength and share the benefits of economies of scale, is reflective of the dynamics at play in the Indian banking space today. The present moves are: presupposing the sharing of IT platform initially for ATMs, formation of a joint appraisal cell in Mumbai to undertake appraisal of large projects for funding, participating in each other's training programmes and building up a common data centre.

9.1.2 Strategic Alliances - Benefits

Strategic alliances bring enterprises the following benefits:

(a) Increase in capital for research and product development and yet lower risk (Innovation)

(b) Decrease in product lead times and life cycles (time pressures)

(c) Ability to bring together complementary skills and assets that neither company could easily develop on its own

(d) Access to knowledge and expertise beyond company borders (technology transfer)

(e) Rapidly achieve scale, critical mass and momentum (economies of scale - bigger is better)

(f) Expansion of channel and international market presence (foreign market entry)

(g) Building credibility in the industry and brand awareness

(h) Providing added value to customers (value-addition)

(i) Establishing technological standards for the industry that will benefit the firm.

Strategic alliances come in all shapes and sizes, and include a wide range of cooperation, from contractual to equity forms.

9.2 MERGER

Merger, also known as amalgamation, is defined as the combination of two or more companies into a single company, where one survives with its name (or a combined new name) and the others lose their corporate existence. According to the Oxford Dictionary, 'merger' means 'combining of two commercial companies into one' and 'amalgamation' means 'merging of two or more business concerns into one'. All the assets and liabilities (both on and off balance sheet items) of the merging company gets transferred to the surviving company. An example of this type of amalgamation in the Indian banking sector is the merger of Global Trust Bank Ltd. with Oriental Bank of Commerce.

9.2.1 Objectives

Mergers are well recognised commercial practices for growth and diversification of manufacturing, business and service activities. Following characteristics motivate mergers:

(a) diversify the areas of activities; achieve optimum size of business;

(b) remove certain key factors and other bottlenecks of input supplies;

(c) improve profitability;

(d) serve the customer better;

(e) achieve economies of scale and size, internal and external;

(f) acquire assets at lower than the market price;

(g) bring separate enterprises under single control;

(h) grow without any gestation period and nurse a sick unit and get tax advantages by acquiring a running concern.

9.2.2 Types of Merger

There are four types of Mergers, viz., horizontal mergers, vertical mergers, concentric mergers and conglomerate mergers. Horizontal Mergers normally involve the merger of two or more companies which are producing similar products or rendering the same type of services, i.e. products oj services which compete directly with each other. This type of merger normally results in reduction in the number of players in that particular industry and may

reduce or eliminate competition. Vertical Mergers involve the merger of two companies, where one of them is an actual or potential supplier of goods or services to the other. The object of this kind of merger could be to ensure a source of supply or an outlet for products and the effect may improve efficiency.
In Concentric or Congeneric Mergers, the two companies may be related through the basic technologies, production process or markets. The merged company provides an extention of product line, market participations or technology to the surviving company. Such mergers provide greater opportunities to diversify into a relative market having higher return than it enjoyed earlier. Conglomerate mergers neither constitute the bringing together of competitors nor have a vertical connection. It involves a

predominant element of diversification of activities. Thus, in this kind of merger, one company derives most of its revenue from a particular industry, acquiring companies operating in other industries - with a view to obtain greater stability of earnings through diversification or to obtain benefits of economies of scale, etc.

9.2.3 Advantages

(a) Brings in synergy in operations and economies of scale in inputs, production and delivery, which
results in cost savings for the acquirer.

(b) Due to increased size, the growth in the top line (sales volume) and bottom line (profit) are significant.

(c) Creates opportunities to penetrate markets - strategic benefits.

(d) Helps build a strong marketing front-end for increased customer comfort and to leverage expertise
in markets.

(e) Enables to achieve world-class standards in their line of business.

(f) Facilitates product innovation as their resources are more so complementary.

9.2.4 Disadvantages

(a) Merger of two companies may result in dilution of competition in the market, adversely affecting consumers' interests.

(b) May result in abuse of market power.

(c) Higher concentration arising out of consolidation could have larger potential for systemic risk.

9.3 CONSOLIDATION

Consolidation is defined as the combining of two existing companies into a new company, in which both the existing companies get extinguished and a new company is made or created. The existing companies lose their identities and a new entity is created with a different or the same name. The assets and liabilities of both the companies get merged into the new company. In the Indian corporate history, we can cite the example of the Birla Group of companies, 'Indian Rayon and Industries Ltd.' and 'Indo Gulf Industries Ltd.' consolidating to give birth to the, now existing new company named 'Aditya Birla Nuvo Ltd.'

9.4 ACQUISITION OR TAKE-OVER

Acquisition or take-over of a company refers to the acquiring of a controlling stake in the ownership of a company by another entity. This is normally done by one company buying into the share capital of another company, either in a hostile manner or with the consent of the existing owners.

9.5 CONSOLIDATION IN THE INDIAN BANKING SCENARIO

In the liberalised era, banks in India will have to be competitive in order to face the challenges and leverage the opportunities. The ultimate goals of a bank are to increase its market share, become more diversified, reduce the risk of entering a new business and redefine the competitive edge through acquiring different streams of businesses.
Consolidation will provide banks with new capabilities, technologies and products, help to overcome entry barriers, ensure immediate entry into new markets and lower operating costs through consolidation of resources. The strategic factors for existing banks competing with

private and international players would be the size, quality of service and low cost finance by achieving 'critical mass'. In contrast to the earlier experience of mergers being initiated by the regulator to protect the interest of depositors of weak banks, the trend of market-led mergers between private banks and private banks with public sector banks may gain momentum. Consolidation may also take
place through strategic alliances or partnerships covering specific areas of business such as Small- to Medium-Sized Enterprise (SME) lending, credit-cards and insurance.

Mergers in Indian banking are not new and dates back to 1921. In fact, in 1921, the three presidency banks - the Bank of Bengal, the Bank of Bombay and the Bank of Madras were amalgamated into the Imperial Bank of India, which is now called the State Bank of India. Over the years many smaller banks have merged into bigger banks as in the case of New Bank of India into Punjab National Bank, Bank of Tamil Nadu into Indian Bank, etc. In these recent years several mergers have taken place in India but not necessarily for business reasons but for bailing out some sick banks. Some of the recent ones are the merger of Global Trust Bank Ltd. with Oriental Bank of India and the merger of United Western Bank with 1DBI. An example of market driven merger took place when the Times Bank was merged with HDFC Bank and Bank of Madura was merged with ICICI Bank. Recently, a number of Regional Rural Banks (RRBs) have been merged to bring about more viable business units and to reduce redundancies in operation. The market has also witnessed mergers in the urban co-operative landscape.

With the ongoing economic reforms and liberalisation accelerating further in the future and with the enforcement of World Trade Organisation's (WTO's) General Agreement on Trade and Tariff (GATT), Indian banks will face stiffer competition as large international banks with varied market experience and financial muscle enter the Indian banking arena. The presence of competitive and strong private and foreign banks will subject the other weaker and fragmented banks to comparisons with regard to 'profitability' and 'efficiency' in operations. This would force the weaker and smaller banks to go for consolidation or get perished.

As of March 2008, India has about 89 commercial foreign, private and state-run banks and several hundred co-operative banks. There are about ninety-six regional rural banks. The State Bank of India and its seven associates have about 13,800 branches; the nineteen nationalised banks about 33,500 branches, the RRBs have some 14,500 branches and foreign banks around 215 branches. This level of fragmentation needs to be corrected so as to create four to five 'right-size' banks; banks of the size of SBI, with world-class standards, which will enable them to respond to the stimulus of global opportunities. Size enables banks to lend large sums to select corporates, thereby ensuring a better quality asset book. Further, significant overhead infrastructure is essential for a wide variety of retail products that are demanded in today's customer-driven banking environment. Such large infrastructure can be effectively sustained only by large sized banks. Continuous capital infusion is an essential ingredient for growth in the banking industry. Larger banks have the ability to augment capital at better valuations than smaller banks.

Raising capital from the financial market will help banks in consolidation without further diluting the basic character of ownership and management and enable them to face global competition. Stakeholders would benefit due to reduced intermediation costs and consolidation is also likely to benefit employees in the banking system, since it would lead to re-training and re-skilling of the work force.

It is apparent, therefore, that competition, consolidation and convergence are the key drivers of the banking sector in India today. Basel II implementation is likely to accelerate the emerging trends of consolidation to overcome capital constraint, streamline risk management, maximise return on capital, better and more extensive use of technology for efficiency gains, for more robust risk-based pricing and closer alignment with international best practices. The Oriental Indian Corporation (OIC) alliance appears to be a step in this direction, aimed as it is, at collaboration in such areas as IT, treasury resources and making a foray into international capital markets, insurance and other financial services.

Future success of banks will depend upon a rigorously defined strategic focus, strengthening operating capabilities and finding a way to grow profitably, either by extending geographical coverage, expanding product/market coverage, going for mergers or acquisitions or a combination of these.

9.6 CHECK YOUR PROGRESS

1. In case of Strategic Alliances,
(a) the partners will remain as separate entities
(b) the partners will lose their individual identities
(c) one partner will get merged with the other
(d) none

2. Three mid-sized public sector banks have entered into a 'strategic alliance' in October 2006.
They are:
(a) Indian Bank, Corporation Bank and Oriental Bank of Commerce
(b) Indian Bank, Punjab National Bank and Canara Bank
(c) Union Bank of India, Syndicate Bank and Corporation Bank
(d) Canara Bank, Syndicate Bank and Corporation Bank.

3. Combining of two or more companies into a single company where one survives with its name
and the others lose their corporate existence is called:
(a) Merger (b) Alliance
(c) Consolidation (d) Acquisition.

4. In 1921, the three presidency banks - the Bank of Bengal, the Bank of Bombay and the Bank of
Madras were amalgamated into one Bank which is now called the:
(a) State Bank of India (b) Reserve Bank of India
(c) Indian Bank (d) none.

9.7 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a), 2. (a), 3. (a), 4. (a).

9.8 KEYWORDS

Alliances, Mergers, Consolidation, Take-over, WTO.

CREDIT INFORMATION BUREAU (INDIA) LIMITED (CIBIL), FAIR PRACTICES CODE FOR DEBT COLLECTION AND BANKING CODES AND STANDARDS BOARD OF INDIA

STRUCTURE

10.0 Objectives

10.0 OBJECTIVES

Reading this unit will enable you to understand:

- the role and importance of CIBIL
- the bankers' fair practices code for debt collection, and
- the role of BCSBI in banks' commitment to fair treatment to customers.

10.1 CREDIT INFORMATION BUREAU (INDIA) LIMITED (CIBIL)

10.1.1 Ownership Structure

CIBIL, India's first credit information bureau was established by SBI and HDFC, with a shareholding of 40 per cent each, while Dun & Bradstreet Information Services India Private Limited (D&B) and Trans Union International Inc. (TU) hold 10 per cent each. D&B and TU have also provided the necessary technical and software support to CIBIL. CIBIL is a repository of information, which contains the credit history of commercial and consumer borrowers. CIBIL provides this information to its members in the form of credit information reports (CIRs).

The Reserve Bank of India (RBI), in its 'Annual Monetary and Credit Policy' for the year 2004-05, had stated that in respect of credit bureaus, 'it is desirable that the objective should be to move towards a sufficiently diversified ownership with no single entity owning more than 10 per cent of the paid-up capital in the first stage and 5 per cent later.' Accordingly, SBI and HDFC have divested their equity stake in favour of significant data providers with representation from all the categories of credit grantors. As on 31 December, 2006, HDFC, SBI, ICICI Bank, D&B and TU, hold 10 per cent stake each in CIBIL, whereas Citicorp Finance (India) Ltd., Standard Chartered Bank, HSBC, Punjab National Bank, Bank of India, Central Bank of India, Union Bank of India, Bank of Baroda and Indian Overseas Bank hold 5 per cent stake each, while the remaining 5 per cent is equally held by GE Strategic Investments Ltd. and Sundaram Finance.

10.1.2 Functions of CIBIL

CIBIL is a composite credit bureau, which caters to both commercial and consumer segments. The Consumer Credit Bureau covers credit availed by individuals while the

Commercial Credit Bureau covers credit availed by non-individuals such as partnership firms, proprietary concerns, private and public limited companies, etc.
The aim of CIBIL's Commercial Credit Bureau is to minimise instances of concurrent and serial defaults by providing credit information, pertaining to non-individual borrowers such as public limited companies, private limited companies, partnership firms, proprietorships, etc. CIBIL maintains a central database of information as received from its members. IT collates and disseminates this information on demand to members in the form of commercial Credit Information Reports (CIR) to assist them in their loan appraisal process.

10.2 FAIR PRACTICES CODE FOR DEBT COLLECTION

10.2.1 Demand for Lenders'Liability Law

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act was enacted in India in 2002. The Act allowed banks to take possession of assets of defaulting companies without going through the cumbersome legal process. In many countries, banks are mandated by law to respect the rights and interests of lenders, depositors and the other customers. Hence, the Indian industry strongly pitched for a lenders' liability law to prevent banks and FIs from misusing the securitisation law. The Government of India rejected such a demand but asked RBI to look into the matter.

On the basis of the recommendations of the working group on Lenders' Liability Laws constituted by the Government of India, Reserve Bank of India, in consultation with the Government and some banks and financial institutions, finalised a set of codes called 'the Fair Practices Code, for Lenders'and advised banks to adopt the guidelines. All the banks in India have framed their own set of Fair Practices Codes as per the guidelines and implemented it from November 1, 2003.

10.2.2 General Guidelines

Applications for Loans and their Processing

(a) Loan application forms in respect of priority sector and advances of up to Rs. 2.00 lakh should be comprehensive. It should include information about the fees/charges, if any, payable for processing. The amount of such fees is refundable in the case of non-acceptance of application. A meaningful comparison with that of other banks can thus be made and the informed decision can be taken by the borrower.
(b) Banks and financial institutions shall give acknowledgement for receipt of all loan applications. The time frame, within which loan applications up to Rs. 2 lakh will be disposed should also be indicated in acknowledgement of such applications.
(c) Banks/financial institutions should scrutinise the loan applications within a reasonable period of time. If additional details/documents are required, they should intimate the borrowers immediately.
(d) In the case of small borrowers seeking loans up to Rs. 2 lakh, the lenders should convey in writing, the main reason/reasons which, in the opinion of the bank after due consideration, have led to rejection of the loan applications within the stipulated time.

Loan Appraisal and Terms/Conditions

(a)Lenders should ensure that the credit proposal is properly appraised after assessing the creditworthiness of the applicants. They should not use margin and security stipulation as a substitute for due diligence on credit-worthiness.
(b)Terms and conditions and other caveats governing credit facilities are arrived at after due negotiation with the borrower should be reduced in writing and duly certified by the authorised official. A copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement should be furnished to the borrower.

(c)The lender should convey to the borrower the sanction of credit limit along with the terms and conditions thereof and keep the borrower's acceptance of these terms and conditions on record.
(d)As far as possible, the loan agreement should clearly stipulate that the credit facilities granted are solely at the discretion of the lenders. These may include approval or disallowing facilities, such as, drawings beyond the sanctioned limits, honouring cheques issued for a purpose other than the one specifically agreed to in the credit sanction and disallowing drawing on a borrowal account on its classification as a non-performing asset or on account of non-compliance with the terms of sanction. It may also be specifically stated that the lender does not have an obligation to meet further requirements of the borrowers on account of growth in business etc. without proper review of credit limits.
(e) In the case of lending under consortium arrangement, the participating lenders should evolve procedures to complete appraisal of proposals in the time-bound manner to the extent feasible and communicate their decisions on financing or otherwise within a reasonable time.
Disbursement of Loans including Changes in Terms and Conditions
Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction. Lenders should give notice of any change in the terms and conditions including interest rates, service charges, etc. Lenders should also ensure that changes in interest rates and charges are effected only prospectively.
Post-Disbursement Supervision
(a) Post-disbursement supervision by lenders, particularly in respect of loans up to Rs. 2 lakh, should be constructive with a view to taking care of any 'lender-related' genuine difficulty that the borrower may face.
(b) Before taking a decision to recall/accelerate payment or performance under the agreement or seeking additional securities, lenders should give notice to borrowers, as specified in the loan agreement or a reasonable period, if no such condition exits in the loan agreement.
(c) Lenders should release all securities on receiving payment of loan or realisation of loan, subject to any legitimate right or lien for any other claim lenders may have against borrowers. If such right is to be exercised, borrowers shall be given notice about the same with full particulars about the remaining claims and the documents under which lenders are entitled to retain the securities till the relevant claim is settled/paid.
General
(a) Lenders should restrain from interference in the affairs of the borrowers except for what is provided in the terms and conditions of the loan sanction documents (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).
(b) Lenders must not discriminate on grounds of gender, caste and religion in the matter of lending. This does not, however, preclude lenders from participating in credit-linked schemes framed for weaker sections of the society.
(c) In the matter of recovery of loans, the lenders should not resort to undue harassment, viz., persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans etc.
(d) In case of receipt of request for transfer of borrowal account, either from the borrower or from a

bank/financial institution, which proposes to takeover the account, the consent or otherwise, i.e.
objection of the lender, if any, should be conveyed within twenty-one days from the date of receipt
of request.

Apart from the Fair Practices Code, every bank has laid down appropriate grievance redressal mechanisms within the organisation to resolve disputes arising in this regard. Such a mechanism ensures that all disputes arising out of the decisions of the lending institutions' functionaries are heard and disposed of at least at the next higher level. The banks also conduct periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of controlling offices. Banks have also put on their website The Fair Practices Code, adopted by them and given wide publicity.

10.2.3 Indian Banks'Association (IBA) Initiative

The IBA had brought out its 'Bankers' Fair Practice' code in June 2004 and all member banks had adopted it voluntarily. The code was essentially a commitment to be fair and transparent in dealing with individual customers. The IBA had also separately come out with 'Fair Practice Code for Credit Card Operations' and 'Model Code for Collection of Dues and Repossession of Security' to address specific concerns voiced by customers about banking practices in these areas. The Banking Codes and Standards Board of India (BCSBI) was set up on 18 February, 2006. On the guidance of Reserve Bank of India, BCSBI had brought out the 'Code of Bank's Commitment to Customers' to be followed by member banks. The code sets minimum standards of banking practices for banks to follow when they deal with individual customers. This code deals with, inter alia, fair practices code for collection of debts.

10.2.4 Banking Ombudsman Service

The banks will display on their website and in all their branches, a notice explaining that it is covered by the Banking Ombudsman Scheme, 2006 of the Reserve Bank of India and the copies of the scheme will be made available on request at a nominal charge.

Within thirty days of lodging a complaint with a bank, if the customer does not get a satisfactory response from it and the customer wishes to pursue other avenues for redressal of grievances, he/she may approach the Banking Ombudsman appointed by the Reserve Bank of India under Banking Ombudsman Scheme, 2006. Salient features of the Banking Ombudsman Scheme are displayed in the branch notice boards and the scheme itself is displayed on the bank's website. The bank's staff would explain the procedure in this regard.

10.3 BANKING CODES AND STANDARDS BOARD OF INDIA (BCSBI)

10.3.1 Introduction

In November 2003, RBI constituted the Committee on Procedures and Performance Audit of Public Services under the Chairmanship of Shri S.S.Tarapore (former Deputy Governor) to address the issues relating to availability of adequate banking services to the common man. The mandate to the committee included identification of factors that inhibited the attainment of best customer services and suggesting steps to improve the quality of banking services to individual customers. The committee felt that in an effort to continuously upgrade the package of services that banks offered to their customers, there was a need of benchmarking of such services. After indepth study at the grass root level, the committee concluded that there was an institutional gap for measuring the performance of banks against a benchmark, reflecting the best practices (Code and Standards). Therefore, the committee recommended setting up of the Banking Codes and Standards Board of India, broadly on the lines of Banking Codes and Standards Board functioning in the UK.

Among the existing institutional structures, the Scheme of Banking Ombudsman, which has been functioning for quite sometime, does not look into systemic issues with a view to enforcing a prescribed quality of service. Ideally, such a function should be performed by a Self Regulatory Organisation (SRO), but in view of the existing framework of the banking sector in India, it was felt that an independent, autonomous board will be best suited for the function. Therefore, RBI, in its Monetary Policy Statement (April 2005), announced setting up of the Banking Codes and Standards Board of India in order to ensure that comprehensive code of conduct for fair treatment of customers was evolved and adhered to.

10.3.2 Formation of Banking Codes and Standards Board of India (BCSBI)

The BCSBI has been registered as a separate society under the Societies Registration Act, 1860 on 18 February 2006. The BSCBI functions as an autonomous body, to monitor and assess the compliance with codes and minimum standards of service to individual customers to which the banks agreed to.

BSCBI is not a department of the RBI. It is an independent banking industry watch dog to ensure that the consumer of banking services get what they are promised by the banks.

To ensure that the board really functions as an autonomous and independent watch dog of the industry, the RBI has decided to extend financial support to the board by way of meeting its full expenses for the first five years. This will enable the board to reach its economic critical mass that will make it truly independent in its functioning and take a view on any bank without its existence coming under any threat. On its part, RBI would derive supervisory comfort in case of banks which are members of the board. In substance, the board has been set up to ensure that the common man, as a consumer of financial services from the banking Industry, is in no way at a disadvantageous position and really gets what he has been promised.

The Role of IB A

The IBA had brought out its 'Bankers' Fair Practice' code in June 2004 and all member banks had adopted it voluntarily. The code was essentially a commitment to be fair and transparent in dealing with

individual customers. The IBA had also separately come out with 'Fair Practice Code for Credit Card Operations' and 'Model Code for Collection of Dues and Repossession of Security' to address specific concerns voiced by customers about banking practices in these areas.

10.3.3 Code of Bank's Commitment to Customers

The Reserve Bank of India, while announcing the formation of the BCSBI in the Annual Policy Statement, had requested the IBA to set up a working group to draft a comprehensive fair practice code, covering all the areas of customer service for uniform adoption by banks. Accordingly, the IBA had set up a working group to study the international practices and review the existing codes. The working group had examined fair practice codes adopted by bankers in other domains like UK, Canada, Hong Kong, Singapore and Australia and prepared a draft Bankers' Fair Practice Code, duly incorporating some of the finer points from those documents. The working group further refined the draft code, incorporating the suggestions from the member banks and submitted it to the BCSBI. BCSBI had made further refinements to the code and the 'Code of Bank's Commitment to Customers' was brought out. The code sets minimum standards of banking practices for banks to follow when they deal with individual customers.

The 'Code of Bank's Commitment to Customers' was released by Dr. Y.V. Reddy, Governor, Reserve Bank of India, in an inaugural function held at RBI on 1 July, 2006.

Banks will be required to register themselves with BCSBI as members and have the Code adopted by their respective boards. Thereafter, when they are ready to implement the commitments contained in the Code, the banks will enter into a covenant with BCSBI, binding them to monitoring by BCSBI as far as implementation of the code is concerned. The banks would also be required to make necessary changes in certain policy and procedural aspects around their products and services. With the adoption of 'Code of Bank's Commitment to Customers' by member banks who are members of BCSBI, the following voluntary codes of IBA would not be applicable to them:

(a) Bankers' Fair Practice Code - w.e.f. June 2004
(b) Fair Practice Code for Credit Card Operations
(c) Model Code for Collection of Dues and Repossession of Security

However, member banks who are not members of BCSBI or eligible to become members of BCSBI would continue to follow these codes.
The code represents each member bank's commitment to minimum standards of service to individual customers in relation to products and services offered by the bank, like:

- Deposit accounts
- Safe deposit lockers
- Settlement of accounts of deceased account holders
- Foreign exchange services
- Remittances within India
- Loans and advances and guarantees
- Credit cards
- Internet banking

In these areas the code, inter alia, dwells upon:

- Interest rates
- Tariff schedule
- Terms and conditions governing relationship between the bank and the customer
- Compensation for loss, if any, to the customer due the acts of omission or commission on the part of the bank

- Privacy and confidentiality of the information relating to the customer
- Norms governing advertisements, marketing and sales by banks.

Every member bank is required to:

- Have a help desk/helpline at the branch
- Have a code compliance officer at each controlling office above the level of the branch.
- Display, at each branch, name and contact number of the code compliance officer.
- Display name and address of the banking ombudsman.

This is to help the customer in case his bank does not provide services as promised in the code.
10.3.4 Function of BCSBI
The main function of the board is to ensure adherence to the 'Code of Bank's Commitment to Customers'. The code is voluntary and sets minimum standards of banking practices for banks to follow when they are dealing with individual customers in their day-to-day operations. The code is not only meant to provide protection to the individual customers but is also expected to generate awareness in the common man about his rights as a consumer of banking services. The common man is, therefore, the raison d'etre of the BCSBI.
10.3.5 Grievance Redressal
Member banks of BCSBI would put in place the following grievance redressal mechanism in their banks:

- Have a help desk/helpline at the branch and display at each branch name and contact number of code compliance officer and Display name and address of the banking ombudsman
- Have a code compliance officer at each controlling office above the level of the branch.

The customer should first approach the help desk of the branch/bank. In case the issue is not resolved, the code compliance officer of the bank may be approached by the complainant. In case the issue is still not resolved to the satisfaction of the customer, he should take it up with the banking ombudsman.
The difference between the banking ombudsman and the banking codes and Standard Board of India is that the banking ombudsman is a redressal mechanism to attend to disputes between banks and its customer as also to attend to individual complaints relating to deficiencies in banking services. On the other hand, the BCSBI is an industry watch dog to oversee compliance with the 'Code of Bank's Commitment to Customers.' It is not a redressal

mechanism and will look into an individual complaint only to the extent it points to any systemic failure in compliance with the code.

10.4 CHECK YOUR PROGRESS

1. One of the following does not own 10 per cent equity stake in the capital of CIBIL:

(a) HDFC (b)SBI
(c) ICICI Bank (d) Standard Chartered Bank

2. CIBIL as a credit bureau caters to:

(a) consumer segments
(b) commercial segments
(c) both commercial and consumer segments
(d) none.

3. The Consumer Credit Bureau covers credit availed by:

(a) individuals (b) proprietary concerns
(c) private and public limited companies (d) banks.

4. Credit information reports can be accessed by:

(a) only those members who have provided all their data to CIBIL
(b) by any bank
(c) by any Indian citizen
(d) none.

5. In case of receipt of request for transfer of borrowal account, the consent or objection of the lender, if any, should be conveyed within:

(a) twenty-one days from the date of receipt of request
(b) fifteen days from the date of receipt of request
(c) immediately on receipt of request
(d) none.

6. The Banking Codes and Standards Board of India was registered on 18 February, 2006 under:

(a) RBI Act (b) Banking Regulation Act
(c) the Societies Registration Act, 1860 (d) none.

7. The 'Bankers' Fair Practice' code was brought out in June 2004 by:

(a) IBA (b) RBI
(c) Government of India (d) None.

10.5 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), 2. (c), 3. (a), 4. (a), 5. (a), 6. (c), 7. (a).

10.6 KEYWORDS

Credit Information Reports, Code of Bank's Commitment to Customers, Post disbursement supervision.

RECENT DEVELOPMENTS IN THE INDIAN FINANCIAL SYSTEM

STRUCTURE

11.0 OBJECTIVES

By studying this unit, you will be able to understand the major segments of the Indian Financial System and the latest developments in these sectors.

11.1 STRUCTURE OF THE INDIAN FINANCIAL SYSTEM

The money market, the government securities market, the capital market and the forex market constitute the important segments of the financial system, besides the market for credit involving banks, non-banks and all India financial institutions.

11.2 REFORMS TO STRENGTHEN THE FINANCIAL SYSTEM

Since the mid-1991, the Reserve Bank of India has taken several steps to develop various segments of the financial markets, strengthen their integration and enhance their efficiency. These steps essentially covered the money market, the government securities market and the foreign exchange market. Steps were also undertaken by other regulators like SEBI and the Government of India to develop other markets, especially the equity and the debt segments of the capital market. Policy initiatives in these areas are related to introduction of new instruments, institutions and practices. Efforts have been made to widen the participant base, improve information base for all participants, create greater transparency and encourage good market practices, introduce efficient settlement mechanisms, rationalise tax structures, create better infrastructure to facilitate faster transactions and lower their costs.

11.3 DEVELOPMENT OF MONEY MARKET

Till the mid-1980s, the Indian money market was constrained by a paucity of instruments and it was regulated heavily with regard to participants and interest rates. Pursuant to the recommendations of the committee to review the working of the monetary system (Chairman: Prof. Sukhamoy Chakravarty, 1985) and the working group on the money market (Chairman: Shri N. Vaghul, 1988), a number of measures were taken up by the Reserve Bank of India to

widen and deepen the money market through institution building and instrument development. The Discount and Finance House of India Ltd. (DFHI), set up jointly by the Reserve Bank, public sector banks and financial institutions, commenced operations in April 1988, to deal in short-term money market instruments with the primary objective of improving liquidity. The introduction of new instruments, broadening of participants' base and strengthening of institutional infrastructure have been pursued during the 1990s, based on the framework provided by the Vaghul Committee and the Narasimham Committee II.
After 2000-01, a number of structural and instrument-specific measures taken up by the Reserve Bank of India have contributed to the growth and sophistication of Indian money market. These include the introduction of Liquidity Adjustment Facility (LAF), which started functioning from 5 June 2000. The introduction of Collateralised Borrowing and Lending Obligation (CBLO) through the Clearing Corporation of India Limited (CCIL) from 20 January 2003 and the expansion of repo market outside the LAF have also provided an avenue for bank and non-bank participants to trade funds after the conversion of call/money market into a pure interbank market. In order to broaden the market, non-scheduled urban cooperative banks and listed companies with gilt accounts with scheduled commercial banks have also been allowed to participate in the repo market outside the Reserve Bank of India..
The technological infrastructure, particularly with the introduction of Negotiated Dealing System (NDS), Real-Time Gross Settlement (RTGS) system and Centralised Funds Management System (CFMS) has brought about responsibilities for Primary Dealers (PDs) to support primary issuances, such as 100 percent

underwriting commitments for PDs; allowing PDs to diversify and expand their business; and the operationalisation of NDS-Order Matching (NDS-OM) system.
In pursuance of the recommendations of the committee on banking sector reforms (Chairman: Shri M. Narasimham, 1998), the process of transforming the call/notice money market into a pure inter-bank market was completed in August 2005. This has been supported by the development of a repo market outside the Reserve Bank, in which non-bank participants are allowed to trade their surplus/deficit liquidity. Prudential limits have been placed on borrowings and lendings of banks and PDs in the call/ notice money market.
A screen-based negotiated quote-driven system for all dealings in call/notice and term money market (NDS-CALL) was operationalised with effect from 18 September 2006. The system has been developed by the CCIL and is expected to improve ease of transactions and bring about greater transparency and efficient price discovery.
In order to enable market participants to assess the liquidity conditions in an efficient and transparent manner, information on transactions in the collateralised segment of the money market is also being provided on the Reserve Bank's website since 24 April 2006.

11.3.1 Commercial Paper

Commercial Paper (CP), an unsecured money market instrument issued in the form of a promissory note was introduced in India in 1990, with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Information on CP issuance as reported by the Issuing and Paying Agents (IPAs) on the NDS platform has been made available on the Reserve Bank's website with effect from July 2005, to enhance transparency and facilitate wider dissemination.

Certificates of Deposit

With a view to further widening the range of money market instruments and giving investors greater flexibility in deployment of their short-term surplus funds, Certificates of Deposit (CDs) were introduced in India in 1989. CD is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. The minimum maturity period of CDs was reduced from 15 days to 8 days with effect from 29 April 2005, to align it with the minimum maturity of CPs and fixed deposits with banks.

11.4 DEVELOPMENT OF GOVERNMENT SECURITIES MARKET

With the abolition of the system of automatic monetisation of deficits and the switchover to market related interest rates for market borrowings, it became possible to develop a genuine market for government securities. Introduction of new instruments, such as, zero coupon bonds, floating rate bonds and capital index bonds, establishment of Securities Trading Corporation, the system of Primary Dealers and Satellite Dealers and the Delivery versus Payments (DvP) system constituted the other areas of reforms in the government securities market.

In order to deepen and widen the government securities market, it was essential to diversify the investor base. In this context, retailing of government securities becomes critical. By establishing a system of PDs and Satellite Dealers (SDs) with provision for liquidity support from the Reserve Bank, it is expected that the dealers will take on a larger role in the primary as well as secondary markets in government securities. The liquidity support arrangements - based on bidding commitments and performance in both primary and secondary markets - would help the dealers to make markets and to minimise volatility in security prices.

Dedicated gilt funds have also been provided liquidity support from the Reserve Bank. Banks have been allowed to freely buy and sell government securities on an outright basis and retail government securities to non-bank clients without any restriction on the period between the sale and purchase. With a view to enabling dematerialisation of securities of retail holders, National Securities Depository Ltd. (NSDL), Stock Holding Corporation of India Ltd. (SHCIL) and National Securities Clearing Corporation Ltd. (NSCCL) have been allowed to open SGL accounts with the Reserve Bank.

The implementation of the Fiscal Responsibility and Budget Management (FRBM) Act has necessitated several structural and developmental measures for the government securities market to prepare it for the withdrawal of the Reserve Bank from the primary segment.

(a) 'When Issued' Market for Fresh Issuance of Securities

Extension A 'when issued' (WI) market in government securities was introduced and trading in this market had commenced from August 2006. To begin with, WI trading has been permitted in reissuable securities. It is now proposed to extend 'when issued' trading in the case of fresh issues of central government securities on a selective basis.

(b) Allowing Short Sale beyond Intra-day Settlement Cycle

On the basis of the recommendations of the technical group on the central government securities market, intra-day short-selling in central government securities was permitted from February 2006. On an assessment of the market feedback, eligible participants, viz., scheduled commercial banks (SCBs) and PDs have been allowed with effect from November 2006, to cover their short positions within an extended period of five trading days. As this arrangement may result in carrying short positions across settlement cycles, the participants would be allowed to deliver a shorted security by borrowing it through the repo market.

(c) Consolidation of Central Government Securities

The RBI believes that there is a need to enlarge the number of actively traded central government securities in order to enhance liquidity and improve pricing in the market and is pursuing its policies accordingly.

11.5 DEVELOPMENT OF CAPITAL MARKET

Setting up of depositories, clearing corporations/houses, stock exchanges etc. and introduction of on¬line trading in all stock exchanges have helped improve the efficiency of the capital market. Delisting norms have been tightened following the recommendations of the Chandratre Committee that were accepted by SEBI. All publicly issued debt instruments, regardless of the period of maturity, are presently required to be rated by credit rating agencies. All listed companies are also required to publish unaudited financial results on a quarterly basis. With a view to enhancing transparency in corporate affairs, SEBI accepted the recommendations of the Committee on Corporate Governance (Chairman: Shri K.M. Birla) and the listing norms have been modified to reflect a code of corporate governance. With a view to detecting market manipulations, SEBI regularly monitors market movements and oversees the activities of the stock exchanges. These measures in the capital market have helped in improving information flows and in reducing the transaction costs in the stock markets.

11.6 DEVELOPMENT OF FOREX MARKET

Measures to integrate Indian markets with those abroad were largely guided by the recommendations of the report of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan) and the report of the Expert Group on Foreign Exchange Markets in India (Chairman: Shri O.P. Sodhani). The former report recommended, inter alia, liberalisation of current account transactions, compositional

shifts in capital flows - away from debt in favour of non-debt, strict regulation of external commercial borrowings (ECBs) - particularly of shorter maturities, and measures to discourage volatile elements in the inflows from Non-Residential Indians (NRIs). Against the background of the gradual liberalisation of current transactions, a transition to the market-determined exchange rate on 1 March 1993, was achieved through a successful experimentation with a dual exchange rate system under the Liberalised Exchange Rate Management System (LERMS) for one year, beginning with March 1992. In October 1993, banks were permitted to rediscount export bills abroad at rates linked to international rates. The introduction of 'Post-Shipment Export Credit in Foreign Currency (PCFC) in November 1993,' enabled Indian merchants to access funds at internationally competitive rates.

In October 1996, Authorised Dealers (ADs) were permitted to use FCNR (B) funds to lend to their resident constituents for meeting their foreign exchange as well as rupee needs. Based on the recommendations of the Sodhani Committee, several measures were instituted to deepen and widen the forex market. ADs were permitted in, April 1998, to borrow from their overseas offices/correspondents, as well as to invest funds in overseas money market instruments up to US$ 10 million. In October 1998, this limit was raised to 15 per cent of Tier I capital of the banks. The uniform limit of Rs. 15 crore on the overnight positions of the ADs was removed with effect from 4 January 1996 and banks were allowed to operate on the limits fixed by their management and vetted by the Reserve Bank. The Aggregate Gap Limit (AGL), which was previously not to exceed US$ 100 million or six times the net owned funds of a bank, was left to be fixed by the individual banks since April 1996, depending upon their foreign exchange operations, risk-taking capacity, balance sheet size and other relevant parameters subject to approval by the Reserve Bank.

Liberalisation of capital account should be viewed as a process and not as a single event. In the approach to capital account convertibility (CAC), the initial reform measures were directed at current account convertibility, leading to the acceptance of Article VIII of the Articles of Agreement of the International Monetary Fund (IMF) in August 1994. For operationalising CAC in India, a clear distinction is made between inflows and outflows with asymmetrical treatment between inflows (less restricted), outflows associated with inflows (free) and other outflows (more restricted). Differential restrictions are also applied to residents versus non-residents and to individuals versus corporate entities and financial institutions. A combination of direct and market-based instruments of control is used for meeting the requirements of a prudent approach to the management of the capital account. The policy of ensuring a well diversified capital account with rising share of non-debt liabilities and low percentage of short-term debt in total debt liabilities is reflected in India's policies of foreign direct investment (FDI), portfolio investment and external commercial borrowings. Quantitative annual ceilings on ECB, along with maturity and end-use restrictions broadly shape the ECB policy. FDI is encouraged through a liberal but dual route - a progressively expanding automatic route and a case-by-case route.

Portfolio investments are restricted to select players, particularly approved institutional investors and the NRIs. Short-term capital gains are taxed at a higher rate than longer term capital gains. Indian companies are also permitted to access international markets through GDRs/ADRs, subject to the prescribed guidelines. Foreign investment in the form of Indian joint ventures abroad is also permitted through both automatic and case-by-case routes.

The committee on Capital Account Convertibility (Chairman: Shri S.S. Tarapore) which submitted its Report in 1998, highlighted the benefits of a more open capital account, but at the same time, cautioned that CAC could pose tremendous pressures on the financial system. To ensure a more stable transition to CAC, the report recommended certain signposts and preconditions of which the three crucial ones relate to fiscal consolidation, mandated inflation rate and strengthened financial system.

Keening in view the recommendations of the report, India has, over the years, liberalised certain

transactions in its capital account. Vastly altered and liberal policy environment for the external sector is reflected in the Foreign Exchange Management Act, 1999 (FEMA), which replaced the earlier Foreign Exchange Regulation Act, 1983 (FERA). The new Act sets out its objective as 'facilitating external trade and payment' and 'promoting the orderly development and maintenance of foreign exchange market in India'.

In recent years, the Reserve Bank has taken several initiatives to liberalise the conduct of foreign exchange business. A key consideration has been the rationalisation and simplification of procedures with a view to facilitating prompt and efficient customer service in external transactions.

The Reserve Bank, in consultation with the Government of India, had appointed a committee on Fuller Capital Account Convertibility (FCAC) (Chairman: Shri S.S. Tarapore) on 20 March 2006. The committee submitted its report to the Reserve Bank in July 2006. Keeping in view the recommendations of the committee, the RBI has initiated the following measures:

(a) Setting up of internal task force for procedural rationalisation and simplification

(b) Enhancement of limit under liberalised remittance scheme: Resident individuals would henceforth be free to remit up to US$ 50,000 per financial year for any current or capital account transaction or a combination of both. The existing facilities for gifts, donations and investment by resident individuals in overseas companies would be subsumed under this revised limit. The existing facility for private travel up to US$ 10,000 per financial year will continue to be available on a self- declaration basis.

(c) Liberalisation of Exchange Earners' Foreign Currency accounts: All categories of foreign exchange earners may henceforth retain up to 100 per cent of their foreign exchange earnings in their Exchange Earners' Foreign Currency (EEFC) accounts with a view to providing the facility uniformly to all eligible residents.

(d) Liberalised procedures with regard to project and service exports

(e) Enhancement of banks' borrowings from overseas

(f) Increased access to external commercial borrowings

(g) Higher flexibility for establishment of offices abroad

(h) Enhancement in FIFs investment limits in government securities

(i) Enhancement of ceiling in overseas investment by mutual funds

(j) Liberalisation of forward contract regulations

(k) Data collection and monitoring

Other Measures

(a) Delegation of Powers to Authorised Dealer Banks with Regard to Bank Guarantees and/or LCs to Cover Temporary Trade Related Credits

Authorised dealer banks are permitted to allow advance remittances for import of services up to US$ 100,000 without the counter-guarantee of a bank of international repute situated outside India. As a measure towards further liberalisation, it is proposed to permit authorised dealer banks to issue guarantees/ LCs for import of services up to US$ 100,000, where the guarantee is intended to secure a direct contractual liability arising out of a contract between a resident and a non-resident.

(b) Remittances Out of NRO Accounts

NRls and Persons of Indian Origin (PIOs) have been permitted to remit up to US $ one million per calendar year for any bonafide purpose out of the balances in their Non-Resident Ordinary (NRO) accounts. The amounts credited to the NRO accounts would also represent the sale proceeds of immoveable property acquired by the non-resident concerned out of her/his resources in India or proceeds

of property received by way of inheritance or gift. The sale proceeds of the immoveable property are now not subject to any lock-in period.

11.7 REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

The Reserve Bank exercises its supervisory role over the financial system encompassing commercial and urban cooperative banks (UCBs), financial institutions, non-banking financial companies (NBFCs) and PDs through the Board for Financial Supervision (BFS). As on 31 March 2006, there were eighty-nine scheduled commercial banks [excluding regional rural banks (RRBs)], 133 RRBs, 1,864 UCBs, 8 development finance institutions (DFIs), 13,049 NBFCs (of which 434 NBFCs are permitted to accept/ hold public deposits) and 18 PDs. The BFS, constituted as a committee of the central board of the Reserve Bank since November 1994, is headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the central board as members. The BFS provides direction, on a continuing basis, on regulatory policies and supervisory practices. In respect of state and district central cooperative banks and regional rural banks, while the Reserve Bank is the regulator, the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD). Insurance companies and mutual funds are regulated by the IRDA and the SEBI, respectively. A coordinated approach to supervision is ensured through a high level coordination committee on financial markets with the Governor of the Reserve Bank, as Chairman, and the chiefs of SEBI, IRDA and Pension Fund Regulatory and Development Authority (PFRDA) and the Secretary, Economic Affairs, Ministry of Finance, Government of India as the members.

11.8 CHECK YOUR PROGRESS

1. In the call/notice money market the following participants are allowed to trade:
(a) all corporates
(b) all banks, Primary Dealers and Mutual funds
(c) only banks
(d) none.

2. The minimum maturity period of certificates of deposit (CDs) with effect from 29 April 2005 is:
(a) 8 days (b) 15 days
(c) 21 days (d) none.

3. Scheduled commercial banks (SCBs) and primary dealers (PDs) have been allowed with effect
from November 2006, to cover their short positions within an extended period of:
(a) five trading days (b) two trading days
(c) short sales not permitted (d) none.

4. Resident individuals are free to remit in a financial year for any current or capital account transaction
or a combination of both up to:
(a) US$ 25,000 (b) US$ 50,000
(c) US$ 10,000 (d) none.

11.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (c), 2. (a) 3. (a), 4. (b).

11.10 KEYWORDS

Primary Dealers, Real-Time Gross Settlement (RTGS), screen-based negotiated quote-driven system.

MODULE B, FUNCTIONS OF BANKS

Unit 12 BANKER-CUSTOMER RELATIONSHIP

STRUCTURE

12.0 OBJECTIVES

After reading this unit, you should be able to:

- describe the requirements of a bank
- describe the various relations between a bank and its customer
- explain the bank's obligations to its customers
- comment upon the limitations of these obligations
- enumerate the precautions to be taken by the bank while disclosing the information regarding the customer.

12.1 INTRODUCTION

The basic function of a banker is accepting of money from the public by way of deposits and deploying the same by means of loans and investments. Apart from this function, bankers render a variety of services to their customers, like providing locker facility, keeping articles in safe custody, collecting bills, cheques and so on. While doing so, different types of relationships are created between the banker and the customers, depending upon the nature of service rendered.

12.2 REQUIREMENTS TO BE CALLED A BANK

The term 'Banking' has been comprehensively defined under the Banking Regulation Act 1949. According to Section 5(b) of the Banking Regulation Act, the term 'Banking' means accepting for the purpose of lending or investment of deposits of money received from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. According to the definition, the banker is engaged in the business of accepting deposits from the public and utilising such deposits either for the purpose of lending or for the purpose of investment.

Let us see what are the essentials laid down by the definition, so that we understand fully the scope of the term 'Banking'.

Essentials to satisfy the requirements of the above definition are laid down as below:

a) Acceptance of deposits should be for the purpose of lending and investment. Thus, companies accepting deposits for the purpose of financing their trading or manufacturing business cannot be considered as a bank.

b) The deposit should be accepted from the public, i.e. “Nidhis” and multi-benefit societies that accept deposit from their members, do not fall under this definition. Even the Cooperative Societies are outside the purview.

c) Acceptance of deposit should be in the form of cash. Banks obtain large funds from millions of depositors. The depositors do not have any control over the management of the banks. The government of the country has therefore to take such steps that would safeguard the interest of the depositors and the public in general and hence there existed a need to have a comprehensive legislation in this regard.

The Act not only defines the term 'Banking' but also provides information about certain essential ingredients to be fulfilled before an entity can be termed as a 'Bank'.

The important aspects are:

a) Only a firm or company and not an individual are permitted to act as a bank.

b) An individual is not allowed to act as a bank and he/she cannot use this term in the business. A firm consisting of not more than ten partners or a company incorporated under Indian Companies Act, 1956 can be a bank, a banker or a banking company. Under Section 5(c) of the Banking Regulation Act, 'Banking Company' means any company that transacts the business of banking in India. Section 7(1) of the Banking Regulation Act prohibits use of the words 'banker' or 'banking' or 'banking company' by a company other than a banking company. Section 7(2) of the said Act further prohibits the use of such words by an individual or a group of individuals or a firm.

c) Moneylenders are not bankers: The definition of banker does not include Indian moneylenders or mahajans, Sahukars or Shettys. The main reason for this is that they run their business as individuals or groups of individuals and not as a company registered under the provisions of the Companies Act and the Banking Regulation Act. In the case of Kadiresan Chettiar vs. Ramanathan Chettiar (AIR 1927, Madras 438), it was held that while a moneylender lends his own money, a banker lends money of his customers/depositors. On the recommendations of the Banking Commission 1972, the Reserve Bank of India has included indigenous bankers in the term 'Banker' for the purpose of credit control and applying banking regulations.

d) Accepting deposits of money from the public: Every institution carrying out the business of banking must accept the deposits of money. The deposits of money must be from the public and should not confine to the deposits from their members only. In the case entitled Mahalaxmi Bank Limited vs. Registrar of Companies, it was decided that if a company gave loan to the public but did not accept deposits from the public, it could not be considered as a banking company under Section 5 of the Banking Regulation Act.

e) Acceptance for the purpose of lending or investment: An institution accepting deposits of money without any purpose or with a purpose other than lending or investment cannot be termed as a bank.

f) Deposit repayable to depositors on demand or otherwise: Deposits of money may be repayable either on demand or if they are term deposits, on the expiry of the stipulated term or period.

g) The deposits may be withdrawable by cheque, draft, order or otherwise. Banks refund the money deposited with them to their customers, whenever the latter makes a demand for it by cheque, draft or by any written order.

Thus, the principal function of a bank is to accept deposits from the public for the purpose of lending and investment. In addition to the above principal functions, banks are authorised to carry out certain other transactions as provided under Section 6 of the Banking Regulation Act, 1949.

Important functions covered under Section 6 are:

a) Discounting of bills. b) Collection of cheques and bills,
c) Remittances. d) Safe custody of articles.
e) Hiring safe deposit lockers.
f) Conducting foreign exchange transactions.
g) Conducting (Central/State) government transactions,
h) Issuing letters of credit and guarantees.

These are various functions and services that are provided by banks to their customers and the following are the relationships that arise from the services rendered:

12.3 BANKER-CUSTOMER RELATIONSHIP

12.3.1 Debtor-Creditor (Bank is a Debtor and Customer is a Creditor)

When a customer deposits money with his bank, the customer becomes a lender and the bank becomes a borrower. The money handed over to the bank is a debt. The relationship between the banker and the customer is that of a debtor and a creditor. The features of this relationship are:

a) The money is lent to the bank and the bank is free to use it in a way most beneficial to it. The bank is not bound to keep such money intact. It is not bound to return the notes and coins of the same denomination as it was deposited.

b) Demand of payment should be made by the customer. The banker is not required to repay the debt voluntarily, unlike in the case of commercial debt.
c) Demand should be made at the branch where the account exists. Except in the case of drafts, travellers' cheque, ATM/credit card etc., the bank is not required to make the payment to the customer elsewhere (at other centres), although all the branches of a bank are constituents of the same bank (Chartered Bank vs. Mohd. Husain AIR 1965 Mad. 266). In the above case, it was held that although the branches were agencies of one principal bank, they were distinct for payment of customer's cheques.
d) The demand should be made in a proper manner. The customer should demand payment not verbally or by a mere telephone call but by cheque, draft, withdrawal form, order or otherwise. Further, demand should be made during the working days and working hours under Sections 25 and 65 of Negotiable Instruments Act, 1881, respectively.
e) For the monies deposited, the creditor (customer) does not call for any security from the debtor (bank) as in the case of commercial debts.
f) In the case of deposit accounts repayable on demand, the law of limitation does not begin to run until demand has been made for repayment. In the case of fixed deposit, normally the deposit receipt must be produced on or after the due date of deposit and the production of receipt is in the nature of demand and hence, the law of limitation begins to run from the date on which the receipt is produced.

12.3.2 Creditor-Debtor (Bank is a Creditor and Customer is a Debtor)

When the bank lends money to the customer, the customer is the borrower and the bank is the lender. The relationship between the banker and the customer is therefore that of a creditor and a debtor.

12.4 BANK AS A TRUSTEE

If a customer keeps certain valuables or securities with the bank for safe-keeping or deposits a certain amount of money for a specific purpose, the banker, besides becoming a bailee, is also a trustee. In the case of Subramanyan Pillai and Others vs. Palai Central Bank Ltd. (AIR 1962 Ker. 210), certain persons deposited Rs. 2,000 each in the bank as guarantee money to purchase cars. The bank failed before they could get the vehicle. The court was of the view that the bank should act as a trustee and that the money should be refunded from the bank's asset on the basis of preferential debts. A trustee holds money or assets and performs certain functions for the benefit of other person called beneficiary.
In another case, a customer remitted money with instructions to purchase shares/stocks of a company. The bank bought shares in parts, but before completing the rest of the purchase, it failed. It was held that the bank stood in the position of a trustee to the remitter and was entitled to the refund of the unspent balance of amount.

12.5 BAILEE-BAILOR RELATIONSHIP (BANK-BAILEE AND CUSTOMER-BAILOR)

When a customer deposits certain valuables, bonds, securities or other documents with the bank, for their safe custody, the bank, besides becoming a trustee as discussed earlier, also becomes a bailee and the customer is the bailor. According to the terms of Section 148 of the Indian Contract Act, 1872, the bank becomes custodian of the securities of the customer and hence as a bailee is liable for any loss caused to the bailor due to negligence. The finder of lost goods (Section 71 Indian Contract Act) should return any increase in goods/animals to the true owner. Under Section 164 (Indian Contract Act), the finder has to take care of such goods as an ordinary prudent man. These are examples of bailee-bailor relationship.

12.6 AGENT-PRINCIPAL RELATIONSHIP (BANK IS AGENT AND CUSTOMER IS PRINCIPAL)

One of the ancillary services rendered by the bank is remittance, collection of cheques, bills, etc. on behalf of the customers. It further undertakes to pay regularly, electricity bills, telephone bills, insurance premium, club fees, etc. In all such cases, the bank acts as an agent, his principal being the customer. The relationship of agency, however, terminates on the death, insolvency and lunacy of the customer or on completion of the work assigned. In the case of remittances, although the relation is that of agency in the case of Traders Bank Ltd vs. S. Kalyan Singh (AIR 1953), Punb p. 195, the High Court has held that the relations is that of debtor-creditor.

12.7 LESSOR AND LESSEE (BANK AS A LESSOR AND CUSTOMER AS A LESSEE)

The banks provide safe deposit lockers to the customers who hire them on lease basis. The relationship therefore, is that of lessor and lessee. In certain banks, this relationship is termed as licensor and licensee. The bank leases out the space for the use of clients. The bank is not responsible for any loss that arises to the lessee in this form of transaction except due to negligence of that bank.

12.8 INDEMNIFIER AND INDEMNIFIED (BANK IS INDEMNIFIED OR INDEMNITY HOLDER AND CUSTOMER IS INDEMNIFIER)

A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or the conduct of any other person is called a contract of indemnity - Section 124 (Indian Contract Act, 1872). In the case of banking, this relationship happens in transactions of issue of duplicate demand draft, fixed deposit receipt etc. The underlying point in these cases is that either party will compensate the other of any loss arising from the wrong/excess payment.

12.9 ANTI-MONEY LAUNDERING

12.9.1 Introduction

Money laundering is a process whereby the origin of funds generated by illegal means is concealed (drug trafficking, gun smuggling, corruption etc.). The objective of the operation, which usually takes place in several stages, consists in making the capital and assets that are illegally gained, seem as though they are derived from a legitimate source and inserting them into economic circulation. Money laundering is not a new phenomenon: It is as old as crime itself. Criminals have always endeavoured to conceal the origin of illegally generated funds in order to erase all trace of their wrongdoings. Nevertheless, the forms and dimensions of this type of crime have evolved in recent years. The offence of money laundering has been defined in Section 3 of the Prevention of Money Laundering Act, 2002 (PMLA) as "whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering."

12.9.2 Stages of Money Laundering

Placement: Placement is the first stage in the money laundering process. It refers to the physical disposal of proceeds of criminal activity.
Layering: 'Layering' refers to the separation of illicit proceeds from their source by creating complex layers of financial transactions. Layering conceals the audit trail and provides anonymity (obscurity).
Integration: The third phase is integration, which means placing laundered proceeds into the legitimate economy as normal funds.

12.9.3 Objectives of Prevention of Money Laundering (PMLA)

a) To prevent criminal elements from using the banking system for money laundering activities.

b) To enable the bank to know/understand the customers and their financial dealings better. This in turn would help the bank to manage risks prudently.
c) To put in place, appropriate controls for detection and reporting of suspicious activities in accordance with applicable laws/laid down procedures.
d) To comply with applicable laws and regulatory guidelines.
e) To take necessary steps to ensure that the concerned staffs are adequately trained in Know Your Client (KYC)/Anti-Money Laundering (AML) procedures.

12.9.4 Money Laundering - Risk Perception

Money laundering activities expose the bank to various risks such as operational risks, reputation risk, compliance risk and legal risk. In order to ensure that banks are not used by the money launderers, the Reserve Bank of India has issued KYC guidelines.

12.10 KNOW YOUR CUSTOMER

A customer, for the purpose of this policy, is defined as:
a) A person or an entity that maintains an account and/or has a business relationship with the bank.
b) One on whose behalf the account is maintained (i.e. the beneficial owner).
c) Beneficiary of transactions conducted by professional intermediaries such as stock brokers, chartered accountants, solicitors, etc., as permitted under the law and any person or entity connected with a financial transaction.

12.10.1 Key Elements of Know Your Client (KYC) Policy

The key elements of the KYC policy are Customer Acceptance Policy, Customer Identification Procedures, Monitoring of Transactions and Risk Management.

- Customer Acceptance Policy

The Bank will:
a) classify customers into various risk categories and based on risk perception
b) decide on acceptance criteria for each category of customers
c) accept customers after verifying their identity as laid down in Customer Identification Procedures
d) not open accounts in the name of anonymous/fictitious/benami persons
e) strive not to inconvenience the general public who desire to transact banking business

- Customer Identification Procedures

Customer identification has been defined as identifying the customer and verifying his/her identity by using reliable, independent source documents, data or information. Emphasis has been laid on verifying customer identity, not only while establishing a banking relationship but also at the time of executing a transaction or when the bank has a doubt about the authenticity /veracity or the adequacy of the previously obtained customer identification data. Wherever applicable, information on the nature of business activity, location, mode of payments, volume of turnover, social and financial status etc., will be collected for completing the profile of the customer.
Customers will be classified into three risk categories namely high, medium and low risk catagories, based on the risk perception. The risk categorisation will be reviewed periodically. Customer identification will be carried out in respect of non-account holders, approaching the bank for high value one-off transaction as well as any person or entity connected with a financial transaction, which can pose significant reputational or other risks to the bank. Banks should obtain sufficient identification data to verify the identity of the customer, his/her address/ location and also his/her recent photograph, while for legal persons/entities, extra caution has been suggested.
An indicative list of documents/information to verify the identity, address and other features suggested is given below.
For individuals: Legal name and any other name used in anyone of the following:

i) Passport, ii) PAN Card, iii) Voter identity card, iv) Driving licence, v) Identity card (subject to the bank's satisfaction) and vi) Letter from recognised public authority or public servant verifying the identity and residence of the customer to the satisfaction of the bank.
For correct permanent address anyone of the following:
i) Telephone bill, ii) Bank account statement, iii) Letter from recognised public authority, iv) Electricity bill, v) Ration card and vi) Letter from employer (subject to the bank's satisfaction).
For companies: To verify the name of the Company:
i) Certificate of Incorporation and MOA (Memorandum of Assosiation) & AOA (Article of Assosiation)- Principal place of business - Mailing address of the Company, ii) Resolution of the Board of Directors to open an account and identification of those who have authority to operate the account, iii) Power of attorney granted to its managers, officers or employees to transact business on its behalf, iv) PAN allotment letter - Telephone No./Fax No. and v) Telephone Bill.
For partnership firms: To verify legal name:
i) Registration Certificate, if registered - Address, ii) Partnership Deed - Names of all partners and their addresses, iii) Power of attorney granted to a partner or an employee of the firm to transact business on its behalf, iv) Any officially valid document identifying the partners and the persons holding power of attorney and their addresses, telephone no. of the firm and v) Telephone Bill.
For trusts and foundations: Any one of the following is needed to verify the names of the trustees, settlers, beneficiaries and signatories:
i) Certificate of registration, if registered, ii) Power of attorney granted to transact business on its behalf - Names and addresses of the founder, the managers/directors and the beneficiaries, iii) Any officially valid document to identify the trustees, settlers, beneficiaries and those holding power of attorney, founders/managers/directors and their addresses, iv) Resolution of the managing body of the foundation/association - Telephone/Fax No. and v) Telephone Bill.
Relaxation for small customers: If a person is unable to produce documents mentioned, a relaxation is extended if:

a) Balance is not exceeding Rs. 50,000 in all their accounts taken together, and
b) the total credit in all the accounts taken together is not expected to exceed Rs. 1,00,000 in a year, subject to introduction from another, at least six-month-old account holder who has gone through complete KYC procedures and showing satisfactory performance. The photograph is also to be verified by such an introducer. Further, RBI has suggested stopping the transactions as and when balance reaches Rs. 40,000 and turnover reaches Rs. 80,000 by notifying the customer.

Monitoring of Transactions: Monitoring of transactions will be conducted taking into consideration the risk profile of the account. Special attention will be paid to all complex, unusually large transactions and all unusual patterns, which have no apparent economic or visible lawful purpose. Transactions that involve large amounts of cash, inconsistent with the normal and expected activity of the customer, will be subjected to detailed scrutiny.

After due diligence at the appropriate level in the bank, transactions of suspicious nature and/or any other type of transaction notified under the PML Act, 2002 will be reported to the appropriate authority and a record of such transactions will be preserved and maintained for a period as prescribed in the Act.
Risk Management: While the bank has adopted a risk-based approach to the implementation of this policy, it is necessary to establish an appropriate framework covering proper management oversight, systems, controls and other related matters.
The bank's internal audit of compliance with KYC/AML policy will provide an independent evaluation of the same including legal and regulatory requirements. Concurrent/internal

auditors shall specifically check and verify the application of KYC/AML procedures at the branches and comment on the lapses observed in this regard. The compliance in this regard will be placed before the audit committee of the board at quarterly intervals.
All employees' training programmes will have a module on KYC Standards/AML Measures so that members of the staff are adequately trained in KYC/AML procedures.
Principal Officer (Money Laundering Reporting Officer): The bank will designate a senior officer as Principal Officer, who shall be responsible for implementation of and compliance with this policy.
The illustrative duties will be as follows:
a) Monitoring the implementation of the bank's KYC/AML Policy. Reporting of Transactions and sharing of the information as required under the law.
b) Maintaining liaison with law enforcement agencies.
c) Ensuring submission of periodical reports to the top Management/Board.

12.11 OBLIGATIONS UNDER PREVENTION OF MONEY LAUNDERING ACT, 2002

Section 12 of PMLA, 2002 casts the following reporting obligations for banking companies to the Director, Financial Intelligence Unit-India (FIU-IND), besides obligations of record keeping and preservation of information:
a) Cash Transaction Report (CTR)
i) all cash transactions of the value of more than Rs. 10 lakh or its equivalent in foreign currency;
ii) all series of cash transactions integrally connected to each other, which have been valued below Rs. 10 lakh or its equivalent in foreign currency where such series of transactions have taken place within a month and the aggregate value of such transactions exceeds Rs. 10 lakh;
iii) all cash transactions where forged or counterfeit currency notes or banknotes have been used as genuine and where any forgery of a valuable security has taken place. However, individual transactions for below Rs. 50,000 are not to be included in CTR.
b) Suspicious Transactions Report (STR).
The strict implementation of the KYC guidelines will prevent the money launderers from using the banking channels for their money laundering activities.

12.12 DIFFERENT DEPOSIT PRODUCTS OR SERVICES

12.12.1 Deposit Products

The major functions of a bank are to mobilise deposits from the public and to invest and/or lend these deposits to individuals, firms and corporate institutions.

- Types of Deposits

Deposits are normally classified as demand deposits and time deposits. The main differences between the two are listed here:

- Demand deposits

1. Payable on demand.
2. Low interest rates or no interest. .
3. includes current, savings, overdue deposits and unclaimed deposits.
4. Interest is paid on half yearly basis in saving accounts.

- Time Deposits

1. Repaid after expiry of the Deposit Period.
2. High interest rates, which vary according to period.
3. Time deposits from 7 days to 120 months period with or without reinvestment plans.
4. Interest is paid on quarterly rests and is *cumulative every quarter

- The Features of Demand Deposits

Demand deposits are classified into current accounts and savings accounts. We elaborate on the features as under:
Current Deposits: Current deposit accounts are opened to meet the transactions of business and trade and hence are not entitled to any interest from the bank. On the contrary, the bank

could levy charges for maintaining the accounts in the form of per page fees, per cheque leaf debit charges, minimum balance fees etc. The minimum balance could differ from bank to bank. There are no restrictions on the number of transactions per day but the customer has to pay cheque leaf charges at the time of issue of cheque books by the bank. Current account is meant, normally for trading or business transactions where every transaction made is only through cheque.
Saving Deposits: Its purpose is to inculcate a habit of saving. It is opened by individuals/trusts, etc. Interest is paid at a rate as determined by RBI. At present, it is 3.5 (4) per cent per annum on the minimum balance in between 10th and last day of the month. The bank's customers can withdraw amounts either by cheque or withdrawal form. Interest paid is on a half yearly basis. Nomination facility is available. In the case of frequent return of cheque due to insufficient funds, the bank can impose a penalty and ultimately close the account after due notice to the customer. The numbers of withdrawals are restricted by each bank and the minimum balance to be maintained could vary between Rs. 100 and Rs. 25,000.

- The Features of Time or Term Deposits

a) Accounts may be opened by individuals or firms or corporates or by designated institutions.
b)Amount is repayable on maturity. Banks issue deposits with maturity from seven days to one hundred and twenty months.
c) Rate of Interest is fixed for each bank for different periods.
d) Deposits are kept for a fixed period but could be withdrawn before maturity at a reduced rate of interest.
e)The interest is cumulative on quarterly rests.
f)Tax has to be Deducted at Source (TDS) by banks, if the interest paid on deposits is Rs. 10,000 or more at a time. The rate of TDS is 10 per cent and surcharge as applicable as per extant Income Tax Rules.
g)Term deposits are not transferable.
h) Term deposits maturing on Sundays and other public holidays or non-business days are paid with interest for such days at the contract rate since the amount is not paid on the due date.
i) Cash payment of term deposits is possible if the amount of the deposit receipt, including interest thereon does not exceed Rs. 20,000. Amount exceeding this limit can be paid only through cheque or is credited to operative saving or current account of the depositor,
j) Term deposits are classified under various schemes as:

i) Fixed Deposits (with simple interest payable every 6 months),
(ii) Monthly Interest Deposits (interest payable monthly),
iii) Quarterly Interest Deposits (interest is payable every quarter),
iv) Short-term Deposits (period of deposit less than a year),
v) Reinvestment Deposit Scheme (interest is not paid out but reinvested by the bank. The interest is capitalized),
vi) Recurring Deposit Scheme (deposits are credited in equal instalments on monthly basis by the customer).
Banks may vary the payment terms in combination with annuity, interest payment being partial or full or flexible in nature etc., and offer variety of deposit products to suit the needs of the customers.

12.13 SERVICES TO CUSTOMERS AND INVESTORS

- Objective

The main objective of services to customers and investors is to provide a comprehensive range of services to the corporate sector, besides augmenting revenue earnings for the banks. The primary activity of a merchant banker is to help a body corporate to mobilise funds either through an IPO, popularly called a Public issue or Private Placements of Debt or Equity.

12.13.1 Merchant Banking Definition

Merchant bankers are financial intermediaries. They act as intermediaries of transfer of capital from those who own it (Investor or Bond Subscriber) to those who use it (Corporates or Governments).

Merchant bankers assist in introducing or selecting or appointing outside technical consultants in addition to in-house technical personnel for preparation of a detailed project report, market survey report, feasibility studies etc. If the company has already prepared the project report, the viability of the project is seen from the financial angle; effective implementation is carried out by guiding the corporate, with regards to procedural matters, viz.:

a) Obtaining regulatory clearances such as RBI, SEBI, Ministry of Finance (MoF), stock exchanges (BSE, NSE), and Registrar of Companies etc.

b) Planning and timing of IPO.

c) Underwriting (guaranteeing) of IPO by financial institutions or brokers. At present major banks act as both merchant bankers and underwriters. But it is not mandatory that all banks acting as merchant bankers to be underwriters.

d) Selection and appointment of Principal Broker and Sub-Brokers. With book building now in vogue for IPO, the merchant bankers also help in identifying lead-book-runners and sub-book runners.

e) Selecting and appointing the registrar for the Issue and fixing their remuneration.

f) Selecting and appointing advertising consultants or agencies for publicity campaigns, investor conferences, analyst conferences and road shows.

g) Printing and distribution of prospectus and application forms to brokers and sub-brokers and book runners.

h) Making application to stock exchanges for listing of the security.

i) Monitoring and reporting the progress of the offering to the company and regulatory bodies and other stake holders if any.

12.13.2 Lease Financing

- Definition

This means leasing out the capital purchase of assets to another company against monthly rents for asset's consumption or use.

Here, the finance is arranged by the institution, which does not enjoy the use of asset, called Lessor. The lessor is entitled to write off a certain amount of capital cost against its taxable profits until it is suspended. While the lessee is benefited in not investing for capital cost plus lease expenses are permitted as revenue expense in the books for the lessee.

The lease can also be arranged on any existing freehold asset(s) or long leasehold property by either mortgaging it or by selling it at market price to a leasing company; this leasing company in turn would lease it back to seller of the asset on lease thus benefiting both. In a lease, the hirer of the equipment will not become the owner thereof.

- Advantages to Lessee

a) Use of asset without incurring the capital cost, thus saving on cost benefit of capital use.

b) As lease rentals are permitted as a permitted business revenue expense, they lead to depression in profits and ultimately less taxation on profits.

c) Since there is no capital cost, this does not impact the liability side of the balance sheet.

d) Credit worthiness of the lessee is intact if lessee approaches a financial institution for other credit related facilities.

- Disadvantages to Lessee

a) Ownership of the asset is with the lessor and not the lessee.

b) Since the lessor imposes usage terms and conditions on assets, asset is permitted to be used for agreed business purposes only; this takes away the leverage from lessee for utilising the asset for alternative business purposes, if any.

c) Confiscation or repossession of asset by lessor on breach of terms and conditions of use of asset.
d) Possibility of lessor/owner becoming insolvent or going into liquidation; thus in such a scenario, the asset may be attached by the creditor's official liquidator.

12.13.3 Plastic Money

Payments for purchases can be made in cash, cheques or cards. In respect of cash, there is the limitation that bigger payments cannot be made in cash on account of the need to carry bulk. Cheques are not often accepted as the credit standing of the person issuing a cheque is not apparent. In the circumstances, plastic money in the form of credit and other cards has become a preferred mode of payments and has wide acceptance among public. With the increasing use of plastic money the financial system is moving towards cashless transactions. There are different types of plastic money, some of which are discussed below:
Charge Card: In this, transactions by the cardholder are accumulated over a period of time, generally a month and the total amount is charged, i.e. debited to the account of the cardholder. The cardholder is given time of about 25 to 50 days to credit his account, in case there are insufficient funds in his account at the time of debit.
Since the transactions are only accumulated and charged when the holder is expected to pay the amount, such cards are called charge cards.
Credit Card: The difference between the credit and charge card is that in case of charge card, the amount becomes payable immediately on the debit to the account. In case of credit cards, the cardholder is sent a bill indicating the dues and he/she has the option to pay the entire amount as soon as the bill is received or choose to pay only certain percentage of the amount billed, in which case the cardholder gets a credit to the extent of the balance amount of the bill. Whereas no fee is levied if the full amount billed is paid within a given due date, a service fee/interest is charged on the payment which is deferred. Whereas charge card would require the cardholder's account in the concerned bank, the dues on the credit card can be paid by a cheque drawn on any bank. In other words, a credit cardholder need not maintain an account with the card issuing bank.
Like other loans and advances, credit card dues may also be defaulted. Thus, Credit Cards might cause credit risk for the card issuing banks. As credit cardholders are dispersed in a large geographical area where the card issuing bank may not have adequate reach and a majority of the cardholders may not have accounts with the bank, the card issuing banks have to select the clients for issue of cards after a thorough appraisal.
Collection of card dues should also be done carefully and methodically. Banks, credit card subsidiaries of banks and card companies use call centers and collection/recovery agents in managing card dues.
There are a number of parties involved in the credit card business. They are:
i) Cardholder: The person on whose name the card has been issued, ii) Card Issuing Bank: This is the bank which identifies the customer and issues the card. This bank will raise a bill on the customer as per agreed billing schedule, iii) Merchant: The person who has accepted payment through the credit card, iv) Merchant Bank or Acquiring Bank: Once the card is swiped in the shop, the merchant will seek credit from his/her bank. The bank which reimburses the merchant is known as the merchant bank or acquiring bank, v) Collecting Bank: The Merchant Bank will claim the payment from the card issuing bank. This is known as the collecting bank, vi) VISA and MasterCard are companies which run the credit card operations and they capture all deals and settle the dues among the different intermediaries.
Debit Cards: Debit cards are same as the credit cards. The only difference in this card is that the amount of dues from the cardholder for each and every transaction is debited to cardholder's account as soon as each transaction is notified to the issuer. If the balance is insufficient to cover the debit, the difference becomes payable immediately or else a service fee is levied. If the amount payable is overdue for a long period, the card may be cancelled. Quite obviously, a debit card may not be the appropriate card for those who would like to have a credit. This has, however, an advantage in the sense that it replaces the requirement of

carrying cash or cheque book, when the transactions are being carried out. As the transactions in the Debit Card are debited to the account instantaneously, they are relatively less risky to banks than credit card.

Debit cards are thus suitable to customers who are willing to avoid the debt trap-like situations and lately debit cards are replacing paper money in wallets; more so after banks started issuing ATM-cum-debit cards. Here, unlike in the case of credit cards, the cardholders do not fall into debt trap, because with debit cards, the cardholders' accounts are directly and immediately debited up to the limit of the balance available, as there is no prescribed credit limit on debit cards.

Let us now list down some salient features of debit cards:

a) Works like a passbook withdrawal, thus withdrawals more than that of available balance in the account of the customer are not allowed.

b) No credit loss to banks since the system works on available funds in the customers' account.

c) It is a paper-less system of payment, i.e. no paper money or cheques are required.

d) Payees and/or member establishments are sure of payments, as the system operates only upon the debit to account of the payee.

e) No transaction costs to customers.

(f) Since the payments are directly debited from the account of payee, there is no late payment fees payable by payee nor there any interest earnings for banks as there is no credit involved.)

g) Zero-risk weightage on debit cards as compared to credit cards where the same has a 125 per cent risk weightage.

ATM Card: These are cards issued to the savings account holders for drawing cash from Automated Teller Machines which can be placed in the branch or off site. Some of the debit/credit cards are also used as ATM cards. The ATMs ensure availability of cash round the clock and the customer need not visit the branch for small transactions.

Advantages of the Credit Card System:

The advantages of credit card system to all those who are concerned are as under:

To the cardholder:

- It is convenient for a cardholder to carry a credit card in his/her wallet and make payment towards travel or purchase. It allows the cardholder to draw cash too.
- It inculcates a sense of financial discipline in them.
- It provides a proof of purchase through banking channels to strengthen the cardholders' position in case of disputes with sellers etc.
- It also allows giving spending power to add-on members.
- It also extends additional facilities like insurance cover/discount etc.

To the merchant establishment:

- Increase in sales because of increased purchasing power of the cardholder due to credit available to the card holder
- Preferred locations by a cardholder.
- Merchant establishments can avoid provision of direct credit to customers.
- Systematic accounting since sale receipts are routed through banking channels.
- Advertising and promotional support on a national scale.
- Development of a prestigious clientele base.
- Assured and immediate settlement / payment.

Avoidance of the cost and security related problems involved in handling cash.

To banks:

- Scope and potential for better profitability out of share earned from the traders' turnover.
- Helps in establishing banking relationship with new customers.
- This also provides additional customer service to the existing clients.

• Better network spread of cardholders and their increased use means higher popularity and image for the banks.
• Savings of expenses on cash holding/stationery printing and manpower to handle clearing transactions.

12.14 SUMMARY

The term 'Banking' has been comprehensively defined under the Banking Regulation Act, 1949. According to the definition, the banker is engaged in the business of accepting the deposits from the public and utilizing such deposits either for the purpose of lending or for the purpose of investment. Not only the term 'Banking' is defined but the Act provides for essentials to be fulfilled before an entity can be termed as 'Bank'. In addition to the above primary functions, banks are authorised to carryout certain other transactions as provided under Section 6 of the Act. These functions and services provided by banks to their customers give rise to certain relationship between them, with the opening of an account by the customer with a banker. The application for opening an account is considered as a letter of agreement for establishing the banker-customer relationship. The general view is that the banker-customer relationship is mainly that of a debtor and a creditor with certain special features.

However, today the range of banking services is more extensive and indeed is expanding all the time. So it must be expected that other relationships will arise besides that of debtor and creditor. For instance, the relationship of principal and agent is present when the customer instructs his bank to buy or sell stocks on his behalf and when items are held in safe-custody the relationship is that of bailer and bailee. Where the bank's executorships service takes on the administration of a deceased's estate, the relationship is that of trustee and beneficiary. Duties akin to a trusteeship might also happen when a branch comes into possession of funds or property that belong to a third party, as when the bank has sold property in mortgage and has a surplus to pass to the subsequent mortgagee. Obviously, the relationship with the customer in that situation is that of a mortgagor with a mortgagee on the customer.

The roads to progress and prosperity can easily be made through friendly behaviour with the customers. If the bankers wish to develop their organisational image, they have to offer better services and cooperation, coupled with courteous service to gain a competitive edge. So the relationships depend on the nature of transaction and changes from customer to customer. A bank customer may be a creditor, a beneficiary and a bailor simultaneously when he/she deposits money, remits money by mail transfer and/or forgets a document in the bank inadvertently (not for security of any loan/advances).

Gathering/collecting of information from the borrower is essential in lending to him. This is known as Know Your Customer (KYC). Such information could be gathered from the statements/financial details and personal interview given by the borrower, about quality of products/services, efficiency of labour, the technical knowledge of the product, confidence level, financial plans, marketing strategies, lifestyles, family conditions etc. Questions relating to business acumen planning, organising, marketing and general administration can also be known. The level of ethics, resourcefulness and drive for performance and results could be obtained through personal interview.

Deposits are lifelines of banks. According to Section 5(b) of Banking Regulation Act, 1949, the banking means accepting deposits for the purpose of lending and investment. Such deposits are either demand
or time deposits. Demand deposits are made up of current accounts and saving accounts, while time deposit include FDR, short-term deposits, recurring deposits, MIDS/QIDS/reinvestment deposits etc.

Time deposits are kept for a minimum period of seven days to a maximum of one hundred and twenty months. Rate of interest varies with the period and the policy of the individual banks.

Other services provided by banks are merchant banking, lease financing, plastic money like credit or debit cards etc.

With the increasing use of credit cards, debit cards and ATM cards, the society is moving towards cashless transactions. In India, however, the use of the credit cards is restricted mostly to personal transactions. Credit and debit cards, popularly also known as plastic money, are used to make payments for purchase of goods and services by the holder from the member establishments. As the name signifies, there is no cash payment involved. Credit cards are available at a certain charge and overdue rate of interest varies from 18 per cent to 36 per cent per annum whereas the debit cards are issued free to user banks' customer or holder. Banks run the credit risk on the holder as and when the credit cards are issued, whereas debit cards are free of such risk on banks because the risk is limited to available balance in the holders' account.

Merchant banking is providing services from preparing project reports to finally obtaining finance from financial institutions, both public and private. Lease financing is to finance the capital expenditure of the project with monthly receivables from the actual user. In leasing, the finance is provided by the lessor and utilisation of asset(s) is by the lessee.

12.15 CHECK YOUR PROGRESS

1. Principle functions of banks are:
(a) accepting deposits (b) lending and investing
(c) non-fund business and remittance services (d) all of above (e) only (a) and (b).

2. In deposit accounts, the main relationship between bank and customer is:
(a) creditor-bank, debtor-customer (b) debtor-bank, creditor-customer
(c) agent-principal (d) servant-owner
(e) only (a) and (b).

3. When a bank lends money to the corporate person the relationship is:
(a) borrower and lender (b) creditor-debtor
(c) debtor-creditor (d) customer and client

4. Bailor-bailee relationship is applicable in:
(a) cash deposited with cashier by customer
(b) safe deposit locker
(c) demand draft issued by bank
(d) keeping articles in safe custody with bank
(e) none of above

5. What relationship is created when the bank collects a cheque in clearing?
(a) holder for value (b) clearing member and principal
(c) agent and principal (d) collecting bank and holder
(e) none of above

6. When any FDR is lost by a customer of a bank, what document is executed:
(a) guarantee bond (b) government bond
(c) promissory bond (d) indemnity bond

7. A credit voucher for Rs. 44,444 favouring Tarun was wrongly posted to Varun Bose by the bank, the relationship established with Varun Bose is of:
(a) trustee and beneficiary (b) debtor and guarantor
(c) creditor and indemnifier (d) creditor and debtor
(e) none

8. Mr. Nanhe has a bank account and credited Rs. 20 lakh in it. Subsequently he was arrested on charge of fraud. The police informed the bank not to allow withdrawals from his account. Two days later, bank receives a cheque of Rs. 15,000 favouring Nanhe's creditor. What should the bank do?
(a) not to pay cheque
(b) return cheque with memo stating A/c holder in jail
(c) honour the cheque
(d) get police orders for payment
(e) get court orders for payment
9. Account holder X draws a cheque for Rs. 5,000 favouring Rajesh (a minor aged 13 years) or bearer. Rajesh presents the cheque on counter duly signed on the back. What should the banker do with the cheque of a minor?
(a) refuse, since no contractual capacity
(b) pay the cheque after inquiring with X
(c) pay to Rajesh without any responsibility of bank
(d) ask Rajesh to bring his parents
(e) Section 26 N.I. Act, 1881, does not allow minor to receive payment
10. A cheque drawn for Rajkumar or order is stolen. The thief made endorsement as Rajkumar on the cheque in his favour. The cheque is presented in clearing and paid by bank. True owner later on sent legal notice to bank. What is the liability of the bank?

(a) the paying bank will get protection under N.I. Act
(b) forgery does not give any rights to bank, hence liable
(c) under section 85, the paying bank is liable
(d) under section 131, the paying bank is liable.
11. After close of business hours by 1.30 hrs. the account holder himself availed payment. At 4.15p.m. (after close of 1.45 hrs) income tax attachment order is received by bank. What would be the liability of paying bank?
(a) payment is made in due course and as payment is debitable next day, bank is protected.
(b) payment is not in due course since paid after reasonable time (i.e. 1.30 hrs. late for today).
(c) attachment order will be effective after bank's right of lien over the late payment bank should approach the customer to get the order changed to next day.
12. Ritesh issued a cheque at 3:30 p.m. (one hour after close of business hours of the bank) to Shubha. Shubha approached to the bank and on request paid the money at 4:00 p.m. as late payment;Ritesh arrived to the bank and stopped payment of cheque issued to Shubha at 4:30 p.m. on the same day. Who is liable for loss?
(a) Payment after business hours is not a payment in due course hence bank is liable, Section 10 N.I. Act.
(b) Payment even though after business hours but within banking hours is protected under Section 31.
(c) Payment late for today is protected under Section 85.
(d) Refused to accept stop payment instructions since late for today.

13. Section 131 of N.I. Act gives protection for collection of
(a) Bills of Exchange (b) Promissory Note
(c) Hundis (d) Cheque
(e) All of the above
14. Rajkumar wants a demand draft striking the word 'Order' and writing the word 'Bearer'. Can bank help him?

(a) Bearer Draft is unlawful under Section 31 of RBI.
(b) Bearer Draft can be issued like a cheque.
(c) Signature of the payee should be attested on the back of draft by the issuing branch.
(d) Attestation of the signature of the payee on a separate slip of paper by bank (without striking out the word 'Order' on draft).

15. A draft purchased is reported lost and the purchaser wants to stop the payment of the draft. Can the Bank do it?
(a) Bank cannot stop payment since it is a promissory note.
(b) Bank can stop payment since covered under negotiable instrument.
(c) Bank can ask the purchaser to suffer for negligence and bank cannot help.
(d) Bank would issue stop payment instructions only after two weeks from date of issue.

16. Objectives of KYC:
(a) to ensure appropriate customer identification
(b) to monitor transactions of suspicious nature
(c) to ensure that he/she would not deceive the bank.
(d) if loan given it would not be a NPA
(e) Only (a) and (b)

17. Sources of credit information
(a) Information's on visit to business premises
(b) On interview with borrower and from documents submitted
(c) Information's from loan proposal
(d) All of above
(e) Only (b) and (c)

18. Demand Deposits are those which can be withdrawn:
(a) On Request (b) On Sanction by Manager
(c) On Demand (d) On Persuasion

19. Current accounts deposits are not entitled to
(a) Cheque book above 100 leaves (b) Monthly Statements
(c) Cash Payments (d) Interest
(e) All of the above.

20. In saving account deposits, interest is paid on balance in the account between 10th to last day of month.
(b) Average
(d) Last balance at the end of month
(b) Financial Intermediaries
(d) Underwriters
(a) Maximum (c) Minimum
(b) Debt and debt related finance

21. Merchant bankers are:
(a) Financial Brokers
(c) Credit Appraisers
(e) All of the above.

22. Merchant bankers' activity relate to:
(a) Equity and equity related finance

(d) Non-Fund Business
(c) Fund Business (e) None of the above

23.Advantages of Lease Financing:
(a) Alternative use of funds b) Arrangement for faster and cheaper credit
(c) Increased capacity to borrow (d) Trading on Tax Shield
(e) All of above

24.Disadvantages of Leasing:
(a) Deprivation of asset ownership (b) Deprivation of asset in case of default.

(c) Attachment on owner going insolvent (d) None of the above
(e) All of (a) to (c)
25. Disadvantages to Credit Card holders:

(a) Over Spending Debt Trap (b) Frauds due to loss or theft of cards
(c) Forged signatures (d) Forged charge slips
(e) All of above (f) Only (a) and (b)
26.The difference between the credit and the debit card is:
(a) Your account gets debited immediately on using a credit card
(b) Your account gets debited immediately on using a debit card
(c) Your account does not get debited immediately on using a debit card
(d) None of the above
27. Credit risk to the bank is high from the:
(a) Credit cardholders (b) Debit cardholders
(c) Both the above (d) None of the above
28. The bank which pays the merchant for the transactions is called as:
(a) issuer bank (b) clearance bank
(c) acquiring bank (d) none of the above
12.16ANSWERS TO CHECK YOUR PROGRESS'
1. (d), 2. (b), 3. (b), 4. (d), 5. (d), 6. (d), 7. (d), 8. (c), 9. (c), 10. (a), 11. (b), 12. (a), 13. (d), 14. (d), 15. (a), 16. (e), 17. (d), 18. (c), 19. (d), 20. (c), 21. (b), 22. (a), 23. (e), 24. (e), 25. (e), 26. (b), 27. (a), 28. (c).
12.17KEYWORDS
Creditor, Debtor, Bailor, Bailee, Lessor, Lessee, Trustee, Beneficiary, Agent, Principal, Indemnifier, Indemnified, Anti-money Laundering, Know-Your-Customer (KYC), Demand Deposits, Time Deposits, Minimum Period of Deposit, Tax Deduction at Source (TDS), Tax on Interest Earned by the Bank's Customer, Recurring Deposits, Merchant Banking, Initial Public Offering (IPO), Public Issue, Underwriting, Listing of Shares, Lease Financing, Bill Finance, Whole Turnover, Off Balance Sheet, Credit Risk, Credit Card and Debit Card, ATM Card.

Unit 13, BANKER'S SPECIAL RELATIONSHIP

STRUCTURE

13.0 OBJECTIVES

A study of this unit will help you to understand the concepts of mandate, power of attorney, garnishee order, banker's lien and right of set-off.

13.1 INTRODUCTION

Normally, the account of a customer with a banker is operated by the customer himself. There are occasions, when the account holder gives an authority to another person through some legal documents to operate the account on his behalf. In such a case, a special relationship is created between banker and customer.

Further, the obligation of a banker to honour a cheque drawn on the customers' account is subject to the condition that the money lying in the account is properly applicable for making payment. There are cases where a banker is justified in refusing payment of a cheque.

13.2 MANDATE – DEFINITION

Definition: A person competent to enter in to a contract may authorise another person to open and operate an account on his behalf. This authority can be granted by a mandate or a power of attorney.

A mandate is an authority given by the account holder in favour of a third person to do certain acts on his behalf. This is issued by an account holder with a direction to his/her bankers authorising the person to operate the account on his behalf. The following are the salient points of a mandate:

- The customer informing the bank that he has authorised a person (mandatory) to operate the account on his behalf.
- The signatures of the mandatory are obtained in the mandate letter and are verified by the customer.
- The mandate is normally issued for a short and temporary period.
- A mandate is not acceptable from institutions. Institutions can issue a power of attorney.
- In the case of joint account holders, all customers must sign the mandate irrespective of operational instructions, while in the case of a partnership firm, all partners should sign the mandate letter.
- A mandate ceases to be valid on death, insanity, insolvency and bankruptcy of the account holder.
- A mandate can be withdrawn anytime by the account holder/s.

13.3 POWER OF ATTORNEY (P/A) – DEFINITION

It is a document executed by one person called donor (principal in favour of another person called donee agent) to act on behalf of the former, as per authority given in the document.

Following are the salient features of P/A:

(a) Two types of P/A are generally granted:

1. General or universal
2. Special or limited.

(a.)General P/A is issued for acting in more than one transaction and confers very extensive powers to donee. Special or Limited P/A is issued for specific purpose and often it is for a single transaction.

(b) General P/A gives power to sign cheques, stop payment of cheques, to sign borrowal documents,
on behalf of the principal.

(c) It is a stamped document and is executed in the presence of a Notary Public/Magistrate of a Court/Government official authorised to do so.

(d) P/A holder must sign as
Per pro
Sd/- Constituted Attorney

The Principal can revoke the P/A at any time for future transactions. A power of attorney stands revoked by the death, insanity or insolvency (winding up or liquidation in case of companies) of the principal.

13.3.1 Delegation of Powers

If the holders of a joint account want to empower a third party to operate the joint account, the authority should be signed by all the account holders. Any authority permitting the operation on a partnership account by a third party should be signed by all the partners. In the case of limited companies, delegation of authority by a person duly authorised to open and operate on the company's account is possible only if that person has the specific authority to further delegate his powers to a third person. The power of attorney has to be affixed with the common seal of the company. Fiduciaries such as executors, administrators and legal guardians cannot appoint agents. An attorney cannot delegate his powers unless his power of attorney specifically provides for the power of substitution. In case more than one person has been authorised, clear instructions about the operation of the account, whether to be operated singly or jointly must be obtained.

13.4 GARNISHEE ORDERS

Garnishee order is an order of the Court obtained by a judgement creditor attaching the funds belonging to a judgement debtor in the hands of his debtors, including a bank, who is called Garnishee, advising not to release the money until directed by the Court to do so.

It is a process of law in favour of judgement-creditor for a debt due from the judgement-debtor (bank customer) upon a third party for attachment. The order is issued under the Indian Civil Procedure Code, Order 21 Rule 46, of the Act. A garnishee order served on a bank attaches the credit balance in the account of the customer named, to the extent specified in the order. If no amount is specified, the order attaches all sums owing and accruing to the customer as on the date and time it is served and received by the bank. Cheques presented after service of the garnishee order should be returned with the remark 'Refer to Drawer'. The service of the garnishee order nisi is the preliminary proceedings of a Court. This is to be followed by subsequent proceedings of a Court to make it absolute, when it is called garnishee absolute. The order can only relate to the present balance in the account of the customer, i.e. amount due and accruing due or payable to the customer at the time of receipt of the order.

13.4.1 BANK - Dos and Don'ts under Garnishee Order

1. Payments of cheques: In case of cash payment of cheques, if order is received after debit to the account, but before the payment of cash, better course would be to refuse payment, with appropriate reason indicated for non-payment. In the case of cheques received in clearing, if the order is received before the stipulated returning time of clearing, then, the cheques must be returned. If the transfer of amount is done internally in another customer A/c the credit can be cancelled and cheque be returned unpaid, provided the other customer has not been advised of the credit.
2. Right to set-off: When a bank has a prior right to set-off, then the bank is not bound by the garnishee order. Where lien is marked on fixed deposit receipts, it cannot be attached by a garnishee order. However, the fact of 'right to set-off has to be intimated to court and the order must be vacated. It should be noted that any excess over the lien marked is attachable by the garnishee order.
3. Uncleared effects and subsequent credits in a/c: Credits received subsequent to garnishee order are not attachable because debts due or accruing at the time of receipt of order are only attachable.

However, in case where there is an agreement for withdrawal by the customer of unrealised

credits, such amounts are attachable. The portion of loan facilities not yet drawn cannot be considered as monies as it does not constitute a debt at all and as such cannot be garnished.

4. Joint accounts: When a garnishee order is in a single name and the customer/s account is in joint names (husband and wife, two brothers, mother and daughter or two friends) with the operation clause 'either or survivor', the monies lying in such account cannot be attached. However, if the amount is payable to former or survivor, it can be attached even though the

garnishee order is in the former's name only. This is because, the money is a debt due and accruing to the former in his lifetime and to the survivor only after the death of the former.

5. Trust accounts: The outstanding amount in a trust account cannot be attached, if the judgement debtor has deposited the money as a trustee.

6. Partnership accounts: The personal account of a partner can be attached for the firm's debt because partners are jointly and severally liable for the firm's debts. Nevertheless, the firm's account cannot be attached for individual debts of the partners.

7. Liquidator: When a company is the judgement - debtor, an order attaching the accounts of the liquidator, cannot be passed as the money does not belong to the company but to the liquidator.

8. When the garnishee order does not name the customer correctly or with a sufficient accuracy, to enable the bank to identify the account in its books, the bank is not bound to act upon it and is not responsible for passing cheques till the order is amended.

9. In case where the customer is having more than one account in the bank's branch, one is in debit and the other is in credit balances, the net result if in credit can be attached. The order will not attach only the credit balance account. But if the debit balance is in a loan account, which has not been recalled by the bank on the date of service of order, credit into another account cannot be adjusted.

10. The bank cannot appropriate the credit balance towards the contingent liabilities of the customer,when a garnishee order is served.

11. Balances held outside India cannot be attached. The above rules also apply to attachment orders issued by income tax officers under The Income Tax Act, 1961. The attachment order under this act lays down certain procedures regarding recovery of tax from the assessee in default. Under the Section 226(1) of the Act, the Income Tax Officer may, by a notice in writing, call upon any person (including a banking company), from whom money is due or may become due to the assessee or any person who holds or may subsequently hold money for, or on account of the assessee to pay to the Income Tax Officer either immediately or upon the money becoming due, so much of the money as is sufficient to satisfy the tax due from the assessee.

The order of the ITO may attach:

(a) any debt due and payable;

(b) debts due but not payable on the date of receipt of the notice; and

(c) any amount received subsequently.

Any balance lying in a joint account can also be attached, even though, a notice is issued on a single account. The shares of the joint account holder in such accounts shall be presumed to be equal, unless the contrary is proved.

13.5 BANKER'S LIEN

Lien is the right of the banker to retain possession of the goods and securities owned by the debtor until the debt due from the latter is paid. The banker's lien is an implied pledge. A banker acquires the right to sell the goods which came into his possession in the ordinary course of banking business, in case the

debt is not paid. Section 171 of the Indian Contract Act, 1872, gives to the banker an absolute right of general lien on all goods and securities received by the banker. However, when a customer inadvertently leaves a packet containing certain share certificates, life insurance policies, fixed deposit receipts of other banks etc., while leaving the bank premises, the banker will have no right of lien over those securities because those were not given to the banker in the normal course of banking business.

1. Where a right can apply?

(a) To sell: A banker's general lien gives the right to sell the debtor's properties.

(b) To a specific person: The right under Section 171 is given not only to the banker but also to

factors, wharfingers, attorneys of high courts and policy brokers. As such, no separate agreement is required.
(c) Against the customer: The right is exercised on the goods and securities of the customer only.
The right cannot be exercised when the debtor has a joint account.
2. Where a right cannot apply?
(a) Safe Custody Articles: When a customer deposits securities, ornaments and other valuable
for their safe custody with a banker, the latter acts as a trustee/bailee, therefore the bank cannot exercise the right of lien unless covered by a special agreement.
(b) Documents/money deposited for specific purposes: Documents/money deposited with a specific purpose cannot be taken under lien.
(c) Articles left negligently in bank premises: Such articles/securities cannot be taken under lien.
(d) Immature debts: Lien cannot be exercised when the debt has not yet matured. The bank discounts a 90 days bill for Rs. 50,000 maturity on 17-11-04 could not have a lien over it before its maturity date.
(e) Stolen goods: If the customer has stolen the goods/securities of the real owner and delivers them to this bank, the bank cannot have lien over it although the transaction has taken place in the ordinary course of business.
(f) No simultaneous rights to bank: When the right of set-off is available to the bank, lien right
cannot apply. These two different rights cannot be exercised simultaneously at the same time.

13.6 RIGHT OF SET-OFF - DEFINITION

Set-off is the right of a debtor to take into account a debt owing to him by a creditor, when claiming a debt due from him to the creditor. In the case of a banker, the right of set-off enables him to adjust a debit balance in a customer's accounts, with any balance outstanding to his credit in the books of the bank. In other words, the banker can adjust his claim from the amount that is payable to the customer.

13.6.1 Essential Features of Set-off

(a) It is a statutory right and can also arise out of an agreement between the parties concerned.
(b) There should be mutual debts and the debts should be for certain sums, while the claim and the cross claim should be for certain sums.
(c) The claims and cross claims should be both for determined amounts. Where the customer has stood as a guarantor to another party, his credit balance cannot be set-off against the borrowers' dues, till
the guarantee amount is determined. For the purpose of set-off, all the branches of a bank are considered as a single entity.
(d) The set-off can be applied only to those debts, which are due and recoverable on the date of exercising
the set-off.
(e) Indebtedness should arise in the same rights. Where the bank has noticed that the amount in the customer account is held under trust, the bank cannot exercise the right against a debit balance on

A deceased's credit account and a customers debit account cannot be combined.
Automatic right of set-off (i.e. set-off without notice) arises in the following cases:
(i) Death or insanity/insolvency of the customer
(ii) Insolvency of a partner or on the winding up of a company
(iii) Receipt of garnishee order

(iv) Receipt of notice of assignment of customer's credit balances (v) Receipt of a notice of secured mortgage over the security charged to the bank. The account of a sole proprietor (of a trading firm) and his individual account can be combined.

A customer does not have a right of set-off against various accounts of various branches (Mohammed Hussein Saheb vs. Chartered Bank (1965) AIR Mod. 266.).

13.7LET US SUM UP

There are various rights of a banker. These have been vested by the law of the country. Along with the rights, there are certain obligations too which a banker is required to fulfil. Such rights and obligations under the special relationship are mandates and power of attorney. Account holder is authorised to operate the account through a third person, in addition to himself, by suitable authority for one time basis and/or also for various functions through a power of attorney. Such P/A is either general or special in nature.

Lien means right of the creditor to retain possession of goods/securities owned by the debtor till the debt is paid. Lien is of two types: (a) general and (b) special lien. Banker's lien is a right available to a banker, where the right extends to all goods in his possession. The banker's lien is an implied pledge.

The customer may at times have two or more than two accounts in his/her name in the same capacity for the sake of convenience. The right to combine these accounts of the customer is known as the right of set-off. The right of set-off is available to the bank without any agreement to that effect. The right of set-off rests on the bank's discretion. If the banker does not want to exercise his right, the other party can do so.

Orders which are issued by the courts, for recovery of certain debts, payable by the bank's customer on behalf of the creditor, are called a garnishee orders. When such orders are issued by the revenue authorities, viz., income tax or sales tax authorities, they are called attachment orders. Garnishee orders are of two types: first, garnishee nisi and second garnishee absolute. Banks are required to pay/attach the amount on getting the order absolute. Banks are required to observe certain precautions while dealing with the attachment orders.

13.8 CHECK YOUR PROGRESS

Fill in the blanks with the suitable option.

1. Lien is a/an of the creditor to retain possession.
(a) right (b) obligation
(c) instrument (d) interest

2. Particular lien gives the creditor right to retain ---- increase the expenses incurred are not paid.
(a) all goods (b) ordered goods
(c) some goods/securities (d) specific goods / securities

3. Banker’s lien is an / a
(a) bailment of goods (b) implied pledge
(c) agreement (d) an stoppage

4. Banker's lien is not applicable in case of _
(b) (c)securities left negligently
(d) (d) all of above
(a) safe custody
(b) debts not due
(e) none

5. Right to combine two accounts by banks is called
(a) garnishee (b) lien
(c) set-off (d) rating

6. The right of set-off is a
(a) customer's right (b) banker’s right
(c) bank's discretion (d) payee’s right

7. Garnishee order is issued by a
(a) police officer (b) revenue officer
(c) CID (d) courts of law

8. Attachment order is issued by
(a) income tax officer (b) sales tax officer
(c) both (a) and (b) (d) public debt office
9. Mandate is a agreement.
(a) stamped (b) unstamped
(c) memorandum (d) calculated
10. Power of Attorney can be -------
(a) universal (b) limited
(c) both (a) & (b) (d) calculated

11. Person to whom power of attorney is given is called ----- and who gives it is called ------
(a) debtor-creditor (b) bailor-bailee
(c) pawner-pawnee (d) donor-donee

13.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a), 2. (d), 3. (b), 4. (d), 5. (c), 6. (c), 7. (d), 8. (c), 9. (b), 10. (c), 11. (d).

13.10 KEYWORDS

Lien, General lien, Special lien, Right to set-off, Mandate, Power of attorney, Notary Public, Garnishee order,
Attachment order, Judgement - debtor, Judgement - creditor.

UNIT
14PAYMENT AND COLLECTION OF CHEQUES AND OTHER NEGOTIABLE INSTRUMENTS

STRUCTURE

14.0 OBJECTIVES

This chapter will enable the reader to have an insight into the various aspects of payment and collection of cheques.

14.1 INTRODUCTION

A banker is under a statutory obligation to make payment of a cheque drawn on an account, if there are sufficient funds in the account properly applicable for making payment. Before doing so, it has to be ensured that the cheque is drawn properly fulfilling various legal requirements so that the payment will be treated as payment in due course.

14.2 NEGOTIABLE INSTRUMENTS ACT 1881

The Negotiable Instruments Act, 1881 deals with three kinds of instruments which are widely used in commercial transactions. They are promissory notes, bills of exchange and cheque. Of these instruments, a cheque is used in day to day banking transactions. The Act contains numerous provisions about cheques.

Definition of Cheque: Section 6 defines a cheque as follows:

A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form.

It contains instruction in writing given by the account holder to his bank for payment of money from his account. The obligation for payment on demand arises only in respect of savings and current accounts and not in term deposit accounts. There is a statutory obligation on the part of a banker to make payment of cheque if,

(a) the cheque is properly drawn.

(b) there is sufficient balance in the account.

(c) there is no legal restraint on the bank's duty to pay.

When a cheque is presented for payment, the following aspects should be looked into:

The branch on which it is drawn: Normally, a cheque is presented for payment only at the branch where the account is maintained. But, nowadays, several banks extend the facility of multi city cheque facility, whereby the customer can present the cheque at any of its branches brought under the core banking solution for getting payment. Even then, the customer's account with the home branch is debited.

Date: A cheque may bear a future date (post-dated), current date or an antedate. If a cheque bears a date six months prior to the date of presentation, it is considered to be a stale cheque which cannot be paid without revalidation by the drawer. A post-dated cheque cannot be paid because in such cases, the bank runs the risk of getting stop payment instructions, death, insanity or insolvency of drawer, serving of any attachment order before the ostensible date of the cheque.

Payee: A cheque may be made payable to a single payee or joint payees or alternative payees. If a cheque is payable to joint payees as X and Y, it should be paid to them jointly. Similarly, if a cheque is payable to X or Y, it may be paid to either X or Y. Some times banks come across cheques made payable to cash or order. Such a cheque can be paid only to the drawer or his agent. If a cheque is drawn payable only to a particular person, say 'X only', it can be paid to him only and not to any other. If a cheque is payable to a limited company, it cannot be paid to a third party.

Whether order cheque or bearer cheque: An order cheque may be presented for payment either by the original payee or by the endorsee. In such cases, proper identification of the presenter should be asked for. Further if the cheque contains endorsements, it must be ensured that they are regular. A bearer cheque can be paid to any person who presents it. In such cases, the paying banker need not verify the endorsement. However, the signature of the presenter should be obtained on the reverse of the cheque for having received the payment.

Whether amount stated in words and figure are the same: Before making payment, it should be ensured that the amount stated in words and figure tallies. Section 18 of the N.I. Act says that when the amount stated in words and figure differs, the amount stated in words shall be

paid. But, in practice the banks prefer returning such cheques unpaid with the reason 'amount in words and figure differs'.
Whether crossed: A cheque may be crossed either generally or specially. According to the Section 123 of the N.I. Act, when a cheque bears across its face an addition of the words "and company" or any abbreviation thereof, between two parallel transverse lines or two transverse lines simply, either with or without the words "not negotiable", that addition shall be deemed to be a crossing and the cheque shall be deemed to be crossed generally.'
According to the Section 126, when a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker. According to Section 129, a banker paying a cheque crossed generally otherwise than to a banker shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid. Such a payment will not be regarded as payment in due course and the banker will lose the protection as given in Section 128 of the Act.
According to Section 124 of the Act, where a cheque bears across its face an addition of the name of a banker, either with or without the words 'not negotiable', that addition shall be deemed to be a crossing and the cheque shall be deemed to be crossed specially and to be crossed to that banker.
According to Section 126, when a cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed or his agent for collection. According to Section 129 of the Act, a banker paying a cheque crossed specially otherwise than to a banker to whom it is crossed or his agent for collection shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid. Such a payment will not be regarded as payment in due course and the banker will lose protection as given in Section 128 of the Act.
According to Section 127 of the Act, where a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the paying banker shall refuse payment thereof.
'Account Payee' crossing has not been dealt under the N.I. Act. However, in banking practice it has significance. This type of crossing is a direction to the collecting banker to the credit of an account. The collecting bank will not get protection, if it collects the cheque crossed 'Account Payee' for a person other than the person mentioned in the instrument, whether payable to bearer or order. As per RBI directives, banks should not collect 'Account Payee' crossed cheques for any person other than the named payee.
Whether the instrument contains any endorsement: According to Section 15 of the N.I. Act, when the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, he is said to endorse the same.
Though the N.I. Act permits endorsement on the face of the instrument, the practice is only on the back of it. The slip of paper annexed to the instrument for negotiation is called 'allonge'.

A bearer cheque is transferred by the holder by mere delivery. Endorsement is not necessary in the case of a bearer cheque. The paying banker need not look into endorsements, if any, on a bearer cheque.
An order cheque can be transferred only by endorsement followed by delivery. According to Section 16 of N.I. Act, an endorsement may be 'in blank' or 'in full'. If the endorser signs his name only, it is endorsement in blank. If the endorser signs and adds a direction to pay the amount to or to the order of specified person, it is then called as an endorsement in full. A paying banker should look into the regularity of the endorsement before making payment so that he could avail the protection under Section 85(1) of the N.I. Act, in case, the endorsement is forged.
Any alteration: According to Section 87 of the N.I. Act, any material alteration of a negotiable instrument renders the same void as against anyone who is a party thereto at the

time of making such an alteration and does not consent thereto, unless it was made in order to carry out the common intention of the original parties. Any material alteration should be authenticated under the full signature of the drawer.

Any mutilation: If a cheque is accidentally torn by the drawer, he may confirm the mutilation and the cheque can be paid if otherwise in order. When a cheque is accidentally torn by the collecting banker, it is the practice to put an endorsement as 'Mutilation guaranteed' on the cheque.

Signature of the drawer: The signature of the drawer on the cheque is an authority given by the account holder to debit his account with the amount of the cheque. In case, where his signature is forged, the banker does not get the authority for debiting the account. Though the N.I. Act provides protection to the paying banker, in case of a forgery of endorsement, it does not give any protection when the drawer's signature is forged.

Stop-payment instruction: Before making payment of the cheque, the bank should see that there is no stop payment instruction with respect to the cheque. When the countermanded cheque is presented for payment, it should be returned with the reason, 'payment countermanded by the drawer'. In the case of joint accounts, an order for a stop payment instruction must be given by all the account holders. In the case of partnership accounts, cancellation of a stop payment instruction must be given by all the partners. In case of limited companies, cancellation of stop payment instruction must be given by all the persons authorised to operate the account.

At the time of making payment, the bank should also verify,

- Whether there is sufficient balance in the account.
- There is no order such as a garnishee order, income tax attachment order etc., prohibiting payment.
- There is no notice of death, insolvency or insanity of drawer.

14.3 PAYMENT IN DUE COURSE - SECTION 10

Protection is available to the paying banker in case of forgery of endorsement in an order cheque under Section 85(1), forgery of endorsement in a bearer cheque under section 85(2), in case of a materially altered cheque under Section 89 and in case of a crossed cheque under Section 128 of the N.I. Act. In all such cases, the condition for getting protection is that the payment made of the cheque should be in due course. Section 10 of the N.I. Act defines payment in due course.

Before making payment of a cheque, the bank should ensure that it is made in due course to enable it to get protection under the various provisions of the N.I. Act.

'Payment in due course means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned.'

Now, we discuss in detail the meaning of such words:

1. Apparent tenor means instructions of the drawer of the cheque, which is apparent from merely looking at the face of the cheque. Such instructions could be the date of cheque/name of payee/ bearer or order/amount in words and figures, crossing, etc.
2. Good faith and without negligence means the common understood meaning of acting honestly whether it is done negligently or not. Since good faith alone is not adequate, it should also be done without negligence. For example, in the deposit slip filled by the customer, if the a/c number is wrongly stated but the name of the depositor is correctly written, then if the bank gives credit to some account holder without verifying the name and account number of the depositor, it is a work done negligently and hence no protection is available to the banker.
3. Payment to a person in possession means that the banker has to make the payment of the cheque to the payee of the cheque holder or holder in due course.

4. Entitled to receive payment means that there are no circumstances to doubt the bona fides of the payee as regards his/her title to the cheque. (P.M. Das vs. Central Bank of India AIR 1978 Cal.)

14.4 LIABILITY OF THE PAYING BANK - SECTION 31

As per Section 31 of the N.I. Act, the drawee bank is under a liability to honour a cheque drawn on its account that is having a sufficient balance. Of course, this liability is subject to the condition that the funds are properly applicable to the payment of the cheque. In case of default, the bank must compensate the drawer for any loss or damage caused by such default.

Sufficient and adequate funds: Following are the circumstances when funds are sufficient and adequate, but are not properly applicable.

(a) When payment of a cheque is stopped.
(b) When drawer is dead and its intimation received.
(c) When funds under a garnishee order/income tax officer/sales tax department are attached.
(d) When the funds are earmarked for specific purposes.
(e) When the funds are set off by the bank.
(f) When the balance is not a clear balance.

Protection available to the paying banker: A paying banker is entitled for protection under the NI Act in the following cases:

(a) forged endorsements in an order cheque under Section 85(1)
(b) forged endorsements in a bearer cheque under Section 85(2)
(c) forged endorsements in a draft under Section 85(A)
(d) material alteration in a cheque under Section 89
(e) payment of a crossed cheque under Section 128.

Protection in case of forged endorsements in an order cheque: According to Section 85(1), where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course. Even though the endorsement on the cheque is not genuine, the paying banker is protected, provided the endorsement/s is/are regular, the payment of such cheque is made in due course as per Section 10 of the Act.

The reason for this protection is that the banker cannot be expected to be conversant with the signature of all the persons, who are not their customers. At the most, what he (the paying banker) can do is that the endorsement seems (purports) to have been made by the payee/endorsee.

Protection in case forged endorsements in a bearer cheque: According to Section85(2) , where a

cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any endorsement appearing on the instrument.

As a bearer cheque can be negotiated by mere delivery, endorsement is not relevant. Hence, if the paying banker makes payment to the bearer of the cheque in due course as per Section 10 of the Act, he is discharged even though the cheque contains forged endorsement or restrictive endorsement.

According to Section 85(A) of the Act, where any draft drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand, purports to be endorsed by or on behalf the payee, the bank is discharged by payment in due course. Even though the endorsement on the draft is not genuine, the paying banker is protected provided,

- The endorsement/s is/are regular.
- The payment of such draft is made in due course as per Section 10 of the Act.

Protection in case of material alteration in a cheque: According to Section 89 of the Act: when a negotiable instrument has been materially altered, but does not appear to have been so altered or where a cheque is presented for payment which does not at the time of presentation appear to be crossed or to have had a crossing, which has been obliterated, the payment thereof by a person or banker liable to pay and paying the same according to the apparent tenor thereof at the time of payment and otherwise in due course, shall discharge such [a] person or banker from all liability thereon and such payment shall not be questioned by the reason of the instrument having been altered or the cheque crossed.

This section gives protection to the paying banker while making payment of a cheque containing martial alteration, which was not visible or of a crossed cheque in which the crossing was not visible at the time of payment, provided the payment was made in according to the apparent tenor of the instrument and in due course.

Protection in respect of payment of a crossed cheque: Section 128 of N.I. Act gives protection for the payment of a crossed cheque. When the drawee bank has paid a crossed cheque in due course, it is entitled to and placed in the same position as if the amount the cheque had been paid to and received by the true owner thereof.

In order to get protection under this section, the banker should comply with the following conditions:

- When the cheque is crossed generally, the payment of it must be made only to a banker.
- When the cheque is crossed specially, the payment of it must be made only to the banker to whom it is crossed.
- The payment must be made in due course as per Section 10 of the N.I. Act.

Section 129 says 'if a banker makes payment of a cheque crossed generally otherwise than to a banker or a cheque crossed specially otherwise than to the banker to whom it is crossed or his agent for collection, being the banker, shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid.'

14.5 COLLECTION OF CHEQUES - DUTIES OF A COLLECTING BANK

A collecting bank is the one that collects promissory notes, bills, cheques and other similar instruments like dividend warrant etc., for and on behalf of customers. A collecting banker may be held liable to the true owner of the cheque for the wrong of conversion, if he collects a cheque for a person in respect of which he has no title. However, Section 131 of the N.I. Act gives protection to the collecting banker in this respect if the following conditions are fulfilled:

- The cheque should have been collected for a customer.
- The cheque should have been crossed either generally or specially before it comes in to the hands

of the banker for collection. If an uncrossed cheque was tendered for collection and after that if the banker adds crossing, the protection will not be available.

While collecting the cheque, the banker acted in good faith and without negligence.

If these conditions are fulfilled, the collecting banker will not be held liable to the true owner of the cheque by the reason of only having received such payment. If the 'know your customer guidelines' have not been followed while opening an account and a cheque is collected for that account, the protection will not be available.

Section 131 A gives protection to the collecting banker while collecting a draft if the above conditions are satisfied.

14.6 ENDORSEMENT OF CHEQUES

According to Section 15 of the N.I. Act, when the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, they are said to endorse the same.

14.6.1 Kind of Endorsements (Sections 15 to 17)

1. Endorsement in blank: Mere signature of the endorser on the back of an instrument without mentioning the name of the specified person in whose favour the endorsement is made, is called blank endorsement (Section 16). This has the effect of making the cheque

payable to bearer and thereafter the cheque, can be negotiated by mere delivery, since a bearer cheque is transferred by mere delivery.

2. Endorsement in full: When the endorser makes a direction to pay the amount specified in the cheque to a certain person or his order then the endorsement is in full (Section 16). Under this, the endorser guarantees that at the time the cheque left his hands, he had transferred his rights in a specific person. He also attests that endorsements made prior to this are genuine.

3. Conditional endorsement: Normally, the endorser binds himself to pay in case of a dishonour of the instrument. But, when he excludes his liability (without recourse) then the endorsement is termed as conditional. Similarly, when the right of endorsee to receive the due on the instrument depends upon happening of a specified event, the endorsement is termed as conditional. This condition can be a contingent event also, which may or may not happen (Section 52).

4. Restrictive endorsement - Section 50: The endorsement may restrict or exclude the right to negotiate or to receive its contents for the use of the endorser is called restrictive endorsement, e.g. Pay to Nalini Mumbaikar only.

5. Sans Recourse (without liability - Section 52): Endorsement with the express words of excluding liability of the endorser is called endorsement without recourse or liability, e.g. pay to Smt. Rameshwari Devi or order without recourse to me.

6. Facultative: As per requirement the endorsee must give a notice of dishonour to the endorser, but the endorser may waive this right in writing to the endorsement, e.g. pay to Smt. Manorama or order notice of dishonour waived. The endorser, however, remains liable to the endorsee for the non-payment of the instrument.

14.7 FORGED INSTRUMENTS

Forged instrument means forging the signature of the drawer and/or endorser, name of the payee and amount of the instrument etc. Forgery in signature and alterations in payee name, amount and date are not protected under law. The transferee will not be able to enforce payment from the parties to the bill, cheque and promissory note. And in case he has obtained payment by some inadvertence, such payment can be claimed from him/her.

This is because of the rule that the forgery gives no title. Thus in the case of a forged instrument, it is not only that the holder in due course has a defective title but no title at all. In case such a holder obtains payment, the true owner can sue for recovery of the amount as the holder would be deemed to be holding the amount for the use of the true owner. The plea of fraud is good only against the party who is guilty of it or against his transferee who knew the fraud when he took it. It will not affect the rights of a holder in due course. The same rule applies to instruments obtained for an unlawful consideration.

Forgery of Drawer's signature: The signature of the drawer on the cheque is an authority given by the account holder to debit his account with the amount of the cheque. In case where his signature is forged, the banker does not get authority for debiting the account. It is already stated that, though the N.I. Act provides protection to the paying banker in case of forgery of endorsement, it does not give protection when the drawer's signature is forged.

14.8 BOUNCING (DISHONOUR) OF CHEQUES FOR INSUFFICIENCY OF FUNDS

Negotiable Instrument Act, 1881, was amended in the year 1988 wherein a new chapter was incorporated ' for penalties in cases of dishonour of a cheque, due to the insufficiency of funds, in the account of the drawer of the cheque. These provisions were incorporated with a view to inculcate the culture of the use of cheques and enhancing the 'creditability' of the instrument. The amendment was again made in the year 2002 by inclusion of new sections.

14.9 RETURN OF CHEQUES

A banker is bound to honour the customer cheques when there are sufficient funds, properly applicable towards payment available. If a cheque is returned, even when sufficient funds are available, this dishonour is a breach of contract and may invite legal recourse on the part of the customer. Due to following reasons, the balance in the customer account is considered not available or applicable for payment:

(a) Payment is stopped by the customer.

(b) Death of the customer.

(c) Garnishee orders/attachment orders from courts and/or revenue authorities.

(d) Set-off rights to recover debts due to bank from the customer.

Reasons of Return: When a cheque is returned unpaid by the bank for reasons:

(a) Insufficient funds (b) No arrangement

(c) Exceeds arrangement (d) Payment stopped

(e) Refer to drawer (f) Closure of Account by drawer

the cheque is considered to have bounced and the drawer is considered to have committed an offence. But, when the drawer has intimated the payee that he shall not present the said cheque without his prior consent, in that event such cases will not fall within the frame of Sections 138 to 147. Now, we deal these sections as below:

Dishonour of a cheque for insufficiency etc., of funds in the account - Section 138: Where any cheque drawn by a person on an account maintained by him with a banker for payment of any amount of money to another person from out of that account for the discharge, in whole or any part of any debt or other liability is returned by the bank unpaid, either because of that amount of money is insufficient to honour the cheque or that it exceeds the amount by an agreement made with that bank; such person shall be deemed to have committed an offence and without prejudice to any other provision of this Act,

be punished with Imprisonment for a term which may be extended to two years or with fine which may extend to twice the amount of the cheque or with both, provided three things are done:

(a) the cheque has been presented within 6 months of its validity period,

(b) a demand for payment is made by notice within 30 days of the return of cheque, and

(c) the drawer fails to make payment within 15 days of receipt of notice.

14.9.1 Case Laws on Return of Cheques

(a) Criminal liability cannot be fastened on the heirs or legal representatives (Smt. Bhupindar Lima vs. State ofAndhra Pradesh (2000)

(b) An offence is committed even if a cheque is returned on account of closure of account [GVenkataramanaiah vs. Sillakollu Venkateswarlu (1999)]

(c) A cheque can be presented any number of times during the period of its validity (S. Bhadram vs. M. Sunil Kumar Air 1998 SC)

(d) A post-dated cheque is deemed to have been drawn on the date it bears and the 6 months periods for the purpose are to be reckoned from that date. (N. Sivalingam vs. A.V. Chandraiyer 1996)

14.10 SECTION 141 - OFFENCES BY COMPANIES

If the person committing an offence is a company, then every person who is responsible for such offence, as well the company, shall be deemed to be guilty of the offence. Provided where a person is nominated as a director by virtue of his holding any office or employment in the Central or State Government or financial corporation, he shall not be liable for prosecution. Company includes a firm or association of individuals, while director in relation to a firm means a partner. Once a cause of action has arisen, the limitation will begin to run and it cannot be stopped by presenting the cheque again, so as to have a fresh cause of action and fresh limitation (Mis Chahal Engg. and Construction Ltd vs. Verma Plywood Co. 1994).

14.11 SECTION 143 - SUMMARY TRIAL BY COURT

All offence under Sections 138/141 shall be tried by a Judicial Magistrate or by Metropolitan Magistrate of the first class and the provision of Sections 262 to 265 of Code of Criminal Procedure shall apply to such trials. In the case any conviction in a summary trial under this section, it shall be lawful for the magistrate to pass a sentence of imprisonment for a term not exceeding one year and an amount of fine not exceeding Rs. 5,000.

14.12 SECTION 144 - MODE OF SERVICE OF SUMMONS
The magistrate issuing summons to an accused or a witness may direct a copy of summons to be served by speed post or by such courier services as are approved by a Court of Session.

14.13 SECTION 145 - EVIDENCE ON AFFIDAVIT
Evidence of the complaint may be given by him on affidavit and may subject to all just exceptions be read in evidence in any enquiry; trial.

14.14 SECTION 146 - BANK'S SLIP PRIMA FACIE EVIDENCE OF CERTAIN FACTS
The court shall on production of the bank's slip or memo, having thereon the official mark denoting that the cheque has been dishonoured, presume the fact of dishonour of such cheque unless and until such fact is disapproved.

14.15 SECTION 147 - OFFENCES TO BE COMPOUNDABLE
Every offence punishable under this Act shall be compoundable. Case Law: Sadanandan Bhadran vs. M. Sunil Kumar 1998 4 CLJ

Payee of a cheque cannot initiate prosecution for an offence under Section 138 for its dishonour for the second time, if he had not initiated such prosecution on the earlier cause of action.

14.16 LET US SUM UP
The Negotiable Instrument Act, 1881, discusses about negotiable instruments and the payment, collection, dishonour, rights and duties of collecting bankers. As per the N.I. Act, negotiable instrument means cheques, bills of exchange and promissory notes. But there are other instruments also viz., Govt. Promissory Note, Shah Jog Hundi, railway receipts, motor transport receipts, dividend warrants as per custom of trade.

Underlying the banker-customer relationship is the contractual obligation on the part of the banker to honour the customer's cheque as and when they are presented provided, of course, certain conditions are satisfied before payment is made by banker. Legally, the bank is not bound to collect cheques/bills etc., drawn upon other banks and parties, for its customer. However, collection of cheques/bills is an important function of the bank, because it provides the facility in respect of crossed cheques.

Conversion means wrongful or unlawful interference with another person's property which is not consistent with the owner's right of possession. A banker, if he collects a cheque for a customer having no title or defective title to the instrument is said to have committed conversion. A bank which has in good faith and without negligence received payment of a cheque, crossed generally or specially to itself for a customer shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment. When the drawer or holder of a cheque draws two parallel transverse lines on the face of the cheque with or without words '& Co' or 'Not negotiable' it is called general crossing. Similarly, when the name of the bank is inserted, it is called special crossing and the paying banker should pay such cheques only to the bank whose name appears between the crossed lines.

When a holder of the negotiable instrument signs for the purpose of negotiation on the back or face thereof, the person so doing is called endorser and the transfer is called endorsement. The effect of endorsement is that the property stands transferred to the endorsee, for further negotiation/payment. Negotiation is possible even though the word 'order' is absent. Endorsements appearing upon a negotiable instrument are deemed to be similar in the order in which they appear thereon - (Section 118).

Forged endorsement is not a separate kind of endorsement. It is an unauthorised endorsement, which is made over the instrument by one who is not the endorsee. Instrument is sometimes obtained by theft, forgery, fraud and unlawful consideration. Such negotiable instruments can be bearer or order. The transferee will not be able to enforce payment because the forgery gives no title.

14.17 CHECK YOUR PROGRESS
1.Payment in 'due course' means

(a) on due date(b) in accordance with apparent tenor
(c) in accordance with apparent signature and specimen
(d) due to sufficient funds.
2.Payment of cheques is governed by sections under N.I. Act
(a) Section 10/31/85/126 (b) Section 15/16/17/131
141
© Section 131/138/147/142 (d) None of the above
(e) All (i) to (iv)
3. The liability of drawee of cheque is to make payment, when there is availability of
(a) Sufficient funds (b) Properly applicable for payment
(c) Required so by drawer (d) All of above
(e) None
4. Crossing in a cheque
(a) may be on the face or back of cheque
(b) must always be between two parallel transverse line
(c)must be on the face of cheque
(d)can be cancelled by drawer as per N.I. Act.
5.Promissory Notes/Bills of Exchange and Cheque are defined as
(a) trust Receipts (b) judicial documents
(c) negotiable instruments (d) documents of title to goods
6. Cheque is payable on
(a) demand (b) usance
(c) fixed future date (d) after sight
7. Crossing is a direction to the
(a) drawer (b) payee
(c) paying (d) passing
(e) collecting
8. One of the following crossings is not provided for, in the N.I. Act
(a) account payee crossing (b) not negotiable crossing
(c) general crossing (d) special crossing
9. Acts done honestly are called acts done
(a) without negligence(b) rashly
(c) mollified (d) in good faith
(e) honourly
10. When the holder of an order cheque signs on the back of it, without specifying the person to whom the amount is to be paid, it is called
(a) full endorsement (b) partial endorsement
(c) conditional endorsement (d) restrictive endorsement
(e) blank endorsement
11. Sans recourse means
(a) without fear (b) without physical touch
(c) without liability to me (d) without liability to payee
12. A bank on whom a cheque is drawn by the customer is
(a) collecting bank (b) paying bank
(c) advising bank (d) issuing bank
(e) confirming bank
13. Section 131 of N.I. Act extends protection to the
(a) collecting bank (b) paying bank
(c) drawee bank (d) negotiating bank
14. Where a customer, by a letter has advised the bank directing the banker not to honour/pay a oarticular cheaue such letter is called---------

(a) letter of credit (b) stop payment letter
(c) mandate (d) garnishee letter
(e) official letter

15. Forged cheque is a.
(a) valid (b) invalid
(c) post-dated (d) stale-cheque
(e) ante-dated

14.18 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (b), 2. (a), 3. (d), 4. (c), 5. (c), 6. (a), 7. (c), 8. (a), 9. (d), 10. (e), 11. (c), 12. (b), 13. (a), 14. (b), 15. (b).

14.19 KEYWORDS

Paying Banker, Collecting Banker, Payment in Due Course, Holder, Holder in Due Course, Conversion, Negotiable Instruments, Promissory Note, Cheque, Crossing, Special Crossing, Endorsement.

OPENING ACCOUNTS OF VARIOUS TYPES OF CUSTOMERS

STRUCTURE

15.0 OBJECTIVES

A study of this unit will help you to understand the various types of depositors and borrowers, also the rules governing the opening of account and their operations.

15.1 INTRODUCTION

A banker deals with different types of customers like Individuals, partnership firms, companies, co¬operative societies etc. While opening and in the conduct of accounts of these persons, the banker has to comply with the law applicable to each of them.

There are certain types of depositors/borrowers, which are different from individuals or proprietary accounts requiring some care and attention not only while opening such accounts but even thereafter. Every person is legally capable of opening an account with a banker provided the bank is satisfied with his bona fides and the banker is willing to enter into the business relations with him.

15.2 MINOR ACCOUNTS

According to the Indian Majority Act, 1875, every person domiciled in India, including a minor for whom, a guardian for the person or property is appointed by a court, attains the age of majority on his/ her completing the age of 18 years. As per Section 11 of the Indian

Contract Act, 1872, "when the age of maturity has been provided by law to be 18 years, any person less than that age, even by a day, would be a minor in law". It further states that "every person is competent to contract who is of the age of maturity according to the law he is subject and who is of sound mind and is not disqualified from contracting by any law to which he is subject." The essence of this is that a minor is not competent to enter into a contract. This affects his capacity to hold, acquire or dispose of property. A contract for the supply of the necessities of life, as per status of the party, to a minor, is a valid contract. In the same way, a minor can also recover money from others, if advanced, since a minor can be a beneficiary. In case of all other contracts, a minor may repudiate his promise or consent.
With a view to inculcating the habit of thrift and savings, banks, however, allow minors above the age of 10 years to open and operate deposit accounts, subject to certain conditions attached to such accounts. Opening of minor's accounts needs completion of certain formalities, viz., Introduction from an existing account holder or identification, identity, age and residence proof and ID Card from the school etc.
Operation by guardian/minor self: Usually, the account should be operated by the guardian on behalf of the minor, whose date of birth and the date of attaining majority recorded in the ledger account. After attaining majority, the guardian is not allowed to operate the account any further, without confirmation from the minor (who is now a major). Section 26 of the N.I. Act provides that a minor may draw, endorse, deliver and negotiate a negotiable instrument and as such, a minor can draw a cheque. Ordinarily, balances in such accounts are subject to a maximum amount and age of the minor should be above 13 years. No overdraft is allowed in these accounts. The minor should be literate. Two minors cannot open a joint account. The father is the natural guardian for opening the account, but RBI has authorised the mother also to sign as a guardian (except in case of Muslim minors).
Rules for Operations
If the guardian dies during the minority, then the balance can be paid to the minor after his attaining majority. If the minor account holder dies, the balance is payable to the natural guardian, as he becomes the absolute owner of it. In the case of a married minor girl, her husband, if a major, shall be the natural guardian, while in other cases the father or mother is the natural guardian. The term natural guardian does not include stepmother or stepfather.

15.3 JOINT ACCOUNT HOLDERS
A joint account is an account opened by two or more persons. While opening the account, an account-opening form should be signed by all the account holders. Instructions for operating the account may be any one of the following:
(a) either or survivor (b) both jointly (c) former or survivor.
In the absence of any instruction for operating the account, the operation will be by all the account holders jointly. If any change is required in operational instructions by any one or more of the account holders or if anyone or more of the account holders desire to revoke the instructions already given, such modification or revocation of the instructions already on record should be signed by all the account holders. However, any of them can stop the payment of a cheque issued by any other joint account holder. The instructions for operations in the account will stand countermanded in cases of insanity, insolvency, death of any of the joint holders and operations in the account will be stopped.
Rules for Claim of Account
(a)On the death of any of the joint account holders, the survivors are entitled to the whole amount.
(b)Nomination can be entertained for payments of balance in the case of death of all the joint account holders.
(c) No right of set off can be exercised in the case of a joint account for the amounts due to the bank in an individual capacity.
(d)A deposit made by a Hindu of his money jointly with his wife or any other person, payable to either or survivor, does not, on his death, constitute a gift by him to the other person. The

deposit amount in the absence of anything to the contrary, should be presumed to belong to the husband and should therefore pass on to the legal heirs of the husband, including the wife who is the survivor.

15.4 HINDU UNDIVIDED FAMILY (HUF)

In a HUF, the business is inheritable. Where a Hindu dies, leaving a business, it passes on to the legal heirs. If he leaves male children, it descends to them and the property becomes a HUF property. The members of the family are called coparceners and eldest male child is the manager or the Karta. When an account is opened in the name of a HUF, all the adult members have to sign even though the Karta would operate on the account. When the business is ancestral, the coparceners are liable to the extent of their share in the family property and no personal liability.

Rules for Operations

(a)The Karta has an implied authority to avail loan and execute the necessary documents. To be on a safer side, the loan documents should be signed by all the adult male members.

(b)The Karta has the power to transfer an asset, provided it is made for a legal necessity or for the benefit of the estate.

(c)The burden of proving legal necessity rests with the transferee.

(d)Names of male minor coparceners should be kept on record and their guardians must sign the documents on their behalf.

(e) Withdrawal of one of the coparceners does not put the existence of the firm in jeopardy.

(f) While opening the account and on the cheques issued, the use of the word HUF is essential along with the name of the unit in order to give notice to the public that the drawer is signing for the HUF and not for the personal assets. The account is operated by the Karta (Head of the family). If it consists of various branches, the other major male cparcnors are allowed to operate on the accounts.

15.5 OPENING OF A PARTNERSHIP FIRM ACCOUNT

Section 4 of the Indian Partnership Act, 1932 defines a partnership as a relationship subsisting between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Registration of a partnership is optional except in the states of Gujarat and Maharashtra where it is compulsory.

Rules for Opening of a Firm's Account

(a)While opening an account, the partnership letter should be signed by all the major partners, stating the nature of business, names and addresses of all partners along with operative instructions as to who will operate the account.

(b)In case of any internal dispute among partners, if any of them gives notice of stoppage of operation, then the account would only be operative by all partners jointly.

(c)Partners are mutual agents and can bind the firm by their acts. It applies to sleeping or secret partner also. (Case Law: M.M. Abbas Bros, and Others vs. Chetandas Fatehchand Air 1979 Mad.)

(d)When the powers of management restricts the rights of other partners and is entrusted in one partner, could it be called a partnership? Yes. [Case Law: K.D. Kamath Co. vs. C.I.T. 1972 ITR(SC)]

When there is an addition into the partnership, the old account can be continued, if the balance in the account is in credit. But when there is a debit balance, the old account should be closed and a new account should be opened to avoid operation of the Clayton's Rule, which states that the first item on debit side is discharged by the first item on credit side and so on chronologically. The liability is thus crystallised and future credits are not adjusted against old liabilities/dues.

(a) The rule that the partner is the agent of the firm for the purpose of the business of the firm, cannot be applied to all transactions and dealings between the partners themselves, where two of the partners of a firm executed a promissory note in favour of the third partner, agreeing to pay him a certain sum due to him, it was held that the remaining partners are not bound. (Hoshiar Singh vs.Udairam AIR 1929.)

(b) Death of a partner dissolves the partnership firm automatically, in the absence of anything to the contrary. In order to determine the liability of the deceased partner, the banker should close the account of the firm and secure a letter of administration from the court. The account would henceforth be styled as for "R.K. Dhoble (deceased) Ritesh Mittal executor (administrators)."

Retirement of a partner needs stoppage of the bank account operations because the liability of the retiring partner towards the bank and third parties ceases, if a public notice is given in a local newspaper in respect of transactions undertaken subsequent to the date of retirement. A new account should be opened.

15.6 OPENING OF ACCOUNTS OF LIMITED COMPANIES

Company is a legal entity and can open accounts in the same way as any other person. There are three types of Limited Companies: (i) Public Ltd. (ii) Private Ltd. (iii) Government company.

(a)Public Ltd. - It has to have a minimum of 7 members and a maximum of unlimited members, with a minimum paid-up capital of Rs. 5 Lakh - Section 3 (i) (iv) of the Companies Act, 1956.

(b) Private Ltd. - It has to have a minimum of 2 members and maximum of 50 with a paid-up share capital of Rs.l Lakh. Maximum number does not include members who are in employment of the company. For banking business, maximum numbers allowed is 20 - Section 3 (i) (iii) of the Companies Act, 1956.Government Companies - where fifty one per cent of the shares are held by the government. The word 'limited' is not required to follow the company's name in such companies.

Rules for Opening Account and Operations

The company should furnish the following for opening of accounts with banks:

(a) Certified copies of memorandum and articles of association and certificate of incorporation.

(b) Names of directors of the company as stated in the Articles.

(c) For Public Ltd. Company, a copy of certificate of commencement of business issued by ROC.

(d) Copy of resolution appointing the bank as company's bank and names of the person authorised to operate the account.

(e) The specimen signatures of all authorised officials who would operate account.

(f) Copies of the balance sheet in case of existing companies.

The company should ensure that

(a) it authorises its employee to collect cash payments.

(b) In order to avoid frauds and operational difficulties, there should be a minimum three persons at a time, to operate the account.

It may also be noted that

(a) Death of the authorised signatories does not demand the stopping of payments, since the company is in existence.

(b) Ltd. Co. doing trading has implied powers to borrow, while a non-trading company is required to specify it in its Memo/Articles.

(c) Introduction is not necessary for opening a company account.

(d) A cheque, payable to the company should never be deposited in the personal account of directors, as it would amount to negligence under Section 131 of N.I. Act 1881.

15.7 OPENING OF AN ACCOUNT FOR TRUSTS

A trust is an obligation annexed to the ownership of a property, arising out of confidence reposed in and accepted by the person for the benefit of another or of another owner. The person who reposes or declares confidence is called the author of the trust. The person who accepts the confidence is called the trustee. The person for whose benefit, the confidence is accepted is called the beneficiary. The instrument by which the trust is created is called the 'Trust Deed'.

Rules for Opening of Account and Operations
(a) Copy of the trust deed is to be examined to ascertain the powers and functions of the trustees.
(b) In the case of two or more trustees, unless specifically stated in the trustdeed, all the trustees will operate the account jointly.
(c) On the death of one or more trustee(s), the authority will be vested in the remaining trustees. When all the trustees are dead or retired, new trustees will be appointed by the court.
(d) The insolvency of the trustee is not the insolvency of the trust.
(e) Trustee(s) cannot delegate his/their powers, unless specifically authorised by the trust deed.
(f) Charitable trusts are required, in several states in India, to be registered with the charity commissioner or such authority under the Public Trust Act. A copy of the registration certificate should first be obtained, before opening such an account.

15.8 OPENING OF ACCOUNTS OF COOPERATIVE SOCIETIES

(a) Rules and bye laws are to be examined to ascertain if there are any restrictions on opening of a bank account with the commercial banks.
(b) Some states have restrictions as to opening a bank account other than with the co-operative banks,

without permission from Ihe Registrar of Co-operative Societies and with certain conditions. These conditions like maximum balances etc., should be observed by the bank.
(c) Investment of funds can be made with any bank or person carrying the business of banking -
approved for this purpose by the Registrar (Section 32 the Cooperative Societies Act, 1912).
(d) Resolution to open a bank account with the signatures of three persons, viz., president/secretary/
treasurer out of these three, signatures of the president and one of the others are essential.

15.9 OPENING ACCOUNT FOR GOVERNMENT AND PUBLIC BODIES

The central government transactions are governed by the Central Government Compilation of Treasury Rules and Account Codes. The state government transactions are governed by the State Financial Handbook of that state. The main function of banks in conducting government business consists of paying, receiving, collecting and remitting money on behalf of the government departments. Banks, while opening the accounts of government and public bodies, should also obtain a copy of the letter of authority issued by the competent authority for opening the account.

Receipts

The receipt is through challans made in duplicate or triplicate as required, showing distinctly the nature of payment and the head of account to which the amount is to be credited. The challan must be passed by the treasury/sub-treasury before presenting for payment. Passed challans are valid for ten days after which they will have to be revalidated. Copies of challans returned to the depositor as receipts should be signed in full. In case a challan is lost, no duplicate is issued, but only a certificate is to be issued.

Payments

The government departments are authorised to issue cheques within the drawing limit permitted to them. Self-drawings in cash are allowed for salary and expenses. Special Cheque books are used by the government departments. They are supplied by the department and are paid for by the banks. No overdraft is to be allowed in these accounts. The credit to these accounts is received through budget allocations by the respective ministries. Refund orders are issued by the central excise and customs department in favour of payees. Refund orders are also issued by the income tax department with a related advice. While paying, the banks should have cheques as well as advice at the time of payment. Advice is also received by the payee along with the cheques. Such refund orders are quasi-negotiable and do not attract any stamped discharge.

Opening of Personal Deposit Account by Government Departments
There are certain government departments like forest, local funds etc., as authorised by the A.G. office where cheques are drawn by the authorised official in these departments and presented at the bank directly for payment without the intervention of the treasury. Such accounts are opened as current accounts. Details like authority for opening account, cheque books issued, person authorised to draw cheques, drawing limits etc., are noted. The cheques issued are valid only for three months. The validity of three months ends at the end of the calendar month. Government officials are also authorised to open accounts in their personal names for disbursement etc. Such accounts are opened and closed by the official after the purpose is served.

15.10 SUMMARY

Banks open accounts of all individuals, institutions, co-operative societies, trusts and government departments. They also open special types of accounts.
Such accounts are: (a) Minor's account for those above 10 years of age.

(b) Joint accounts with different operational instructions, viz., either or survivor, former or survivor, jointly.
(c) Accounts of Hindu undivided family with Karta operating the account. All the major male members' signatures are obtained and on the death of the Karta, the next in line is considered as Karta of the HUF
(d) Partnership accounts are opened and the existing accounts become inoperative/closed due to admission/retirement/death of any partner.
(e) Accounts of limited companies can be opened with copies of memorandum/articles of association/ balance sheets/certificate of incorporation/certificate of commencement of business and resolution to open new account in a bank.
(f) Trust accounts are opened with trust deed/certificate of registration issued by the Charity Commissioner/resolutions to open a/c.
(g) Cooperative societies can also open bank accounts with public/private banks other than banks. Permission cooperative is required from registrars of cooperative societies with maximum ceiling on balances.
(h) Bank accounts are also opened for government/public bodies for receiving monies and payments on behalf of concerned departments.

15.11 CHECK YOUR PROGRESS

1. Introduction in opening accounts is
(a) Optional (b) Compulsory
(c) Discretionary (d) Waived from year 2003.
2. A minor for whom the court has appointed a guardian attains majority on completion of
(a) 21 years (b) 18 years
(c) 15 years (d) 17 years.
3. The minimum number of members in a public limited company is
(a) 50 (b) 20 (c) 10 (d) 7 (e) no limit.
4. Government companies are those companies where the government holds at least---------- shares.
(a) 51 per cent (b) 26 per cent
(c) 100 per cent (d) No such requirement
5. Delegation of powers under a trust is
(a) Possible (b) Not possible
(c) Beneficiary's permission (d) Charity commissioner's permission.
6. Which document stipulates internal rules of a company ?
(a) Memorandum (b) Resolution
(c) Articles (d) Declaration
(e) Companies Act, 1956.

7. Minor's account can be opened in the guardianship of
(a) Mother and Father (b) Mother or Father
(c) Grandmother (d) Elder brother.
8. Two or more minors if desirous of opening a bank a/c in your bank, whether they can open
(a) Either or Survivor (b) Jointly
(c) Only two can join (d) Cannot open.
9. A Hindu minor having a natural guardian attains majority on completion of
(a) 18 years (b) 21 years (c) 13 years
(d) 13 years provided he has power of understanding.

10. Who shall be natural guardian in case of married minor girl?
(a) Father (b) Mother
(c) Father-in-law (d) Mother-in-law
(e) Husband
11. Sanjay, a minor aged 11 years, desires to open a saving account. His mother is illiterate and his father has become sanyasi. He has his grand parents. Who will be his natural guardian?
(a) Father (b) Mother
(c) Grand father (d) Guardian appointed by court
(e) Sanjay himself can operate.
12. In a limited Co. certificate of incorporation was obtained though the memorandum was signed by two persons for all the seven signatories where the signatures were forged. Will the bank accept memo as genuine for opening bank a/c?
(a) Yes (b) No
(c) Yes because incorporation certificate is valid
(d)No because forged documents cannot be accepted
(e)Bank will ask its H.G.
13. There should be two persons to open a partnership account in a bank. Which of the following is correct?
(a) X aged 25 years Y aged 17 years (b) X aged 25 years Y aged 21 years
(c) X aged 17 years and Y aged 16 years
(d)Ku. Shubha aged 30 years and Ku. Rachna aged 16 years (daughter of Ku. Shubha)
(e)X aged 71 years Y aged 57 years but lunatic.
14. HUF account is to be opened in a bank where there are three major persons Shivkumar - Father; Mrs. Ramawati - Shivkumar's Mother, Sharat Kumar - Son; Who can become Karta of HUF?
(a) Shivkumar (b) Sharat Kumar
(c) Mrs. Ramawati (d) Both Shivkumar and Ramawati
(e) Both Shivkumar and Sharat Kumar.
15. One of the directors of a Ltd. Co. expired and cheques signed by him are presented for payments should the bank pay those cheques?
(a) Cannot pay(b) Company on other directors confirmation
(c) Can pay as a routine (d) Payments be stopped by Co.
16. X a partner in the firm xyz Co. wants to open a bank account in the firm's name. Does it require signatures of
(a) All partners (b) Anyone
(c) Managing partner only (d) Sleeping partner not required.

15.12 ANSWERS TO CHECK YOUR PROGRESS'

1. (b), 2. (b), 3. (d), 4. (a), 5. (b), 6. (c), 7. (b), 8. (d), 9. (a), 10. (e), 11. (b), 12. (c), 13. (b), 14. (a), 15. (c), 16. (a).

15.13 KEYWORDS

Minor, HUF, Joint Accounts, Partnership deed. Payable to either or survivor, former or survivor, Jointly operative, Limited companies, Resolution, Memorandum and Articles of Association, Certificate of incorporation, Trustdeed, Clayton's rule.

ANCILLARY SERVICES

STRUCTURE

16.0 OBJECTIVES

A study of this unit will help you to learn more about the various ancillary services rendered by banks.

16.1 REMITTANCES: INTRODUCTION

Remittance means transfer of funds from one branch of a bank to another branch of the same bank or a different bank. Customers can make local remittances through banker's cheques and remit funds from one centre to another through demand drafts, telegraphic transfers, national electronic funds transfer (NEFT) and real time gross settlement (RTGS) at specified service charges.

Each transaction of remittance is based on an application in the prescribed form available at the branch of remittance. The customers shall fill in full particulars regarding the remittance, such as nature of remittance, i.e. by DD/TT/MT/BC, name and address of the beneficiary, name of the place to which the remittance is to be made, name, address and account number (if any) of the purchaser/remitter.

16.2 DEMAND DRAFTS (DP) AND BANKERS' CHEQUE (BC)

The most common mode of funds transfer - the demand draft/banker's cheque system is paper based. Application for purchase of demand draft/banker's cheque may be made by a duly filled in form, signed by the applicant (with address), giving full particular of the draft intended to be purchased.

A DD/BC is a negotiable instrument and is made payable to order of the beneficiary. Banker's cheques and drafts are valid for three and six months respectively and can be revalidated by the issuing branches on a written request of the purchasers. The drafts can be revalidated only once within one year from the date of issue. After one year of the draft being purchased, it can be cancelled at the issuing branch and a fresh draft can be obtained after paying the requisite service charges. Refund on cancellation of a DD/BC shall be made only if the original instrument is tendered without any sign of an endorsement or any special crossing or negotiations having been made. All refunds are subject to the establishment of the proper identity of the purchaser to the satisfaction of the bank.

Purchaser of a DD/BC has no authority to countermand its payment after it has been delivered to the payee. However, the bank shall exercise caution if the purchaser of a DD/PO reports a loss or theft of the instrument, if the payment has not already been made. All such intimation shall have to be made in writing at the branch from where the DD/BC was purchased.

The issue and payment of the banker's cheques and drafts in cash across the counter is subject to Income Tax provisions and RBI rules against money laundering activities.

Purchase/payment of drafts/ BC for Rs. 50,000 and above are to be made through banking channels and not in cash with exceptions like Govt. accounts.

16.2.1 Issuance of a Duplicate DD/BC

A customer is entitled to the issuance of a duplicate DD/BC in place of the lost instrument and the same will be subject to:

(a)intimation to the bank

(b)payment of DD/BC has not been already made by the drawee bank/branch.

(c)execution of an indemnity letter signed by both the payee and the purchaser in the prescribed form duly .stamped

(d)payment of the prevalent service charges for issuance of such duplicate instruments.

16.3 MAIL TRANSFER (MT)

A mail transfer is a form of remittance in which the amount remitted by a customer or a non-customer

is directly credited to the account of the beneficiary with another branch. Drawee branches afford credit of mail transfer to customer's account within a maximum period of seven days from the date of receipt of funds. The concept of mail transfer has no relevance when the remitting branch and the receiving branch are brought under core banking solution. The mail transfer is sent by the issuing branch directly to the drawee branch on the same day by post.

16.4 TELEGRAPHIC TRANSFER (TT)

A telegraphic transfer is a form of remittance, which is advised by telegram, telex or fax machine. The fundamental principles of such a transfer are otherwise identical with the mail transfer. Drawee branches afford credit of telegraphic transfer to a customer's account within a maximum period of 2 days from the date of deposit of funds for TT. Normally, Inward telegraphic transfers shall be credited on receipt of the telegram or the confirmation thereof whichever is earlier.

16.5 TRAVELLER'S CHEQUES (TC)

Traveller's cheques are issued in pre-printed denominations. TCs are issued to any Individual and the purchaser has to sign on the TCs in the space provided for in the presence of bank officials at the time of purchase. The TCs have an unrestricted validity period. At the time of encashment, purchaser is required to countersign each TC in the presence of branch officials at the space provided. Identification of the purchaser is not insisted on by the bank and payment is made once the signature tallies with the one already appearing on the cheque.

16.6 NATIONAL ELECTRONIC FUNDS TRANSFER SYSTEM (NEFT)

The Reserve Bank has introduced a system called "The Reserve Bank of India National Electronic Funds Transfer System" which is referred to as NEFT System. The transactions under this system may be made for amounts inclusive of paisa component when there is no upper value limit for putting through an individual NEFT transaction. The system facilitates an efficient, secure, economical, reliable and expeditious system of funds transfer and clearing in the banking sector. The NEFT system also relieves the stress on the existing paper based funds transfer and clearing system. The remitting branch prepares a structured financial messaging solution (SFMS) message and sends it to its service centre for NEFT. The RBI at the clearing centre sorts the transactions bank-wise and prepares the accounting entries of net debit or credit for passing on to the banks participating in the system.

16.7 REAL TIME GROSS SETTLEMENT SYSTEM (RTGS)

RTGS is an electronic payment environment where payment instructions are processed on a 'continuous' or 'REAL TIME' basis and settled on a 'GROSS' or 'individual' basis without netting the debits against credits. The payments so effected are 'final' and 'irrevocable' settlement is done in the books of the central bank - the ultimate liquidity depository of the country. The RTGS system allows transfer of funds across banks on a nearly instantaneous basis. Each participant bank will be required to open a dedicated settlement account for putting through its RTGS transactions. Not only does it allow transfer of funds, it also reduces the credit risk. Both customers and banks can transfer monies the same day in various cycles, compared with cheques, which are cleared a day or two later. Readers will know more about the RTGS system in a separate chapter on EFT Systems.

16.8 SAFE DEPOSIT LOCKERS

Safe deposit locker is a facility extended to the customers to enable them to keep their valuables/ documents etc. in a specially designed locker on payment of prescribed rentals.

16.8.1 Aspects Governing Locker

A locker may be hired by an individual (not minor), firms, limited companies, specified associations and societies etc. Nomination facility is available to an individual hirer of safe deposit locker. Lockers are available in different sizes, i.e. small, medium, large and extra large with varying rents. Lockers are rented out for a minimum period of one year. Rent is payable in advance. In case of overdue rent, banks will charge a penalty. Standing instructions can be accepted for transfer of rent from a savings/current accounts. The bank will hire a locker only to properly introduced persons. Loss of key should be immediately informed to the branch. Banks normally reserve the right to break open the locker, if the rent is not paid in spite of giving notice as per bank's rules and recover their charges thereof.

16.8.2 Nomination for Safety Locker

Section 45 of the Banking Regulation Act deals with the nomination for lockers.

In the case of a sole hirer of a safety locker, nomination can be made in favour of only one individual. Where the safe deposit locker is hired from the bank by two or more individuals jointly, nomination can be made by them in favour of one or more persons.

Only the locker hirers can make a change in or cancel the nomination in case of safety lockers hired by two individuals jointly. Where the safety locker is hired in the name of a minor, the nomination shall be made by a person lawfully entitled to act on behalf of the minor.

16.8.3 Important Guidelines of RBI on Lockers

(a) The KYC (Know Your Customer) assessment for the safe-deposit locker customers (either new or existing) should be done at least to the levels prescribed for medium risk or the risk categories attributable to their bank account, if higher.

(b) Where the lockers have remained non-operational for more than one and three years for high- and medium-risk categories respectively, banks should immediately contact the locker-hirers and advise them to operate the lockers or surrender the lockers even if the rent is being paid regularly. In case the locker-hirers still do not operate the locker, banks should consider opening the lockers with help of the police after giving due notice to the locker-hirers.

(c) Banks should have an explicit policy for taking appropriate action including breaking open the lockers in cases where the rents are not paid by the locker-hirers.

Access to locker (with survivor/nominee clause)

(a)In case of death of a sole locker-hirer (where there is nomination), access to locker may be given to the nominee. In such cases, except for the death certificate and identification of nominee, no other document is required.

(b)In case of death of one of the hirers, where there are joint locker-hirers and as per the contract of locker hire, the locker has to be operated jointly, and where there is nomination,

access to the locker may be given to the nominee jointly with the surviving hirer(s). In such cases, except for the death certificate and identification of nominee, no other document is required.
(c)Where both/all the joint locker hirer(s) die and where there is nomination, access to the locker may be given to the nominee(s). In such cases, except for the death certificate and identification of the nominee(s), no other document is required.
(a) Where there are joint locker-hirers having a contract of hire with survivorship clause such as 'either or survivor', 'anyone or survivor' etc., but the locker is not to be operated jointly, access to the locker may be given only to the survivor in case of death of one of the hirers.
Access to locker (without the survivor/nominee clause)
(a) In case of the death of a sole locker-hirer (where there is no nomination) and there is a valid will, access may be given to the executor/administrator. In other cases, access may be given to the legal

representative of the deceased. In such cases, a death certificate and proof of legal representation is required.
(b) Where there are joint locker-hirers and as per the contract of locker hire, the locker is to be operated jointly, and where there is no nomination, if one of the hirers die, access to the locker may be given to the survivor jointly with the legal heirs (or the executor/administrator, if appointed) of the deceased hirer. In such cases, death certificate and proof of legal representation is required.
(c) Where there are joint locker-hirers having a contract of locker hire with a 'either or survivor' clause and where there is no nomination, access to the locker may be given to the survivor in case of death of one of the hirers. In such cases, only a death certificate is required.
(d) Where there are joint locker-hirers, and all the hirers die and where there is no nomination, access to the locker is given jointly to the legal heirs of all the deceased hirers (or the executor/administrator if appointed). In such cases, only a death certificate and proof of legal representation is required.
16.9 PORTFOLIO MANAGEMENT
Portfolio - Definition
Portfolio means a basket of investments or securities in a combined form. Debt securities will yield interest income and equity investments will yield dividend income apart from capital appreciation over a period of time. Various groups of securities, when held together, behave in a different manner and give interest payments and dividends, which are different from the analysis of individual securities. A combination of securities held together will give a beneficial result if grouped in a manner so as to secure higher return after taking into consideration the risk element. Different portfolios will behave differently in the market and the return on the portfolio will depend on the choice of securities.
Portfolio Management
Portfolio management deals with management of a combination of securities to get the most efficient portfolio. The process of portfolio management involves a logical set of steps common to any decision: planning, implementation and monitoring. Yet applying this process to actual portfolios can be complex and opinions are divided on how best to do so. Large gaps now exist in the current investment theory and empirical tests often yield contrary results.
Basic Principles of Portfolio Management
(a) It is the portfolio that matters: Individual securities are important only to the extent that they affect the aggregate portfolio. The risk of a security should preferably not be based on the uncertainty of a single security's return but on the contribution to the uncertainty of the total portfolio's return.
(b) Large portfolio returns come only with a larger portfolio risk: The most important portfolio decision is the amount of risk which is acceptable and is determined by the asset

allocation within the security portfolio. This is not an easy decision, as it calls for information on the risk and returns available on different classes of assets.
(c) The risk associated with a type of security depends on when the investment is liquidated: Risk depends on the period of the security and is reduced by selecting those securities with a payoff close to when the portfolio is to be liquidated.
(d) Diversification works: Diversification across various securities will reduce a portfolio's risk. If such broad diversification results in an expected portfolio return or a risk level which is lower than desired, then borrowing can be used to achieve the desired level.
(e) Each portfolio is preferably tailored to the particular needs of its owner: People have varying tax rates, knowledge, transaction costs, etc., and as such, the portfolio strategy should take into account the unique needs and characteristics of the owner.

(f) Competition for abnormal returns is extensive: A large number of people are continuously using a large variety of techniques in an attempt to obtain abnormal returns. If the actions of the speculators are truly effective, security prices will adjust instantaneously to new information.

Portfolio Management Scheme - RBI Guidelines

The Portfolio Management Service (PMS) in a broader sense means advising for a fee in the deployment of surplus funds in profitable channels at the risk and responsibility of the owners of the funds.
(a) PMS services are provided at the customer's risk, without guaranteeing them a pre-determined return;
(b) The services are provided to parties in respect of their long-term investible funds;
(c) The minimum period, for which funds are placed by the clients, should be one year;
(d) The transactions should be booked at market rates only;
(e) Proper accounting and documentation has to be ensured;
(f) Funds accepted for portfolio management should not be entrusted to another bank for management;
(g) A definite fee is charged for such services independent of the return to the client;
(h) The funds are expected to be deployed essentially in capital market instruments such as shares, debentures, bonds, securities etc., but are not to be employed for lending in call money/bill market and lending to/placement with corporate bodies;
(i) Transactions between the bank's investment account and portfolio account are to be strictly at market rates;
(j) While putting through transactions on behalf of a portfolio account, a clear indication has to be given that the transactions pertain to the 'portfolio';
(k) The undeployed funds are the same as outside borrowings of the bank and Cash Reserve Ratio
(CRR Statutory Reserve Ratio (SLR) has to be maintained on such funds; (1) The banks' liability to its clients in respect of funds accepted for portfolio management has to be properly reflected in the published accounts.

16.10 SUMMARY

The conventional modes of remittance of funds are demand draft, bankers' cheque, mail transfer, telegraphic transfer. Following the technological advancements the new system of remittances such RTGS, National Electronic Fund Transfer (NEFT) have come in, which facilitate immediate transfer of funds between banks.
Portfolio means a basket of investments or securities in a combined form. Portfolio management deals with management of a combination of securities to get the most efficient portfolio. Portfolio management involves certain basic principles and the process involves efficient planning, proper implementation and effective monitoring. The Reserve Bank has come out with certain guidelines for banks to follow while managing a customer's portfolio.

16.11 CHECK YOUR PROGRESS

1. A Demand Draft is issued by the banks to be valid for,

(a) 12 months (b) 6 months
(c) 3 months (d) None of the above
2. A customer is entitled to issuance of a duplicate DD in place of the lost one, provided
(a) he gives due intimation to the issuing branch
(b) payment of DD not already made by the drawee branch
(c) execution of an indemnity signed by both the payee and the purchaser of the DD

(d) payment of a fee as applicable for issue of such duplicate DD
(e) all the above
3. One of the following statements is not true with regard to a locker facility in the bank.
(a) In the case of a sole hirer of a safety locker, nomination can be made in favour of only one individual.
(b) A locker cannot be hired by limited companies, specified associations and societies etc.
(c) In the case of death of a sole locker-hirer (where there is nomination) access to locker may be given to the nominee
(d) Where there are joint locker-hirers having a contract of locker hire with a 'either or survivor' clause and where there is no nomination, access to the locker may be given to the survivor in case of death of one of the hirers.
4. One of the following statements is not true with respect to RTGS:
(a) Funds are transferable from the branch of one bank to the branch of another bank.
(b) Only the corporate and Government departments can avail of the facility
(c) The RTGS system is maintained and operated by the RBI
(d) Each participant bank here of the RTGS will be required to open a dedicated settlement account for putting through its RTGS transactions.
5. One of the following statements is not true with respect to NEFT.
(a) Funds are transferable electronically from one customer account of a participant bank branch to another customer account of any other participant bank branch.
(b) The individual branches participating in NEFT can be located only in the urban/metro centres.
(c) The remitting branch prepares a structured financial messaging solution (SFMS) message and sends it to its service centre for NEFT.
(d) The RBI at the clearing centre sorts the transactions bank-wise and prepares the accounting entries of net debit or credit for passing on to the banks participating in the system.
6. State True/False
(a) Portfolio management relies on the combination of securities to get most efficient portfolio
(b) Risk and return have the same meaning in selection of a portfolio
(c) The role of a portfolio manager lies in study of investor, investment strategy etc.
(d) A portfolio manager is any person who, pursuant to a contract or arrangement with a client, advises, directs or undertakes on behalf of the client the management or administration of a portfolio of securities or the funds of the client.
(e) A purchaser of a Demand Draft can countermand its payment by the drawee bank.

16.12 ANSWERS TO CHECK YOUR PROGRESS'

1. (b); 2. (e); 3. (b); 4. (b); 5. (b); 6. (a) T, (b) F, (c) T, (d) T, (e) F.

16.13 KEYWORDS

Demand Draft, Bankers Cheque, Mail Transfer, Traveller's Cheque, Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT), Lockers, Portfolio, Portfolio Management, Portfolio Investment.

STRUCTURE

UNIT 17

PRINCIPLES OF LENDING, WORKING CAPITAL ASSESSMENT AND CREDIT MONITORING

17.0 OBJECTIVES

After reading this unit, the student should be able to know:

- The principles or basics of lending by banks. Analysing the lending principles with the changing times and developments in the society. Implications of the new prudential accounting norms based on the principles of lending, methods of assessing a borrower and his credit requirements.
- The concept of working capital/net working capital/term loan finance/ adequacy of working capital.

17.1 INTRODUCTION

The main source of funds for a banker is deposits from the public, which are repayable whenever demanded by the depositors. The banker while lending should, therefore, follow sound principles of lending and should assess the permissible limits of finance on the basis of accepted norms.

17.2 PRINCIPLES OF LENDING

17.2.1 Cardinal Principles of Lending

The business of lending is not without certain inherent risks, especially when the lending banks depend largely on the borrowed funds. The cardinal principles of lending are, therefore, as follows:

(a) Safety * (b) Liquidity (c) Profitability
(d) Purpose (e) Diversification of Risks (f) Security

(a) Safety

Safety first is the most important principle of good lending. When a banker lends certain monies, he has to ensure that the advance is safe and that the money lent will comeback. While banks are, no doubt, traders in money; the money lent does not belong to them but to the public, i.e. the depositors. The banker is a custodian of public funds and lends money which has been entrusted to his care by the depositor and which is to be repaid in accordance with the tenure of the deposit. The repayment of loans depends upon the borrower's (i) capacity to pay, (ii) willingness to pay, (iii) income generation. The banker must, therefore, take utmost care in ensuring that the enterprise or business, for which a loan is sought, is a sound one and the borrower is capable of carrying it out successfully.

(b) Liquidity

It is to be seen that money lent is not going to be locked up for a long time. The money should return to the bank as per the repayment schedule. About seventy per cent of the deposits collected are repayable within a year, so the funds advanced should be for working capital and not for term loans of above three years. The art of banking consists of knowing the difference between a mortgage and a bill of exchange.

(c) Profitability

A fair return on investment is essential so also in the case of lending by banks. Banks are commercial organisations and profit earning is the motto of banks to pay adequate dividend to the stakeholders. The interest margin of three to four per cent between lending and borrowing is essential to meet their administrative expenses. While looking at profitability, it is prudent for a banker to look at the overall profitability from all businesses undertaken for a customer instead of applying the test of profitability against each component of business or service offered separately. Possibly a banker may not be earning a desirable return on a service undertaken for a customer, while he may be more than compensated in respect of another service or business undertaken for the same customer. It is, therefore, advisable to have a Customer Profitability Analysis (CPA) done when the banker is engaged in more than one

service or business for a customer, this is all the more necessary not only to assess the profitability of the operation/business vis-a-vis a customer but also to enable a banker to decide on as to what length he can go in parting with a portion of profit and offer a competitive rate for the customers. Such an analysis will be very helpful to the banker in pricing his product whether it is in lending or offering a service to a customer.

In the current context of the availability of freedom to a banker in the matter of pricing credit and services, a very conscious and a careful exercise is called for on his part in order to strike a proper balance between the twin aims of making a desirable level of profit and at the same time offering a competitive price for the product/service offered. This is the kind of approach that is required of a banker in order to entice new customers to his fold while retaining the existing customers. Hence, there is a direct relationship between profit and pricing of credit or service offered by a banker.

(d) Purpose

Loans for undesirable and speculative purposes cannot be granted. Although the earnings on such business activities may be higher, even then a bank cannot resort to these loans.

(e) Diversification of Risks

It means that the banker should not grant advances to only a few business houses, undertakings, cities, industries or regions. It should be ensured that the advances are diversified in a good number of customers.

(f) Security

The security offered against the loans may consist of a large variety of items. It may be plot or land, building, flat, shop, ornaments, insurance policies, shares, debentures, bonds etc. There may be cases where there is no security except the personal security. The banker must realise that it is only a cushion to fall back upon in case of need. The security and its adequacy alone should not form the sole consideration for judging the suitability of a loan. Of course, the security, if accepted, must be adequate and readily marketable, easy to handle and free from encumbrances.

17.3 NON-FUND BASED LIMITS

While ascertaining the credit needs of the borrower, the bankers should assess both the fund based and non-fund based limits required by him together and sanction them as a package. The non-fund based limits are normally of two types: (i) bank guarantees, (ii) letters of credit.

17.3.1 Bank Guarantees

By issuing a bank guarantee, the guarantor bank accepts the responsibility for an obligation, if the entity with the primary responsibility for the obligation does not meet it. The guarantor is one who guarantees an obligation and has a legal duty to fulfil it. On issuing a guarantee, the guarantor pays when the primary debtor fails to meet his obligation.

While assessing the bank guarantee limit required by a borrower, details such as the nature of guarantee, its purpose, the particulars of the contract period and the amount for which the guarantee is sought are collected first, then these have to be assessed from the aspect of creditworthiness of the customer and his relationship with the bank, before a decision is taken regarding the sanction of limits requested by the customer. Appropriate conditions with regard to cash margin and security, registration of charge with ROC, in case the customer is a corporate, will have to be laid down in the sanction to protect the interests of the bank, in the event of a default of the customer to fulfil his part of the obligation of the contract relating to which the bank guarantee has been issued and the liability thereon likely to be crystallised on the banker. While issuing the bank guarantee, the banker has to keep in mind the

instructions of RBI with regard to certain purposes that prohibit the issue of bank guarantees and also the extended liability period that has been occasioned consequent to amendment of Section 128 of Indian Contract Act with respect of guarantees issued in favour of the government departments.

17.3.2 Letters of Credit (L/C)

A Letter of Credit (L/C) is a binding document that a buyer of goods can request from the bank in order to guarantee that the payment for goods will be transferred to the seller. In order for the payment to occur, the seller has to present the bank with necessary documents as per L/C terms.

While sanctioning the letter of credit limits for the purchase of raw materials, the banker has to collect the following particulars:

(a) Value of raw materials consumed in the ensuing year as projected
(b) Value of raw materials that are purchased on credit out of the above
(c) Time taken for advising the letter of credit to the beneficiary
(d) Time for shipment and the consignment to reach the customer's destination.
(e) Credit period (usance period) agreed between the beneficiary and the customer
(f) Credit period projected and reckoned for calculation of the maximum permissible bank finance (MPBF) while sanctioning the funded limits to the borrower customer

Once the above information is available, the banker can assess the letter of credit limit as explained in the following illustration:

Estimation

1. Value of raw material consumption projected: Rs. 3,600 lakh
2. Value of raw material (to be) bought on credit: Rs. 2,400 lakh
3. Time for advising L/C: 10 days
4. Shipment time: 20 days
5. Credit period agreed upon between the seller and the customer OR the credit period projected as available in CMA format considered for calculation of MPBF while sanctioning funded limits, whichever is less: 30 days

Time required for one cycle of operation of L/C will be 10 + 20 + 30 = 60 days.

Assuming 360 days in a year, there could be 6 rotations/cycles in a year. If the raw material consumed, to be bought on credit is Rs. 2,400 lakh in a year, the limit of L/C per rotation/cycle will work out to.

Rs. 2,400 lakh /6 = Rs. 400 lakh

The letter of credit limit required, given the above situation, would be Rs. 400 lakh. A banker should ensure that the stocks procured through the L/C are taken under hypothecation and are not included in the stocks declared as security for the fund based limits granted to the customer. If the L/C limit is sanctioned for purchase of capital goods, the same is taken under a hypothecation charge by the banker.

17.4 WORKING CAPITAL AND TERM LOANS

Concept of Working Capital

The term working capital denotes the requirement of the money by a manufacturing enterprise for its day-to-day financing of:

(i) purchase a raw materials, stores and spares (ii) payment of wages to employees

(iii) payment of other expenses towards energy, fuel and water consumption, statutory dues, rates and taxes carriage expenses etc.

(iv) other expenses required to be incurred in connection with the production, selling and administration etc.

The banks normally define the working capital as the sum total of inventory, receivables and other current assets held by a business entity. It is computed by the banks through the concept of the operating cycle, i.e. the time taken by a business entity to get the money released from the raw materials, semi¬finished goods, finished goods, receivables etc., it carries at a point of time. The time taken to convert the inventory of raw materials, semi-finished goods, finished goods and the due receivables into cash generally differs from industry to industry.

There are two concepts of working capital:

(a)Gross working capital means the firm's investment in total current or floating (circulating) assets.

(b)Net working capital means

(i) the excess of current assets over the current liabilities or,

(ii) that portion of a firm's current assets financed by the long-term funds.

The long-term resources comprise owned funds of the company, i.e. paid-up capital/reserves including the current year's profits and term loans from banks and financial institutions/debentures etc.

17.5 ADEQUACY OF WORKING CAPITAL

A firm should have adequate working capital, i.e. as much as needed by the firm. It should neither be excessive nor inadequate. Both situations are dangerous. Excessive working capital means the firm has idle funds, which earn no profits for the firm. Inadequate working capital means the firm does not have sufficient funds for running its operations, which ultimately results in production interruptions leading to reduced profitability which may even lead to losses.

It is interesting to understand the relationship between working capital, risk and return. In a manufacturing concern, it is generally accepted that the higher levels of working capital decrease the risk and also decreases the profitability, While lower levels of working capital increase the risk but have the potentiality of increasing the profitability also. This principle is based on the following assumption:

(i) Higher the risk, higher is the profitability, while lower is the risk, lower the profitability,

(ii) Current assets are less profitable than fixed assets, (iii) Short-term funds are less expensive than long-term funds.

On account of the above principle, an increase in the ratio of current assets to total assets will result in a decline in the profitability of the firm. This is because investment in current assets is less profitable than those in fixed assets. However, an increase in this ratio would decrease the risk of the firm becoming technically insolvent. On the other hand, a decrease in the ratio of current assets to total assets would increase the profitability of the firm because investment in fixed assets is more profitable than the investment in current assets. However, this will increase the risk of the firm becoming technically insolvent on account of its possible inability of meeting its commitments in time due to a shortage of funds.

Term loans are loans which are payable after one year and up to ten years. It is availed of for acquisition of fixed assets, i.e. land, factory, office building, warehouses, machinery etc., needed for commencing, expanding or modernising its activities. These loans are repaid by the borrowing concerns in instalments out of the profits earned. The schedule of repayment and duration of the loan is fixed on the basis of the assessed ability of the undertaking to generate surpluses for making repayments. Loans for periods up

to three years are called short-term loans, loans from three years to seven years, medium-term loans and periods exceeding seven years up to ten years are known as long-term loans.

17.6 DIFFERENCE BETWEEN TERM LOANS AND WORKING CAPITAL

The major difference between term loans and working capital finance lies in the purpose of the finance, the type of assets created out of it and the form in which the advance is made by the bank. The other differences are:

(i) Term loans are utilised for establishing, expanding or modernising a manufacturing unit by acquisition of fixed assets, while the working capital finance is utilised for operating purposes resulting in the creation of current assets for production and the sale of finished goods.

(ii) Term loans are usually of medium- or long-term duration and are repayable in quarterly or half yearly instalments over an agreed period of time.

(iii) The working capital finance is generally availed of in cash credit hypothecation accounts with frequent drawings and repayments and is payable on demand.

17.7 CREDIT APPRAISAL TECHNIQUES

In the credit appraisal process, the decision maker makes an attempt to find the answer to two important questions. First, whether the entrepreneur requires funds, also what are his credentials? If the answer to the first question is positive, the second question is all about the extent of his requirements and the ways in which the requirements can be met.

Assessment of credit requirements for small enterprises is often difficult because of a lack of data relating to operations of the units in this category. RBI has, therefore, suggested that lending banks may not insist on the submission of audited financial statements up to credit requirements of Rs. 25 lakh from the prospective borrowers. Beyond this level, lending bankers usually compute the credit requirements after undertaking a structured analysis of the financial statements.

Till about 1990, bank credit was considered a scarce commodity and, therefore, there was a strong focus on the need to optimally use this resource towards the creation of primary assets, which are known as primary security charged in favour of the lending bank. With gradual liberalisation, commercial banks have begun providing credit to other sectors and even for those commodities which are not in the manufacturing sectors. In the monetary policy of 1997-98, RBI declared the MPBF method as optional and suggested that commercial banks may evolve their own rational methods for financing. RBI suggested 'CASH BUDGET' method as an alternative option. Due to non-performing asset norms, credit appraisal techniques are increasingly focused on the assessment of repayment capacity of the borrowers, which in turn depends on their cash generating ability.

17.8 SOURCES OF WORKING CAPITAL FUNDS

The major sources of working capital funds for investment in current assets are; trade credits/unsecured loans/deposits/bank borrowings/advance payments/stage-by-stage payments, etc.

17.9 ESTIMATION OF WORKING CAPITAL NEEDS

The conditions of commercial banks for lending on a short-term basis are rigorous. A customer has to satisfy his bank about his character, capacity, capital and collateral, in brief he has to establish his creditworthiness. If the overall appraisal is satisfactory, the bank will finance only the residual gap in the customers' resources, after taking into consideration the expected availability from all other sources of funds. Generally, there are four methods of estimating the working capital requirements of a borrower:

165

(a) The operating cycle method (b) The projected net working capital method
(c) The projected turnover method (d) The cash budget

These methods require the preparation of:

(a) Projected financial statements (b) Projected fund flow statements
(c) Projected cash flow statements/cash budgets

It must be emphasised that the assessment of the working capital requirements of a firm must be preceded by a detailed appraisal of the past and future viability of the firm's planning, operations and financial position. It is implicit that the firm will have to submit an acceptable business plan, in the form of projected financial statements, to the bank. Thereafter, the assessment of working capital needs is made based on the past trends, the end use of funds and the estimated requirement of additional funds as revealed by the firm's business plan or the cash budget, in cases of those firms which have a marked seasonality of operations.

17.10 OPERATING CYCLE METHOD

The second step is the estimation of the holding periods of major current assets. If part of raw materials is available on credit, then bank finance will be required only for that portion of the raw materials which represents fully paid purchases. Similarly, if advance payments are received against orders, only that part of the finished goods net of the advance payment will require bank credit.

Borrowers in the small and medium enterprises segment face a problem in collecting dues from their customers, particularly from the corporate sectors. In order to provide a relief to borrowers who face such a situation, the banks as part of their loan policy, decided as follows:

(i) While assessing working capital requirement, creditors will not be set-off against stock (ii) The borrowers will submit details age-wise list of sundry creditors and sundry debtors as well as the stock statement, (iii) Only those debtors will be considered who are outstanding for less than the period specified (up to 180 days maximum) from a case to case basis, (iv) The total outstanding creditors will be netted from the total outstanding eligible debtors. If creditors are in excess, the excess portion will be deducted from the value of stocks. If debtors are in excess, the bank could consider financing the surplus debtors as per the banks policy, (v) The borrower will have to hypothecate his entire book debts to the bank, (vi) The bank will not finance the borrower's book debts if creditors exceed debtors.

17.11 PROJECTED NET WORKING CAPITAL

The margin requirements have to be met by the borrower from the accruals during the course of the year and/or other long-term funds, in the form of net working capital. The projected net working capital, if higher than the current level maintained by the borrower, would be built up progressively with the growth in production, sales and profits. Therefore, during the initial stages in the current year, the NWC would generally be lower than the assessed, and in such circumstances, the borrower may not be able to maintain the stipulated current ratio, ranging from 1.25 to 1.33 or higher. On the merits of each case, banks, in such circumstances, may accept either of the two alternatives.

(i) Release the assessed limits/credit on the borrower's undertaking to augment the NWC to the required level within a time frame of 2 quarters, provided the borrower maintains a current ratio between 1.17 and 1.25. In the meantime, the borrower brings in short-term funds from other sources to meet the shortfall in NWC.

166

(ii) Release a temporary limit equivalent to the shortfall in NWC for a short term, say one quarter, in addition to the duly assessed limits. In this case, the short-term loan from the bank is in lieu of the market borrowings that the borrower had to raise as the other alternative: Here again, the borrower has to maintain a lower current ratio between 1.17 and 1.25, but restore the ratio within a stipulated time frame.

Banks may also, on a case to case basis, allow the computation of NWC of a borrower for assessment of working capital needs, by excluding the term loan instalments payable, from current liabilities.

17.12 PROJECTED TURNOVER METHOD

Banks, as a matter of policy and based on RBI guidelines, assess the working capital requirements including those of village industries, tiny industries, (SSI units and traders) with a fund based working capital limit of up to Rs. 4 crore by the turnover method.

RBI has given following instructions:

(i) Twenty per cent of their projected annual gross sales turnover may be considered as minimum working capital finance by banks, (ii) In order to ensure that a minimum margin supports the working capital needs of a borrower, a five per cent contribution is given by the promoters, (iii) Guideline for the turnover method is framed, assuming an average operating cycle of three months.

If the cycle is more than three months, the borrower should bring in a proportionately higher stake in relation to his requirement of the bank finance, (iv) Drawing power is calculated through stock statements. Unpaid stocks are not to be financed, as it would result in double financing.

The critical issue in the turnover method is the determination of the projected annual gross sales or turnover.

17.13 CASH BUDGET SYSTEM

The current loan policies of most banks state that, for an assessment of the working capital needs of a borrower who enjoys or requires fund based limits in excess of Rs.10 crore, the cash budget system should be used.

A cash budget is a statement of cash receipts and cash payments. It is distinct from the cash flow statement, in as much as the latter deals both cash and non-cash funds, while the cash budget deals with cash transactions only. Cash budget is a substitute for the operating cycle method for the assessment of working capital. A cash budget is usually prepared for short periods, i.e. a week/fortnight/month or a quarter. Cash budget has to have the following steps in sequence when prepared for a quarter.

(a) Actual receipts and payments during the first, the second and the third month.

(b) The position of the cash surplus/deficit is computed at monthly intervals. A surplus is generated if the receipts exceed the payment and a cash deficit occurs if payments are more than the receipts during the month.

(c) The opening cash balance for the first month is adjusted against the cash surplus/deficit that is generated during the month. The adjusted figure is the closing balance at the end of the first month, which becomes the opening balance for the next month, viz., the second month.

(d) A cash surplus generated during a month results in a higher closing cash balance vis-a-vis the opening balance of the month. Conversely, a cash deficit during the month would cause a lower level of the closing cash balance as compared to the opening balance.

(e) If the enterprise has a net position on borrowed funds (i.e. the company maintains a cash credit/ overdraft account), a cash surplus generated during a month brings down the level of the borrowed funds at the end of the month.

A cash budget is, therefore, a projection into the future, as against a cash flow statement that is usually historical in nature. Cash budgets are essential for assessment of working capital needs in situations like (I) opening of LC, (ii) ad hoc working capital, (iii) bill financing, (iv) financing construction activities, (v) financing seasonal industries, (vi) tea growing, (vii) sugar manufacturing, (viii) software development activities, (ix) coffee/rubber/cardamom/rice milling, etc.

Advantages

Short-term lending on the basis of cash budget offers a viable alternative to the existing security oriented pattern of credit allocation by banks. The main advantages of cash budget system are:

(a) The customer plans his cash requirements in advance and in case his bank is unable to sanction additional funds, the customer can seek alternative sources well in advance.

(b) The banker is in close touch with his customers. He would, therefore, be able to spot any danger signals quickly and initiate corrective action in time.

(c) The banker can plan his resources to meet expected credit demands. Credit planning would thus become a meaningful exercise.

17.14 CREDIT MANAGEMENT

Credit management is the management of the credit portfolio of banks and financial institutions. The expression 'credit' refers to short-term loans and advances as well to medium-/long-term loans and off balance sheet transactions. Management includes, within its preview, pre-sanction appraisal, sanction, documentation, disbursement and post-lending supervision and control. In the highly competitive ^nd deregulated environment, banks and financial institutions have to evolve better systems and procedures to manage the credit needs of their highly demanding customers, particularly in the corporate and retail sectors. The developments of the past decade have totally changed the credit management perspectives in banks. The term 'Credit management' encompasses the following:

(a) Capital adequacy norms
(b) Risk management, including asset liability management (ALM)
(c) Exposure norms
(d) Risk pricing policy and credit risk rating
(e) Asset classification, income recognition and provisioning norms
(f) Appraisal, credit decision-making and loan review mechanism

From 1 April 2002, the exposure ceiling is 15 per cent of the capital funds in the case of a single borrower and 40 per cent in the case of group borrowings. Exposure to borrowers, belonging to a group, may exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent total up to 50 per cent, provided the additional exposure is on account of an extension of credit to infrastructure projects.

Several risks affect credit decisions. The main risks are credit risk, market risk (mainly liquidity risk and interest rate risk) and operational risk. Credit risk is defined as the possibility of losses associated with a diminution in the credit quality of borrowers or counter parties. Such risks are:

(a) Principal/interest amount may not be paid.
(b) Funds may not be forthcoming from clients upon invocation of L/C, guarantees.
(c) Payments or series of payments due from the counter parties may not be coming in case of treasury operations.

(d) Funds/securities settlement may not be effected in securities trading.
(e) Availability and free transfer of foreign currency funds may either cease or restrictions may be imposed by the sovereign.

RBI has defined market risk as the possibility of loss to a bank, caused by changes in market variables, which are:

(b) Interest rate risk
(d) Commodity price risk
(a) Liquidity risk

(c) Foreign exchange rate risk

(e) Equity price risk.

Assets and Liability Management Committee (ALMC) functions as the top operational unit for a bank. Banks also face another risk, known as operational risk. The operational risk arises from human or technical error or acts of omission and commission such as ineffectiveness or breakdown in the internal control and internal audit systems. The risk can lead to losses through fraud, errors or a failure in performance in a timely manner. Operational risk includes legal risks but excludes strategic and reputation risk.
Banks' advances portfolio is classified under the following four categories:
(a) Standard assets (b)Sub-standard assets
(c) Doubtful assets (d) Loss assets
Provisions at different rates are to be made on the above category of assets.
The impact of the credit appraisal exercise, undertaken by banks at the time of a fresh credit sanction or credit extension, should be felt in the credit risk rating as per the risk pricing policy of the bank. The position should be periodically reviewed with the concerned borrowers and remedial measures recorded and implemented without loss of time.
Notices for renewal or reviews of the loan accounts are sent to the borrowers well in advance. Though renewals for the working capital advance, as per present practice, is done annually, for those loan accounts showing signs of incipient sickness and deteriorating credit risk, quarterly short reviews should be conducted. Close monitoring of loan accounts with a high or a deteriorating credit risk by branches and controlling offices and/or head office will ensure that the overall risk exposure of the bank is controlled.

17.15 CREDIT MONITORING

The credit monitoring in a bank is to ensure that the funds are utilised for the sanctioned purposes and at the same time complying with all sanction terms and conditions The purpose of the exercise is also to avoid the time lag and cost overruns, to detect early warning signals and symptoms of incipient sickness in the units financed by banks and to initiate timely action for recovery or rehabilitation.
Under Credit Monitoring Arrangement, banks ensure the following:
(a) Borrower should maintain reasonable estimates of current assets, current liabilities and working capital.
(b) Should maintain classification of current assets and current liabilities as per bank's guidelines.
(c) Should maintain a minimum current ratio of 1.33 except for export industry and for new units.
(d) Should submit annual audited accounts in time for annual review by banks.
(e) Ad hoc limits are sanctioned for periods not exceeding three months.
(f) As far as possible, post-sale limits are sanctioned in the form of Bill Finance.

17.16 CHECK YOUR PROGRESS

1. Cardinal principles of lending are
(a) Safety and liquidity (b) profitability and diversification of risks
(c) purpose and security (d) Only (i) and (iii)
(e) All of (i) to (iii)
2. Liquidity with a banker means
(a)Cash on Hand
(b)Cash and Bank balances
(c) Short-term current assets to convert into cash
(d)All of above
(e)None
3. Customer profitability analysis means
(a)Exercise done by bank before lending to a customer
(b) Exercise before opening a new branch
(c) Assess the profitability of customer's business

(d)Only (i) and (iii)
(e)None
4. Banker can reduce risk in lending to a borrower
(a) By obtaining adequate security
(b)By ensuring that there will be no problem of liquidity with borrower
(c) By ensuring that there will be no default on account of lack of liquidity and lack of willingness
to pay on the part of the borrower.
5. In banker's parlance, credit risk in lending refers to
(a) Default of repayment by a borrower
(b) Default of bankers in maintaining SLR
(c) Default of a banker to release credit to a borrower
(d) None of above
6. Net working capital means
(a) Current assets - Current Liabilities (b) Owned funds – Goodwill
(c) Use of assets + Sources of funds (d) None of above.
7. Major Current assets are
(a) Marketable investments and Cash/receivables/inventories
(b) Inventories + Cash + Receivables
(c) Shares in sister concern + Unquoted shares + Cash
(d) All of above.
8. What are the sources of working capital?
(a) Trade credits + Unsecured loans + Deposits
(b) Bank borrowings + Advance payments
(c) Net working capital
(d) All of above
(e) None
9. Working capital means
(a)Requirements for the day-to-day transactions
(b) Excess of current assets over current liabilities
(c)Fixed assets - Current assets
(d) None of above.

10. Term loans mean Loans
(a) Payable after one year to ten years
(b) Repayments are done in instalments
(c) Term loans are utilised for acquisition of fixed assets
(d) All of above
(e) Only (i) and (ii)
11. Working capital needs are estimated by
(a) Operating cycle method (b) Projected turnover method
(c) Cash budget method (d) Any of above
(e) None of above.
12. Difference between cash budget and cash flow
(a) Cash flow deals with cash and non-cash funds.
(b) Cash budget deals with cash transactions only.
(c) Cash flow statements are generally for quarterly or half-yearly while cash budgets are for shorter periods.
(d) Cash budget is a projection into the future while a cash flow statement is historical.
(e) All of above.
13. Advantages of cash budget could be
(a) Borrower should plan in advance the cash requirements.

(b) Banker is able to spot a danger signal quickly and corrective measures are taken.
(c) Banker can plan his resources to meet credit demands.
(d) All of above.
(e) Any of the above.
14. Is there any exposure ceiling for banks in providing advances/loans to borrowers?
(a) 15 per cent of capital funds for single borrower and 40 per cent in a borrower's group.
(b) 10 per cent of capital funds for single borrower and 20 per cent in a borrower's group.
(c) 25 per cent of capital funds for single borrower and 50 per cent in a borrower's group for infrastructural projects.
(d) no such ceiling.
15. Credit decisions are affected by risks like:
(a) Credit risk/market risk/operational risk (b) Liquidity/ interest rate/ foreign exchange rate
(c) Commodity price/equity price risks (d) None of the above

17.17 ANSWERS TO CHECK YOUR PROGRESS'

1. (e), 2. (d), 3. (c), 4. (c), 5. (a), 6. (a), 7. (a), 8. (d), 9. (a), 10. (d), 11. (d), 12. (e), 13. (d), 14. (a), 15. (a).

17.18 KEYWORDS

Customer Profitability Analysis (CPA) Fund Based Limit, Non-funded or Non-Fund Based Limit, Bank Guarantee, Letter of Credit (L/C), Maximum Permissible Bank Finance (MPBF), Working Capital Limit, Net Working Capital (NWC), Term Loan, Credit Appraisal, Cash Budget, Fund Flow Statement, Cash Flow Statement, Operating Cycle, Credit Monitoring, Capital Adequacy, Credit Risk, Market Risk, Liquidity Risk, Operational Risk, Risk Management, Asset Classification, Income Recognition, Provisioning Norms, Asset Liability Management (ALM), Loan Review Mechanism (LRM), Doubtful Asset, Loss Asset, Quarterly Production Record (QPR).

PRIORITY SECTOR ADVANCES

STRUCTURE

18.0 OBJECTIVES

A study of this unit will facilitate you to learn the concept of Priority Sector Lending by the banking sector, the RBI guidelines on priority sector lending and the latest developments in this field.

18.1 INTRODUCTION

At a meeting of the National Credit Council held in July 1968, the Government of India emphasised that commercial banks should increase their involvement in the financing of priority sectors, viz., agriculture and small scale industries. The description of the priority sectors was later formalised in 1972 on the basis of the report submitted by the informal study group on statistics relating to advances to the priority sectors constituted by the Reserve Bank in May 1971. Based on this report, the Reserve Bank prescribed a modified return for reporting on the priority sector advances and certain guidelines issued in this connection indicating the scope of the items to be included under the various categories of priority sectors. Although initially there was no specific target fixed in respect of priority sector lending, the Reserve Bank advised the banks in November 1974 to raise the share of these sectors in their aggregate advances to the level of 33 and one-third per cent by March 1979. At a meeting of the Union Finance Minister with the CEOs of public sector banks held in March 1980, it was agreed that banks should aim at raising the proportion of their advances to priority sectors to 40 per cent by March 1985. Based on the recommendations of the working group on the modalities of implementation of priority sector lending and the twenty point economic programme by banks, all commercial banks were advised to achieve the target of priority sector lending at 40 per cent of the aggregate bank advances by 1985. Sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector. Since then, there have been several changes in the scope of priority sector lending and the targets and sub-targets applicable to various bank groups.

18.2 CATEGORIES OF PRIORITY SECTOR: WITH EFFECT FROM 30 APRIL, 2007

(i) Agriculture (Direct and Indirect finance): Direct finance to agriculture would include; short-, medium- and long-term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, beekeeping, etc.) directly to individual farmers, self-help groups (SHGs) or joint liability groups (JLGs) of individual farmers without limit and to others (such as corporates, partnership firms and institutions) up to certain limits, for taking up agriculture and allied activities. Indirect finance to agriculture shall include loans given for agriculture and allied activities to those engaged in distribution of inputs like fertilisers, pesticides, seeds, cattle and poultry feeds, etc., and to State Electricity Boards and such other organisations.

(ii) Small Enterprises (Direct and Indirect Finance): Direct finance to small enterprises includes all loans given to micro and small (manufacturing) enterprises engaged in the manufacture/production, processing or preservation of goods, and micro and small (service) enterprises engaged in providing or rendering of services, and whose investment in plant and machinery and equipment (original cost excluding land and building and such items) respectively does not exceed the amounts specified in the Table 18.1.

The micro and small (service) enterprises shall include small road and water transport operators, small business professional and self-employed persons, and all other service enterprises. Indirect finance to small enterprises shall include finance to any person providing inputs to or for marketing the output of artisans, village and cottage industries, handlooms and to co-operatives of producers in this sector.

(iii) Retail Trade: Includes retail traders/private retail traders dealing in essential commodities (fair price shops), and consumer co-operative stores.

TABLE 18.1: Description of Micro, Small and Medium Sectors

Enterprise	Manufacturing Sector	Services sector
Micro	Where the investment in plant and machinery does not exceed Rs. 25 lakh. (Currently called as Tiny Sector)	Where the investment in equipment does not exceed Rs. 10 lakh. (Currently called as SSSBEs)
Small	Where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore.	Where the investment in equipment is more than Rs. 10 lakh but does not exceed Rs. 2 crore.
Medium	Where the investment in plant and machinery is more than Rs. 5 crore but does not exceed Rs. 10 crore.	

Where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

Note: Hitherto SSIs were units with an investment limit up to Rs. 1 crore and for select items up to Rs. 5 crore. Now the investment ceiling has been increased to Rs. 5 crore for all SSIs. Further hitherto, Services Sector under SMEs were not defined but now defined.

(iv) Micro Credit: Provision of credit and other financial services and products of very small amounts not exceeding Rs.50,000 per borrower, either directly or indirectly through a SHG/JLG mechanism or to NBFC/MFI for on-lending up to Rs. 50,000 per borrower, will constitute micro credit.

(v) Education Loans: Education loans include loans and advances granted to only individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad, and do not include those granted to institutions.

(vi) Housing Loans: Loans up to Rs. 20 lakh to individuals for purchase/ construction of a dwelling unit per family, (excluding loans granted by banks to their own employees) and loans given for repairs to the damaged dwelling units of families up to Rs. 1 lakh in rural and semi-urban areas and up to Rs. 2 lakh in urban and metropolitan areas.

18.3 TARGETS/SUB-TARGETS

The scheduled commercial banks are expected to enlarge credit to the priority sector and ensure that priority sector advances constitute 40 per cent of the net bank credit and that a substantial portion is directed to the weaker sections. Within the overall main lending target of 40 per cent of net bank credit, banks should ensure that eighteen per cent of net bank credit goes to agricultural sector, 10 per cent of net bank credit is given to the 'weaker sections' and one per cent of previous year's total advances is given under the Differential Rate of Interest (DRI) scheme. Non-achievement of priority sector targets and sub-targets will be taken into account by RBI while granting regulatory clearances/approvals for various purposes.

The targets and sub-targets set under priority sector lending for domestic and foreign banks operating in India are furnished below:

Total Priority Sector Advances

For Domestic Commercial Banks: Forty per cent of adjusted net bank credit (ANBC) or credit equivalent amount of off balance sheet exposure, whichever is higher.

For Foreign Banks: Thirty-two per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher.

Total Agricultural Advances: Eighteen per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher. Of this, indirect lending in excess of 4.5 per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher, will not be reckoned for

computing performance under the 18 per cent target. However, all agricultural advances under the categories 'direct' and 'indirect' will be reckoned in computing of performance under the overall priority sector target of 40 per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher. (No target for foreign banks)

Small Enterprise Advances: Advances to small enterprises sector are taken in consideration for computing performance under the overall priority sector target of 40 per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher. (For foreign banks, it is 10 per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher.)

Micro Enterprises within Small Enterprises Sector

(i) Forty per cent of total advances to small enterprises sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs. 5 lakh and micro (service) enterprises having investment in equipment up to Rs. 2 lakh;

(ii) Twenty per cent of total advances to small enterprises sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs. 5 lakh and up to Rs. 25 lakh, and micro (service) enterprises with investment in equipment above Rs. 2 lakh and up to Rs. 10 lakh.

Thus, 60 per cent of the small enterprises advances should go to the micro enterprises. The target for foreign banks is the same as that for domestic banks.

Advances to Weaker Sections: Ten per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher. No target for foreign banks.

Differential Rate of Interest Scheme: One per cent of total advances outstanding, as on the end of the previous year. It should be ensured that not less than forty per cent of the total advances granted under DRI scheme go to scheduled caste/scheduled tribes. At least two-third of DRI advances should be granted through rural and semi urban branches. No target for foreign banks.

Export Credit: Export credit is not a part of priority sector for domestic commercial banks. However, the target for foreign banks is 12 per cent of ANBC or credit equivalent amount of off balance sheet exposure, whichever is higher.

Weaker Sections

The weaker sections under priority sector include the following:

(a) Small and marginal farmers with land holding of 5 acres and less, and landless labourers, tenant farmers and share croppers;

(b) Artisans, village and cottage industries where individual credit limits do not exceed Rs. 50,000;

(c) Beneficiaries of Swarnjayanti Gram Swarozgar Yojana (SGSY);

(d) Scheduled castes and scheduled tribes;

(e) Beneficiaries of DRI scheme;

(f) Beneficiaries under Swarnajayanti Shahari Rozgar Yojana (SJSRY);

(g) Beneficiaries under the scheme for liberation and rehabilitation of scavengers (SLRS);

(h) Advances to self-help Groups;

(i) Loans to the distressed poor to pre-pay their debt to informal sector against appropriate collateral or group security.

18.4 RECENT DEVELOPMENTS IN PRIORITY SECTOR LENDING

During the budget speech 2006-07, Honourable Finance Minister has announced the Government's decision to ensure that the farmers receive short-term credit at seven per cent with an upper limit of Rs. 3 lakh on the principal amount.

The salient features of the guidelines are:

- The Government will provide interest subvention of 2 per cent p.a. to the banks in respect of short- term production credit up to Rs, 3 lakh provided to farmers.
- The amount of sub-vention will be calculated on the loan amount from the date of disbursement/ withdrawal up to the date of payment or up to the date loan becomes overdue. This subvention will be available to banks on the condition that they make short-term credit available at the ground level with ROI of 7 per cent per annum.

With the significant changes in the economic environment and the thrust given by Government of India for doubling of agriculture in the tenth five year plan, it is important to increase the farmers' participation in the existing extension system. The RBI has advised banks to form farmers' advisory committee in all rural branches. This committee will play a vital role in the rural development and it will not only strengthen the extension system, but will also make it more reliable and transparent by proper planning and resource allocation. A branch advisory committee comprising of select elected representatives, including women leaders of local Panchayat Raj institutions, within the service area of the branch, is established at every rural branch. It should meet at least once in a quarter. These meetings are made mandatory and are to be attended by the controlling official of the bank.

18.5 LET US SUM UP

Explained in this chapter are various purposes for which banks are granting advances to agriculture and other allied activities and how is the bank credit essential for development of our economy keeping in view our large population, rural base of the economy, the limited resources available and the competition emerging from the liberalisation of the economy. We have also discussed the other priority sectors and their relevance to the overall economic development. Various features like targets and sub-targets assigned to both domestic and foreign banks under each sector and sub-sector are also discussed, when the revised definition of micro, small and medium enterprises each under manufacturing and services sector was seen. In conclusion, we have also seen the recent developments in priority sector lending by commercial banks with a view to bringing farmers in general and the rural poor in particular within the reach of the extension system and the enhanced flow of bank credit.

18.6 CHECK YOUR PROGRESS

1. Housing Loans granted to individuals up to Rs.----- for construction of houses (excluding loans granted by banks to their employees) are treated as priority sector advances,

(a) 5 lakh (b) 10 lakh

(c) 20 lakh (d) 15 lakh

2. Educational loans granted to individuals for educational purposes up to Rs for studies in India, will be classified as priority sector.

(a) 7.5 lakh (b) 10 lakh

(c) 15 lakh (d) 20 lakh

3. The scheduled commercial banks are expected to enlarge credit to the priority sector and ensure
that priority sector advances constitute

(a) 18 per cent of net bank credit (b) 40 per cent of net bank credit

(c) 12 per cent of net bank credit (d) 25 per cent of net bank credit

18.7 ANSWERS TO CHECK YOUR PROGRESS'

I.fc). 2. (b\ 3. (b)

18.8 KEYWORDS

Priority sector, Small farmers, Marginal farmers, NABARD, Margin, Weaker sections, Micro Enterprise, Micro Credit, Differential Rate of Interest Scheme, Indirect Finance, Adjusted Net Bank Credit (ANBC), Services sector, Housing Loan, DRI Scheme, Subvention.

UNIT
19

AGRICULTURAL FINANCE

STRUCTURE

19.0 OBJECTIVES

A study of this unit will help you to understand and evaluate the various aspects of agriculture finance through banking sector.

19.1 INTRODUCTION

The credit needs of a farmer are met through broad categories of advances viz., direct finance and indirect finance. Based on the period of credit, direct finance is classified as short-term loans and medium-/long-term loans.

19.2 SHORT-TERM LOANS

Loans repayable up to 18 months are termed as short-term loans. This includes: crop loan and the limits sanctioned through Kisan Credit Cards scheme for raising crops, loan against gold ornaments for agricultural purposes.

19.3 MEDIUM-/LONG-TERM LOAN

The period of credit under this category is more than thirty-six months. This includes loan for the purpose of minor irrigation, farm/land development, farm mechanization, plantation and horticulture, allied activities such as dairy farming, sheep/goat raring, piggery and rabbit farming, poultry farming, fisheries, sericulture, bee-keeping, mushroom cultivation, bio-gas plants. Indirect finance includes credit for financing distribution of fertilisers, pesticides, loans granted to Electricity Boards for energising of pump set under Rural Electrification Corporation (REC) Scheme, finance for construction and running storage facilities in the producing areas, loans to individuals, institutions or organisations who undertake spraying operations, advance to State Corporations for onward lending to weaker section. Certain important features of agricultural loans are given below:

19.4 CROP LOAN

The purpose of the crop loan is to facilitate the agriculturists to carry on seasonal operations, i.e. to meet the expenses for raising of seasonal crops including the cost of seeds, fertilisers and pesticides, irrigation charges; labour charges, etc. Agriculturists, tenant farmers and share croppers who actually cultivate the lands are eligible for these loans. All categories of farmers - small/marginal (SF/MF) and others are included. Loan amounts are worked out based on the cost of cultivation (scale of finance) incurred, for each crop per acre of the crop cultivated, keeping a margin, say of 10 per cent.

19.5 KISAN CREDIT CARD

All farmers who require loan for their cultivation expenses are eligible to get loan under Kisan credit card scheme.

Purpose: Kisan credit cards can be issued to farmers to meet their cultivation needs and non-farm requirements, including purchase of inputs and other short-term requirements together with working capital requirements for allied activities in a flexible and cost effective manner. Apart from a loan for cultivation purposes, a consumption loan of a certain percentage of limit is also given for other/household expenses.

Eligibility: Owner cultivators or those engaged in allied activities are eligible for Kisan credit cards. Farmers cultivating authorised leased lands are also eligible.

Credit Limits: Limit is fixed based on the crops proposed to be raised and the area to be cultivated. The credit extended under the Kisan credit card scheme is in the nature of a revolving case credit and Provides for any number of withdrawals and repayments within the limits.certain percentage of increase, say 10 per cent in the limit is allowed every year, to take care of increase in scale of finance.

Period: Normally, the Kisan credit card is valid for a period of three years subject to an annual review.

Issuance of Cards: Beneficiaries under the scheme are issued a credit card and a passbook. The borrowers would be required to produce this over the counter for operating the account.

Documents: Farmers are required to submit land records once in three years only.

19.6 AGRICULTURAL TERM LOANS

Purpose: Agricultural term loans are provided for the purchase of assets (farm machinery, bullocks, sheep, etc., creation of assets (orchard development, poultry, dairy development, etc.) connected with rural activities under agriculture, horticulture, plantation, sericulture, animal husbandry, fisheries, etc., where the loan amount is repayable over a period of time exceeding three years.

Eligibility: All categories of farmers and agricultural labourers are eligible.

Documents: For activities like purchase of bullocks, etc., there is no need for any supportive documents. For larger amounts of loan, an estimate/quotation/project report will be called for. For land based activities, land records are to be produced.

19.7 LAND DEVELOPMENT

Purpose: Credit for land development projects, in the form of direct finance to cultivators, for better productivity. Loans under this head cover various activities like land clearance (removal of bushes, trees, etc.), land levelling and shaping, bench terracing for hilly areas, contour stone walls, staggered contour trenches, disposal drains, reclamation of saline/alkaline soils and fencing, etc.

Eligibility: All farmers owning agricultural land are eligible.

Documents to be submitted: The borrower has to produce a report on the estimated cost, supported by estimates of an engineer.

19.8 MINOR IRRIGATION

Purpose: Credit for the creation of irrigation facilities from underground/surface water sources. All structures and equipments connected with the proposed facility are also financed. Loans covering various activities like digging of new wells (open/borewells), deepening of existing wells (traditional/bore), energising of wells (oil engine/electrical pump set), laying of pipe lines, installing drip/sprinkler irrigation system and lift irrigation system.

Eligibility: All those farmers who are having known source of water, which is usable for irrigation purposes.

Documents to be submitted: An estimate for the civil works to be undertaken and quotations for the assets to be purchased are required. Land records to ascertain the title to the property, a Geologist certificate and a feasibility certificate from the electricity board, where relevant.

19.9 FARM MECHANISATION

Purpose: Credit for the purchase of farm equipments and machinery for agricultural operations. The

scheme covers activities ranging from purchase of tractors and accessories, trailers, power tillers, combine harvesters, power sprayers, dusters, threshers etc.

Eligibility: Farmers owning a minimum of 8 acres of perennially irrigated lands are eligible. Eligibility for purchase of other farm equipments is dependent on the income generated by the agricultural activity undertaken by the borrower.

Documents to be submitted: Quotation for the assets to be purchased has to be submitted. Land records to ascertain cultivation rights/title to the property are also required.

19.10 FINANCE TO HORTICULTURE

Purpose: Loans for development of fruit orchards like mango, chikoo, guava, grapes, pomegranate, apple, lechee, etc., as well as short-term fruit crops (banana, pineapple, etc.), flowers in open and green houses (roses, carnation, chrysanthemums, jasmine, etc.) and vegetable crops (potato, tomato, brinjal, gourds, peas, etc.) are financed.

Eligibility: All farmers having cultivable lands.

Documents to be submitted: For orchard development, the borrower has to submit the following:

(i) Water and soil test report
(ii) A feasibility certificate from the local horticulture department
(iii) Land records
(iv) Quotation/estimates for the costs to be incurred
(v) If the project is large than a project report.

19.11 LAND PURCHASE

Purpose: Loan to small and marginal farmers/landless labourers for purchase of agricultural land.

Eligibility: Small/marginal farmers, tenants, sharecroppers subject to land holding criteria.

Security: Land purchased with the bank finance will be mortgaged as security. No other security will be insisted upon.

Repayment: Normally, repayment of loan will be half yearly/yearly instalments depending on the harvest of the crops or the liquidity created by the agricultural activity undertaken over a period of ten years. Adequate gestation period is allowed for development of land.

19.12 LET US SUM UP

The credit needs of a farmer are met through broad categories of agricultural advances viz., direct finance and indirect finance. Based on the period of credit, direct finance is classified as short-term loans and medium-/long-term loans. Direct finance to agriculture is provided to farmers for short-term purposes like cultivation of crops or for other medium-/long-term purposes like, among others, land development or for augmenting water resources. A novel offering by banks to farmers for meeting their cultivation needs and other non-farm requirements, including consumption needs in timely manner and without any procedural delay by banks is Kisan Credit Cards. With these cards issued to farmers, they can draw amounts from banks whenever needed by them and up to a pre-fixed limit. Finance is also provided by banks for undertaking allied activities like dairy development, poultry farming, bee keeping, sericulture, piggeries, pisciculture, sheep/goat rearing, etc., Indirect finance to agriculture includes credit for distribution of fertilisers and other inputs used by farmers in agricultural operations. Finance for construction and running of warehouse facilities in the producing areas and advances to State

181

Electricity Boards for energising wells in villages and to State corporations for onward, lending to weaker sections also come under this category.

19.13 CHECK YOUR PROGRESS

1. Kisan Cards are issued to farmers

(a) to withdraw money from ATM in rural branches

(b) to purchase farm equipments

(c) to purchase agricultural implements on credit from dealers

(d) to meet their cultivation needs and non-farm requirements, including purchase of inputs and other short-term requirements and working capital requirements for allied activities

2. Under farm mechanization scheme, loan is given for

(a) providing irrigation facilities (b) cultivation expenses

(c) purchase of farm equipments (d) for digging wells

19.14 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), 2. (c).

19.15 KEYWORDS

Agriculture, Horticulture, Kisan Credit Cards, Farm Mechanization, Direct Finance, Indirect Finance, Crop Loan, Minor irrigation, Drip Irrigation, Sprinkler Irrigation, Sericulture, Pisciculture, Dairy Development, Plantation Crops, Warehousing.

MICRO, SMALL AND MEDIUM ENTERPRISES IN INDIA

STRUCTURE

184

20.0 OBJECTIVES

This unit will facilitate the reader to understand the concept of Micro, Small and Medium Enterprises (MSMEs) and their development in India through decades after independence.

20.1 INTRODUCTION

With the advent of planned economy from 1951 and the subsequent industrial policy pursued by Government of India, both the planners and the Government earmarked a special role for the small scale industries and medium scale industries in the Indian economy. Due protection was accorded to both sectors and particularly for the small scale industries from 1951 to 1991, till the nation adopted a policy of liberalisation and globalisation.

The policy for Small, Tiny and Village Enterprises of August 1991 laid the framework for government support in the context of liberalisation, which sought to replace protection with competitiveness to infuse more vitality and growth to MSMEs in the face of foreign competition and open market. Supportive measures concentrated on improving infrastructure, technology and quality. The Small Industries Development Bank of India (SIDBI) and a Technology Development and Modernisation Fund (TDMF) were created to accelerate finance and technical services to the sector. The delayed Payment Act was enacted to facilitate prompt payment of dues to MSMEs.

The Ministry of MSME (earlier known as Ministry of Small Scale Industries and Agro & Rural Industries) came into being from 1999 to provide focused attention to the development and promotion of this sector. The new Policy Package announced in August 2000 sought to address the persisting problems relating to credit, infrastructure, technology, and marketing more effectively. A credit Linked Capital Subsidy Scheme was launched to encourage technology upgradation in the MSME sector and a Credit Guarantee Scheme was started to provide collateral-free loans to micro and small entrepreneurs, particularly the first generation entrepreneurs. The exemption limit for relief from payment of Central Excise duty was raised to Rs. one crore and a Market Development Assistance Scheme for MSMEs was introduced. At the same time, consultations were held with stakeholders and the list of products reserved for production in the MSME Sector was gradually reduced year by year. In 2006, the long-awaited enactment for this sector finally became a reality with the passage of the Micro, Small and Medium Enterprises Act. In March 2007, a package for the promotion of Micro and Small Enterprises was announced which comprises the proposals/schemes having direct impact on the promotion and development of the micro and small enterprises, particularly in view of the fast changing economic environment wherein to be competitive is the key to success.

As seen above, MSMEs always represented the model of socio-economic policies of the Government of India which emphasised a judicious use of foreign exchange for import of capital goods and inputs; a labour intensive mode of production; employment generation; non-concentration or diffusion of economic power in the hands of few; discouraging monopolistic practices of production and marketing; and finally an effective contribution to foreign exchange earning of the nation with low import intensive operations, coupled with the policy of decongestion or diffusion of industrial activities in few geographical centres.

20.2 AIM OF MSMEs

It can be observed that MSMEs in India have met the expectations of the Government in this respect. MSMEs developed in a manner, which made it possible for them to achieve the following objectives:

- High contribution to domestic production

- Significant export earnings
- Low investment requirements
- Operational flexibility
- Mobility
- Low intensive imports
- Capacities to develop an appropriate indigenous technology
- Import substitution
- Contribution towards defence production
- Technology-oriented industries
- Competitiveness in domestic and export markets

At the same time, one has to understand the limitations of MSMEs, which are:

- Low capital base
- Concentration of functions in one/two persons
- Inadequate exposure to international environment
- Inability to face impact of WTO regime
- Inadequate contribution towards R&D
- Lack of professionalism

In spite of these limitations, the MSMEs have made significant contribution towards technological development and exports. MSMEs are established in almost all the major sectors in the Indian industry such as:

Food processing	Agricultural inputs
Chemicals and Pharmaceuticals	Engineering; Electricals; Electronics
Electro-medical equipment	Textiles and garments
Leather and leather goods	Meat products
Bio Engineering	Sports goods
Plastics products	computer software etc.

Resulting from globalisation and liberalisation, coupled with the WTO regime, Indian MSMEs have been passing through a transitional period. With a slowing down of the western economies, particularly USA and European Union and enhanced competition from China and a few low cost centres of production from abroad, many units in India have been facing a tough time. Those MSMEs who have a strong technological base, international business outlook, competitive spirit and willingness to restructure themselves shall withstand the present challenges and come out with flying colours to make their own contribution to the Indian economy.

20.3 MICRO, SMALL AND MEDIUM ENTERPRISES DEVELOPMENT (MSMED) ACT, 2006

The Government of India vide its notification dated 16.6.2006 enacted an Act named "Micro, Small and Medium Enterprises Development Act, 2006" (MSMED Act, 2006). This Act has been made effective from 2 October, 2006 as per the notification dated 18 July, 2006. In this Act, the word 'Enterprise' replaces the word 'Industry'. The 'enterprises' in this Act have been classified as micro, small and medium. Based on their activities, these enterprises have been further categorised as manufacturing enterprises and service.

The MSMED Act, 2006 has defined the micro, small and medium enterprises in both the manufacturing and services sector as follows:

'Enterprise' means an industrial undertaking or a business concern or any other establishment engaged

in the manufacture or production of goods in any manner, pertaining to any industry specified in the first schedule to the Industries (Development and Regulations) Act, 1951 or engaged in providing or rendering of any service or services. The three categories of enterprises, viz., micro, medium and small, both under manufacturing and services sectors are described as in Table 20.1.

TABLE 20.1: Description of Micro, Small and Medium Sectors

Enteprises

Micro

Small

Medium Manufacturing sector

Where the investment in plant and machinery does not exceed Rs. 25 lakh. (Currently called as Tiny Sector)

Where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore.

Where the investment in plant and machinery is more than Rs. 5 crore but does not exceed Rs. 10 crore.

Services sector

Where the investment in equipment does not exceed Rs. 10 lakh. (Currently called as SSSBEs).
Where the investment in equipment is more than Rs. 10 lakh but does not exceed Rs. 2 crore.
Where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

Note: Hitherto SSIs were units with an investment limit up to Rs. 1 crore and for select items up to Rs. 5 crore. Now the investment ceiling has been increased to Rs. 5 crore for all SSIs. Further hitherto, Services Sector under SMEs were not defined but now defined.

The Act seeks to facilitate the development of these enterprises as also enhance their competitiveness. It provides the first-ever legal framework for recognition of the concept of "Enterprise" which comprises both manufacturing and service entities. It defines medium enterprises for the first time and seeks to integrate the three tiers of these enterprises, namely, micro, small and medium. The Act also provides for a statutory consultative mechanism at the national level with balanced representation of all sections of stakeholders, particularly the three classes of enterprises; and with a wide range of advisory functions. Establishment of specific funds for the promotion, development and enhancing competitiveness of these enterprises, notification of schemes/ programmes for this purpose, progressive credit policies and practices, more effective mechanisms for mitigating the problems of delayed payments to micro and small enterprises and assurance of a scheme for easing the closure of business by these enterprises are some of the other features of the Act.
The Ministry of MSME has also taken a view, in the light of the liberalised provisions of the MSMED Act 2006, to do away with the restrictive 24% ceiling prescribed for equity holding by industrial undertak¬ings, whether domestic or foreign, in the MSMEs. This coupled with an expected legislation on Limited Liability Partnerships (introduced in the parliament by the Ministry of Corporate Affairs) should pave the way for greater corporatisation of the Small and Medium Enterprises - thereby enhancing their access to equity and other funds from the market of these products in keeping with the global standards.
20.4 POLICY PACKAGE FOR MSMEs - CREDIT/FINANCE
Credit is one of the critical inputs for the promotion and development of MSMEs. Some of the features of the existing credit policy and those evolving for the MSMEs are:
(i) Credit to the MSMEs is part of the Priority Sector Lending Policy of banks. For the public and private sector banks, 40 per cent of the net bank credit (NBC) is earmarked for the priority sector. For the foreign banks, however, 32 per cent of the NBC is earmarked for the priority sector, of which 10 per cent is earmarked for the MSME sector. Any shortfall in this by the foreign banks has to be deposited in the Small Enterprise Development Fund (SEDF) set up by the Small Industries Development Bank of India (SIDBI).

(ii) The SIDBI is the principal financial institution for promotion, financing and development of the MSME sector. Apart from extending financial assistance to the sector, it coordinates the functions of institutions engaged in similar activities. SIDBI's major operations are in the areas of
(a) refinance assistance
(b) direct lending
(c) development and support services
(iii) Commercial banks are important channels of credit dispensation to the sector and play a pivotal role in financing the working capital requirements, besides providing term loans.
(iv) At the state level, State Financial Corporations (SFCs) and twin-function State Industrial Development Corporations (SIDCs) are the major sources of long-term funds, (v) Recognising the importance of easy and adequate availability of finance in sustainable growth of the MSME sector, the Government has announced a "Policy Package for Stepping

up Credit to MSMEs", with the objective of doubling the flow of credit to this sector within a period of five years and the banks have been accordingly directed to ensure that there is at least a 20 per cent year on year growth in credit to MSMEs in order to double the credit in five years.

(vi) The banks have also been directed that each rural and semi-urban branch should provide credit cover to at least five new micro/small/medium enterprises including agro-rural industries and artisans per year.

(vii) Faced with the increased competition on account of globalisation, MSMEs are beginning to move from bank credit to a variety of other specialised financial services and options. In recent years, the sector has witnessed increased flow of capital in the form of primary/secondary securities market, venture capital and private equity, external commercial borrowings, factoring services, etc. More advanced MSMEs have started realising the importance of these alternative sources of finance and the consequent need for adopting better governance norms to take advantage of these funding sources.

(viii) Efforts are on to put in place Limited Liability Partnership Act so as to provide a thrust to MSMEs in their move towards corporatisation.

20.5 DELAYED PAYMENTS

The MSMED Act has provisions to safeguard the interests of SMEs by putting penalty clauses on delayed payments. When the buyer of goods fails to make the payment of the amount to the supplier within a period of forty-five days, the buyer shall be liable to pay compound interest to the supplier on the amount with monthly interest at three times of the bank rate. The amount of interest payable or paid by the buyer is disallowed as a deduction under the IT Act. The Act also has provisions for the establishment of MSE facilitation council for dispute resolution within a framework in ninety days. The Act has provisions/clauses for credit facilities (as per guidelines or instructions issued by RBI), procurement preference policy, funds, grants by the Central Government and administration and utilisation of funds.

20.6 PERFORMANCE AND CREDIT RATING SCHEME

As per the scheme approved by the Government of India and launched in April, 2005 for performance and credit rating of manufacturing MSEs, the National Small Industries Corporation (NSIC) empanels credit rating agencies for rating of small enterprises engaged in manufacturing activities. The rating scheme aims at helping them in accessing credit from banks faster and at competitive terms. The Government of India also provides a subsidy to these enterprises for getting rated to the extent of 75 per cent of the charges/fees paid to the rating agency subject to a maximum of Rs. 40,000.

20.7 LET US SUM UP

The MSMEs fulfil not only the economic objectives but also the social needs. However, in view of the intense competition from large enterprises, they need special protection and support from the Government, for their survival and growth. This has been provided by the Government and the Reserve bank of India through their various directives, policy prescriptions and guidelines. Accordingly, banks have been advised to earmark certain per cent of Net Bank Credit to this sector and allocations should also be made among the sub-sectors within the overall exposure to MSME sector by banks.

The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 was enacted in 2006 which has redefined micro, medium and small enterprises in both the manufacturing and services sectors. The Act provides the first-ever legal framework for recognition of the concept of 'enterprise' which comprises both manufacturing and service entities. It defines medium enterprises for the first time.

The Act has provisions for penalty for delayed payments so as to protect MSMEs. A rating scheme has come into being for credit rating of manufacturing MSMEs so as to enable them to access banks for faster and cheaper credit. Certain policy packages for the healthy growth of MSME sector were also announced by the Government and Reserve Bank.

20.8 CHECK YOUR PROGRESS

1. A micro enterprise in manufacturing sector is one where the investment in plant and machinery does not exceed Rs.

(a) Rs. 10 lakh (b) Rs. 20 lakh
(c) Rs. 25 lakh (d) Rs. 50 lakh

2. The Government of India also provides subsidy to the SSI units for getting rated to the extent of 75 per cent of the charges/fees paid to the rating agency by the SSI units subject to a maximum of Rs

(a) Rs. 40,000 (b) Rs. 60,000
(c) Rs. 75,000 (d) Rs. 1 lakh

3. A medium enterprise in service sector is one,

(a) Where the investment in equipment is more than Rs. 3 crore but does not exceed Rs. 10 crore.
(b) Where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 10 crore.
(c) Where the investment in equipment is more than Rs. 5 crore but does not exceed Rs. 10 crore.
(d) Where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

20.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (c), 2. (a), 3. (d).

20.10 KEYWORDS

Liberalisation, Globalisation, Low Intensive Imports, WTO, Import Substitution, Enterprise, Manufacturing Sector, Service Sector. Technology Upgradation, Payment Protection.

GOVERNMENT SPONSORED SCHEMES

STRUCTURE

21.0 OBJECTIVES

A study of this unit will help you to appreciate the important Government sponsored schemes like Swarnajayanti Gram Swarozga Yojana, Swarna Jayanti Shahari Rozgar Yojana, and the Prime Minister's Rozgar Yojana.

21.1 SWARNAJAYANTI GRAM SWAROZGAR YOJANA (SGSY)

Government of India has launched a new programme known as 'Swarnajayanti Gram Swarozgar Yojana' (SGSY) by restructuring the following existing schemes:

(a) Integrated Rural Development Programme (IRDP)
(b) Training of Rural Youth for Self-Employment (TRYSEM)
(c) Development of Women and Children in Rural Areas (DWCRA)
(d) Supply of Improved Toolkits to Rural Artisans (SITRA)
(e) Ganga Kalyan Yojana (GKY)
(f) Million Wells Scheme (MWS)

The SGSY Scheme is operative from 1 April, 1999 in the rural areas of the country. The scheme is funded by the Centre and the States in the ratio of 75:25 and will be implemented by commercial banks, regional rural banks and cooperative banks. Other financial institutions, Panchayat Raj institutions, district rural development agencies (DRDAs), Non-Government Organisations (NGOs), technical institutions in the district, will also be involved in the process of planning, implementation and monitoring of the scheme.

The scheme aims at establishing a large number of micro enterprises in the rural areas. The list of below poverty line (BPL) households, identified through the BPL census, duly approved by gram sabha, will form the basis for the identification of families for assistance under SGSY. The objective of SGSY is to bring the assisted poor families (Swarozgaris) above the poverty line by ensuring an appreciable sustained income over a period of time. This objective is to be achieved by, inter alia, organising the rural poor into self-help groups (SHGs) through the process of social mobilisation, training, capacity building and provision of income generating assets. The rural poor such as those with land, landless labour, educated unemployed, rural artisans and disabled are all covered under the scheme.

The assisted poor families, known as Swarozgaris, can be either individuals or groups and would be selected from BPL families by a three member team consisting of block development officer (BDO), banker and sarpanch.
SGSY will focus on the vulnerable sections of the rural poor. Accordingly, the SC/ST will account for at least 50 per cent, Women 40 per cent, and the disabled 3 per cent of those assisted.

21.1.1 Skill Upgradation/Training

Once the person or a group of persons has been identified for assistance, their training needs are also to be ascertained with reference to the minimum skill requirement. This programme includes elements of book keeping, knowledge of market, identification and appraisal, acquaintance with product costing, product pricing, familiarisation with project financing by banks as well as basic skills in the key activity identified.

21.1.2 Activity Clusters, Key Activities

The focus under the scheme should be on development of activity clusters with emphasis on key activities identified in the block, both for the group as well as for individual assistance. The activity clusters would be in geographic clusters of neighbouring villages within a reasonable radius. However, assistance is not prohibited for other activities.

21.1.3 Self-Help Groups (SHGs) under SGSY

The self-help groups shall be organised by 'Swarozgaris' drawn from the BPL list approved by the gram sabha. The scheme provides for the formation of self-help groups (SHGs), nurturing and their linkages with banks. The assistance (loan-cum-subsidy) may be extended to individuals in a group or to all members in the group for taking up income generation activities.
Group activities will be given preference and progressively, the majority of the funding will be for Self-Help groups. Half of the groups formed at the block level should be exclusively women groups.

21.1.4 Definition of Family and Wilful Defaulter

'BPL Family' under the guidelines would be treated as a unit for the purpose of giving income generating assets. The 'Family' would consist of members of a household and united by ties of marriage, blood and adoption. The family would consist of husband, wife, dependent parents/sons/daughters/brothers and sisters. The moment a parent/son/daughter/brother/sister is no longer dependent and has a separate household, he will no longer be a member of the same BPL family.
The term 'Wilful Defaulter' is defined as 'one who is capable of repaying the loan, but has been defaulting intentionally and not repaying the loan deliberately and wilfully'. It is desirable that wilful defaulters should not be financed under SGSY. In case wilful defaulters are members of a group, they might be allowed to benefit from the thrift and credit activities of the group including the corpus built up with the assistance of revolving fund. But at the stage of assistance for economic activities, the wilful defaulters should not have the benefit of further assistance until the outstanding loans are repaid. Wilful defaulters of the group should not get benefits under the SGSY scheme and the group may be financed excluding such defaulters.

21.1.5 Revolving Fund

SHGs that are in existence for about six months and have demonstrated the potential of a viable group enters the stage, wherein it receives the revolving fund from DRDA and banks, as cash credit facility. The revolving fund is provided to the groups to augment the group corpus so as to enable a larger number of members to avail loans and also to facilitate an increase in the per capita loan available to the members. The revolving fund imparts credit discipline and financial management skills to the members, so that they become credit worthy. SHGs that have demonstrated their successful existence, will receive assistance for economic activities under the scheme.

21.1.6 Lending Norms

The size of loan under the scheme would depend on the nature of project. There is no investment ceiling other than the unit cost, i.e. investment requirement worked out for the project. The loans under the scheme would be a composite loan comprising both a term loan and working capital. The loan component and the admissible subsidy together would be equal to total project cost. Disbursements up to Rs. 10,000/- under industry, service and business (ISB) sector may be made in cash where a number of items are to be bought.

(i) Group Loans

Ideally, under the group loan, the group should take up a single activity, but if necessary, the group could also take up multiple activities under the group loan. In either case, the loan will be sanctioned in the name of the group and the group stands as the guarantor to the bank, for prompt repayment of loan. The group is entitled to a subsidy of 50 per cent of the project cost, subject to per capita subsidy of Rs. 10,000/- or Rs. 1.25 lakh, whichever is less.

ii) Multiple Doses of Credit

Emphasis is laid on multiple doses of assistance. This would mean assisting a Swarozgari over a period of time with a second and subsequent dose(s) of credit, enabling him/her to cross the poverty line, as also access higher amounts of credit. Subsidy entitlement for all doses taken together should not exceed the limit prescribed for that category.

(iii) Interest Rates

Loans under the scheme will carry an interest as per the directives on interest rates issued by the Reserve Bank of India from time to time. However, the rates of interest to be charged on group loans under SGSY may be linked to per capita size of the loans, so as to mitigate the burden on the BPL beneficiaries.

(iv) Loan Applications

Time limit for disposal of applications: All loans granted under the scheme are to be treated as advances under priority sector. Loan applications under the scheme should be disposed of within the prescribed time limit of fifteen days and at any rate, not later than one month.

(a) Rejection of loan applications: If some loan applications are rejected by the branch managers, the reason for rejection should be clearly recorded on the application form itself and the relevant application should be returned to the sponsoring authority immediately for their information and further action as they deem necessary.

21.1.7 Insurance Cover

Insurance cover is available for assets/live stock bought out of the loan. Swarozgaris are covered under the group insurance scheme.

Insurance coverage of the SGSY Swarozgaris: The maximum age of Swarozgaris at the time of sanction has to be kept at sixty years of age. The insurance coverage, however, would be for five years or till the loan is repaid, whichever is earlier, irrespective of the age of Swarozgaris at the time of sanction of loan.

21.1.8 Security Norms

For individual loans up to Rs. 50,000 and group loans up to Rs. 5 lakh, the assets created out of the bank loan would be hypothecated to the bank as a primary security. In case where movable assets are not created, as in land based activities such as dug well, minor irrigation, etc., mortgage of land may be obtained. Where mortgage of land is not possible, third party guarantee may be obtained at the discretion of the bank.

For all individual loans exceeding Rs. 50,000 and group loans exceeding Rs. 5 lakh, in addition to the primary security such as hypothecation/mortgage of land or third-party guarantee as the case may be, suitable margin money/other collateral security in the form of an insurance policy; marketable security/ deeds of other property, etc., may be obtained at the discretion of the bank. The upper ceiling of Rs. 5 lakh is irrespective of the size of the group or pro rata per capita loan to the group. While deciding the limit for collateral security, the total project cost (bank loan plus Government subsidy) should be taken into consideration by banks.

21.1.9 Subsidy

Subsidy under SGSY will be uniform at 30 per cent of the project cost, subject to a maximum of Rs 7,500. In respect of SC/STs it will be 50 per cent of the project cost, subject to a maximum of Rs. 10,000. The group is entitled to subsidy of 50 per cent of the project cost subject to a per capita subsidy

of Rs. 10,000 or Rs. 1.25 lakh, whichever is less. There will be no monetary limit on subsidy for irriga¬tion projects. Subsidy under SGSY will be back ended. Banks should not charge interest on the subsidy potion of the loan amount.

21.1.10 Post-Credit Follow Up

Loan pass books in regional languages may be issued to the Swarozgaris which may contain all the details of the loans disbursed to them.

21.1.11Repayment of Loan

All SGSY loans are to be treated as medium-term loans with minimum repayment period of five years. Instalments for repayment of loan will be fixed as per the unit cost approved by the NABARD/Dist. SGSY Committee.

Swarozgaris will not be entitled for any benefit of subsidy if the loan is fully repaid before the prescribed lock-in period. The repayment period for various activities under SGSY can broadly be categorised into five, seven and nine years depending on the project. The corresponding lock-in period would be three, four and five years respectively. If the loan is fully repaid before the currency period, the Swarozgaris will be entitled only to pro rata subsidy.

21.1.12 Recovery

Prompt recovery of loans is necessary to ensure the success of the programme. The banks may engage the services of NGOs or individuals (other than government servants) as monitoring-cum-recovery facilitators, on a commission basis.

21.1.13 Refinance of SGSY Loans

Banks are eligible for refinance from NABARD for the loans disbursed under SGSY as per their guidelines.

21.2 SWARNA JAYANTI SHAHARI ROZGAR YOJANA (SJSRY)

Government of India has launched a rationalised poverty alleviation scheme called the 'Swarna Jayanti Shahari Rozgar Yojana' replacing three existing schemes, viz.,

- Nehru Rozgar Yojana (NRY),
- Urban Basic Services for the Poor (UBSP), and
- Prime Minister's Integrated Urban Poverty Eradication Programme (PMIUPEP)

The scheme contains all essential features of the three schemes and is operative from 1 December 1997 in all urban towns in India. SJSRY seeks to provide gainful employment to the urban poor (living below the urban poverty line) unemployed or under-employed, through setting up of self-employment ventures or provision of wage employment. Inputs under the scheme would be delivered both through the medium of community structures to be set up on UBSP pattern and urban local bodies (ULBs). The scheme is to be funded on a 75:25 basis, between the Centre and the States.

Swarna Jayanti Shahari Rozgar Yojana consists of two special schemes, namely -

- The Urban Self-Employment Programme (USEP)
- The Urban Wage Employment Programme (UWEP)

21.2.1 Urban Self-Employment Programme (USEP)

Assistance to individual urban poor beneficiaries for setting up gainful self-employment ventures. Identification: A house-to-house survey for identification of genuine beneficiaries should be done.

Non-economic parameters also should be applied to identify the urban poor in addition to the economic criteria of the urban poverty line. Community structures like community

development societies (CDS) should be involved in this task under the guidance of the town urban poverty eradication cell (TUPEC)/ Urban local bodies (ULBs).
Eligibility: Under-employed and unemployed urban youth whose annual family income is below the poverty line and who have got education up to the ninth standard shall be assisted with a bank loan and Government subsidy.
Minimum/Maximum age limit: No age limit is prescribed.
Definition of family: Identification of the family will have to be done on the basis of independent kitchen.
Coverage: SJSRY would be implemented in all areas falling under the jurisdiction of ULBs of any category, irrespective of population size. The scheme is applicable to all urban towns in India and is implemented on a whole town basis with special emphasis on urban poor clusters including those in the metropolitan cities. However, UWEP (Urban Wage Employment Programme), a component of SJSRY, applies to all urban local bodies, the population of which was less than 5 lakh as per the 1991 Census.
Project cost: Project cost up to Rs 50,000 is provided under the scheme in case of an individual. If two or more eligible persons join together in a partnership, the project with higher costs would also be covered provided the share of each person in the project cost is Rs. 50,000 or less.
Subsidy: Subsidy would be provided at the rate of 15 per cent of the project cost, subject to a ceiling of Rs. 7,500 per beneficiary (for individual USEP). In case of more than one beneficiary who join together and set a project under partnership, subsidy would be calculated for each partner separately at the rate of 15 per cent of his share in the project cost limited to Rs. 7,500 per partner.
Margin money: The borrower has to bring in 5 per cent of the project cost as margin money. Partnerships would be permitted, wherein the overall project cost will be a simple sum of individual project cost allowable per borrower. Such project would be eligible for subsidy equal to the total permitted subsidy per person and each member would have to bring in 5 per cent of his share of project cost as margin money.
Repayment: Repayment schedule ranges from three to seven years, after initial moratorium of six to eighteen months, as decided by the bank.
Physical targets: Physical targets under the USEP of SJSRY are decided by the State Governments in conformity with the guidelines of the scheme as also the result of beneficiary survey to ensure adequate flexibility of operation of the scheme.
21.2.2 Development of Women and Children in Urban Areas (DWCUA)
Activities: The programme envisages special incentives to the urban poor women who decide to set up self-employment ventures in a group. Such groups may take up any economic activity suited to their skill, training, aptitude and local conditions.
DWCUA group shall consist of at least ten urban poor women and will be entitled to a subsidy of Rs. 1,25,000 or 50 per cent of the cost of project, whichever is less. Every effort should be made to encourage the group to set itself up as a thrift and credit society.
Loan component: If the project cost is up to Rs 2,50,000: The loan component would be, project cost less 50 per cent subsidy and less margin money (5 per cent of the project cost).
Loan component if the project cost exceeds Rs 2,50,000: No maximum ceiling is prescribed for the project cost. In cases where the project cost exceeds Rs. 2, 50,000 for the DWCUA Group, the project

cost less subsidy (Rs 1,25,000) and margin money (at the rate of 5 per cent of the project cost), would be the component of bank loan.
Margin money: Five per cent of the project cost will be contributed as margin money by the group as a whole.
Repayment of loan: Same as under USEP for individual self-employment.
Income criteria: Each member of the Group should fulfil the urban poverty norms as per official methodology as decided by the Planning Commission. The beneficiaries under

SJSRY will be identified on the basis of a monthly per capita income and not by the annual family income.

21.2.3 Guidelines

Sub-targets: The percentage of women beneficiaries under the SJSRY Scheme shall not be less than 30 per cent. SCs/STs must be benefited to the extent of the proportion of their strength in the local population. A special provision of 3 per cent shall be made for the disabled under the scheme.

Priority sector status: The loans granted under the scheme should be treated as advances under the priority sector and accordingly the loan applications should be disposed of expeditiously within the time schedule prescribed in this regard, i.e. applications for loans up to Rs. 25,000 within a fortnight and those for credit limits above Rs. 25,000, within eight to nine weeks.

Rejection of applications: Branch managers may reject applications (except in respect of SC/ST) and such cases of rejections are to be verified subsequently by the divisional/regional managers. In case of proposals from SCs/STs, rejection should be at a level higher than that of a branch manager. Further, rejection of applications should not be on flimsy grounds. The reasons of rejection may also be commu¬nicated to the sponsoring agency while returning the applications.

Security: An entrepreneur eligible for assistance under the self-employment scheme can take a composite loan up to Rs. 50,000/- and group loans up to Rs. 3 lakh which would not require a collateral/guarantee. Besides margin, as also the subsidy by the Government, the borrower would hypothecate/mortgage/ pledge to the bank the assets created out of bank loan.

Rate of interest: Loans under the scheme will carry interest as per the directives on interest rates issued by Reserve Bank of India from time to time.

Defaulter: A defaulter to a bank/financial institution will not be eligible for assistance under the scheme.

21.2.4 Administration of Subsidy

It should be noted that the subsidy under USEP/DWCUA component of SJSRY is to be treated as back-ended subsidy with a lock-in period of two years. The subsidy amount may be utilised/adjusted towards repayment of the loan at the time of maturity. The subsidy admissible to the borrower should be kept in the subsidy reserve fund account borrower-wise. Further, no interest will be paid on the subsidy amount held by the banks and, for the purpose of charging interest on loan amount, the subsidy amount would be excluded from there.

21.3 PRIME MINISTER'S ROZGAR YOJANA (PMRY)

21.3.1 Introduction

The Prime Minister's Rozgar Yojana (PMRY) has been designed to provide employment to the educated unemployed youth by setting up of micro enterprises by the educated unemployed poor. It relates to the setting up of the self-employment ventures for industries, services and business. The scheme covers the whole of the country.

21.3.2 Target Group

The scheme covers all educated youth with the minimum qualification of VIII Standard (passed). Preference will be given to those who have been trained for any trade in Govt. recognised/approved institutions for a duration of at least six months.

21.3.3 Reservation

Preference should be given to weaker sections including women. The scheme envisages 22.5 per cent reservation for SC/ST and 27 per cent for other backward classes (OBCs).

21.3.4 Eligibility Norms

All educated unemployed youth between the age of 18 and 35 years on the date of receipt of application by the concerned DIC will be eligible for loan under the scheme in general with a ten years relaxation for SC/ST/Ex-servicemen/physically handicapped and women, i.e. up to the age of 45. Educated/ unemployed youth with a minimum qualification of VIII Standard (passed). Preference is to be given to persons who have received training in any trade in a

Government recognised/approved institution (ITI, etc.) for a minimum duration of six months. Applicants with higher qualifications or who are still pursuing further course of studies after their matriculation are also eligible for assistance. The annual family income should not be more than Rs. 1 lakh per annum and the beneficiary should be a permanent resident of the area for three years. Here 'Area' means the district.

21.3.5 Other Conditions

A defaulter to a bank/financial institution will not be eligible for assistance under the scheme. Further, if a member of a family is a defaulter other members of the family will not be eligible for assistance.

More than one member of the same family may not be assisted under the scheme. However, another member of the same family having been assisted under any other Central/State/State owned Corporation sponsored scheme (with/without subsidy) need not be a bar to assistance under PMRY.

A person who had been earlier assisted under a subsidy-linked programme will not be eligible for assistance under the PMRY.

21.3.6 Eligible Activities

Assistance will be provided for all economically viable activities including agricultural and allied activities but excluding direct agricultural operations like raising crop, purchase of manure, etc. The implementing agencies will decide the eligibility and classification of the activity proposed to be financed under industry/service/business sectors. Earlier stipulations on ceilings on the activities to be covered under the Industry, Service and Business sectors since stand withdrawn.

Relaxations of PMRY norms for North-East Region, Himachal Pradesh, Uttaranchal and Jammu & Kashmir have been provided. Government of India has decided to provide certain relaxations on the various parameters in the implementation of PMRY in the States of North-Eastern Region, viz., Assam, Mizoram, Manipur, Tripura, Nagaland, Arunachal Pradesh, Meghalaya and Sikkim as well as Himachal Pradesh, Utlaranchal and Jammu & Kashmir. These are:

- The PMRY is expanded to cover areas of horticulture, piggery, poultry, fishing, small tea gardens,etc., to cover all economically viable activities.
- Family income not exceeding Rs. 1 lakh per annum for each beneficiary, along with his/her spouse and the parents of the beneficiary.
- The upper age limit is relaxed to 40 years in general. For the SC/ST/Ex-servicemen, physically handicapped and women, the relaxation shall be up to the age of 45 years.

- In the case of SHGs, the subsidy per beneficiary is Rs. 12,500 subject to a maximum of Rs. 1.25 lakh.
- Banks will be allowed to take margin money from the borrower varying from 5 per cent to 12.5 per cent of the project cost so as to make the total of subsidy and margin money equal to 20 per cent of the project cost. (Applicable to cases sanctioned from 1 April, 1999).

21.3.7 Project Funding Components of Project Cost

The project cost for the business services sector will be restricted to Rs. 2 lakh and 5 lakh for the Industry sector. A borrower under the scheme will be eligible for sanction of a composite loan (working capital + term loan) based on a project cost of up to Rs. 2 lakh for other than business sector.

Loan amount: Banks may provide a composite loan (term loan/working capital) not exceeding Rs. 1,90,000 per individual borrower depending upon whether the project is in the business sector or other than the business sector respectively, after satisfying about the viability and bankability of the project. Banks should disburse the amount inclusive of margin money deposited by the borrowers.

The rate of interest charged for such loans are same as the rate applicable to priority sector loans up to Rs. 2 lakh, viz., not exceeding the PLR of individual banks.

Margin

(a) Banks will be allowed to take margin money from the borrower varying from 5 per cent to 16.25 per cent of the project cost so as to make the total of subsidy and margin money equal to 20 per cent of the project cost. In the North Eastern States (including Sikkim), Himachal Pradesh, Uttaranchal and Jammu & Kashmir, banks have been allowed to take margin money from the borrower varying from 5 per cent to 12.5 per cent of the project cost so as to make the total of subsidy and margin money equal to 20 per cent of the project cost.

(b) The margin money deposited by the borrower is not retainable as a security for the advance.

Subsidy Amount

Subsidy eligible is 15 per cent of the project cost, subject to a ceiling of Rs. 12,500 per borrower in States other than North Eastern States, Uttaranchal, Himachal and J&K. In case the amount disbursed is less than the original project cost, the subsidy eligibility will be restricted to 15 per cent of the revised project cost. In the case of Dairy loans, where the disbursement will be made in two stages (second batch of animals after six months), the branches may be advised to claim the subsidy from the head office only at the time of the final (second) disbursement of the loan.

Security

Apart from the margin and the personal guarantee provided by the borrower as also the subsidy by the Government, the borrower will have to hypothecate/mortgage/pledge to the bank assets, created out of the bank loan. If no fixed assets are proposed to be created in case of loans exceeding Rs. 50,000, banks should exercise special care while sanctioning such cases. Borrowers will not be required to give a collateral security under the industry sector projects with the cost up to Rs. 2 lakh and up to Rs. 1 lakh for business and service sectors. In case of a partnership, the exemption from collateral is limited to Rs. 1 lakh per person, participating in the project. The exemption limit in respect of a partnership project in the industries sector for obtaining of collateral security will be Rs. 5 lakh per borrowal account in the tiny sector. Even where offered, such collateral security or guarantee is not accepted.

Repayment Schedule

Repayment schedule may be fixed in the range of 3 to 7 years after an initial moratorium, as may be prescribed by the financing bank, The repayment schedule is to be worked out only for the term loan component.

Additional Finance

Additional finance towards working capital may be provided to the extent that the term loan component and working capital sanctioned should not exceed the prescribed ceiling amount fixed for the borrower (i.e. Rs. 1 lakh or Rs. 2 lakh depending upon whether the loan is for the business sector or for other than the business sector) or for all the partners collectively and proposal for additional finance should also be approved by the task force committee.

Penal Interest/Processing Charges

No penal interest or processing charges is levied on loans granted under the PMRY scheme.

Subsidy Management

Subsidy disbursal: The subsidy is made available by Government of India in advance and passed on to the banks through Reserve Bank of India. The subsidy portion will be kept as a fixed deposit with the banks in the name of the borrower for the duration of the term loan component but will not earn any interest. The subsidy deposit will be available to the borrower for adjustment against the last instalment(s) due under the term loan component. In any case, the fixed deposit should run for a minimum period of 3 years and would be available for adjustment only thereafter.

Effective Date of FDR

As the subsidy amount is remitted in advance to the head office of the bank, the date of the fixed deposit created out of the subsidy amount will be the date on which the last instalment of the loan is disbursed by the branch. From that date, no interest will be charged on the subsidy portion of the loan. Even if the subsidy amount is received by the head office after the loan is disbursed, to avoid inconvenience to the borrowers, the FD shall run from the date on which the last of instalment of the loan was disbursed and no interest on the subsidy portion of the loan shall be charged from that date.

Non-Payment of Interest on FDR Representing Subsidy

On the subsidy amount retained by the banks as a fixed deposit, in the name of the beneficiary, no interest is paid by the bank. On the portion of the loan, representing the subsidy, no interest would be charged by banks. The rate of interest to be charged will be decided, based of the loan amount net of subsidy.

21.3.8 Joint Ventures/Partnerships

Group activity stands a better chance of success because it is easier to provide back up support and marketing linkages. Group activities are, therefore, encouraged.

If more than one applicants join together and form partnership concern, they will be eligible for a total loan and subsidy, subject to the condition that proportionate loan/subsidy to each borrower does not exceed the prescribed ceiling per individual borrower and the total project cost should not exceed Rs. 10 lakh. Also, the individual ceiling on the share of the project cost for each one of the partners will be dependent on the nature of the activity undertaken by the firm. It would be preferable if the shares of partners were equal. All the partners should be prima facie eligible for assistance under PMRY scheme.

21.3.9 Financing for SHGs under PMRY

Self-help groups (SHG) could be considered for financing under the PMRY provided:

(a) Educated unemployed youth, satisfying the eligibility criteria as laid down under the scheme,volunteer to form a SHG to set up self-employed ventures (Common Economic Activity).

(b) Self-help group may consist of 5-20 educated unemployed youth.

(c) No upper ceiling on loan.

(d) Loan may be provided as per individual eligibility taking into account the requirement of the project.

(e) SHG may undertake a common economic activity for which a loan is sanctioned without resorting to onward lending to its members.

(f) Subsidy may be provided to the SHG as per the eligibility of individual members taking into account relaxation provided in North-Eastern States, Uttaranchal, Himachal Pradesh and Jammu & Kashmir.

(g) Required margin money contribution (i.e. subsidy and margin to be equal to 20 per cent of the project cost) should be brought in by the SHG collectively.

(h) The exemption limit for obtaining collateral security will be Rs. 5 lakh per borrowal account for projects under the industry sector. Exemption from collateral will be limited to an amount of Rs. 1 lakh per member of SHG for projects under service and business sectors. Banks may consider an enhancement in the limit of exemption of collateral in deserving cases.

21.3.10 Other Aspects: Deceased Borrowers

In the case of the death of a borrower under PMRY, it would be in order for banks to transfer the liability to the legal heir/near relative of the deceased or any third party willing to take the liabilities and continue to run the unit/activity, even if they do not satisfy the criteria stipulated under the scheme, provided the person to whom the unit/activity is thus transferred, without changing in any way the terms of the loan, satisfies the lending bank regarding the timely repayment of the loan instalments.

The subsidy amount will also accrue only to the transferred account. If, however, an arrangement of this type is not feasible, banks may take steps to recover the loan and adjust the subsidy amount towards the dues of the deceased beneficiary. -

Recovery

Banks have been permitted to file criminal complaints against those borrowers who misuse/divert the loans sanctioned under PMRY.

Banks are sometimes facing difficulties in the recovery of their loans availed by unmarried girls after marriage due to their migrating to a new place. It has now been decided that banks may include the parents/heads of the family of the unmarried girls as a co-borrower of the PMRY loan.

Refinance

Banks would be eligible to avail of the refinance under the Small Industries Development Bank of India (SIDBI) or NABARD schemes, to the extent that these are available for the purpose specified.

21.4 SCHEME OF LIBERATION AND REHABILITATION OF SCAVENGERS (SLRS)

The Government of India has launched on 22 March, 1992 a National scheme for the rehabilitation of scavengers and their dependents (SLRS).

21.4.1 The Scheme

The objective of the scheme is to liberate scavengers and their dependents from their existing hereditary

and obnoxious occupation of manually removing night soil and filth and to provide for and engage them in alternative and dignified occupations within a period of five years.

A scavenger is one who is partially or wholly engaged in the obnoxious and inhuman occupation of manually removing night soil and filth. The dependent of a scavenger is one who is a member of his/her family or is dependent on him/her irrespective of the fact whether he is partially or wholly engaged in the said occupation.

The scheme would cover primarily all scavengers belonging to the scheduled caste community and scavengers belonging to other communities engaged in servicing specifically dry latrines, to eliminate the practice of manual scavenging. Persons engaged in cleaning occupations, other than dry latrines, are not eligible for assistance under the scheme.

21.4.2 Salient Features

The National SLRS is applicable to public sector banks. The scheme would cover scavengers in urban areas, semi-urban areas, rural areas, any other town or area including cantonment boards, colonies set up by public sector undertakings, etc., where manual scavenging prevails. The unit for assistance under the scheme is not the family but each scavenger and each dependent of the scavengers.

For the purpose of training in various trades the age limit is 18 to 50 years. No minimum qualification is prescribed for providing training to scavengers. Loans granted by banks to the scavengers under the scheme will be eligible for a classification under priority sector and loans up to Rs. 6,500 as loans under the DRI scheme.

21.4.3 Funding

The scheme provides for funding of projects costing up to Rs. 50,000 per beneficiary and also for margin money to the extent of 15 per cent of the project cost at 4 per cent rate of interest. For projects costing Rs. 50,000 the break up would be Rs. 10,000 subsidy, Rs. 7,500 margin money from State Scheduled Caste Development Corporations (SCDC) and Rs. 32,500 loan from the banks. Under the scheme, subsidy would be 50 per cent of the project cost with a ceiling of Rs. 10,000.

Loans up to Rs. 6,500 are treated as loans under DRI Scheme and concessional rate of interest at 4 per cent is extended notwithstanding the fact that the project cost may exceed Rs. 6,500. Where the loan sanctioned/disbursed is more than Rs. 6,500 such loans will attract a rate of interest according to the RBI directive on interest.

21.4.4 Eligibility

An applicant may be considered for assistance, even if he/she had been assisted earlier under any subsidy-linked scheme if the applicant is otherwise eligible. However, an existing defaulter applicant will not be eligible for assistance. A member of family being a defaulter need not be a bar for considering the application of another member of the family for assistance.

21.4.5 Security

The security for the loan will be only the hypothecation of assets created out of the loan/subsidy in favour of the banks. The SCDC allows having a second/parri passu charge over the assets to cover their margin money loan assistance.

21.4.6 Repayment

The repayment of loans will be in monthly/quarterly instalments within three to seven years, inclusive of the grace period not exceeding six months. The recovery is first appropriated towards the recovery

21.4.7 Other Aspects

The banks should not insist on a deposit amount in the fixed deposit, from the beneficiary. All loan applications up to a credit limit of Rs. 25,000 should be disposed of within a fortnight and those for over Rs. 25,000 within 8-9 weeks.

21.5 LET US SUM UP

The various Government sponsored schemes are aimed at helping the poor to come above the poverty line, with the help of a loan and subsidy assistance. The SGSY is the major scheme announced by the Government of India towards alleviation of poverty. The PMRY aims at providing employment to the educated unemployed.

21.6 CHECK YOUR PROGRESS

1. 'Swarnajayanti Gram Swarozgar Yojana' (SGSY) did not replace one of the following schemes:

(a) Integrated Rural Development Programme (IRDP)
(b) Training of Rural Youth for Self-Employment (TRYSEM)
(c) Development of Women and Children in Rural Areas (DWCRA)
(d) PMRY

2. Under SGSY, the group is entitled for a subsidy of

(a) Fifty per cent of the project cost subject to per capita subsidy of Rs. 10,000/subject to maximum of Rs. 1.50 lakh.
(b) Twenty-five per cent of the project cost subject to per capita subsidy of Rs. 10,000 subject to maximum of Rs. 1.25 lakh.
(c) Thirty-three per cent of the project cost subject to per capita subsidy of Rs. 10,000 subject to maximum of Rs. 1.50 lakh.
(d) Fifty per cent of the project cost subject to per capita subsidy of Rs. 10,000 subject to maximum ofRs. 1.25 lakh.

3. Under SJSRY, the percentage of women beneficiaries should not be less than

(a) 30 per cent (b) 33 per cent
(c) 50 per cent (d) 22.5 per cent

4. Under PMRY, the maximum age limit for availing loan by physically handicapped persons is

(a) 28 (b) 35
(c) 40 (d) 45

21.7 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), 2. (d), 3. (a), 4. (d).

21.8 KEYWORDS

Swarnajayanti Gram Swarozgar Yojana, Swarnajayanti Shahari Rozgar Yojana, Prime Minister's Rozgar Yojana, Urban Poor, Rural Poor, Activity Clusters, NGO, SHG, Skill Upgradation, Subsidy, DRDA, Swarozgaris, Wilful Defaulter, Below Poverty Line (BPL), Project Funding, Target Group, Loan Component, Margin Component, Income Criteria, Urban Local Body (ULB).

SELF HELP GROUPS

STRUCTURE

22.0 Objectives

22.0 OBJECTIVES

This unit will help you to understand the concept of Self-Help Groups (SHGs), a vehicle through which the concept of micro-finance is carried to the unreached and under reached sections of the rural poor.

22.1 SHG - DEFINITION

Self-Help Group is a silent revolutionary concept that is taking place in the credit delivery system. Micro-finance through SHGs offers best form of credit for reaching the unreached and the under reached. The SHG concept has gained momentum due to active participation of banks.

'Self-Help Group is a voluntary association of poor formed with the common goal of social and economic empowerment.'

The members volunteered to organise themselves into a group for the eradication of poverty of the members. They agree to save regularly and convert their savings into a common fund known as the group corpus. The members of the group agree to use this common fund and such other funds that they may receive as a group through a common management.

22.2 NEED FOR SHGs

The rural poor is incapacitated due to various reasons, such as; most of them are socially backward, illiterate, with low motivation and a poor economic base. Individually, a poor is not only weak in a socio-economic term but also lacks access to the knowledge and information, which are the most important components of today's development process. However, in a group, they are empowered to overcome many of these weaknesses. Hence, there are needs for SHGs, which in specific terms are as under:

(a) To mobilise the resources of the individual members for their collective economic development
(b) To uplift the living conditions of the poor
(c) To create a habit of savings
(d) Utilisation of local resources
(e) To mobilise individual skills for group's interest
(f) To create awareness about rights
(g) To assist the members financially at the time of need
(h) Entrepreneurship development
(i) To identify problems, analysing and finding solutions in the group
(j) To act as a media for socio-economic development of the village
(k) To develop linkages with institutions of NGOs
(1) To organise training for skill development
(rn) To help in the recovery of loans
(n) To gain mutual understanding, develop trust and self-confidence
(o) To build-up teamwork
(p) To develop leadership qualities

The group formation will keep in view the following broad guidelines:

Normally, the number of members in a group should not exceed twenty; otherwise, registration becomes compulsory, Generally, a self-help group may consist of ten to twenty persons. However, in difficult areas like deserts, hills and areas with scattered and sparse population and in case of economically weaker and/or physically disabled persons, this number may be from five to twenty. Generally, all members of the group should belong to families below the poverty line. However, if necessary, a

maximum of twenty per cent and in exceptional cases, where essentially required, up to a maximum of thirty per cent of the members in a group may be taken from families marginally above the poverty line living contiguously with BPL (Below Poverty Line) families and if they are acceptable to the BPL members of the group. However, the APL members will not be eligible for the subsidy under the scheme. The BPL families must actively participate in the management and decision making, which should not ordinarily be entirely in the hands of APL (Above Poverty Line) families. Further, APL members of the Self-Help group shall not become office bearers (Group Leader, Assistant Group Leader or Treasurer) of the group.

The group shall not consist of more than one member from the same family. A person should not be a member of more than one group. The group should devise a code of conduct (Group management norms) to bind itself. This should be in the form of regular meetings (weekly or fortnightly), functioning in a democratic manner, allowing for a free exchange of views, participation by the members in the decision making process. The group should be able to draw up an agenda for each meeting and take up discussions as per the agenda. The members should build their corpus through regular savings. The group should be able to collect the minimum voluntary saving amount from all the members regularly in the group meetings. The savings so collected will be the group corpus fund.

The group corpus fund should be used to advance loans to the members. The group should develop financial management norms covering the loan sanction procedure, repayment schedule and interest rates. The members in the group meetings should take all the loaning decisions through a participatory decision making process. The group should be able to prioritise the loan applications, fix repayment schedules, fix an appropriate rate of interest for the loans advanced and closely monitor the repayment of the loan instalments from the loanee.

The group should operate a group account preferably in their service area bank branch, to deposit the balance amounts left with the groups after disbursing loans to its members. The group should maintain simple basic records such as minutes book, attendance register, loan ledger, general ledger, cash book, bank passbook and individual passbooks.

22.3 FUNCTIONS OF SHGs

To develop a group into well-managed self-help group, the members should evolve rules and regulations, which are to be adopted, after discussions with all the members for compliance in full. Some illustrative guidelines for the formulation of such rules and regulations are given as under:

Meeting: The group should meet regularly; ideally, the meetings should be weekly or at least monthly. (Advantage: They become closer if they meet regularly. This helps them to understand each other's difficulties better).

Compulsory attendance: Full attendance in all the group meetings will make it easy for the SHG to stabilise and start working to the satisfaction of all.

Membership register, minutes register, etc., are to be kept up to date by the group, by making the entries regularly. (Advantage: This helps you to know about the SHG easily. It also helps to build trust among the SHG members).

Fixed day for meetings: The group should have a fixed day or date for the meetings. (Advantage: This will help the members to plan in advance their routine works).

Common place: The group should fix a common place to conduct the meetings.

Savings: Savings should be deposited by all the members in the meeting itself. No interest will be paid to the members for their money with the group. The members will not be encouraged to adjust their savings amount against their loan due to the group.

Keeping of accounts: Simple and clear books for all transactions, to be maintained. If no member is able to maintain the books, the SHG may take outside help. All registers and account books are written during the course of the meeting.

Resolution from the SHG: The SHG has to pass a resolution in the group meeting, signed by all members, indicating their decision to open SB A/c with the bank. This resolution is filed with the bank.

Authorisation from the SHG: The SHG should authorise at least three members, any two of whom, to jointly operate upon their account. The resolution along with the filled in application form duly introduced by the promoter may be filed with the bank branch.

Copy of the rules and regulations of the SHG: This is not necessary. If the group has not formulated any such rules or regulations, loans are sanctioned without them. A savings bank account passbook is issued to the SHG. This should be in the name of the SHG and not in the name of any individual(s).

Conduct of internal lending by SHG: After saving for a minimum period of two to three months, the common savings fund should be used by the SHG for lending to its own members.

The purpose, terms and conditions for lending to its members, the rate of interest, etc., as decided by the group through discussions during its meetings (RBI and NABARD have permitted the members to decide on these aspects). The interest is usually kept as two or three rupees per hundred rupees per month. Simple and clear books of account of savings and lending are kept by the SHG.

22.4 OTHER CONDITIONS OF INDIRECT FINANCE TO SHGs THROUGH NGOs

(a) NGO is registered under the Society/Company/Partnership/Cooperative act
(b) Audited balance sheet for three years analysed
(c) Provision in the by-laws of NGO to borrow for SHG activities
(d) Resolution to borrow from bank
(e) A statement of credit required by SHGs

Self-Help Groups (SHGs) are considered for assistance under PMRY provided:

- Educated unemployed youth satisfying the eligibility criteria as laid down under the scheme, volunteer to form SHG to set up self-employed ventures (Common Economic Activity).
- A Self-Help Group may consist of 5 to 20 educated unemployed youth.
- No upper ceiling on loan.
- Loans provided as per individual eligibility, taking into account the requirement of the project.
- SHG may undertake a common economic activity for which a loan is sanctioned without resorting to onward lending to its members.
- Subsidy is provided to the SHG as per the eligibility of the individual members, taking into account the relaxation provided in North Eastern States, Uttarakhand, Himachal Pradesh and Jammu & Kashmir.
- Required margin money contribution (i.e. subsidy and margin to be equal to twenty per cent of the project cost) should be brought in by the SHG collectively.
- The exemption limit for obtaining collateral security will be Rs. 5 lakh per borrowing account for projects under the Industry Sector. Exemption from collateral will be limited to an amount of Rs. 1 lakh per member of SHG for projects under service and business sectors. Enhancement in limit of exemption of collateral; may be considered in deserving cases.
- Implementing agencies may decide the necessity of pre-disbursal training for all the members/ majority of the members in the group.

22.5 SELF-HELP GROUPS AND SGSY SCHEME

The SGYS scheme has come into operation from 1 April, 1999 replacing all other schemes like the IRDP, TRYSEM, DWCRA, SITRA, GKJ, MWS, etc. The objective of the scheme is to bring the poor people above the poverty line within three years. For this purpose, an emphasis has been laid on group financing and group activities, taking into account the natural resources available in the area and the activities suitable to that area. The scheme envisages supplementary doses of credit if necessary to the participants. Preference will be given to well functioning SHGs in the villages both under the group finance and individual finance.

22.6 CAPACITY BUILDING OF THE SELF-HELP GROUPS

SHGs that are in existence for about six months and have demonstrated the potential of a viable group enters the stage, wherein it receives the revolving fund of Rs. 25,000 from the bank as a cash credit facility and also embarks on further capacity building of its entire team. DRDAs will arrange to provide the revolving fund to such groups, meeting their share from out of the SGSY fund. Of this, a sum of Rs. 10,000 is given to the bank by the DRDA. Banks may charge interest only on the sum exceeding Rs. 10,000. The subsidy of Rs. 10,000 released by DRDA is adjusted against the loan at the end of cash credit period on the request of the group.

22.7 LET US SUM UP

SHG is an unregistered group of less than twenty people; otherwise registration is compulsory, from a homogeneous class who come together for addressing their common problems, both economic and community problems. They are encouraged to make voluntary savings on a regular basis. They use these savings to make interest-bearing loans to their members. In the process, the essentials of financial intermediation including prioritisation of needs, setting terms and conditions and keeping financial accounts are imbibed in them. The group, which has learnt this basic process of savings money, lending and recovering it back, are ready to be linked to the bank, thereby having access to the larger resources of the bank. The peer pressure among the group ensures timely repayment. The concept is well received in the developing and the under developed countries, as evidenced by the recognition the father of the SHG Movement, Mr. Mohammed Yunus of Bangla Desh received by Nobel Award. The salient features of the SHG Movement are:

(a) Groups of homogeneous people from similar economic background living in the neighbourhood.
(b) Focus on women.
(c) Saving first, credit later.
(d) Credit prioritised among the members, which builds pressure for timely repayment.
(e) Transparent operation, as decisions are taken collectively in meetings.

22.8 CHECK YOUR PROGRESS

1. Maintenance of the following books, registers is not compulsory for SHG
(a) Minutes book (b) Savings and Loan register
(c) Visitors book (d) Members' passbook
2. SHGs, for assistance under PMRY may consist of
(a) 5-20 educated unemployed youth (b) 3-15 educated unemployed youth
(c) 10-25 educated unemployed youth (d) 2-10 educated unemployed youth

22.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (c), 2. (a).

22.10 KEYWORDS

Self-Help Group, Joint Liability Group, Linkage, Capacity building, Micro-finance, Thrift, Entrepre-neurship Development, Team Work, Skill Development, Below Poverty Line (BPL), DRDA.

CREDIT CARDS, HOME LOANS, PERSONAL LOANS, CONSUMER LOANS

STRUCTURE

23.0 OBJECTIVES

By reading this unit, the learner will be able to know about credit cards and the guidelines of the regulatory authority on matters pertaining to credit card, procedures and practices on home loan, personal loan and consumer loan.

23.1 CREDIT CARD

23.1.1 Introduction

Credit card is the one of the delivery channels of the banking services. Due to the advancement of technology and easy accessibility to credit, the credit cards are gaining popularity nowadays. It is a novel way of providing value added services to banks' customers. Cards are issued to approved clients for purchase of goods or services from authorised merchant establishments on the credit guarantee of issuer of credit card.

23.1.2 Benefits to Credit Card Holders

(a) They can purchase goods and services at a large number of merchant outlets up to the inbuilt ceiling credit limit amount without using cash or cheque. This is generally useful in emergencies.

(b) Card holder has a period of interest free credit, depending upon the issuing bank and the card scheme, i.e. the normal card and gold cards, as offered by various banks. The period of interest free credit ranges from 15 days to 51 days.

(c) Cash up to a ceiling, within the credit limit is obtainable from the banks' branches or ATMs (Automated Teller Machines).

23.1.3 Disadvantages to Credit Card Holders

(a) Often results in over spending.

(b) Frauds, due to a loss of card in the intervening periods.

(c) Since signatures are already on the cards, forged signatures could cause a loss to the card holders. Such kind of a forged signature loss is avoided with the use of photo credit cards (Credit cards with the photograph of the User).

23.1.4 Guidelines on Credit Card Operations of Banks

The Reserve Bank of India had constituted a working group on regulatory mechanism for cards. The group has suggested various regulatory measures aimed at encouraging growth of credit cards in a safe, secure and efficient manner as well as to ensure that the rules, regulations, standards and practices of the card issuing banks are in alignment with the best customer practices. Each bank/NBFC must have a well-documented policy and a 'Fair Practices Code' for credit card operations. In March 2005, the IBA released a 'Fair Practices Code' for credit card operations which could be adopted by the banks/ NBFCs. The following are the guidelines issued by Reserve Bank of India on various aspects of the credit card operations by banks:

Issue of Cards

(a) Banks/NBFCs should independently assess the credit risk, while issuing cards to persons, especially
to students and others with no independent financial means. Add-on cards, i.e. those that are subsidiary to the principal card, are issued with the clear understanding that the liability will be that of the principal cardholder.

(b) As holding several credit cards enhances the total credit available to any consumer, banks/NBFCs should assess the credit limit for a credit card customer having regard to the limits enjoyed by the cardholder from other banks based on self-declaration/credit information.

211

The card issuing banks/NBFCs would be solely responsible for fulfilment of all KYC requirements, even where agents solicit business on their behalf.

© While issuing cards, the terms and conditions for issue and usage of a credit card is mentioned in a clear and simple language (preferably in English, Hindi and the local language) easily comprehensible to a card user.

Interest Rates and Other Charges

(a) Card issuers should ensure that there is no delay in dispatching bills and the customer has sufficient number of days (at least one fortnight) for making payments before the interest starts getting charged.

(b) Card issuers should quote annualised percentage rates (APR) on card products (separately for retail purchase and for cash advance, if different). The method of calculation of APR is given with a couple of examples for better comprehension. The APR charged and the annual fee is shown with equal prominence. The late payment charges, including the method of calculation of such charges and the number of days, are to be prominently indicated. The manner in which the outstanding unpaid amount will be included for calculation of interest should also be specifically shown with prominence in all monthly statements. Even where the minimum amount indicated to keep the card valid has been paid, it should be indicated in bold letters that the interest will be charged on the amount due, after the due date of payment. These aspects may be shown in the 'Welcome Kit' in addition to being shown in the monthly statement.

(c) The bank/NBFC should not levy any charge that was not explicitly indicated to the credit card holder at the time of issuance of the card and getting his/her consent. However, this would not be applicable to charges like service taxes, etc., which may subsequently be levied by the Government or any other statutory authority.

(d) The terms and conditions for payment of credit card dues, including the minimum payment due, should be stipulated, so as to ensure that there is no negative amortisation.

(e) Changes in charges (other than interest) may be made only with prospective effect, giving notice of at least one month. If a credit card holder desires to surrender his credit card on account of any change in the credit card charges to his disadvantage, he may be permitted to do so, without the bank levying any extra charge for such a closure.

Wrongful Billing

(a)The card issuing bank/NBFC should ensure that wrong bills are not raised and issued to customers. In case, a customer protests any bill, the bank/NBFC should provide an

explanation, and if necessary, documentary evidence to the customer, within a maximum period of sixty days with a spirit to amicably redress the grievances.
(b) To obviate frequent complaints of delayed billing, the credit card issuing bank/NBFC may consider providing the bills and statements of accounts online, with suitable security.
Protection of Customer Rights
Customer's rights, in relation to credit card operations, primarily relate to personal privacy, a clarity relating to rights and obligations, preservation of customer records, maintenance of confidentiality of customer information and fair practices in debt collection. The card issuing bank/NBFC would be responsible as the principal, for all acts of omission or commission of their agents (DSAs/DMAs and recovery agents).
(i) Right to privacy
(a) Unsolicited cards should not be issued. In case, an unsolicited card is issued and activated without the consent of the recipient and the latter is billed for the same, the card issuing bank/ NBFC shall not only reverse the charges forthwith, but also pay a penalty without demur to

(b) Unsolicited loans or other credit facilities should not be offered to the credit card customers.
In case, an unsolicited credit facility is extended without the consent of the recipient and the latter objects to the same/the credit sanctioning bank/NBFC shall not only withdraw the credit limit, but also be liable to pay such penalty as may be considered appropriate.
(c) The card issuing bank/NBFC should not unilaterally upgrade credit cards and enhance credit
limits. Prior consent of the borrower should invariably be taken whenever there are any change(s) in the terms and conditions.
(d) The card issuing bank/NBFC should maintain a 'Do Not Call Registry' (DNCR) containing
the phone numbers (both cell phones and land phones) of customers as well as non customers (non constituents), who have informed the bank/NBFC that they do not wish to receive unsolicited calls/SMS for marketing of its credit card products.
(e) The intimation for including an individual's telephone number in the DNCR should be facilitated through a website maintained by the bank/NBFC or on the basis of a letter received
from such a person addressed to the bank/NBFC.
(f) The card issuing bank/NBFC should introduce a system whereby the DSAs/ DMAs as well as its call centres have to first submit to the bank/NBFC a list of numbers they intend to call for marketing purposes. The bank/NBFC should then refer to the DNCR and only those numbers which do not figure in the DNCR should be cleared for calling.
(g) The numbers cleared by the card issuing bank/NBFC for calling should only be accessed. The bank/NBFC would be held responsible if a DNCN is called on by its DSAs/DMAs or call centre.
(h) The card issuing bank/NBFC should ensure that the DNCR numbers are not passed on to any unauthorised person/s or misused in any manner, (i) Banks/NBFCs/their agents should not resort to an invasion of privacy, viz., persistently bothering the card holders at odd hours, violation of "do not call" code, etc. (ii) Customer confidentiality
(a) The card issuing bank/NBFC should not reveal any information relating to customers obtained
at the time of opening the account or issuing the credit card; to any other person or organisation,
without obtaining the specific consent of the customer, as regards the purpose(s) for which the information will be used and the organisations with whom the information will be shared.
(b) The disclosure to the DSAs/recovery agents should also be limited to the extent that will
enable them to discharge their duties. Personal information provided by the card holder but

not required for recovery purposes should not be released by the card issuing bank/NBFC. The card issuing bank/NBFC should ensure that the DSAs/DMAs do not transfer or misuse any customer information during marketing of credit card products.

(iii) Fair practices in debt collection

(a) In the matter of recovery of dues, banks/NBFCs may ensure that they, as also their agents,
adhere to the extant instructions of the RBI as also IBA's code for collection of dues and repossession of security. In case, the bank/NBFCs have their own code for collection of dues, it should, at the minimum, incorporate all the terms of IBA's code.

(b) In particular, with regard to the appointment of third party agencies for debt collection, it is
essential that such agents refrain from any action that could damage the integrity and reputation
of the bank/NBFC and that they observe strict customer confidentiality. All letters issued by recovery agents must contain the name and address of a responsible senior officer of the card issuing bank whom the customer can contact at his location.

(c) Banks/NBFCs/their agents should not resort to intimidation or harassment of any kind, either verbal or physical, against any person in their debt collection efforts, including acts intended

to humiliate publicly or intrude the privacy of the credit card holders' family members, referees and friends, making threatening and anonymous calls or making false and misleading representations.

Redressal of Grievances

(a) Generally, a time limit of sixty (60) days may be given to the customers for preferring their complaints/grievances.

(b) The card issuing bank/NBFC should constitute 'Grievance Redressal' machinery within the bank/ NBFC and give wide publicity about it through electronic and print media. The name and contact number of the designated grievance redressal officer of the bank/NBFC should be mentioned on the credit card bills. The designated officer should ensure that genuine grievances of credit card subscribers are redressed promptly.

(c) The grievance redressal procedure of the bank/NBFC and the time frame fixed for responding to the complaints should be placed on the bank/NBFC's website. The name, designation, address and contact number of important executives as well as that of the grievance redressal officer of the bank/NBFC may be displayed on the website. There should be a system of acknowledging customers' complaints for follow-up, such as complaint number/docket number, even if the complaints are
received on phone.

(d) If a complainant does not get a satisfactory response from the bank/NBFC within a maximum period of thirty (30) days from the date of his lodging the complaint, there should be a provision to escalate the complaint to the next higher authority in the bank/NBFC.

Internal Control and Monitoring Systems

With a view to ensuring that the quality of customer service is ensured on an ongoing basis in banks/ NBFCs, the 'Standing Committee' on customer service in each bank/NBFC may review on a monthly basis the credit card operations including reports of defaulters to the CIBIL, credit card related complaints and take measures to improve the services and ensure the orderly growth in the credit card operations. Banks/NBFCs should put up a detailed quarterly analysis of credit card related complaints to their top management. Card issuing banks should have in place, a suitable monitoring mechanism to randomly check the genuineness of merchant transactions.

Right to Impose Penalty

The Reserve Bank of India reserves the right to impose any penalty on a bank/NBFC under the provisions of the Banking Regulation Act, 1949 for violation of any of these guidelines.

23.2 HOME LOANS

23.2.1 Introduction

Banks accept deposits from the public and as in return, it pays interest to the depositors. After accepting deposits, the bank cannot keep the money idle. It has to deploy it in a profitable manner so that it can earn a profit. Loans and advances are the main source of deployment for the bankers.

Banks have formulated several loan schemes, so as to meet the needs of the different segments of the society. The popular loans schemes are Home Loans, Vehicle Loans, Consumer Loans, Loan to Pensioners, Loan against gold ornaments, Loan against NSC, LIP, Educational Loan, etc. The home loan is the predominant loan in the present context. Most of the banks are offering these loans at competitive terms. Home loans are available to resident Indians and NRIs for the purchase or construction of house or flats, repairs and renovation of house. Certain hanks are givine loans for purchase of house

23.2.2 The Procedure and Practices for Home Loans

Target Group: Normally, the target group is the salaried class, professionals, self-employed and business¬men. Banks fix the age criteria for availing the loan.

Purpose: The purpose of the loan is for the purchase or construction of house or flats, repairs and renovation of house, and in some banks, for purchase of house sites also.

Quantum of loan: The quantum of eligible loan is fixed based on the gross monthly income/net monthly income. For this, banks ask for a salary certificate for the salaried class or the Income tax return for others. Bank also ask for the statement of bank account for a prescribed period.

Age: Banks fix the lower and upper age for availing the loan taking in to consideration the remaining period of service, in the case of salaried class and the income earning capacity during the period of loan for others.

Repayment: Most of the banks are giving long repayment period, say 20-25 years. The repayment will be based on equated monthly instalments (EMI). In case of loan for purchase of a ready built house, it should be ensured that the remaining life of the building should be longer than the repayment period allowed, plus a cushion period, says ten years.

Normally banks allow a holiday period for repayment. The holiday period for construction will be more than it is, for the purchase of ready built house.

Security: Generally, the property purchased or constructed out of the bank loan is taken by way of mortgage. Sometimes, when the income of the spouse is taken for arriving at the quantum of loan, his/ her guarantee is also taken as personal security.

Margin: Banks stipulate that a certain percentage of the project cost, say fifteen per cent, is to be borne by the borrower from his own sources. When the loan is for repairs/renovation, banks stipulate a higher margin.

Rate of Interest: When compared to the rate of interest for other loans, the rate of interest for home loan is cheaper. Most of the banks offer a rate of interest below the 'Bench Mark Prime Lending Rate' (BPLR). Banks also offer a floating rate and a fixed rate option to the borrower. Under the floating rate, whenever there is a change in the BPLR or in 'Tenor Premium' (TP), the home loan interest rate also changes. However, in case of fixed rate, the rate of interest through out the period of loan will be constant. As the banks are running a risk of loss of interest in this case whenever there is upward revision of BPLR/TP, a small amount of additional rate is loaded over and above the floating rate. Some banks give an option to those who have opted for the fixed rate of interest optees, to switch in to a floating rate after a certain period, either with or without penalty. If the EMI is not paid on the due date, penal interest, normally at two per cent, will be charged.

23.2.3 Documents Required

At the time of applying for the loan, the banks ask for some necessary documents namely;

(a) Agreement of Sale/Sale deed

(b) No Encumbrance certificate NIL EC (for 13 years)

(c) Parent document for 30 years
(d) Approved building plan
(e) Patta (NOC from Housing Board, etc., wherever applicable)
(f) Valuation report from the Bank's approved engineer
(g) Bank statement for last 12 months

(h) Salary Certificate for self and spouse (if spouse income is also taken into account for arriving at the eligibility) and as proof of employment. (i) IT Returns for 3 years in case of professionals/businessmen/self-employed persons.

While processing the home loan application, the bank will take into consideration the opinion given by bank's panel advocate and the valuation report/project cost report of bank's panel engineer. Normally, banks levy a certain percentage of the loan amount, say one per cent, as a processing fee. After sanctioning of the loan, banks take the necessary loan document such as DPN, home loan agreement, etc., from the borrower and a guarantee agreement from the guarantor, if any. The building financed has to have an insurance policy against the risk of fire, earthquake, floods, etc. These days, banks are insisting on the insurance on the life of the borrower so as to cover the loan amount by paying a one time premium.

23.3 PERSONAL LOANS

23.3.1 Introduction

Generally, banks give a loan against some security, so that it can fall back on it in case of a default. However, sometimes loans are given against personal security without any tangible security. Examples are salary loan, loan to pensioners, loan to professionals, etc. Most of the banks give loans to the salaried class as the source of income is regular.

23.3.2 Procedure and Practices for Salary Loans

Target group: Permanent employees with a minimum service/experience of say three years, with a Govt./quasi Govt./boards/endowments/reputed companies/corporate industrial establishments, etc. The stipulation of minimum period of service may vary from bank to bank.

Purpose: For meeting of marriage/educational and medical expenses, to celebrate family functions and for other household expenses.

Eligible Amount: The eligible amount of a loan is calculated based on so many times of the gross/net salary. While arriving at the quantum of loan, the minimum take home pay say, forty per cent of the gross salary, will be stipulated after the proposed EMI. Some banks consider a greater amount of the loan, if the employer gives an undertaking to the bank to recover the EMI from the salary and remit it into the bank. In addition, when the salary credited with an account, maintained with the branch, banks normally consider a larger quantum of loan.

Security: Sometimes banks insist on the guarantee of another person, if there is no collateral security, or in case, the account is with the branch, a letter giving an undertaking from the borrower to debit his account for the EMI. When the employer of the borrower sponsors the loan, h is asked for an undertaking, to the bank to recover the EMI from the salary and remit into the bank.

Documents: Proof of employment and salary certificate are normally obtained. After sanction of the loan, banks take the necessary loan documents such as; DPN, salary loan agreement, etc., from the borrower and a guarantee agreement from the guarantor, if any.

23.3.3 Other Aspects

The rate of interest on this loan will be higher than other loans as there is no collateral security.

Some banks are taking post-dated cheques for the future EMI.

Banks allow 36-60 months as repayment period.

- Normally banks levy a certain percentage of the loan amount; say one per cent, as a processing fee.

216

23.4 CONSUMER LOANS

Another major category of loans considered by the banks is the consumer loan.

23.4.1 Procedure and Practices for Consumer Loans

Target group: Salaried class, pensioners, professionals, self-employed business persons and other individuals who have regular income.

Purpose: For purchase of consumer durables and white goods like TV, VCR, VCP, air conditioners, refrigerators, personal computers and accessories, etc.

Eligible amount: While arriving at the quantum of loan, the cost of the article to be purchased and the margin be brought by the borrower are taken into account. The minimum take home pay, say forty per cent of the gross salary, shall also be ensured after the proposed EMI.

Security: Hypothecation of the article purchased out of the bank loan.

Margin: Normally a margin of 10-20 per cent is stipulated.

Repayment: Banks allow a thirty six to sixty months repayment period.

Documents: The documents to be obtained are: salary certificate for three months for self and spouse (if spouse income is also taken into account for arriving at the eligibility) IT returns/Form 16 for two to three years in case of professionals, businessmen, Self-employed persons. Quotations of the articles selected from a reputed dealer. Statement of account/passbook, showing one year's transactions. Some banks are taking post-dated cheques for the future EMI.

After sanction of the loan, banks take necessary loan documents such as DPN, hypothecation agreement, etc., from the borrower and a guarantee agreement from the guarantor if any. Normally banks levy a certain percentage of the loan amount, say one per cent, as a processing fee.

23.5 LET US SUM UP

The retail lending in banks has, of late, grown by leaps and bounds. Of retail loans extended by banks, home loans and consumer loans form a major percentage. Apart from being a delivery channel of the banking services, credit cards issued by banks are also a good source of credit delivery. Due to advancement of technology and easy accessibility to credit they provide for card users, they have gained popularity and wide acceptance in the market today. It is, no doubt, a novel way of providing value added services to bank customers. If used prudently, they offer a bundle of benefits to card users. To prevent the customers from falling into a debt trap and consequent harassment from the recovery agents of the card issuers, Reserve Bank of India has come out with a well-documented policy guidelines called "Fair Practices Code" for banks. This apart, the customers' rights in relation to card operations are protected. The card issuing banks/NBFCs are responsible as the principal, for all acts of omission and commission of their collecting/recovery agents. Clear-cut grievance redressal machinery and procedures are also put in place by banks.

With the growth in employment and the per-capita income and savings, the demand for housing has gone up. A hassle-free approach to buying a house for a salaried employee is to take a home loan from banks or housing finance companies. The related procedures for raising a home loan and the practices the banks follow, while sanctioning such loans are explained in this unit. Following the home loans, the demand for consumer loans is increasing also corresponding to the increase in the living standards of the people. So is the case with personal loans and the demand for credit cards. The details of the personal and consumer loans are also provided in this Unit.

217

23.6 CHECK YOUR PROGRESS

1. One of the following statements is not true with respect to credit cards.

(a) The card issuing banks would not be responsible for fulfillment of KYC requirements, where
agents solicit business.

(b) While issuing cards, the terms and conditions for issue and usage of a credit card should be mentioned in clear and simple language
(c) Card issuers should quote annualized percentage rates (APR) on card products.
(d) The card issuing bank/NBFC should not unilaterally upgrade credit cards and enhance credit limits. Prior consent of the borrower should invariably be taken whenever there are any change(s) in terms and conditions.

2. If the guidelines of the RBI in the matter of credit are violated, it can levy penalty on the violating bank under
(a) Reserve Bank of India Act(b) Negotiable Instrument Act
(c) Indian Penal Code (d) Banking Regulation Act

3. When banks give home loans, the nature of charge created is
(a) Hypothecation (b) Mortgage
(c) Assignment (d) Pledge

23.7 ANSWERS TO CHECK YOUR PROGRESS'

1. (a), 2. (d), 3. (b).

23.8 KEYWORDS

Credit card, Home loans, Consumer loans, Processing fee, Fixed rate of interest, Floating rate of interest, Margin, Delivery Channel, Fair Practices Code, Merchant Establishment, KYC Norms, Card Issuing Bank, Annualised Percentage Rate, Processing Fee, Unsolicited Card, Do Not Call Registry (DNCR), Direct Selling Agent (DSA), Direct Marketing Agent (DMA), Grievance Redressal Machinery, CIBIL, EMI, BPLR, Tenor Premium, Patta, Post-dated Cheque, Fixed Rate of Interest, Floating Rate of Interest, Margin.

UNIT
24DOCUMENTATION

STRUCTURE

24.0 OBJECTIVES

After studying this unit, you will be able to know and appreciate the importance of documentation and the procedure for obtaining a proper and error free documentation.

24.1 INTRODUCTION

Documentation is one of the vital areas in the credit portfolio of a bank. The purpose of taking documents are to fix the terms and conditions between the bankers and the borrowers, to identify the borrowers, to identify the securities, to count the period of limitation, to resort to legal remedies in case of need and so on. There are certain enactments such as Indian Contract Act, Partnership Act, Companies Act, Indian Registration Act, Limitation Act, Indian Stamps Act, etc., which affect directly the bankers' loan documentation. While taking documents for a credit facility, the provisions of these enactments are to be kept in mind. Non-compliance of any of the provisions of any of these enactments may affect the validity of documents. For example, if a loan is given to a minor other than for his necessities, the documents executed may not be enforceable in a court of law, as a contract with a minor is void ab initio. This is as per the provisions of the Indian Contract Act.

24.2 DIFFERENT TYPES OF DOCUMENTS

The documents taken by a banker for a loan may be:

(a) Demand Promissory Notes (DPN) (b) Agreements

(c) Forms

Demand Promissory Notes: Where no specification for a fixed period for the repayment of loan is given, the bankers take the DPN. In DPN, the borrower makes a promise to the banker to repay the loan amount on demand with agreed rate of interest. The form of DPN should be in conformity with Section 4 of the Negotiable Instruments Act, 1881. The form of a DPN varies normally to suit the situation such as fixed rate of interest, floating rate of interest, single borrower, joint borrowers, joint and several borrowers, etc. DPN attracts a stamp duty as per Indian Stamp Act. The rate of stamp duty on DPN is uniform through out India. As per Section 35 of the Indian Stamp Act, if a DPN is unstamped or under-stamped, the defect cannot be rectified even by paying a penalty. Such a DPN cannot be admissible as evidence in a court of law. It must be ensured that the DPN is duly filled in and stamped before the borrower signs it.

Agreements: The form of an agreement should be in conformity with the Indian Contract Act. The terms and conditions are set out in the agreement. The amount of loan, rate of interest, rate of penal interest, percentage of margin, period of repayment, rights of the bankers, in case of default of loan, details of security/securities charged, are included in the agreement. The agreements attract a stamp duty as per Indian Stamp Act. The rate of stamp duty on agreements varies from State to State. The bankers use different forms of agreement such as pledge agreement, hypothecation agreement, term Loan agreement, clean loan agreement, Inter- se agreement, guarantee agreement, etc. The agreement duly filled in and stamped, is checked before the party signs it.

Forms: Forms are not in the nature of promise or agreement. These are obtained to specify clearly the intention of the borrower. For example, when a loan is granted against the security of a fixed deposit standing in joint names, one of the depositors gives an authorisation to the other to raise a loan on the deposit. Such an authorisation is taken in a form. Similarly, when a payment is to be made out of loan proceeds to a supplier of goods, a letter from the borrower authorising the bank to pay the proceeds by means of draft or bankers cheque, is taken by means of a form. Such forms are used as part of documentation to prove the intention of the borrowers.

24.3 DOCUMENTATION PROCEDURE

For a document to be error free and proper, the steps are to be followed are:

24.3.1 Selection of Correct Set of Documents

Documentation varies depending upon the nature of facility and type of person. The document prescribed for a cash credit facility may not be used for a term loan facility. Similarly, a document meant for an individual borrower can not be used for a company or partnership borrower. As the bankers have pre¬printed forms of documents, it should be ensured that the correct set of documents, which are relevant for the particular facility and borrower are used.

24.3.2 Stamping

The next aspect of documentation is stamping. A document shall be stamped in accordance with the Indian Stamp Act as amended by the concerned State Governments. Indian Stamp

Act contains provisions regarding time of stamping for instruments executed in India and out of India. A document executed in India shall be stamped before or at the time of execution. Section 12 of Indian Stamp Act provides for cancellation of adhesive stamp so that the same cannot be used again. Any instrument bearing an adhesive stamp which has not been cancelled, so that it cannot be used again, shall be deemed to be unstamped.

24.3.3 Filling

The next aspect of documentation procedure is filling. As bankers are generally using the preprinted formats of documents with blanks in appropriate places, it is necessary to fill these blanks as per the terms of sanction of the credit facility before execution. Once the document is executed it becomes a concluded contract and any subsequent filling by bank without the consent of the executant will invalidate it. The document is completed without any alteration, overwriting or cutting. The entire document shall be filled with same ink, in same handwriting by same person in single sitting. Otherwise, it may give rise to a suspicion that the document is filled, subsequent to the execution.

24.3.4 Execution

After filling, the next step in the documentation procedure is the execution or signing of the document. It should be ensured that the signature in the document tallies with the signature as appearing in the application for the loan and also with the specimen signature, in case the party maintains a deposit account with the bank. In case, of execution in the representative capacity of sole proprietor or partner or director or agent or trustee or executor, etc., the property should be clearly mentioned. Similarly, in case document is taken for a loan sanctioned to a minor borrower for his necessity, the signature of the guardian is to be obtained for self and as guardian of the minor borrower. Normally, bankers take the signature of the executant in all the pages of the documents, so that he (executant) may not argue in future, that the contents of the pages were not known to him. In case the document contains any alteration, overwriting or cutting, it must be authenticated with the full signature of the executant/s. The documents shall be executed in the presence of bank officials and the fact of execution of documents with the date and time of execution, the details of documents executed, the fact of having explaining the contents of the documents in the language known to the executant shall be recorded in a register with the signature of two bank officials so that in case of any dispute regarding execution of documents, this register may be produced as evidence before appropriate authority.

24.3.5 Legal Formalities

In some cases, after execution of the document, certain legal formalities are required to be undergone. For example, in case of advances to limited companies against its assets, the required forms are to be

presented to the Registrar of Companies with the thirty days from the date of execution. Similarly, in the case of creation of registered mortgages, the mortgage deed is presented for registration before the Registrar of Assurances within four months from the date of execution of the deed. If these formalities are not observed then the bank may have to loose priority over the security. The documents may not be admissible as evidence before the competent authority.

24.3.6 Keeping Documents Alive

The documents taken by banks for a credit facility do not have perpetual life. The provisions of Limitation Act apply to them. The limitation Act prescribes the period of limitation for different types of documents. For example, the period of limitation for a DPN is three years from the date of execution. If a loan is not repaid within the period of limitation, then the bank has to get fresh document/s for extending the period of limitation as per the provisions of limitation Act. As per Section 18 of the Act, when the borrower acknowledges the debt before the expiry of period of limitation, then the life of the document is extended by one more period from the date of such acknowledgement. As per section 19 of the Act, if the borrower or his duly authorised agent makes any part payment towards the loan before the expiry of period of limitation, then the period of limitation is extended by one more period from the date of such part payment.

According to Section 3 of Limitation Act, a suit cannot be filed for recovery on the strength of a time barred document. Even the provisions regarding condonation of delay in taking appropriate legal action as per section 5 of the Act, is not applicable for filing a suit for recovery of debt. Hence, if the documents are time barred, the bank's right of legal remedy for recovery is lost.

Renewal of Documents

At the time of renewal or variation within the limit the bank should obtain a fresh set of documents or continue the existing set of documents duly supported by supplemental/additional deeds if required. Cancellation of the existing set of documents would cause a discontinuity in the bank's charge on the security for the credit facility.

It is not mandatory to obtain fresh sets of documents for renewal of the credit facility. A formal letter to the borrower agreeing to continue the credit facility by the bank for a further period of say, one year, at his request would suffice. Acknowledgement of the debt and security incorporating particulars of the original security document duly signed by the borrower are obtained, at the time of renewal and attached to form part of the original set of documents.

Revival of Time Barred Debts

When time barred debts are to be revived, the recourse may be to subsection 3 of Section 25 of the Contract Act, 1872. This section provides that a promise made in writing and signed by the person to be charged therewith, or by his agent, generally or specially authorised in that behalf, to pay wholly or in part, a debt, of which the creditor might have enforced payment but for the law of limitation of suits, is not void for want of consideration.

A statement made by a witness in court, admitting a time barred debt, does not constitute a promise to pay within the meaning of Section 25(3), (Lalan Sanbayya vs Pattan, AIR 1963 AP 337). To bring the case within the meaning of Section 25(3), it is necessary to show that there was an express promise to pay, as a mere acknowledgement of liability, even if it implied a promise, would not be sufficient for this purpose (Ganesh vs Mallu Mai Girdar Das, AIR 1931 All).

The Calcutta High Court in a decision (Manoj Kumar Saha vs Nobadwip Chandra Poddar, AIR 1978 Cal. Ill) stated that a mortgage by deposit of title deeds, in lieu of a barred debt, is valid. Section 25(3) does not govern it because it is a payment of the debt in as much as the mortgage virtually discharged the debt by assigning to the mortgagee an interest corresponding in money value.

24.3.7 Safekeeping and Preservation of Documents

Nowadays banks give loan for a longer period say twenty years or even twenty-five years. Until such time the entire dues are recovered, the documents are to be preserved in good condition.

24.4 STAMPING OF DOCUMENTS

The Indian Stamp Act, 1899, contains provisions regarding instruments chargeable with duty, mode of using stamps, time of stamping instruments, etc.

As per Section 17 of the Act, all instruments chargeable with duty and executed by any person in India shall be stamped before or at the time of execution.

As per section 18 of the Act, every instrument, other than a bill of exchange and promissory note, which are chargeable with duty and executed out of India may be stamped within three months after it has been first received in India.

As per Section 19 of the Act, the first holder in India, of any bill of exchange payable otherwise than on demand or promissory note drawn or made out of India shall affix there to the proper stamp and cancel the same before he presents the same for acceptance or payment or endorses or transfers or otherwise negotiates the same in India.

Section 35 of the Act provides that any person shall not admit an instrument, not duly stamped in evidence for any purpose. However, instruments other than bill of exchange and promissory note can be admitted in evidence on payment of duty with which the same is chargeable together with a penalty of five rupees or ten times of the amount of proper stamp duty, whichever is higher.

24.5 SECURITISATION

Securitisation is the process of acquisition of large non-performing asset (NPA) loan or portfolio of loans such as housing, by Securitisation or Reconstruction Co. from a bank or financial institution on mutually agreed terms and conditions, i.e. the sale or transfer price, with or without recourses transfer/ sale, etc.

The SCRC transfers the acquired loans to a special purpose vehicle [SPV] set up by it, that manages the assets for the purpose of realisation or holds them as investments till maturity. The SPV issues the consideration of transfer price to the originator bank in the form of cash or debentures/bonds as mutually agreed. This process provides banks and financial institutions a summary procedure for recovery of their secured dues which have been classified as NPA in their books, by setting up of SCRC for taking over the defaulted loans. Till now banks/financial institutions had to enforce their security through court. This was a very slow and a time consuming process. There was also no provision in any of the present law in respect of hypothecation, though hypothecation is one of the major security interests taken by the bank/financial institution. Keeping in mind the above factors, among many others, the Securitisation and Reconstruction of Financial Assets [SRFA] and Enforcement of Security Interest Act [ESI] was enacted with effect from 21 June, 2002. The Act deals with three aspects:

1. Enforcement of Security Interest by secured creditor (Banks/Financial Institutions).
2. Transfer of non-performing assets to Securitisation Company or Reconstruction Company [SCRC], which will then dispose of those assets and realise the proceeds.
3. To provide a legal framework for securitisation of assets.

SCRC can either finance the acquisition from their own resources or raise resources from Qualified

mutually agreed terms and on assessment of risks involved. The guidelines for such acquisitions have been prescribed by Reserve Bank of India.

24.6 LET US SUM UP

Among the various purposes of taking documents, resorting to legal remedies, in case of necessity, is the prime one. The various steps namely, selection of correct set of documents, stamping at right point of time, filling in a proper manner, execution, observing the legal formalities, keeping the documents alive always and preserving the documents till the entire dues are recovered, discussed in this unit, will help a banker to make error-free documentation.

24.7 CHECK YOUR PROGRESS

1. As per the Stamp Act, a document executed in India shall be stamped

(a) only before execution (b) at any time, but before filing suit

(c) within 30 days after execution (d) before or at the time of execution

2. One of the following statements is not true

(a) The Court cannot condone delay in filing suit as per Section 5 of the Limitation Act

(b) If a demand promissory note is not stamped before or at the time of execution in India, the
defect can be cured by paying penalty

(c) When the borrower acknowledges the debt before the expiry of limitation period, the period
of limitation is extended by one more period.

(d) If the borrower makes part payment in to the loan account before the expiry of limitation period, the period of limitation is extended by one more period.

24.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), 2. (b).

24.9 KEYWORDS

Documentation, Demand Promissory Note, Agreement, Stamping.

DIFFERENT MODES OF CHARGING SECURITIES

STRUCTURE

25.0 OBJECTIVES

By reading this unit, the learner will be able to get an insight into the characteristics of the different types of charges created on 'securities'.

25.1 INTRODUCTION

Banks tend to safeguard their advances by taking different kinds of securities. The main purpose of taking a security is to fall back on it in case the loan is defaulted. Banks take movable properties, immovable properties or a debt as security for a loan. The method of creating charge over a property depends upon the nature of property and nature of charge. For example, when a bank gives a loan against the security of gold ornaments, it takes the possession of the ornaments whereas when it advances against the security of a vehicle or a house property, the bank does not take physical possession.

25.2 TYPES OF CHARGES

Banks charge over properties confines itself to one or more of the following six types of charges.

(a) Assignment (b) Lien (c) Set-off
(d) Hypothecation (e) Pledge (f) Mortgage

25.2.1 Assignment

It is a mode of providing security to a banker for an advance. It is transfer of a right, property or a debt. The transferor is called assignor and the transferee assignee.

Borrowers generally assign the actionable claims to the banker as security for an advance. In terms of Section 130 of the Transfer of Property Act, the transfer of an actionable claim can be effected only by the execution of an instrument in writing, signed by transferor or by his duly authorised agent. Section 3 of the Transfer of Property Act defines an actionable claim as a claim to any debt other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property or to any beneficial interest in movable property, not in the possession of the claimant, which the Civil Courts recognise as affording grounds of relief. All the rights and remedies of the transferor vest in the transferee. The

transferee of an actionable claim takes it, subject to all the liabilities and equities to which the transferor was subject on the date of the transfer.
In banking practice, a borrower may assign the book debt, money due from Government department, and life insurance policies as security for an advance.
As regards the mode of assignment, no particular form or words is necessary for effecting an assignment, if the intention is clear from the language used. An assignment can be absolute or by way of security.
An assignment may be a legal or equitable assignment. A legal assignment is the absolute transfer of an actionable claim, must be in writing and signed by the assignor. The assignor informs his debtor, also in writing, intimating the assignee's name and address. The assignee also serves a notice on the debtor and seeks his confirmation of balance assigned. If the formality is not fulfilled, the assignment is called an equitable assignment.
Under the provisions of the Insurance Act, a life insurance policy is assignable by an endorsement on the back of the policy or by a separate deed of assignment, but notice of such assignment must be given to the insurer by the assignee or assignor.
25.2.2 Lien
Lien is the right of the banker to retain possession of the goods and securities owned by the debtor until the debt due from the latter is paid. The banker's lien is an implied pledge. A banker acquires the right

to sell the goods which came into its possession in the ordinary course of banking business, in case the debt is not paid. Section 171 of the Indian Contract Act, 1872 gives to the banker an absolute right of general lien on all goods and securities received by the banker. However, when a customer inadvertently leaves a packet containing certain share certificates, life insurance policies, fixed deposit receipts of other banks, etc., while leaving the bank premises, the banker will have no right of lien over those securities because those were not given to the banker in the normal course of banking business.
25.2.3 Set-off
Set-off means total or partial merging of a claim of one person against another in a counter claim by the latter against the former. It is in effect, the combining of accounts of the debtor and creditor, to arrive at the net balance payable to one or the other. The right of set-off is a statutory right and can also arise out of an agreement between parties.
Salient Features of Set-off
(a) Both debts must be for certain sums. A debt-accruing due cannot be set-off against the debt already due.
(b) The banker cannot set-off the credit balance in the account of guarantor till the liability of the
guarantor is determined.
(c) The credit balance in the current account cannot be set-off against a contingent liability of a bill
discounted but not yet due.
(d) A banker cannot set-off a debt due to him upon a loan account repayable on demand or at a specified date against a credit balance in the current account until the demand is made or due date arrives.
(e) The parties must be mutually indebted in the same right.
(f) The credit balance in the partner's account can be set-off against the debit balance of a partnership account since the liability of the partners is joint and several.
(g) Right of set-off is exercisable between two firms, which have separate names but are composed of
same set-of partners.
(h) The credit balance in the personal account of a sole proprietor can be set-off against the debit balance of the sole proprietary concern and vice versa, (i) When the right set-off is

available to the bank, lien right cannot apply. These two different rights cannot be exercised simultaneously at the same time.

Automatic right of set-off arises in the following circumstances:

(a) On the death, insanity or insolvency of the customer

(b) On the insolvency of a partner of a firm or winding up of a company

(c) On receipt of a garnishee order

(d) On receipt of notice of assignment of a customer's credit balance.

25.2.4 Hypothecation

The term 'Hypothecation' means a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor, without delivery of possession of the movable property to such creditor, as a security for financial assistance and includes floating charge and crystallisation of such charge in to fixed charge on movable property.

The mortgage of movable property is called 'Hypothecation'. It may be described as 'a transaction whereby money is borrowed by the debtor (owner of the goods) on the security of the moveable property without transferring either the property or the possession to the creditor'. Hart describes hypothecation as 'a charge against property for an amount of debt where neither ownership nor possession is passed to the creditor'. Hypothecation differs from pledge because goods remain in the possession of the borrower

and are equitably charged in favour of the creditor under documents signed by the borrower. However, the document provides for a covenant, whereby the borrower agrees to give possession of the goods when called upon to do so by the creditor. Once the possession is given up, the charge becomes transformed into pledge.

Hypothecation differs from mortgage in two respects. Firstly, mortgage relates to immoveable property whereas hypothecation relates to movables. Secondly, in a mortgage, there is transfer of interest in the property to the creditor but in hypothecation there is only obligation to repay money and no transfer of interest.

25.2.5 Pledge

'Pledge means bailment of goods for purpose of providing security for payment of debt or performance of promise' (as per the section Section 172 of Contract Act, 1872).

The person, whose goods are bailed is called the Pawnor, the person who takes the goods as security is called the Pawnee.

The following are the legal implications of a pledge:

(a) The ownership of the property is retained by the pawnor, which is subject only to the qualified interest which passes to the pawnee by the bailment.

(b) One of the main and most essential requirements of a pledge is the actual or constructive delivery of the goods tu the pawnee. By constructive delivery, it is meant that there need be no physical transfer of goods from the custody of the pledger/pawnor to the pawnee. AH that is required is that the goods must be placed in the possession of the pawnee or of any person authorised to hold them on his behalf.

Goods may be delivered by one of the following ways (as mentioned in the Sale of Goods Act):

(i) By handing over the key of the godown, in which the goods are kept,

(ii) By attornment, i.e. if goods are in public warehouse, the warehouseman acknowledges to the pawnee that he will hold the goods thereafter on behalf of the pawnee,

(iii) Handing over the document of title to goods, such as railway receipt, bill of lading, warehouse receipts, etc.

(iv) Even if goods are in possession of the pawnor, he may acknowledge that he holds them thereafter for and on behalf of the pawnee..

(v) An agreement of pledge may be implied from the nature of the transaction or the circumstances of the case. However, an agreement in writing clearly laying down the terms and conditions leaves no ambiguity.

25.2.6 Mortgage

Mortgage is a transfer of interest in immoveable property to secure an advanced loan, or an existing debt or a future debt or performance of an obligation. Transfer of Property Act contemplates six types of mortgages, they are:

(a) Simple mortgage (b) Mortgage by conditional sale

(c) Usufructuary mortgage (d) English mortgage

(e) Mortgage by deposit of title deeds (f) Anomalous mortgage

In simple mortgage, the mortgage is by deposit of title deeds and in English mortgage, the possession of the mortgaged properties is not given to the mortgagee.

In usufructuary mortgage and in mortgage by conditional sale, possession of mortgaged properties is normally given to the mortgagee.

In the case of simple mortgage and mortgage by deposit of title deeds, the mortgagee has a right to proceed against the property mortgaged and also personally against the mortgagor.

Mortgage is to be created by way of deed and requires to be registered under the Registration Act.

Mortgage by deposit of title deeds, is not required to be created by way of a deed and does not require registration.

The rule of priority in case of successive mortgages is in the order of time they are created.

Limitation period for filing a suit for sale of mortgaged property is twelve years from the date mortgage debt becomes due.

Limitation period for filing a suit for foreclosure is thirty years from the date mortgage debt becomes due.

Enforcement of mortgage is governed by the Code of Civil Procedure, 1908. Suit for sale of mortgaged properties should be filed in the Court, within whose jurisdiction the mortgage property is situated.

In a suit for sale of mortgaged properties, the Court first passes a preliminary decree and thereafter a final decree.

25.3 LET US SUM UP

The charge of pledge and hypothecation applies with respect to movable properties. In the case of pledge, the possession of the property is transferred and it is not so in the case of hypothecation. In both cases, the ownership does not change. The Indian Contract Act specifies the rights of the pledger and pledgee. Among the various mortgages, normally, the mortgage by deposit of title deeds and simple mortgage are usually taken by banks. Resort to a charge of assignment is done in case of an advance against LIPs. Lien is the right of retention whereas set-off is the right of combining two mutually due accounts and arriving at the net balance due.

25.4 CHECK YOUR PROGRESS

1. One of the following statements is not true in the right of set-off.

(a) Set-off means partial or total merging of a claim of one person against another in a counter claim of the latter against the former.

(b) Both debts must be for certain sum.

(c) A debt accruing due cannot be set-off.

(d) A banker can set-off the credit balance in the guarantor's account before the liability of the guarantor to the bank is determined.

2. State true or false:

(a) In the case of assignment of LIP as a security to an advance, the assignment is not complete unless a notice of assignment is given to the Insurance Company.

(b) The above notice of assignment may be given either by the assignor or by the assignee.

(c) The banker's lien is an implied pledge.

(d) When a customer inadvertently leaves a packet containing certain share certificates while leaving the bank premises, the banker can take these securities under lien against certain liability incurred by the customer to the bank.

(e) Right of lien and right of set-off can be exercised simultaneously at the same time.
(f) There is less risk for a bank when hypothecation facility is granted to a Company, because of the registration of the bank's charge with the ROC.

(g) One of the essential requirements of a pledge is the actual or constructive delivery of the goods pledged by the pawner to the pawnee, (h) Limitation period for filing a suit for sale of mortgaged property is thirty years from the date mortgage debt becomes due.

25.5 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d); 2. (a) T, (b) T, (c) T, (d) F, (e) F, (f) T, (g) T, (h) F.

25.6 KEYWORDS

Assignment, Set-off, Lien, Implied Pledge, Auctionable Claim, Legal Assignment, Equitable Assignment, Attornment, Constructive Delivery, Usufructuary Mortgage, Simple Mortgage.

UNIT
26TYPES OF COLLATERALS AND THEIR CHARACTERISTICS

STRUCTURE

26.0 OBJECTIVES

By reading this unit, the learner will be able to know the different types of securities taken by bankers, while advancing and the characteristics of these securities.

26.1 INTRODUCTION

Banks are financial intermediaries where the resources of the public are mobilised and lent to various sectors of the economy. The money mobilised from the public by way of deposit is repayable as and when demanded by the depositors. Therefore, bankers take utmost care to see that the money lent to various types of borrowers is repaid as per the repayment schedule along with interest. In order to safeguard the advance, bankers normally take securities, on which they fall back in case the borrowers commit default.

In the banking practice, the securities offered by the borrowers are of different types. They may be immovable security, movable security, debts, etc. The land and buildings, machineries embedded to earth, etc., come under the category of immovable, whereas goods, vehicles, furniture, machineries, gold ornaments, etc., come under the category of movable securities. Accounts receivable, known as book debts, get classified as intangible securities. Whatever may be the nature of the securities, the banker, while taking them, has to ensure that

- they are saleable, whenever the need arises, as in the case of default by borrowers.
- the value of the securities is ascertainable at any time from reliable sources, to fix the drawing limit, saleable value, etc.
- the value is not subject to heavy fluctuation; otherwise banks have to fix a higher percentage of margin.
- they are easily transferable without, as far as possible, going through legal formalities.

Classification of security may also be as personal and tangible as well as primary and collateral. Personal security means personal liability. The banker has a right of action against the borrower, e.g. guarantee. Tangible security is something that can be realised by a sale or transfer, e.g. land, goods, stock.

Classification of security is also as a primary security and collateral security. Primary security is one that is regarded as the main cover for an advance; generally, assets against which advance is made. For example, stock for cash credits, machinery for term loans. Collateral security is security other than the primary security lodged by the borrower or by a third party. Let us see about types of collaterals and their characteristics.

26.2 LAND AND BUILDINGS

This type of security is not self-liquidating nature. In the event of the bank wanting to sell the property for recovering its advance, it can do so through the legal process. Normally, banks have to file a suit before the civil court for recovery, if the amount due in the loan account is less than Rs. ten lakh and, before the Debt Recovery Tribunal (DRT), if the amount due is Rs. ten lakh and above. However, under the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, banks can sell the immovable property taken, by way of mortgage, without intervention of the court after observing the formalities mentioned in the Act. Because of this right of sale without the court intervention, this type of security has gained importance now and viewed with favour by banks. The nature of charge created on this type of security is mortgage.

Mortgage of immovable property is either primary or collateral security. If any advance is granted

against the primary security of immovable property, the purpose for which such advance is sanctioned is to be made very clear. If it is sanctioned for working capital purposes, the follow-up review/renewal proposal as applicable to working capital/cash credit facilities should be followed. In other cases, if any overdraft against title deeds is sanctioned, it is desirable to fix a realistic repayment programme as in the case of term loans.

26.2.1 Examining the Title to the Property

Before any immovable property is accepted as security, the title to the borrower over the said property should be examined by the bank's lawyer, to ascertain that the person in whose name the property stands has a good, valid, subsisting and marketable title over the property, that the property is free from all encumbrances and is not subject to any litigation or attachment from any Court or Statutory authorities.

26.2.2 Documents to be Called for from the Mortgagor

(a) All material documents of title, like the sale deed/gift deed/will/partition deed conveying the title in his favour.

(b) Parent documents for the prescribed period to ascertain the flow of title. Some banks call for parent documents for thirty years.

(c) Encumbrance certificate, normally for thirteen years to see, if any encumbrance subsists on the property. It is advisable to apply for an encumbrance certificate for the property through the bank's advocate so as to avoid manipulation.

(d) Tax receipts for the property to evidence the possession of the property by the proposed mortgagor.

(e) If the property offered is standing in the name of a minor, permission of the competent court to encumber the property.

(f) Search report, if the immovable property belongs to a joint stock company, in order to ascertain any charge is subsisting on the property.

(g) Normally, banks take an opinion from their panel advocate regarding the clear, good and marketable title of the proposed mortgagor over the property. The advocate should see that the documents produced are genuine and not fake. The advocate's opinion should be clear and unconditional and should certify that a valid mortgage can be created by the proposed mortgagor over the property.

26.2.3 Valuation of Property

Where an advance is desired against the security of an immovable property, it is necessary to get it valued by an approved engineer of the bank before the grant of the advance. Valuation must be conservative, realistic and should be on a forced sale basis.

In fixing the valuation, the points for consideration are:

(a) The nature of construction
(b) Nature of title, free-hold or lease-hold
(c) Age of the building and its present strength
(d) The rent yield
(e) Taxes paid
(f) Area of the land and building
(g) Value of the site
(h) Cost of construction
(i) Its location

26.2.4 Leasehold Properties

If the land is a leasehold, it is necessary to ascertain whether the terms of the lease permit the borrower to assign or transfer by way of mortgage, the leasehold rights in the land. It must be ensured that the repayment of loan by the borrower does not extend beyond the period of lease.

It is advisable to apply for an encumbrance certificate for the property through the bank's advocate. The bank must inspect the property offered as security, to ensure existence and must also make an inquiry through independent sources to satisfy the ownership of the property.

235

26.3 GOODS

Banks advance loans routinely against the security of goods such as agricultural goods, raw material, semi finished goods, finished goods. An advance against goods may be extended by way of; loan, key cash credit or open cash credit. The nature of the charge created may be either a pledge or hypothecation. When the possession of the goods is transferred to the banker, as in the case of key cash credit, the nature of charge created is a pledge. When the possession of goods is not transferred, as in the case of open cash credit, the nature of charge created is hypothecation. In either case of pledge and hypothecation, the title in the goods is not transferred to the bank.

An advance granted against goods is known as trade finance. Such advances are of short-term nature and are granted for meeting the working capital requirement of the borrower.

While considering an advance against goods, the banker should see that the goods offered as security are not perishable, are readily saleable, are not obsolete, possess a price which is easily ascertainable and are capable of easy handling and transport.

26.3.1 Precautions for Advance against Goods

The borrower should be dealing in the goods for a sufficient period

(a) No advance should be made for speculation or hoarding purpose
(b) The goods charged to the bank should have been fully paid
(c) The goods should command good demand in the market
(d) The age of the stock should be taken into consideration
(e) The ownership of the goods shall be ensured by verifying with the original paid invoices
(f) Stipulated margin should be maintained at all times
(h) Borrower should be asked to arrange the goods in the godown in such a way that stocks of different kinds are kept separately. (i) The goods should have adequate insurance against risks such as fire, strike riot etc.

26.3.2 Storing of Goods

The stocks should be arranged in an order, in distinctive lots such that verification of stocks is easy and samples of stocks from different lots, if required, can be taken. Hazardous goods should be removed from non hazardous goods and kept separately. Goods should be stored in such godowns that are of good construction so that they can be protected from the vagaries of weather or monsoon. It also be ensured that the godowns are good from the safety point of view.

26.3.3 Inspection of Stocks

All the stocks charged to the bank under a pledge/hypothecation are subject to inspection, without any exception. Verification of the stock is required at regular intervals, say once in a month. An element of surprise in the inspection is also desireable. Borrower's vehicle should not be normally used for the purpose of inspection, as it would enable them to set things right before the inspection. In case goods are stored in bags, the inspecting official of the bank should count the number of bags and if necessary weigh a few of them at random. A few of the bags selected at random may be ordered to be opened to ensure that the goods stated to have been stored are actually held in bags. Verify borrowers' records, if any, such as purchase register, sales register, stock register, sales tax records, excise records.

26.3.4 Stock Audit

Stock audit is an effective credit monitoring tool, which offers an opportunity for making a qualitative assessment of the advance. Stock audits also contribute to an improvement in the borrower's management of inventories and receivables. This

initiation of suitable and timely remedial measures. The stock audit of borrowal accounts enjoying fund based and non fund based working capital facilities above a cut-off limit, say Rs. 1 crore, at least once in a year should be conducted by the lending bankers.

For the advance against warehouse receipts, the goods covered by the warehouse receipt are inspected at periodic intervals. Following points are noted with regard to the stocks in a warehouse. Receipts are issued by an approved warehousing agency in the prescribed form. The borrower should endorse the warehouse receipt against which advance is made. Goods covered by the warehouse receipt should not be deteriorating in nature. Inspecting bank official should ensure that warehouse goods (nature, quality, grade, etc.) are the same as stated in the warehouse receipt. It should be ensured that stocks held by the warehouse authority are favoured for the full cost price or market price. Particulars of the insurance policy obtained and recorded from the warehouse authority in the bank's books.

26.3.5 Valuation

Normally, valuation of the stock is done on the basis of cost price or market price whichever is less.

26.3.6 Margin of Stock

Maintaining an adequate margin on the stock as stipulated in the sanction. Drawing power is calculated after deducting the margin to be maintained. Where a part of the stock is unpaid, such portion of the equalling the value of the unpaid stock is removed from the total value and the stipulated margin is maintained thereafter.

26.3.7 Recovery in Case of Default

Generally, the agreement of hypothecation executed by the borrower at the time of grant of the advance contains a clause empowering the bank to take possession of the hypothecated goods and sell it privately or in a public auction and to appropriate the sale proceeds towards the loan account. Whether the banker can exercise this right without the intervention of the Court is a matter on which different Courts have given different verdicts. However, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, gave a right to the hypothecatee bank to take possession of the goods hypothecated and to sell it without Court's intervention after observing certain formalities.

In the case of pledged goods, Section 176 of the Indian Contract Act gives a right to the pledgee (bank) to sell the things pledged after giving a reasonable notice to the pledgor.

26.4 DOCUMENTS OF TITLE TO GOODS

Section 2(4) of Sale of Goods Act defines a document of title to goods as "a document used in the ordinary course of business as a proof of possession or control of goods authorising or purporting to authorise either by endorsement or delivery, the possessor of the documents to transfer or to receive the goods thereby represented".

26.4.1 The Essential Requisites of a Document of Title to Goods

The mere possession of documents creates a right by virtue of either law or trade or usage, to possess the goods represented by the documents.

Goods represented by the documents are transferrable by endorsement and/or delivery of the documents. The transferee of the document can take delivery of the goods in his own right. Although it appears to be a negotiable instrument, they are not negotiable instruments, since the bonafide transferee for value can be affected by defects in the title of transferor. They may be called quasi negotiable instruments.

237

Examples of documents of title to goods are bill of lading, dock warrant, warehouse-keepers certificate, railway receipts, delivery orders, etc.

26.4.2 Merits of this Security

By mere pledge of the instruments, goods are pledged and serve as a good security. The person in possession of the document can transfer the goods by endorsement and delivery. The transferee thereafter is entitled to take delivery of goods in his own rights. The documents are easily transferable and the formalities involved are minimum.

26.4.3 Demerits of this Security

Possibility for Fraud and Dishonesty

Since the bill of lading/railway receipt or a warehouse-keepers certificate, does not certify or guarantee the correctness of the contents of the bags or packages, the banker will have no remedy against the carrier or warehouse keeper, if they turn out to be worthless.

Forged and Altered Documents

The documents might be forged ones, or even if genuine, the quantity may be altered.

Not negotiable documents: The documents being 'Not negotiable' the transferee of such documents will not get a better title than that of transferor. Therefore, if a person who pledged the documents has a defective title, the banker will not acquire a better title.

Unpaid Vendors right of stoppage in transit: Under the Sale of Goods Act, an unpaid vendor has the right of stoppage in transit and he is entitled to direct the carrier that the goods not be delivered, if not already done. If the unpaid vendor exercises this right, banker cannot obtain the goods and his security is of no value.

In case of lost documents, delivery of goods is allowed in the execution of an indemnity bond, which can be misused by the borrower. To avoid such a contingency, the banker can give notice to the carrier regarding his interest in the goods.

26.4.4 Precautions to be taken by the Banker

The documents must be examined thoroughly to ensure that they are genuine and of recent origin. In the case of bills of lading, they are prepared in triplicate and as such all the copies must be obtained by the banker. The banker should ensure that the documents do not contain any onerous clause or prejudicial remark about the conditions of goods received. Banker should ensure that the goods are adequately covered by insurance for their full value against the risk of theft, fire, damage in transit, etc., and in the case of goods shipped by sea, all the marine risks should be covered.

26.4.5 Trust Receipts

Whenever the bank releases documents of title of goods to the borrower without a payment, then a letter of trust should be taken. So also in the case of goods hypothecated to the bank. The reasons are that:

(a) the borrower, on sale of the goods has to hold proceeds in trust for the banker

(b) the goods taken under such trust receipts or the sale proceeds thereof are not available to the

Official Receiver in case the borrower becomes insolvent.

A trust letter incorporates the following clauses:

(a) borrower's recognition of bank's rights in the goods as a security and in case of sale, the proceeds thereof

238

(b) borrower's undertaking to hold the goods or the sale proceeds thereof in trust for the banker

(c) borrower's undertaking to ensure proper storage and insurance at his cost
(d) borrower's undertaking to direct the buyer to pay the monies directly to the banker, if so required by the banker
(e) borrower's undertaking to return unsold goods on banker's request or dispose of the same as directed by the banker.

26.5 ADVANCES AGAINST LIFE INSURANCE POLICIES

Life insurance policies are acceptable either as a primary or collateral security for an advance.

26.5.1 Points to be taken in to Consideration

Before making an advance, the points to be taken in to consideration are:

- The policy must be in force and the premium paid up to date. The latest premium receipt must be kept on record by the bank.
- The policy should be an original, duly stamped and signed by the issuing authority.
- The policy should be free from restrictive/onerous clauses.
- The insurance company should have admitted to the age of the assured.

Generally, the following life policies are not acceptable as security
(a) Children endowment policy.
(b) Policies taken out specifically for purposes like estate duty.
(c) Children deferred policy.
(d) Policies with nominations under Section 6 of the Married Women's Property Act.
Banks lend against the life policies based on surrender value. Surrender value is the amount, which the insurance company will pay if the policy is surrendered.

26.5.2 Assignment of the Policy

The assignment on the policy or on a separate stamped paper should be obtained and it should be witnessed by a person. Nominee under the policy need not join in assigning the policy as nomination under the policy is automatically cancelled in the event of assignment of the policy. The assignment shall not be operative as against the insurance company until the notice in writing of assignment is given to the insurance company.

In case of death of the assured, the assignee becomes entitled to receive the policy amount. When the advance is repaid, the policy has to be reassigned in favour of the policyholder.

26.6 ADVANCE AGAINST SHARES

Advances against shares should be for productive purposes and not for speculative purposes. Banks provide either a demand loan or an overdraft against the security of the shares. The nature of charge created while making advances against shares is pledge. Now banks insist, the shares to be in demat form while advancing. Advance are granted against fully paid shares only. The shares should be quoted in a recognized stock exchange. No loan can be given against the shares of a private limited company.

26.6.1 Statutory Limit on shareholding in companies.

In terms of section 19(2) of the Banking Regulation act, 1949, no banking company shall hold shares in any company, whether as pledge, mortgagee, or absolute owner, of an amount exceeding thirty per cent of the paid up share capital of that company or thirty percent of its own paid up share capital and reserves, whichever is less. Shares held in the demat form should also be included for the purpose of determining the exposure limit.

26.6.2 Regulatory Limits of the Banks' Exposure to Capital Market

The RBI guidelines on banks' financing against shares, debenture, etc., are given below: Banks' aggregate exposure to the capital market covering direct investment, in equity shares, convertible bonds and debentures, units of equity oriented mutual funds, all exposures to 'Venture Capital Funds' (VCFs) [both registered and unregistered], advances, against shares to individuals for investment in equity shares (including IPOs/ESOPs), bonds and debentures, units of equity oriented mutual funds, etc., secured and unsecured advances to stockbrokers, guarantees issued on the behalf of stockbrokers and market makers, should not exceed five per cent of their total outstanding advances (including Commercial Paper) as on 31 March, of the previous year. This ceiling of five per cent prescribed for investments in shares would apply to a total exposure including both the fund based and non fund based exposure to capital market in all forms. Within this overall ceiling, the banks' investment in shares, convertible bonds and debentures, units of equity oriented mutual funds, all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed twenty per cent of their net worth. The banks are bound to this ceiling on an ongoing basis.

26.6.3 Advances against Shares to Individuals

Loans against the security of shares, debentures and PSU bonds to individuals should not exceed the limit of Rs. 10 lakh per individual borrower, if the securities are held in physical form and Rs. 20 lakh per individual borrower, if the securities are held in a demat form. The banks can grant advances to employees for purchasing shares of their own companies under the 'Employees Stock Option Plan' (ESOP) to the extent of ninety per cent of the purchase price of shares or Rs. 20 lakh, whichever is lower. Further, banks can extend loans up to Rs.10 lakh to individuals for subscribing to IPOs. Finance extended by a bank for IPOs/ESOPs will be reckoned as an exposure to capital market.

Banks should formulate, with the approval of their boards, the lending policy for grant of advances to individuals against shares, debentures, bonds keeping in view the RBI guidelines. As a prudential measure, the banks may also consider laying down appropriate aggregate sublimits for such advances.

26.6.4 Advances against Shares to Stockbrokers and Market Makers

Banks are free to provide credit facilities to stockbrokers and market makers on the basis of their commercial judgment, within the policy framework approved by their boards. However, in order to avoid any nexus emerging between interconnected stock broking entities and banks, the board of each bank should fix, within the overall ceiling of five per cent of their total outstanding advances (including Commercial Paper) as on 31 March of the previous year, a subceiling for total advances to:

- all the stockbrokers and market makers (both fund based and non fund based, i.e. guarantees)
- to any single stock broking entity, including its associates/inter-connected companies

26.6.5 Margins on Advances against SharesAssue of Guarantees

A uniform margin of fifty per cent shall be applicable on all advances/financing of IPOs/issue of guarantees. A minimum cash margin of twenty five per cent (within the margin of fifty per cent) shall be maintained in respect of guarantees issued by banks for capital market operations.

26.6.6 Bank Finance to Employees to Buy Shares of their Own Companies

Banks may provide finance to assist employees to buy shares of their own companies under ESOPs to the extent of ninety per cent of the purchase price of the shares or Rs. 20 lakh, whichever is lower. However, all such financing should be treated as part of the bank’s exposure to capital market within the overall ceiling of five percent of bank's total outstanding advances, as on 31 March , of the previous year. These instructions , however will not be applicable to the banks' exceeding financial assistance to their own employees for acquisition of shares under ESOPs/ IPOs. Banks, therefore should not extend advances, including advances to their employees/ employee trust set up by them , for the purpose of purchasing their (bank's) own shares under ESOP/ IPO or from secondary market. This prohibitions will apply irrespective of whether the advances are unsecured or secured.

26.7 LOAN AGAINST BOOK DEBTS

Book debts are claims arising out of credit sale. Credit sales can be effected in two ways:

1. by drawing bills
2. by debiting the purchaser's account.

The total of the bills outstanding is called 'Bills Receivable' and the total of debit balance in the purchaser's account is called 'Account Receivable'. These account receivables are called book debts. This represents the amount receivable from others on account of trade transactions.

26.7.1 Risks in Lending upon account Receivables

(a) The account may be fictitious, old or disputed.
(b) The integrity of the borrower may not warrant the risk
(c) the proceeds may not be turned over to the bank for the credit of the borrower's account.
(d) To give notice of assignment to every debtor may pose practical difficulty.

26.7.2 Factors to be considered while advancing against Book debts

the integrity of the borrower should be par excellence. Hence, a thorough investigation of the borrower should be done and only if the credit worthiness of the borrower is found satisfactory, an advance of this nature should be considered.

The credi worthiness and standing of the purchaser of the borrower's produce should be ascertained.

Banker should take care to see that accounts receivable against which finance is to be given do not pertain to one buyer only.

26.7.3 Method of charging the Security

Book debts are charged by way of assignment or hypothecation.. While assignment is transfer of the right to the bank to recover the debt, the hypothecation creates an equitable charge or interest on the book debt.

26.7.4 Modes of financing Book Debts

Book debts can be financed by:

(a) Factoring
(b) forfeiting (outright purchase of book debts)
(c) Overdraft, cash credit against hypothecation of book debts

26.7.5 Guidelines

This facility should be restricted to first class borrowers whose integrity and credit worthiness are beyond question. It should be ensured that the borrower keeps his account in a proper manner and the same are audited regularly.Book debts offered as security should be of those customers whose record of accomplishment, reputation and status are satisfactory. The borrower should have an effective debt

collection and control mechanism. Age of the book debts should not be more than six months. Some banks do not consider book debts of more than three months. Normally, a margin of 50 per cent is maintained.

26.7.6 Verification of Book Debts

Sales invoices and debtors ledgers are to be verified, to ascertain the overdue receivable position, over due debtors, reasons for long outstanding, if any, possibility of recovery. Verification of the list of buyers to ascertain whether a major share of the sales is to a single buyer. If so, the market opinion on them is to be obtained. If sales are to sister concerns, the sales invoice and the modalities of transactions effected, verification of realization of such receivables becomes a necessisity. It is to be ensured that all the book debts have arisen out of genuine trade transactions and do not comprise lending transactions of the following nature:

- Transactions with sister concerns - not related with business activity.
- Advance payments, which are not likely to be realised within the period of working capital cycle.
- Advance payment for capital expenditure.
- Any other advance payments disguised as debtor arising out of sale transaction.

26.7.7 Other Aspects

Confirmation obtained from debtors for outstanding dues whenever debt arises. Ensuring that the age of the book debts declared is as specified in the terms of sanction. It is to be ensured that the bills discounted are not declared, simply for purposes of arriving at 'Drawing Power'. Verification that bills returned and resubmitted are not financed again.

26.8 LOAN AGAINST TERM DEPOSITS

26.8.1 Nature of Facility

Banks often lend against their term deposits, such as fixed deposits, cumulative deposits, recurring deposits, etc. The nature of a facility granted against the security of term deposits may either be a loan or an overdraft. The nature of charge created while granting this type of loan is a pledge.

26.8.2 Margin and Rate of Interest

Normally, banks lend up to ninety per cent of the deposit amount/accrued value of the deposit. The rate of interest charged on the loan would be one per cent or two per cent above the interest rate offered on the deposit.

The borrower can repay the loan out of his sources on any date before the maturity. If not paid in full before the maturity of the deposits, only the surplus if any will be paid to the party. If there is any shortfall in the maturity proceeds of deposit, the party has to pay the same to the bank.

26.8.3 Deposits in the Name of Minor

Normally, no loan can be granted against the security of deposit receipt standing in the name of a minor. However, if the loan is sought by the guardian for the necessities of the minor depositor, the bank may consider it on getting from the guardian an undertaking letter to the effect that the proceeds of loan would be utilized only for the necessities of the minor depositor.

26.8.4 Other Aspects

While granting the facility, banks get the deposit receipt duly discharged by the deposit holder. In case of more than one deposit holder, all of them should discharge the deposit receipt. The depositor should execute necessarv loan documents. In case of more than one depositor, all of them should execute the

documents or one of them on the strength of authorisation letter given by the depositors who is/are not executing the loan documents.

Loan given to a sole proprietor against deposits in the name of the proprietary concern should not be treated as a third-party loan, whereas loan granted to a partner against the deposits in the name of the firm should be classified as third-party loan and interest shall be charged at the commercial rate.

In case of premature closure of deposits, the interest should be 1 -2 per cent over the actual rate of interest applicable for the prematurely closed deposit.

Loan can be granted against deposits receipt of other branches of the same bank. However, before grant of loan, lien should be noted in the records of the deposit branch.

Where a loan sought by a company against its deposits, a board resolution authorising the company to raise the loan should be obtained. The charge of pledge need not be registered with the ROC.

No loan can be considered against a deposit held under the 'Capital Gain Scheme'.

26.9 LOAN AGAINST GOLD ORNAMENTS

Banks give loans against gold ornaments for agricultural as well as for non-agricultural purposes. The nature of charge created while giving this type of loan is a pledge. Some banks allow a overdraft also against the security of gold ornaments.

26.9.1 Important Aspects

(a) The amount of loan on ornaments depends upon the market value and purity of the gold. Normally, banks keep a margin of around thirty per cent on the market value of the ornaments.

(b) The rate of interest varies with the purpose of the loan. A loan cannot be given against the security of pure gold.

(c) The repayment period depends upon the purpose of the loan. If the loan is for agricultural purpose, the repayment period normally coincides with the harvest and marketing of the produce.

(d) On closure of the loan, the ornaments should be returned to the pledgor or his authorized representative.

(e) Even after the closure of this loan, the banker can retain the possession of the ornaments, if any other overdue loan is there in the name of the borrower, by exercising the right of general lien.

(f) In case of a default in repayment of the loan, the bank as pledgee has the right to sell the ornaments pledged, in an auction or by private sale, only after giving to the pledgor a reasonable notice of intended sale as per Section 176 of the Indian Contract Act; otherwise the bank has to compensate
the borrower for the loss suffered. The expenses incurred by the bank in connection with notice of sale, including paper publication if any, shall be recovered from the party.

(g) Normally, banks appoint appraisers for the purpose of appraising the purity of the gold ornaments,

(h) The loan granted under this category is subject to NPA norms.

26.10 SUPPLY BILLS

A supply bill arises in relation to transactions with Government and Public Sector Undertakings. A party might have taken a contract for execution and he is entitled for progress payment-based on work done, for which he has to submit bills in accordance with the terms and conditions of the contract. Similarly, parties who have accepted tenders for supply of goods are entitled for payments on the supply of goods for which they submit bills in accordance with the terms of contract. These bills are known as 'Supply Bills'.

26.10.1 Procedure to be Followed in Respect of Supply Bills

- The supplier sends the goods and then produces documents like railway receipt or bill of lading as evidence of the dispatch of goods. These' goods must be inspected by an appropriate authority and the supplier should obtain an inspection note. In the case of contracts, obtaining an engineer's certificate regarding the work done is required.
- The supplier or the contractor, as the case may be, prepares the bill for obtaining payment. Government departments take quite sometime to verify the bills and pass them for payment. Therefore, the supplier or contractor submits these bills together with the inspection note or engineer's certificate to the appropriate Government department through the banker and requests the banker for a requsite advance against such bills. The railway receipt is sent direct to the department, but the number and other particulars of the railway receipt are entered in the supply bills.
- It must be noted that these bills do not enjoy the status of negotiable instruments. They are in the nature of debts, which can be assigned in favour of the banker for payment,

after affixing a revenue stamp for having received the amount. The banker should also obtain a letter from the supplier or contractor requesting the appropriate department to make the payment direct to the banker.

- 26.10.2 Risks Involved in Advancing against Supply Bills
- Although the advance is self-liquidating in nature, in certain cases it can take quite a long time before the advance is realised because of the administrative and other Governmental procedures. It is virtually a clean advance and the bank may not realise the full amount, because of the possibility of counter claim or the right of set-off by the Government Department, as the charge is only by way of an assignment. Sometimes the Government may not pass the bills for full amount because of the unsatisfactory quality of goods or defective work done by the contractor or delay in completion of the work.
- 26.10.3 Precautions to be taken by the Banker
- Advance against supply bills can be made only to borrowers who have sufficient experience in Government business and Government regulations.
- The contract between the supplier and Government Department should be scrutinised by the banker so as to know the volume of transaction, period of supply, rates agreed upon and other terms and conditions. The Government will not pass the bills unless there is faithful adherence to the terms and conditions by the supplier.
- The banker should obtain an irrevocable power of attorney form the supplier favouring the banker to receive the money. The same should be registered with the appropriate Government Department.
- The banker should obtain the inspection note or the engineer's certificate along with the bills. There should be no adverse remarks on the inspection report regarding the quality and quantity of the goods.
- There are two types of bills that are usually given by the suppliers. They are:
- Interim bills against which the Government pays 80-85 per cent of the amount
- Final bill for the balance of 15-20 per cent, that will be paid after complete verification of goods at

the point of destination. Because of the delay involved in the settlement of final bills, banks should prefer the interim bill for advancing and the final bill for collection.

Banker must reserve the right of demanding the repayment of advance, if the bills remain unpaid for a specific period.

26.11 LET US SUM UP

Bankers take different types of securities for safeguarding their advances. Each type of security contains its own features. The method of creation of a charge on these securities varies according to the type. This unit explains the basic features of the securities that the banker resorts to.

26.12 CHECK YOUR PROGRESS

1. The nature of charge created while advancing against LIC policies is

(a) Assignment (b) Lien
(c) Pledge (d) Set-off

2. Documents of title to goods has been defined in

(a) Indian Contract Act (b) Negotiable Instruments Act
(c) Transfer of Property Act (d) Sale of Goods Act.

3. In the terms of Section 19(2) of the Banking Regulation Act, 1949, 'no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its ----- , whichever is less'. Shares held in a demat form should also be included for the purposes of determining the exposure limit.

(a) own paid up share capital and reserves
(b) tangible net worth

(c) risk weighted assets
(d) paid-up capital
4. Loans against the security of shares, debentures and PSU bonds to individuals should not exceed the limit ofper individual borrower, if the securities are held in the demat form.
(a) Rs. 10 lakh (b) Rs. 15 lakh
(c) Rs. 20 lakh (d) Rs. 50 lakh
5. Loan against minor's term deposit
(a) can be granted if the documents are signed if the minor has completed the age of 14 years
(b) cannot be granted under any circumstances as the minor does not have the contractual capacity
(c) can be granted to the guardian of the minor, if it is for the necessities of the minor
(d) can be granted only with the permission of the Court.

26.13 ANSWERS TO CHECK YOUR PROGRESS'

1. (a), 2. (d), 3. (a), 4. (c), 5. (c).

26.14 KEYWORDS

Immovable property, Goods, Inspection of goods, Documents of title to goods, Trust Receipt, Shares, Book debts, Supply bills, Guarantee, Principal Debtor, Right of subrogation.

UNIT
27NON-PERFORMING ASSETS

(Prudential Norms on Income Recognition, Asset Classification and Provisioning, pertaining to Advances)

STRUCTURE

Check Your Progress
Answers to 'Check Your Progress'
Keywords

246

27.0 OBJECTIVES

A study of this unit will help the learner to know the guidelines on classification of assets, income recognition and provisioning norms.

27.1 INTRODUCTION

In line with international practices and as per the recommendations made by the 'Committee on the Financial System' (Chairman Shri M. Narasimham), the Reserve Bank of India has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks, to move towards greater consistency and transparency in the published accounts.

The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks should be done based on a objective criteria, which would ensure an uniform and consistent application of the norms. In addition, the provisioning should be made based on the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof. Banks are to ensure that, while granting loans and advances, realistic repayment schedules fixed, based on cash flows of the borrowers. This would gc, a Jong way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.

27.2 DEFINITION

27.2.1 Non-Performing Assets (NPA)

An asset. including a leased asset, becomes an NPA when it ceases to generate income for the bank. An NPA is a loan or an advance where;

(i) the interest and/or instalment of principal remain overdue for a period nfmore than ninety days in respect of a term loan.

(ii) an account remains 'out of order' as indicated in the paragraph below, in respect of an overdraft/ cash credit (OD/CC),

(iii) a bill remains overdue for a period of more than ninety days, in the case of bills purchased and discounted,

(iv) an instalment of the principal or the interest thereon remains overdue for two crop seasons for short duration crops,

(v) an instalment of the principal or the interest thereon remains overdue for one crop season for long duration crops.

Banks should classify an account as an NPA only if the interest charged during any quarter is not serviced fully within ninety days from the end of the quarter.

27.2.2 'Out of Order' Status

An account treated as 'out of order', if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases, where the outstanding balance in the operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for ninety days as on the date of balance sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

27.2.3 Overdue

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

247

27.3 INCOME RECOGNITION

27.3.1 Income Recognition – Policy

The policy of income recognition has to be objective and based on the record of recovery. Internationally, income is not recognised from an NPA on an accrual basis, but is booked as

income only when it is actually received. Therefore, the banks should not charge and take to the income account, interest on any NPA.
However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies are taken to the income account on the due date, provided adequate margin is available in the accounts.
Fees and commissions earned by the banks because of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.
If Government guaranteed advances become an NPA, the interest on such advances should not be taken to income account unless the interest has been realised.
27.3.2 Reversal of Income
If any advance, including bills purchased and discounted, becomes an NPA at the close of any year, the interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
In respect of NPAs, fees, commission and similar income that have accrued will cease to accrue in the current period and reversed or provided for, with respect to past periods, if uncollected.
Leased Assets
The finance charge component of finance income [as defined in 'AS 19-Leases' issued by the Council of the Institute of Chartered Accountants of India (ICAI)] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.
27.3.3 Appropriation of Recovery in NPAs
Interest realised on NPAs taken to income account, provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.
In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e. towards principal or interest due), banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.
27.3.4 Interest Application
There is no objection to the banks using their own discretion in debiting interest to an NPA account taking the same to the interest suspense account or maintaining only a record of such interest in proforma accounts.
27.3.5 Reporting of NPAs
Banks are required to furnish a report on NPAs as on 31 March each year, after completion of audit. The NPAs would relate to the banks' global portfolio, including the advances at the foreign branches.
While reporting NPA figures to RBI, the amount held in interest suspense account, is to be shown as a deduction from the gross NPAs as well as the gross advances

non-performing advance accounts may furnish the amount of interest receivable on NPAs as a footnote to the report.
Whenever NPAs are reported to RBI, the amount of technical write off, if any, should be reduced from the outstanding gross advances and gross NPAs to eliminate any distortion in the quantum of NPAs being reported.
27.4 ASSET CLASSIFICATION
27.4.1 Categories of NPAs
Banks are required to classify non-performing assets into the following three categories based on the period for which the asset has remained non-performing and the readability of the dues:
(a) Substandard Assets (b) Doubtful Assets (c) Loss Assets

Substandard Assets
With effect from 31 March, 2005, a substandard asset would be one, which has remained a NPA for a period less than or equal to twelve months.
Doubtful Assets
With effect from 31 March, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of twelve months.
Loss Assets
A loss asset is one, where the bank or the internal or external auditors or the RBI inspection has identified the loss but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.
27.4.2 Guidelines for Classification of Assets
Accounts with Temporary Deficiencies
The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with such deficiencies, banks may follow the following guidelines:

(a) Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on the stock statement, which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. A working capital borrowal account will become an NPA if such irregular drawings are permitted in the account for a continuous period of ninety days even though the unit may be working or the borrower's financial position is satisfactory.

(b) Regular and ad hoc credit limits need to be reviewed/regularised not later than three months from the due date/date of the ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that

renewal/review of credit limits is already on and would be completed soon. In any case, a delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ad hoc credit limits have not been reviewed/renewed within 180 days from the due date/ date of ad hoc sanction, will be treated as NPA.
Upgradation of Loan Accounts Classified as NPAs
If arrears of the interest and the principal are paid by the borrower, in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts.
Asset Classification to be Borrowerwise and not Facilitywise

(i) It is difficult to envisage a situation when only one facility to a borrower/one investment in any of the securities issued by the borrower becomes a problem credit/investment and not others. Therefore, all the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA and not the particular facility/investment or part thereof which has become irregular.
(ii) If the debits arising out of devolvement of letters of credit or invoked guarantees are in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.
Advances under Consortium Arrangements
Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks and other aspects that have a bearing on the recoverability of the advances.
Accounts where there is Erosion in the Value of Security due to Frauds Committed by Borrowers
In respect of accounts where there are potential threats for recovery, because of erosion in the value of security or non-availability of security, the existence of other factors such as frauds committed by borrowers, it will not be prudent that such accounts should go through various stages of asset classification. In cases of such serious credit impairment, the asset should be straightaway classified as doubtful or loss asset as appropriate.
(i) Erosion in the value of a security can be reckoned as significant, when the realisable value of the security is less than fifty per cent of the value, assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs come under the doubtful category classification and provisioning, as applicable, for the doubtful assets is required straightaway.
(ii) If the realisable value of the security, as assessed by the bank/approved valuers/RBI is less than ten per cent of the outstanding in the bbrrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as a loss asset. It may either be written off or fully provided for, by the bank.
Advances against Term Deposits, NSCs, KVP/IVP, etc.
Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.
Loans with Moratorium for Payment of Interest
(i) In the case of bank finance given for industrial projects or for agricultural plantations, etc., where

a moratorium is available for the payment of interest, then it becomes "due' only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence do not become an NPA, with reference to the date of debit of interest. They become overdue after the due date for payment of interest, if uncollected.
(ii) In case of a housing loan or similar advances granted to staff members where interest is payable after the recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest, on the respective due dates.
Agricultural Advances
(i) A loan granted for short duration crops is treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops is treated as NPA only if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, 'long duration' crops would be crops with a crop season longer than one year and crops, which are not 'long duration' crops, would be treated as 'short duration' crops. The crop season for each crop, which means the period up

to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms also made applicable to the agricultural term loans availed of by him. The above norms are made applicable to all direct agricultural advances. In respect of agricultural loans, other than those specified and the term loans given to non-agriculturists, identification of NPAs would be done on the same basis as for non-agricultural advances which, at present, is the ninety-days delinquency norm.

(ii) Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own, as a relief measure, conversion of the short term production loan into a term loan or a rescheduling of the repayment period or the sanction of a fresh short-term loan.

(iii) In such cases of conversion or rescheduling, the term loan as well as the fresh short-term loan are treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if the interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops.

(iv) While fixing the repayment schedule in the case of rural housing advances granted to agriculturists under the 'Indira Awas Yojana' and 'Golden Jubilee Rural Housing Finance Scheme', banks should ensure that the interest/instalment payable on such advances are linked to crop cycles.

Government Guaranteed Advances

The credit facilities backed by guarantee of the Central Government, though overdue, may be treated as an NPA only, when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPA is not for the purpose of recognition of income. The requirement of invocation of guarantee was delinked for deciding the asset classification and provisioning requirements in respect of State Government guaranteed exposures. With effect from the year ending 31 March, 2006, State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms if interest and/or principal or any other amount due to the bank remains overdue for more than ninety days.

Upgradation of Restructured Accounts

The substandard accounts which have been subjected to restructuring, etc., whether in respect of principal instalment or interest amount, by whatever modality, would be eligible for upgrading to the standard

category, only after the specified period, i.e. a period of one year after the date when the first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms as aforesaid, could also be reversed after the one-year period. During this one-year period, the substandard asset will not deteriorate in its classification if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one-year period is not evident, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

27.5 PROVISIONING NORMS

Banks should make provisions against substandard assets, doubtful assets and loss assets as below:

27.5.1 Loss Assets

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

27.5.2 Doubtful Assets

(i) Hundred per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.
(ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from twenty per cent to hundred per cent of the secured portion depending upon the period for which the asset has remained doubtful.
TABLE 27.1 Provisioning Norms for Assets

Period for which the advance has remained in 'doubtful' category
Up to one year
One to three years
More than three years
(i) outstanding stock of NPAs as on March 31, 2004
(ii) advances classified as 'doubtful more than three years' on or after April 1, 2004
Provision requirement (in %)
20 per cent 30 per cent
- 60 per cent with effect from March 31, 2005
- 75 per cent with effect from March 31, 2006
- 100 per cent with effect from March 31, 2007
-
100 per cent with effect from March 31, 2005

27.5.3 Substandard Assets
A general provision of ten per cent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available. The unsecured exposures, which are identified as 'substandard' would attract additional provision of ten per cent, i.e. a total of twenty per cent on the outstanding balance. The provisioning requirement for unsecured 'doubtful' assets is 100 per cent. Unsecured exposure is defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank's inspecting officers, is not more than ten per cent, ab initio, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees, comfort letters, etc.

27.5.4 Standard Assets
(i) Banks should make general provisions for standard assets at the following rates for the funded outstanding on global loan portfolio basis:
(a) direct advances to agricultural and SME sectors at 0.25 per cent;
(b) advances to specific sectors, i.e. personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs. 20 lakh and commercial real estate loans at one per cent;
(c) all other advances not included in (a) and (b) at 0.40 per cent.
(ii) As regards the additional facilities sanctioned as per the package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.
Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, and life policies would attract provisioning requirements as applicable to their asset classification status. However, advances against gold ornaments, government securities and all other kinds of securities are not exempted from provisioning requirements.
27.5.5 Advances Covered by ECGC Guarantee
In the case of advances classified as doubtful and guaranteed by ECGC, provision should be made only for the balance in excess of the amount guaranteed by the corporation. Further,

while arriving at the provisions required for doubtful assets, realisable value of the securities must first be deducted from the outstanding balance in respect of the amount guaranteed by the corporation and then provision made.

27.5.6 Advance Covered by DICGC Guarantee

In case of advances covered by DICGC guarantee become non-performing, no provision needs to be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for, as per the extant guidelines on provisioning for non-performing advances.

27.5.7 Provisioning for Country Risk

Banks shall make provisions, with effect from the year ending 31 March, 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent according to the risk categories mentioned below. To begin with, banks shall make provisions as per the ECGC risk classification.

27.6 LET US SUM UP

In this unit, we learnt what are non-performing assets, when a loan account is classified as NPA, the policy on income recognition, norms for classification of non-performing assets in to substandard, doubtful and loss assets and also provisioning requirements of various categories of advances. An asset becomes a non-performing assert when it ceases to generate income for the bank. The policy of income recognition is based on the record of recovery. Non-performing assets are classified into three categories based on the period for which they remained in non-performing category. The quantum of provisions made depends upon the category of assets such as standard, substandard, doubtful and loss.

27.7 CHECK YOUR PROGRESS

1. When will a loan be NPA?

(a) Interest and/or loan instalments overdue for more than 90 days.

(b) A/c is out of order for more than 90 days in case of overdraft/cash credit

(c) Bill remains overdue for more than 90 days in BP/BD

(d) All of the above

(e) Only (a) and (c)

2. Charging of interest at monthly rests would/would not change overdues under NPA.

(a) Would make overdue of 90 days from monthly interest debiting

(b) Would make overdue 90 days from previous quarter ending

(c) Both of above.

(d) None of above.

3. Direct advances to agriculture and SME under standard assets category requires provision at the rate of

(a) 0.40 per cent (b) 0.10 per cent

(c) 1.00 per cent (d) 0.25 per cent

4. A substandard asset is one which has remained NPA for a period less than or equal to

(a) 12 months (b) 6 months

(c) 90 days (d) 180 days

27.8 ANSWERS TO CHECK YOUR PROGRESS'

1. (d), 2. (b), 3. (d), 4. (a).

27.9 KEYWORDS

Non-performing Assets, Standard Assets, Substandard Assets, Loss Assets, Provisioning, Upgradation of NPA.

UNIT
28
FINANCIAL INCLUSION

28.0 OBJECTIVES

This unit will help the learner to understand the financial inclusion and its role in rural development.

28.1 INTRODUCTION

By financial inclusion, we mean the provision of affordable financial services, viz., access to payments and remittance facilities, savings, loans and insurance services by the formal financial system to those who tend to be excluded. It is important to recognise that, in the policy framework for development of the formal financial system in India, the need for financial inclusion covering more and more of the excluded population by the formal financial system has always been consciously emphasised. Even after decades of such emphasis, there are large segments of the society outside the financial system. Simultaneously, the growth of the NGO and the self-help groups has been significant and their linkage with banks has facilitated a greater financial inclusion. The SHG movement in India has enabled social and economic inclusion of women. The SHG-bank linkage movement, where SHGs are linked to banks in a gradual way - initially through savings and later through loan products, has been able to ensure financial inclusion to a certain extent. The formal financial system has to recognise the huge business potential coming from the unmet demand for financial services from those who normally tend to be excluded. The focus on financial inclusion comes from the recognition that financial inclusion has several externalities, which can be exploited to the mutual advantage of those excluded, the banking system and society at large. Banks need to understand the markets and develop products suited to the clientele. They need to develop data sets to evolve risk assessment models for proper rating and pricing. Financial inclusion has to be viewed as a business strategy for growth and banks need to position themselves accordingly.

The Reserve Bank of India has continued to lay stress on the need for financial inclusion of the under privileged sections, which have hitherto remained outside the periphery of the banking system. In many banks, the minimum balance requirement and charges levied, although accompanied by a number of free facilities, deter a sizeable section of population from opening/maintaining bank accounts.

As a proactive measure, the RBI in its annual policy statement for the year 2005-06, while recognising the concerns in regard to the banking practices that tend to exclude, rather than attract vast sections of population, urged banks to review their existing practices to align them with the objective of financial inclusion. In the mid-term review of the policy (2005-06), the RBI exhorted the banks, with a view to achieving greater financial inclusion, to make available, a basic banking 'no frills' account, either with nil or very minimum balances as well as charges that would make such accounts accessible to vast sections of the population. The nature and number of transactions in such accounts would be restricted and made known to customers in advance in a transparent manner.

Further, in order to ensure that persons belonging to the low income group, both in the urban and rural areas, do not face difficulty in opening the bank accounts due to the procedural hassles, the KYC procedure for opening accounts has been simplified for those persons with balances not exceeding rupees fifty thousand (Rs. 50,000) and credits in the accounts not exceeding rupees one lakh (Rs. 1,00,000) in a year.
RRBs have been specifically advised to allow limited overdraft facilities in the 'no frills' accounts without any collateral or linkage to any purpose. The idea is that a provision of such overdraft facility provides a ready source of funding to the account holder, who is thereby induced to open such accounts.

28.2 FINANCIAL INCLUSION BY EXTENSION OF BANKING SERVICES

28.2.1 Use of Business Facilitators and Correspondents

With the objective of ensuring a greater financial inclusion and increasing the outreach of the banking sector, the RBI has decided to enable banks to use the services of NGOs/SHGs, micro-finance institutions (MFLs) and other civil society organisations (CSOs) as intermediaries in providing financial and banking services through the use of business facilitator and correspondent models as indicated below.

Business Facilitator Model: Eligible Entities and Scope of Activities

Under the 'Business Facilitator' model, banks may use intermediaries, such as NGOs/farmers' Clubs, cooperatives, community-based organisations, IT enabled rural outlets of corporate entities, postoffices, insurance agents, well functioning Panchayats, village knowledge centres, agri clinics/agri business centers, Krishi Vigyan Kendras and KVIC/KVIB units, depending on the comfort level of the bank, for providing facilitation services. Such services may include:

(a) identification of borrowers and fitment of activities;
(b) collection and preliminary processing of loan applications including verification of primary information/data;
(c) creating awareness about savings and other products and education and advice on managing money and debt counselling;
(d) processing and submission of applications to banks;
(e) promotion and nurturing self-help groups/joint liability groups;
(f) post-sanction monitoring;
(g) monitoring and hand holding of self-help groups/joint liability groups/credit groups/others;
(h) follow-up for recovery.

As these services are not intended to involve the conduct of banking business by business facilitators, no approval is required from RBI for using the above intermediaries for facilitation of the services indicated above.

Business Correspondent Model: Eligible Entities and Scope of Activities

Under the 'Business Correspondent' model, NGOs/MFIs set up under the Societies/Trust Acts, societies registered under the Mutually Aided Cooperative Societies Acts or the Cooperative Societies Acts of States, registered NBFCs not accepting public deposits and postoffices may act as business correspondents. In engaging such intermediaries as business correspondents, banks should ensure that they are well established, enjoying a good reputation and having the confidence of the local people. Banks may give wide publicity in the locality about the intermediary engaged by them as business correspondent and take measures to avoid being misrepresented.

In addition to activities listed under the business facilitator model, the scope of activities to be undertaken by the business correspondents will include:

(a) disbursal of small value credit;
(b) recovery of principal/collection of interest;
(c) collection of small value deposits;

(d) sale of micro-insurance/mutual fund products/pension products/other third party products;
(e) receipt and delivery of small value remittances/other payment instruments.
The activities undertaken by the business correspondents would be within the normal course of the bank's banking business, but conducted, through the entities indicated above at places other than the bank premises.

258
Accordingly, in furtherance of the objective of increasing the outreach of the banks for micro-finance, in the public interest, the Reserve Bank hereby permits banks to formulate a scheme for using the entities indicated above as business correspondents.
Payment of commission/fees for engagement of business facilitators/correspondents: Banks may pay a reasonable commission/fee to the business facilitators/correspondents, the rate and quantum of which may be reviewed periodically. The agreement with the business facilitators/correspondents should specifically prohibit them from charging any fee from the customers directly for services rendered by them on behalf of the bank.
28.2.2 Other Terms and Conditions for Engagement of Business Facilitators and Correspondents
As the engagement of intermediaries as business facilitators/correspondents involves a significant reputational, legal and operational risks, due consideration should be given by banks to those risks. They should also endeavour to adopt technology-based solutions for managing the risk, besides increasing the outreach in a cost effective manner.
The arrangements with the business correspondents shall specify the following:
(a) Suitable limits on cash holding by intermediaries, as also limits on individual customer payments and receipts.
(b) The requirement that the transactions are accounted for and reflected in the bank's books by end of day or next working day.
(c) All agreements/contracts with the customer shall clearly specify that the bank is responsible to the customer for acts of omission and commission of the business facilitator/correspondent.
Redressal of grievances in regard to services rendered by business facilitators/correspondents.
(a) Banks should constitute a grievance redressal machinery within the bank for redressing complaints about services rendered by business correspondents and facilitators and give wide publicity about it through electronic and print media. The name and contact number of designated grievance redressal officer of the bank should be made known and widely publicised. The designated officer should ensure that genuine grievances of customers get redressed promptly.
(b) The grievance redressal procedure of the bank and the time frame fixed for responding to the complaints should be placed on the bank's website.
(c) If a complainant does not get satisfactory response from the bank within 60 days from the date of his lodging the compliant, he will have the option to approach the office of the Banking Ombudsman concerned for redressal of his grievance/s.
Compliance with KYC norms will continue to be the responsibility of banks. Since the objective is to extend savings and loa facilities to the underprivileged and unrepresented population, banks may adopt a flexible approach within the parameters of guidelines issued on KYC from time to time.
In addition to introduction from any person on whom KYC has been done, banks can also rely on certificates of identification issued by the intermediary being used as banking correspondent, block development officer (BDO), head of village Panchayat, postmaster of the post office concerned or any other public functionary, known to the bank.
28.3 FINANCIAL LITERACY
Financial Literacy is the process by which people improve their knowledge and understanding of the use of financial products and services. It is also described as one's

ability to make informed judgements and to take effective decisions regarding the use and the management of money.

259

The financial literacy is promoted by the provision of financial education and is a prelude to financial inclusion in villages. Financial literacy, besides acquiring and/or acquainting with the information on financial services through the process of financial education by an individual, is a state of mind at which the individual is equipped with the skills necessary to access resources to make him capable of dealing with financial intermediaries, like banks. The delivery of financial education comprises of three key themes: building skills, increasing knowledge and developing understanding and within each of these an individual's confidence should also be developed, which alone will pave way for faster financial inclusion of the hitherto excluded population in the rural areas. One of the aims of financial education is to guide the rural population in management of existing debt and the exit methods.

28.4 LET US SUM UP

Financial Inclusion is a provision of affordable financial services, to those who tend to be excluded. The RBI has continued to lay stress on the need for financial inclusion of the under privileged sections, which have hitherto remained outside the periphery of the banking system. The RBI has decided to enable the banks to use the services of non-governmental organisations, etc., as intermediaries in providing the financial and banking services through use of business facilitator and correspondent models. One of the objectives of this model is to promote financial literacy through the provision of financial education. The delivery of financial education in villages encompasses three key themes: building skills, increasing knowledge and developing understanding and within each of these an individual's confidence should also be developed, which alone will make the hitherto excluded population in the rural areas financially included.

28.5 CHECK YOUR PROGRESS

1. The scope of activities undertaken by the business correspondents will not include:
(a) disbursal of small value credit
(b) recovery of principal/collection of interest
(c) collection of small value deposits
(d) payment of money on demand drafts not exceeding Rs. 1,000

2. Bank cannot use the services of one of the following person/association/organisation as intermediaries in providing financial and banking services through the use of business facilitator and correspondent models
(a) non-governmental organizations (b) self-help groups (NGOs/SHGs)
(c) village sarpanch (d) Micro Finance Institutions (MFIs)

28.6 ANSWER TO 'CHECK YOUR PROGRESS'

1. (d), 2. (c).

28.7 KEYWORDS

Financial Inclusion, Business Facilitator, Business Correspondent.

MODULE -C
BANKING TECHNOLOGY

Unit 29. Essentials of Bank Computerisation
Unit 30. Payment Systems and Electronic Banking
Unit 31. Data Communication Network and EFT Systems
Unit 32. Role of Technology Upgradation and its Impact on Banks
Unit 33. Security Considerations

UNIT
29ESSENTIALS OF BANK COMPUTERISATION

STRUCTURE

29.0 OBJECTIVES

After studying this unit, you should be able to:

- know different approaches to Bank Computerisation
- classify the networking and processing concepts
- explain the types of computer networking and understand the UPS.

29.1 INTRODUCTION

The wind of liberalisation sweeping through India has affected all sectors of the economy and the centre of all these activities is the Indian Banking Industry. In such a fast-changing environment, to meet emerging needs, the operations in banks need immediate automation to provide services comparable to best international standards and to match technological changes taking place in other countries.

Indian Banks undertook very little efforts for modernisation in respect of work technologies particularly in the areas of introduction of computers and communication networks until the early 1980s.

Prior to 1983 (when the agreements with unions on computerisation was signed), most of the banks, being practically unable to computerise, had taken a passive view of this issue resulting in automation taking a very low priority. However, the new agreement reversed this trend and banks started the process of computerising operations at various levels.

Only after 1983 and after the first report of 'Rangarajan Committee' were there brisk activities in order to bring quick technological changes in the field of computers and communications.

29.2 BANK COMPUTERISATION

The concept of Bank Computerisation practically started after 1980-81 and more precisely gained pace in the year 1983-84, after setting up a committee in the year 1983 under the chairmanship of the then Deputy Governor of RBI, Dr. C. Rangarajan. This Committee was set up to study the possibilities and stages involved in bank computerisation and to prepare guidelines for the same. The report submitted by the committee in the year 1984 was known as First Rangarajan Committee Report on bank mechanisation.

Another Committee was constituted in 1988 under the chairmanship of Dr. C. Rangarajan to draw up a perspective plan on computerisation of banks for a five year period 1990-94.

29.2.1 Need for Computerisation

The four major objectives of computerisation in banking are to improve:

(a) customer service (b) housekeeping

(c) decision-making (d) productivity and profitability.

A question, often raised, is whether in order to achieve these objectives, computerisation is at all necessary. Speed and accuracy are the hallmarks of computers. Computers have a vital role to play wherever there is a huge volume of transactions and the work needs completion within a specified period. Consumers today are becoming more discerning and demanding. There is a price on their time and therefore, when they visit a branch for a deposit or a cheque encashment, they are looking for a quick settlement of their transactions. Thus, the advantages flowing from computerisation are many and most people working in the banking industry recognise it.

The main objectives of computerisation at the branch level should be to improve customer service, quality of housekeeping and generation of data for better management control. At the regional and head

office levels, the purpose of computerisation should be to store, analyse and retrieve data received from branches, generating information speedily, thereby strengthening the internal control over branches for policy formulation.

29.2.2 Stand-alone Computer System

The stand-alone computer system is normally the initial stage of computerisation at a bank. The single user computer system is a small system, which as its name implies, is used by only one person at a time.

Stand-alone systems are best suited for the decision-making process, which involves processing and analysis of data. The managers, executives who are responsible for making managerial decisions benefit from such systems. The stand-alone systems cannot be used in a multi-user environment, but these systems can be easily connected to the existing multi-user systems to access corporate database and other shared information and resources. Normally in such cases a stand-alone system is called a workstation or a node. Today's stand-alone systems are also capable of handling multimedia, high-quality graphics, fax messages, etc.

The major advantages of installing single-user systems are numerous, such as low equipment cost, no complicated software required, easier to impart training to banking staff for operation of these machines and better security. However, the single-user system has limitations such as slow processing speed and low data storage capacity, and to its use by one person at a time they are suitable only for front-office branch computerisation at bank branches with a low workload.

29.2.3 Multi-user Systems

The multi-user systems, as their names signify, are computers on which several people can work at the same time. Mini computers, Main Frame Computers, Micro-computers and the more powerful Super Computers all fall under this category,

Multi-user Computer Networking

In such a system computers are based on the centralised processing concept. All information is kept and processed at the main central machines and various terminals are attached to the main computer. The main computer can store a huge amount of information and possesses high-processing speeds enabling a large number of users to be connected to the main central computer. Each user has his/her own terminal. Systems like Unix are used as operating system. These systems work on a time-sharing basis and are well suited for the development of online applications. Most of the banking systems are developed using the centralised computing concept. This is due to the widespread popularity of the Unix system. Most of the Relational Data Base Management Systems (RDBMSs) and other Data Base Management Systems (DBMSs) use the Unix platform. In this approach, the terminals have limited powers and cannot process the information locally. Whatever information required and processed is through the central machine only. The load on the central machine increases with the increase in the number of users.

In most of the computerised information systems, the data is processed at one EDP department. The EDP department has to process large volumes of data everyday and a considerable amount of infrastructure and maintenance is required.

The advantages of using a centralised data processing system are namely,

(a) availability of corporate level information at one location is possible

(b) cost of acquiring hardware, software and other infrastructure is more profitable than acquiring the
same for individual departments

(c) due to the high volume of data processing the computing resources can be fully utilised

(d) technical manpower can also be efficiently managed at a central level

(e) costly resources like leased telephone lines, satellite links, etc., can be shared among the various departments

Branch-level Computerisation

The emphasis on branch-level computerisation is for two important reasons. First, customer interface is at the maximum at the branch level. Increased use of computers and advanced technology can lead to reductions in waiting time, accuracy in reporting statement of accounts and expeditious transfer of funds. All these lead to improved customer service. Second, the emphasis on online transactions processing at the branch level is because only if the data is initially captured in the machines, further processing becomes speedier and easier.

Computerisation at the branch level can be used to:

(a) Provide better and speedy customer service

(b) Improve housekeeping services

(c) Analyse the branch-level data for decision making

(d) Generation of various reports.

The terminals or the PCs are connected together with a single powerful PC acting as a server. Various productivity tools are utilised to analyse the branch-level data to make branch-level policy decisions. Security measures play an important role in branch-level computerisation because of online banking applications. Most of the security features are in-built in the operating system and hardware themselves, such as use of password provision at different levels, various access rights to system and data, locking facilities, etc. The provision of features like disk mirroring, disk duplexing, transaction tracking systems, regular backups, use of uninterrupted power supply, prevent failures and help in recovering from failures. The generation of audit trails and exceptional transaction reports ensure proper functioning of the computerised systems.

Total Branch Automation

With total branch computerisation, all the customer and business transactions are done with the help of computers. This is a real time online banking. Whenever a transaction is entered through a terminal, the transaction is recorded. Then it is verified and authenticated and all corresponding updates are reflected instantly. The activities (independent modules) are interlinked to form an integrated system such that changes are effected without a time lag. Various security controls are enforced to ensure data integrity and security. Various outputs such as ledger extracts, passbooks, vouchers, statements of accounts of customers, etc., are generated online. By using total branch computerisation, it is possible to provide the 'single window' transactions concept. That means a customer can approach any counter for completing all his or her transactions, but the system should be capable of shifting from a single window to a partial window and or universal window transactions depending upon the customers' convenience and branch needs. EFT (Electronic Fund Transfer) can be used to facilitate the automatic transmission and processing of messages and funds from one branch/bank to another branch/bank. EFT at points of sale terminals allows transfer of funds electronically and debit and credit the respective accounts. EFT system can be integrated with an existing online system to automate and speed up the fund transfer process. Off-site ATMs are also linked to the branch system to enable the customer to bank anytime/anywhere. Software and hardware requirements depend upon the size of the branch.

Computerisation at Regional/Circle/Zonal Office

RO/ZO acts in between branches and the head office. They exercise effective control over the functioning of the branches including collection of data from them and transmitting the same to the head office after amalgamation. The most common tasks performed by the regional office/zonal office are:

(a) branch profile, (b) inter-branch reconciliation, (c) credit monitoring, (d) personnel data manage¬ment, etc.

Branch profiles: The Branch profile has two components:

(a) Fixed particulars - includes the (1) branch location details such as state, district, city, etc. (2) the type of premises, whether rental or owned, etc. (3) the area details like metropolitan/urban/semi-urban/rural, etc. (b) variable particulars include budgeted business volumes, actual performance, income and expenditure data, various statistical reports, etc.

(b) Inter-branch reconciliation: The manual matching of inter-branch transactions among the branches can be very difficult, being a time-consuming task but it can be done easily through computerisation at the ROs/ZOs. Another approach is to perform easily and expeditiously the branch-to-branch reconciliation at head office. The job of ROs/ZOs in this case is to collect the transactions from branches under their jurisdiction and transmit them to the head office for further processing.

(c) Credit monitoring: Monitoring of loans and advances is one of the major tasks of any bank and this task can be effectively decentralised to the regional/zonal authorities to have an effective control and supervision. This involves maintenance of a large database at ZO/RO of branches, covering all accounts and details of borrowers. This information helps ROs/ZOs to make decisions to plan various budgetary provisions and policies.

(d) Personnel data management: This is the database containing the information about the personnel working within their region or zone. The personnel database may include information like educational qualifications, age, seniority details, various posts held, training programmes attended, transfer details and so on. This database can be analysed to decide manpower requirements, planning, promotions, transfers, career planning, performance evaluation, etc.

Most of the ROs/ZOs of banks are equipped with minicomputers and Unix as an operating system with Informix, Oracle, etc., as database back-ends and applications are either software from different vendors or developed in-house using COBOL, C, BASIC, etc., languages.

Computerisation at Head Office Level: The head office of a bank is responsible for bank-level planning, and control functions, policy decisions. The head office activities are divided into different functional areas like:
(a) operations, (b) planning, (c) personnel,
(d) international business,(e) services, etc.
The computerisation at various functional areas may include application areas:
(a) personnel management and administrative support (b) funds management
(c) investment portfolio management (d) branch profiles
(e) credit information system, etc.
The information generated from various functional areas is important for the top management to make various strategic decisions.
(a) Personnel management and administrative support: The database containing details of employees of the bank is kept at the head office. This database can be decentralised and can be kept at the ZOs/ROs. The administrative support may include computerisation of various office activities, for example, pay rolls, which includes calculation of the monthly salaries, printing of pay sheets/slips, generation of various salary reports, recovery reports, management of provident fund, loans and advances to employees, etc., the banks should limit their balances with RBI and investments in Government securities to the minimum stipulated in the regulations. The fund management task is very complicated due to day-to-day variations in withdrawals and deposits. The quick and accurate information about the advances and deposits from the branches enables the head office to manage

268

the funds effectively. Most of the time, it happens that few branches account for large portion of day-to-day variations. The communication network connecting such branches to the head office computer plays a very important role in providing online information about the business position of such branches. This helps in better fund management.
(b) Investment portfolio management: Banks invest a substantial share of their assets in approved
securities to meet liquidity and current liabilities. The average yield from such investments is always
lower than other investments like commercial lending and personal loans. Before an investment is
made, a number of parameters need to be analysed. Various analytical tools are used to analyse the
investments. The target is to increase the yield on any investment. Various software packages are
available that help to build mathematical and analytical models to solve the problems and are used
to select and manage the investment portfolios and thereby maximise the return on investment.
(c) Branch profiles: Most banking business is carried out at the branches. The controlling authorities
at the head office control and support the branch activities. To do this, the head office needs a proper flow of management information from the branches to the head office. This information is
provided by the branches by sending various reports at regular intervals. The information sent from
branches to head office covering branch profile may contain:
(i) Standing data file (SDF form)
(ii) Performance report file (PRF).
(i) The SDF form covers information about the branch such as name of the branch, name of the zone, date of opening, pin code, type of premises (owned/leased/rented), name of the district and state, number of tellers, etc. This information is collected only once and updates

may be made at the end of every year. This information helps to create various reports, e.g. list of branches in a particular region, zone, a list of branches conducting specific business and so on.
(ii) PRF contains the business details of the branches and is sent quarterly. This report includes deposits, advances, other income, overheads, earnings and expenses, number of accounts, capital expenditure, etc. These reports are used to analyse and monitor the performance of branches. This information is valuable for planning and control activities at head office. Various reports generated from the PRF database like the list of loss-making branches, performance of the branch, region-wise advances and deposits, etc.
(d) Credit information system: The purpose of the computerised credit information system is to provide
a comprehensive credit information that is used for credit planning and monitoring. The major
objectives are:
(a) to have up-to-date information on all borrowal accounts for the entire bank,
(b) to generate various statutory statistical reports and control returns,
(c) to reduce the drudgery of work at all levels,
(d) to ensure timely and accurate availability of data and to generate exceptional reports for
management information,
(e) to facilitate the review and renewals of borrowal accounts,
(f) to make available consolidated information for the borrowal accounts being one entity.

29.3 LANs AND WANs

29.3.1 Local Area Network (LAN)

A computer network is an interconnected system of autonomous computers, each system being capable of independent operation as well as being able to communicate with other systems. A computer network is a data communication network mainly used to share data, hardware and software resources and to improve the flow of information within an organisation or beyond.

The computer network that links computers and peripherals within a localised area say, within a building is known as LAN. Computers and related equipment can be connected through nodes placed anywhere in the network.

FIGURE 29.1 Local Area Network

Generally, LAN will not extend beyond 100 metres. However, it can be up to a maximum spread of 1 km and the number of devices supported may also vary from 2 to as many as 1000.
In LANs, each independent system is known as a node and when such nodes are interconnected, it is known as a LAN.. Usually, there will be one central node (Server) providing and controlling all the services of the network. The client nodes route their requests to the server and obtain the necessary services. The way in which the server handles these services differ depending upon the topology and protocols.
A LAN distinguishably uses network adapters that employ special techniques to share a common medium (such as a cable or a radio or light wave) between the connected computers. ALAN also uses some type of software to deal with simultaneous requests for service from many client stations. Sharing common cabling and pooling resources within a work group are the key elements of LAN operation.

29.3.2 Topology (Layout)
The way in which the devices are interconnected is known as topology. These are two basic forms of local area network design used in information transmission; centralised control and distributed control. The popular centralised control networks are star, tree and loop topologies, while that of the distributed controls are ring and bus topologies. Each topology has its advantages and disadvantages. Before we go into the details of the topologies, let us understand how the data transmission takes place in a network. The methods of operation for the transfer of data over networks are called packets switching.

(a) Star Topology

FIGURE 29.2 Topology (Layout)
The data, a user wishes to send commonly referred to as a message, is broken down into smaller units called packets. Each packet consists of some data bits and a header containing its destination address. The packets are passed from one packet by the switching exchange to another, until they reach their destination.
With the bus topology, all devices on the network are connected to a single continuous cable. Transmission from any station travels the length of the bus in both directions and is received by all other stations. The main advantage of bus topology is that it is quite easy to set up. Further, if one station on the LAN fails, it will not affect the rest of the network. The advantage is that it not only limits the geographic spread but also offers limited flexibility for change.
In a ring topology, the devices are connected in a closed loop and information is passed from one node to the other in series. Data transmission is possible in one direction only. As the packet circulates, the destination recognises its address and copies the packet contents onto it. The breakdown of any one station on the ring can disable the entire LAN.
In a star topology, the central node is often the master. Each of the other nodes is joined to the master by separate links. While this topology gives the advantage of giving maximum ability to change, it cannot handle large traffic as every transaction has to pass through the central node. However, if one node fails, it will not affect the network.
29.3.3 Protocols
When any two pieces of equipment are connected, effective communication will take place only when they 'talk' and 'understand' the same language. In other words, there should be a standard communication protocol. There are protocols for all aspects of communication links like cables, connectors, etc., including the software running on the connected devices which control the transmission of data over the network. The protocols are the rules for communication between similar modules of processes, usually in different nodes. Protocols define message formats and the rules for message exchange. It controls priority and sequence of transmission, errors in transmission, and the process of beginning and concluding conversion.
The network protocols depend on the adapters. Some of the commonly used types of adapters are Ethernet and Token-RING. In the ethernet system, the listen-before-transmit media sharing system is called the Carrier-Sense Multiple Access with Collision Detection

(CSMA/CD) system is used. Ethernet cards share the common wire by transmitting only when the channel is clear. If two stations try to transmit simultaneously, a collision occurs. The stations halt transmission and wait for a random period of time before retransmitting. Token-ring systems use what is termed as a deterministic media-access

control system. The 'token' in 'token-ring' is actually a special frame, passed from node to node, that gives a node permission to enter a frame into the ring. In the 'token-ring', the token circulates when all stations are idle. A station wanting to transmit must wait until it detects a token passing by. It then seizes the token and transforms it to a start-of-packet sequence for its data packet. The data packet on the ring makes a round up. The destination station, on seeing the data pass-by, copies data bits from this packet onto it. When the data packet comes back to the source station, it removes the data bits from the packet and the token is set free.
Other Devices: There are several other devices used in connection with the networking. A device called multiplexer is used to receive signals from several communication lines and pass on to one communication line and vice versa. A multiplexer takes multiple low-speed lines and combines their individual data transmission capacity needs so that a specific grouping of them can be transmitted on a single high¬speed line.
Network Operating System: The function of the networking software is to set up some computers as hosts, or servers, and some computers as clients to those hosts. The servers manage the printer sharing, file sharing and communications link sharing to their clients. All of these capabilities may run on a single server or be dedicated to several servers. The networking software can run over any standard network. Generally, the network operating systems fall into two categories: those that use DOS as the file system on the server and those that use UNIX as the file system.
Branch-level Computerisation: The concept of LANs is fast becoming popular for branch computerisation in banks. This is especially so where front-office computerisation is concerned.
The front-office computerisation comprises the installation of several stand-alone systems with online data entry and updates. These stand-alone systems are connected together via a LAN, thus giving each system access to each other's database. The customer who comes to make a withdrawal can go to any of the counters and present his cheque. The teller checks the account number, whether sufficient balance is available and then issues the token to the customer. The teller enters the withdrawal details and amount into the computer and the balance of the account holder is reduced to that extent.
The above scenario can also be envisaged without a LAN, but the benefit of having a LAN is that the customer is free to go to any counter and present his cheque. If the computers were not networked, the customer would have to go to the particular counter, handling his ledger account. This would have been a duplication of the manual system and would not lead to any great leaps in productivity or saving of time.
Another scenario is where the stand-alone systems in the front-office, connected through a LAN with each other, are also connected to a mini-computer installed in the branch for back-office computerisation. Here, the networked stand-alone systems function as intelligent terminals to the mini computer. The mini computer can access any data that is required from the stand-alone systems at any time.
A major advantage of the above scenario is that the data entered into the stand-alone systems need not be entered again into the mini computer. Another advantage of having stand-alone systems in the front-office linked to the computer in the back-office is that the transaction processing load of the front-office does not come on the back-office machine, which would happen, if only dumb terminals connected to the mini computer were installed in the front-office.
The advantages of using LANs in banks are that:
(a) The expensive resources such as computer hardware and software can be shared by several users.

This brings down the overall cost of computerisation.
(b) The information stored on the host computer is available to all users of the system. Therefore, there is no necessity of duplication of databases.

(c) Since all the terminals are intelligent terminals, the processing load is shared between the various machines and there is no overloading on any single machine.
These are the various reasons why LAN is becoming very popular in front-office branch computerisation. There are also a few shortcomings of a LAN, such as:
(a) Complicated software has to be installed for data management.
(b) Security risks are higher, since each user access the host computer independently.
(c) Maintenance cost of such a system is high, since it has to be done frequently.
29.3.4 Wide Area Network (WAN)
Wide Area Networks (WAN) are defined as a large-scale computer network spread over a span of sizeable geographic area, normally utilising the telecommunication network. Generally, the transmission speed and capacity are limited and the data transfer rates are very low in case of WANs when compared to that of LANs. In the banking sector, the WANs are generally used to interconnect branches with the regional offices, and regional/zonal offices to head office, etc.
How a WAN Works
The wide area networks are formed based on the telecommunication network and hence the type of network will differ in the method of telecommunication used. Separate data lines dedicated between two or more computers are used, and such a network is called the leased lines network. Computers can be linked by using ordinary telephone lines which is called dial-up network. Connectivity can also be established by using satellite links or microwave links. There could be a combination of all these methods also in single network.
Microwave systems are capable of broad band transmission. The signals in a microwave system are transmitted directly from a dish antenna to a receiving dish antenna at the next microwave station, located in a direct line of sight no more than about twenty five miles away. Each relay station can catch and 'boost' the data signals, passing them on to other receiving stations.
Satellite communications network is an alternative to wire telecommunications. Text, data, voice and video information are converted to radio waves at Earth stations and are beamed up over a broad band transmission channel to a satellite. The satellite relays the data back to an Earth station or an antenna atop a tall building at the receiving location across the country or around the world. Transmission takes only a fraction of a second.
Logically, any two computers connected through a telephone line needs a modem at each end. These modems convert the digital signals of the computer into analogue signals at the transmitting end and reconverts analogue signals into digital signals at the receiving end. Depending upon the geographical location of the computers that are being connected, the type of telecommunication media could be chosen.
Each of the computers connected in a WAN, requires connectivity to a telecommunication line, a modem and a communication software that will take care of the transmission and receipt of data.
Regional Office/Circle/Zonal Office-level Computerisation (LAN and WAN): A distributed system is an approach to data processing in which processing and data storage tend to be located at or near the points where the data occurs or the information is used, but with communication links to allow access to and from other processing facilities and data storage are required. With this concept, the data processing and transmission is done through LANs and WANs.
By placing the computing resources at the user's end, provision of good support for analysis and decision-making is made. Since much of the work is done locally, the cost is lower than when it is done on the

273

mini/main frame computer system. The system itself works faster as the processing is shared between several processors and the central computer does not get overloaded with the processing load.

In fact, in its conclusion, the Rangarajan Committee Report on Computerisation (1989), also favoured the DDP approach as it felt that this option would provide a better response time and also more security in the case of line failures, since the majority of transactions, which are 'local' in nature, can be still handled through the distributed data processing. The central computer could also be updated later, as and when link is re-established.

The intelligent nodes can be installed in respective departments and they may be equipped with a user friendly, menu-driven software to update, process and release of reports as and when required.

The branch computer can also be linked with RO/ZO computers through WAN for faster transfer of data and various reports to them, which help greatly in the quality of decision-making and effective monitoring.

Use of the LAN, client server computing, RDBMS packages like Oracle, Sybase, etc., and front-end tools like Powerbuilder, Developer 2000, visual tools may provide better performance with considerable price. The use of various methods helps to analyse the RO-Ievel or ZO-Ievel data for manpower planning, credit monitoring, etc.

Head Office-level Computerisation (LAN and WAN)

There is another approach of computerisation of the head office apart from main frame computer networking, i.e. through LAN and WAN. In this system, the departments of the head office would be provided with intelligent terminals having appropriate software packages specially for the respective department. The head office computer should be linked with the RO/ZO computers through WAN for faster transfer of information to the head office. This way the data can be directly accessed by the respective departments also it would be processed by them for decision-making, monitoring and policy implementation effectively. The data, reports or proposals can also be directly sent to respective departments of the head office by RO/ZO computers for a quick decision and response. This reduces the higher computerisation expenditure.

The head office can also take decisions for investments or can submit returns to regulatory authorities in time. In the current technological environment, the transfer of information at an appropriate time and place is an important part of day-to-day business. This would not only help in enhancing business and profitability, but also provide security to a greater extent.

29.4 UNINTERRUPTED POWER SYSTEM (UPS)

Uninterrupted power system provides clean and reliable AC power to the computer systems protecting them from power blackouts, brownouts, swells, sags, surges, and interface. In case of a power failure, the UPS attached with the file server automatically takes over the power supply to the file server or to the main computer to eliminate the chance of data loss. The work stations and other terminals are also attached with the UPS.

The general feature of an UPS is an inverter and battery charger with an automatic change over of power supply from battery or load. The UPS are of two types:

Online UPS: In an online UPS, the main 230 V input current is converted into 48 V DC and from the battery charger-cum-rectifier is then converted to a 230 VAC, even in the case of main supply available and the power is supplied to the computer systems. In case of power failure, the 48 V DC is supplied by the batteries. It comes back automatically to the normal status when the main supply recovers. In bank computerisation, online UPS is used.

274

Offline UPS: In offline UPS, battery charger and inverter are two separate parts for doing their jobs independently. When the power is available through main, the battery charger is only charging the battery and inverter is on stand-by. In case of a mains power supply interruption, the batteries are connected to the inverter through an electronic change-over and the current is supplied to the computer systems. It supplies raw power and does not regulate the input frequency. In this system, backup time is very low (in the order of a few milliseconds).

FIGURE 29.3 UPS

29.5 CORE BANKING

Core banking has a centralised branch computerisation model where the branches are connected to a central host, which incorporates branch automation modules and online multiple delivery channels like ATM, ABB, Debit Card, Tele-banking/mobile banking, internet banking, etc., under one roof. In core banking, there is a central database for the bank and transactions are done centrally, online. It offers integrated products and services to customers round the clock. There is scope for induction of modern banking services and one single software for all the branches and is operated on the bank's WAN infrastructure.

29.5.1 Business Components

(a) To have retail customer banking modules
(b) Deposits, loans, bills, remittances, locker, clearing, etc.
(c) Trade finance/forex modules
(d) Government business modules
(e) To have corporate finance and service branch modules
(f) To have enhanced MIS modules
(g) To have modules for business intelligence
(h) To integrate with the existing ATMs, tele-banking, debit card, kiosks and other delivery channels (i) To have any branch banking, Internet banking and call centre

(j) To interface with existing corporate systems like treasury, IBR, centralised accounting system, HRMS, ALM, credit appraisal and management, credit monitoring and NPA management, etc. (k) To interface with systems like NDS, SFMS, RTGS, CFMS, etc.

29.5.2 Benefits

(a) Enables the establishment of a reliable centralised data repository for the bank
(b) Facilitates data warehousing and data mining technologies for business intelligence
(c) Easy implementation of integrated customer centric services like online ATMs, tele-banking, internet banking, any branch banking, kiosk banking, cash management services, etc.
(d) Enables centralised management information, decision support and executive information systems
(e) Efficient and effective MIS, ALM, risk management, etc., using the central data pool
(f) Enables centralised management and control with centralised data
(g) Standardisation of the branch automation software using a single version. Quick adoption of software changes as changes are done only at the central site
(h) Facilitates business process re-engineering (BPR) to streamline the existing processes
(i) Relieves branches of jobs like data backup, MIS generation, etc.
(j) Requires infrastructure at the central location, backup location and at branches
(k) Servers are not mandatory at branch locations
(1) Attracts higher investment in the beginning
(m) Cost of implementation for further branches and delivery channels relatively cheaper
(n) Core infrastructure can be used for future expansions
(0) No extra cost for implementation of SFMS, RTGS, CFMS, etc.

29.5.3 Essential Requirements

Creation of Primary Data Centre

(a) For housing the central server for online transactions
(b) The central database will be used for all customer centric delivery channel services integrated with the CBS and for the bank's various corporate business requirements
(c) To be manned round the clock to offer 24 x 7 service to customers

(d) Skilled activities such as database administration, backups, network monitoring, on call support, troubleshooting, parameterisation, customisation, support of delivery channels are performed at the data centre.

Disaster Recovery Site (DRS)

Disaster recovery sites (DRSs) are used for the following purposes:

(a) To avoid disruption in the business activities of CBS branches due to central system or network failures

(b) To ensure non-stop functioning of branches and online delivery channels integrated with CBS

(c) To act as a backup for providing reliable and continuous processing environment

These technologically advanced centres have the presence of various multinational IT companies.

Business Process Re-engineering (BPR)

Business Process Re-engineering (BPR) helps in the following tasks:

(a)To help the bank to realign the existing business processes in tune with benefits provided by the new technology platform.

(a) To help the bank in taking advantage of the best business practices available in the technology platform to provide more efficient services

(c) Processes aligned with the technology platforms provide the bank with the capability for the delivery of enhanced value to their customers and also gain from the changed processes.

Specialised Consultancy

(a) CBS being a critical project with complexities of multi-level delivery systems involving higher
investments as well as manpower requirements, a specialised consultancy service was suggested
for centralised banking

(b) Consultant to have expertise/experience in implementing CBS in other banks

(c) To assist in the designing, crystallising requirements and formulation of implementation of strategies.

(d) To advise the bank on all aspects of centralised banking requirements

(e) To proceed further, after getting the expert recommendations/suggestions of the specific consultants.

Infrastructure

Software: The software comprises:

(a) Branch functional modules

(b) Delivery channel requirements like ATMs, tele-banking, internet banking, and information kiosks

(c) Interfaces to integrate systems like NOS, SFMS, RTGS, CFMS, etc.

(d) Tools tor business intelligence and management information.

Hardware: The hardware at the data centre and DRS will be 'configured' based on the transaction volume of the proposed branches.

Networking

(a) Leased lines of WAN should be used as a primary communication channel for CBS.

(b) Adequate redundancies will be built-in to address any network failures.

(c) ISDN link will be used as a backup

29.6 LET US SUM UP

The objective of computerisation in India is not to replace men with machines. Rather, the objective is to make the work life more meaningful. As we deal in an industry, which is the largest processor of information and data, reliance on technology is inevitable. Needless to say, absorption and effective utilisation of the new technology will involve a change in structure, organisation and systems as well as attitudes of those working in the industry.

29.7 CHECK YOUR PROGRESS

(b) Software
(d) All of the above
1. A computer network mainly used to share
(a) Data
(c) Hardware (e) None of these
(b) Nodes (d) CPU
2. Terminals connected to a server is known as
(a) Clients
(c) (a)&(b) (e) None of these
3. For uninterrupted power supply in branch computerisation, the following device is used
(a) Online UPS (b) Offline UPS
(c) Convertor (d) Generator
(e) None of these

4. Proper functioning of a computerised system is ensured by
(a) Generation of audit trails (b) Exceptional transaction report
(c) Tallying of cash book (d) All of the above
(e) None of these
5. In muiti-user computer networking
(a) Computers are based on a centralised processing concept
(b) Various terminals are attached to the main computer
(c) All data and information is kept on the main computer
(d) Large number of users can be connected to a central computer
(e) All of above
6. In star topology
(a) Each node is joined to the central node by a separate link
(b) Devices are connected in a closed loop
(c) Information is passed from one node to the another in series
(d) Devices on the network are connected to a single continuous cable
(e) All of above
7. In bus topology
(a) Each node is joined to the central node by a separate link
(b) Devices are connected in a closed loop
(c) Information is passed from one node to another in series
(d) Devices on the network are connected to a single continuous cable
(e) All of above
8. In ring topology
(a) Each node is joined to the central node by a separate link
(b) Devices are connected in a closed loop
(c) Information is passed from one node to the other in series (d) (b) & (c)
(d) All of above
9. In Core banking system
(a) Branches are connected to a central host
(b) Branch automation modules and delivery channels are incorporated
(c) Transactions are done centrally and online
(d) All of above
(e) None of these
10. Benefits in Core Banking is
(a) Reliable centralised data recovery
(b) Data warehousing and data mining technologies

(c) Integrated customer centric services
(d) Core infrastructure can be used for future expansion
(e) All of above

29.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), 2. (c), 3. (a), 4. (d), 5. (e), 6. (a), 7. (d), 8. (c), 9. (d), 10. (e).

29.9 KEYWORDS

Channel, Disk mirroring, Disk duplexing, Dumb terminals, Server.

PAYMENT SYSTEMS AND ELECTRONIC BANKING

STRUCTURE

30.0 OBJECTIVES

After reading this unit, you should be able to:

- Define electronic payment systems and describe the different types of such systems.

- Describe the various electromagnetic cards.
- Explain electronic banking in terms of the process and types.
- Appreciate the signature and retrieval systems.
- Identify the use of other electronic devices.

30.1 INTRODUCTION

The growth of technology has changed payment systems the world over during the past two decades. More and more innovations are being introduced in both the cash payment systems and non-cash payment systems. Cash in the form of notes and coins was the principal method of payment before the introduction of the 'Banking' paper instruments such as 'Cheques' and 'Credit Transfer' now have become a part of the payment system with the popularity of banking. With the introduction and implementation of the recent technology in banking, electronic devices are making the job of cash payment as well as non-cash payments easy and efficient. The introduction of the automatic teller machines (ATMs) and the plastic cards has given the banking customers the facility of round the clock (24 hours) banking.

30.2 ELECTRONIC PAYMENT SYSTEMS

The major routine processing in day-to-day banking operations originates at the cash counter or teller counters in the banks. Essentially, the idea behind the electronic payment system is that a number of the activities related to payment should be done with the help of computers.

30.2.1 Automated Teller Machines (ATMs)

Automated Teller Machines (ATMs) are primarily used for performing some of the banking functions such as the withdrawal of cash or the deposit of cash/cheque, etc., by using an ATM card. The committee headed by Dr. C. Rangarajan recommended the setting up of ATMs in India. They are to be strategically located at airports, railway stations, hospitals, important commercial centres, as well as bank branches, for use by the customers.

Stand-alone ATMs made their appearance in India, in the early 1990s. For facilitating the operations through these ATMs, the customer was provided with an ATM card with a unique personal identification number (PIN). Whenever a customer performs a transaction, the person has to key in the PIN which is validated by the ATM, before the machine permits any transaction. The PIN has to be kept secret by the customer, to prevent any misuse or fraudulent transactions in the event of loss of the card.

Convenience of ATMs

To the Customers:

(a) 24 x 7 access availability
(b) Less time for transactions (less queue)
(c) Privacy in transactions
(d) Any branch/anywhere banking enabled
(e) Acceptability of card across multiple bank ATMs, even foreign tourists can access Maestro/VISA / ATMs
(f) Other services enabled in ATMs in addition to cash dispensing includes clearing cheques deposits, balance enquiry, cheque book requisition, details of recent transactions.

To the Bank:

(a) Cost of setting up ATMs is lower than setting up a branch
(b) Migration of the routine transactions to the ATMs frees the bank staff for more productive work
(c) ATMs serve as the crucial touch point for cross-selling of the bank's products
(d) Enables the bank to display products on the screen and serves as a media for publicity for the bank
(e) Less hassle in handling cash.

ATM Models in India

Online: When the ATM is connected to the bank's database and provides online real time access to the customers accounts, it is said to be 'online.' Normally, there is a daily limit of withdrawal set by the bank. This limit is monitored by the ATM switch centre.

Offline: When an ATM is not connected to bank's database, it is stated to be 'offline.' In this mode, withdrawals are permitted up to a pre-fixed limit only, irrespective of the balance available in customers' accounts.

Stand-alone: When an ATM is not connected to any ATM network, it is said to be 'stand-alone'. In this case, transactions at an ATM are restricted to customers of the ATM branch and its link branches.

Networked: When ATMs are connected to an ATM network, they are said to be 'networked'. The advantage of networked ATMs is that cardholders can use their ATM cards at any of the networked-ATMs. This in effect permits 'anywhere anytime' banking.

Cash Dispenser (CD)

Cash dispenser is a pruned down version of the ATM. CD is an ATM without a depository and is intended to serve the customers for making cash withdrawals only.

Networking of ATMs

For optimising the cost on investments in ATMs, Banks joined together in small clusters to share their ATM networks. There are many such ATM network clusters functioning in India. In order to facilitate inter-operability among these clusters at the national level, the IDRBT has initiated the process of setting up a 'National Financial Switch' to facilitate apex level connectivity of other switches established by banks.

Indian Banks' Association (IBA) was the first to set up a shared payment network system (SPNS) or SWADHAN network of ATMs of its member banks in Mumbai. The network went live on 1 February, 1997. The objective behind the SWADHAN network is to provide 24 hours, 7 days a week electronic banking service to the customer of a member bank any where in the city of Mumbai. The customer is free to conduct transactions at the ATMs of any of the member banks located in the neighbourhood.

Thus, ATMs in India have come to occupy a key component of retail channel strategy adopted by the banks worldwide. As a self-service channel, banks have delivered exceptional customer convenience in deploying the ATMs. In the Indian situation, the public sector banks are implementing their technology blueprint by networking their branches. Their customers have started experiencing the transition from being a branch customer, to becoming a customer of the bank, thanks to the core banking solutions which are under implementation.

ATMs Customer Interface

The following components of the ATM provide the customer interface:

(a) Video Display Monitor

(b) Keyboard/Keypad

(c) Touch Screen

(d) Slots: There are slots in the ATM for various purposes as detailed below:

(i) Card Reader (ii) Cash Dispenser

(iii) Envelope Dispenser (iv) Deposit Slot

Future Perspectives of ATMs

The future plans include expanding the network by connecting more ATMs over the next five years for:

(a) increasing the number of transactions per day per ATM

(b) establishing connectivity with point of sale (POS) terminals at merchant establishments

(c) e-ticketing in railways, roadways and airways

(d) providing international payment networks such as VISA and Master Card.

FIGURE 30.1 ATM 30.2.2 HWAK (The Intelligent Auto-teller and Netware Management System)

Intelligent auto-teller systems are a special breed of auto-teller machines capable of thinking for themselves, that means they are fast, impose less demands on your banking systems and serve the customers more like a personal banker than less sophisticated auto teller systems.

HWAK provides unsurpassed service even without benefit of a reliable communication network.

Benefits of HWAK are:

(a) Customer satisfaction.
(b) High availability
(c) Online and offline auto-recovery
(d) Anytime full banking service
(e) Low cost, shorter queues and less number of tellers with ease of use
(f) Quick and early implementation
(g) Enhanced security and audit control
(h) Network management
(i) Predictable cost of ownership
(j) Comprehensive 'One Stop' autobanking.

30.3 PERSONAL IDENTIFICATION NUMBER (PIN)

A magnetic strip is fixed on the back of the cards. This strip holds certain information about the customer

such as his account number, personal identification number (PIN), etc. After insertion of the card into the appropriate slot, the ATM or POS device reads the account number, with the number embossed on the card itself and checks the number with the information stored into the database available to it through an attached computer. Once the card is found valid, the ATM/POS terminal prompts the cardholder to enter his/her PIN. Once this PIN is entered by the cardholder, the ATM/POS terminal checks whether it is correct or not. Once the PIN matches with the one stored in the computer, the cardholders will be allowed to proceed with his transaction on the ATM/POS terminal. A PIN is similar to the password that a user of a computer has to give when he/she wants to use it. Unfortunately, in an ATM or a POS terminal, the passwords can be a combination of numerical digits only as it uses a limited number of keys to operate.

Banks which issue cards for use on ATMs, POS terminals, etc., also give a PIN along with the card. The PIN is a randomly generated sequence of digits which is printed on paper and is automatically folded and sealed before it even reaches the bank's own officials. The seal is to be opened only by the card holder and has to be kept secure. It is generally suggested that the card and the sheet of paper containing the PIN be kept in separate pouches, so that the chances of it being lost or stolen together are rare.

30.4 ELECTROMAGNETIC CARDS

In the modern day of commerce, credit cards have acquired a fairly prominent and pervasive role. With the increasing use of the credit cards, the society is moving towards cashless transactions. In India, however, the use of the credit cards is restricted to small values and mostly personal transactions. The two international credit card giants, viz., Visa International and Master Card International are already present in India and are poised to make deeper inroads in the untapped Indian market.

30.4.1 Credit Cards

Let us see how a credit card is issued and used. Generally, a bank enters into an agreement with its customer and issues the customer a credit card. A credit card is a small plastic card around 8.5 cm by 5.5 cm. It has the name and the account number of the holder embossed on it. In addition, the date up to which the card is valid will also be embossed and a specimen signature panel on the reverse. The card issuer should normally get the card holder to sign on the specimen signature panel in his presence

FIGURE 30.2 Master Card and Visa Card

before parting with the credit card. The limit up to which the card holder can make purchases in a month is also informed to the card holder; this limit is called the card-limit.
Many card issuers, being banks, also allow withdrawals of cash for emergency purposes and levy a service fee for such withdrawals. Many banks also have credit cards which double up as ATM cards.
There are different types of credit cards, some of which are discussed below:
(a) Charge card (b) Debit card (c) Credit card
(d) Smart card or Chip card (e) Restricted card/Member card

Charge Card

In such cards, transactions are accumulated over a period of time, generally a month and the total amount charged, i.e. debited to the account. The credit card holder is given about 25 to 50 days' time to credit his account in case there are insufficient funds in his account at the time of debit.
Since the transactions are accumulated, it is only charged, i.e. not debited to the account immediately, such cards are called charge cards.

Credit Card

This is the same as a charge card where the transactions are charged to the account with the total value of transactions debited to the card holder's account once in a month. The difference between the credit and charge card is that in case of charge card, the amount becomes payable immediately on the debit to the account. In case of credit cards, the cardholder has the option to pay the entire amount as soon as the account is debited or he may choose to pay only a certain percentage of the amount debited and he gets a credit to extent of rest, i.e. he can pay it in monthly instalments later. However, a service fee is charged on the amount, payment of which is deferred.

Debit Cards

A bank-issued card that allows its user to access their funds for the purpose of paying for merchandise. A debit card acts like a credit card, the difference being that funds are immediately taken from the cardholders accounts.

Smart Cards

The Smart Card looks exactly like any other plastic card or an ATM card with an integrated circuit (IC Chip) installed. The IC chip contains memory, may contain a processor, and communicates with the external world through contacts on the surface of the card. The size, position and utility of the contacts are specified by an international standard (ISO 7816), so that cards can interact with a variety of equipment.

FIGURE 30.3 Smart Card and Smart Card Readei

There are two main types of smart cards: Intelligent memory chip and micro-processor cards. Memory smart cards have been around for several years. They are being used in pay phones, identification, access control, voting and other applications.
Processor smart cards are the most advanced and are ideally suited for banking and financial applications where reuse of the card is allowed. These cards have a built-in memory and the processor along with an operating system. They perform the financial operations. As intelligence is built-in, they can protect themselves against fraudulent operations. This protection is based on the data encryption standard (DES), which is accepted by the International Standard Organisation as safe enough for protecting electronic funds transfer (EFT) transactions. For smart cards, ISO 7816 defines the physical features and the communication protocols. ISO 10202 defines the security features.

Terminal Requirements: A special terminal must be used to read and update the smart card, with the following features:
A smart card reader must be available that meets ISO specifications and can read and write the card.
A secure pin pad must be provided, which allows the user to enter the PIN and have it checked by the smart card. The pin pad would have to store the secret keys for the application and must be designed so that it is impossible to extract these keys under any circumstances.
Security Advantages: The security level has even been certified by independent and competent authorities. Unlike a conventional magnetic strip card, which can be easily erased or copied, smart card has a protected and much larger memory. Smart cards also have confidential memory zones holding secret user information.
The Future is Bright: The future of the smart card in the banking and the financial sector is very bright and it is evident that leading players in electronic funds transfer have already realised this. Earlier in 1993, NATWest Bank of the UK announced its Mondex system, based on smart cards. Visa and Master Card have also joined hands with Europe's largest ATM network, Europay to set standards for smart card-based electronic fund transfer systems. In India too, there are moves afoot to introduce smart card-based personal banking.
Member Card
This is used exclusively by members of a club or a chain of hotels. For example, the Taj Card is a card issued by the Management of Taj Group of Hotels to be used by patrons of their hotels. The cards are for use in their hotels only. Similarly, there are many other types of cards where the usage is exclusive to the members of a group or establishment.
The advantages of credit card system to the concerned parties are as under: To the cardholder:
(a) It is convenient for him to carry a credit card in his wallet and make trouble-free travel or purchase.
It allows him to draw cash too
(b) It inculcates a sense of financial discipline in him
(c) It provides a proof of purchase through banking channels to strengthen his position in case of disputes with sellers, etc.
(d) It also gives him exposure to banking
(e) It also allows him to delegate spending power to add-on members
(f) It also extends additional facilities like insurance cover/discount, etc.
To the merchant establishment:
(a) Increase in sales because of increased purchasing power of the cardholder due to unbilled credit

(b) Preferred locations by a cardholder
(c) Less need for the merchant establishments to provide customers with extended credit facility, which
is likely to be a costly burden to them
(d) Systematic accounting since sale receipts are routed through banking channels
(e) Advertising and promotional support on a national scale
(f) Development of a prestigious clientele base
(g) Assured and immediate settlement/payment
(h) Avoids all the cost and security problems involved in handling cash.
To banks:
(a) Scope and potential for better profitability out of share earned from the traders' turnover
(b) Helps in establishing banking relationship with new customers
(c) This also provides additional customer service to the existing clients. Better network spread of
cardholders and their increased use means higher popularity and image for the banks

(d) Savings of expenses on cash holding/stationery printing and manpower to handle clearing
transactions.

Modes of Acceptance of Card Manual

(a) In this mode, merchant has to verify the genuineness of the card from the warning bulletin which is
supplied regularly

(b) After ascertaining the genuineness of the card, the merchant has to take the imprint of the card on
charge slips supplied for the purpose

(c) Interchange fee: This is the percentage on the total value of transaction which goes to the bank. In
case of manual acceptance, it is 1.67 per cent

(d) Manual acceptance is recommended at merchant establishments with low ticket size (average value
of transaction) except jewellery, electronic goods, handicraft, hotels and air tickets, where chances
of fraudulent transactions are high.

Electronic

(a) Card is accepted through electronic EDC (Electronic Data Capture) machines. Validity of the card
and credit limit is verified online and approval is by the merchant online

(b) Interchange fee in this mode is 1.10 per cent per month. Here, the merchant should have a telephone
facility.

30.4.2 Multiple PINs

One of the most primary features of the smart card is security to prevent card-related crimes and frauds. Chips for smart cards are not publicly available. We have seen that the smart card has different pockets of storage of cash for different types of transactions. Personal identification security concerns the linking of the card to its rightful owner, which is the most commonly used method for identifying. There may be unique PIN for each pocket, meaning that a smart card may have multiple PINs.

Apart from multiple PIN facility, other security features are also available with the smart card, which are as under:

Dynamic signature verification: It traces the way in which a signature is written - the dynamic signature tablet automatically verifies whether the signature is genuine or not.

Fingerprint verification: It is used to identify whether the user of the smart card is genuine or not by electronically scanning fingerprint ridges.

Voice recognition systems: It uses a computer which is programmed to recognise different voices and compares the voice with the recorded original.

Hand geometry: Research has shown that individual hands have unique features such as finger lengths, skin web opacity and radius of curvature of fingerprints. Systems are available to measure hand geometries by scanning them.

Retinal pattern verification: The pattern of the blood vessels on the retina of the human eye is a unique physical characteristic; the retina is scanned using a low intensity infrared beam and the person's identification is thereby ascertained.

Vein recognition: This method, like retinal pattern identification, uses the unique vein structure of the human body to identify individuals. The 'vein check' system uses a simple infrared scanning and encoding technique to locate the number, position and size of subcutaneous vessels.

Visual recognition: It is possible to digitise a picture of a person and store it in a smart card memory. The picture, usually obtained by a scanning video camera, is digitised and then compressed to enable it to be stored in the smart card. These days, this system is becoming very popular.

30.4.3 Electronic Purse

The card has space for several 'electronic purses', each for the storage of an amount. These can be used for different types of accounts of the user. In addition, there is space for user data such as address, the branch where the user has his account, and even the last thirty to fifty transactions.

The advantages of the processor smart card are: security, reliability and longer life. No wonder that this card is being used for financial systems in many developed countries.

For the Bank: Electronic purse provides a new method of payment which allows the bank to enter into a transaction market which is complementary to the credit or debit card transaction market. Electronic purse presents no risk of bad payment. Revenue is guaranteed from existence of the float account.

For the Purse Holder: The cash in an electronic purse cannot be spent if the purse is reported stolen or lost. A new electronic purse can be issued after loss, theft or destruction with the original balance restored. A single card can conveniently pay all small to medium purchases.

For the Merchants: Electronic purse represents a single method of accepting payments with no cash float to manage and no risk of theft.

30.4.4 Bank Card

Bank card service provider, European International is embarking on a programme to update its European payment systems network. EPS - Europay is a private network which carries transaction information on personal payment cards such as Eurocard and Master Card. Europay provides a full range of services including Travellers cheques, cheque guarantee, ATM, electronic point-of-sale, credit and charge card services. EPS-Net is getting updated due to demands for increased security and to keep pace with new card technology.

30.4.5 Electronic Cheque

The smart card can be used during electronic fund transfer at the point-of-sales (EFTPOS). At a retailer's checkout, the card is placed in the reader, where it automatically goes through authentication sequences. To authorise payments, the customer types in the PIN and the cardholder's bank account is automatically debited and the retailer's account credited. Also a record of the transaction is stored in the card.

30.4.6 Electronic Cash

Funds can be loaded into a card for use as cash. This electronic cash can then be used for making

purchases, necessarily requiring authorisation of PIN; the retailer presents this information to the bank so that his account can be credited.

30.4.7 Electronic Token

The principle here is that a prepaid area is set aside to store electronic units of time or electronic tickets, etc., for a specific service or item. Magnetic strip cards are often used with public telephones, parking meters and vending machines.

30.4.8 Corporate Cash Management Services

Banks are now beginning to provide corporate cash management services to companies and other major clients. In this area, the smart card can act as secure keys, allowing the account holders to access the banks' mainframe computers to view their accounts and transfer money automatically between accounts.

30.5 ELECTRONIC BANKING

With the introduction of computers in Indian banks and with the advent of ATMs, the banking services are provided across the banks. Customers need not necessarily visit the branch to do banking transactions, when the banks provide them with tele-banking or remote-banking facility. This type of banking is called electronic banking and the concept is becoming popular with individuals as well as corporate entities in India.

30.5.1 Anytime Banking

ATMs have eliminated the time limitations of customer service, and offer a host of banking services, including deposits, withdrawals, requisitions, instructions and transfers. The customer need not be concerned much about the security, as most ATM locations have guards, or alternately are located in lobbies, access to which is electronically controlled by means of the customer's ATM card. Besides, access to the account is through a PIN which is strictly supposed to be only known to the cardholder.

HSBC Ltd., for instance, has taken the concept of remote banking further by providing a service called Hexagon, which allows the customer to access his accounts from a PC that is installed at his office or at his home - that is desktop banking - for the customer. This access is also available for worldwide locations, giving the customer fingertip access to his accounts worldwide.

30.5.2 Anywhere Banking

With the introduction of ATMs and tele-banking, financial details can be accessed from remote locations and basic transactions can be effected even outside the bank. Interstation connectivity of ATMs has also facilitated withdrawals from other stations, a service particularly useful for frequent travellers. The facility of using credit cards on ATMs is also available and more recently, mutual arrangements between banks are made for allowing the use of any bank's ATM card on any other bank's ATMs. With the implementation of Rangarajan committee's report, Government approval to set up ATMs at non-branch locations, such as airports, shopping malls and office complexes, as is prevalent in other countries has revolutionised banking in the Indian context. In some of the Indian public sector banks, remote banking is being further extended to the customer's office and home.

30.5.3 Home Banking (Corporate and Personal)

Today, banking customers are more affluent and technologically sophisticated than ever before. With less and less time available to conduct routine banking business, more and more of them have become comfortable with the idea of using machines for a wide range of banking services.

Corporate Banking

Remote banking has become very popular among corporate customers especially big business/industrial houses which are already automated. More and more banks are providing customer terminals right in the customer's office, which facilitates the customers to operate the account without physically coming to the bank. For availing these services from the banks which have this facility, the customer requires a computer, a telephone connection and a modem. Moreover, any of these items need not be dedicated for this purpose and could be utilised only at the time of performing banking transactions thereby do not involve any additional investments.

At present, by utilising remote banking facility, corporate customers will be able to get the following services:

(a) Getting their current balance or getting their statement of accounts for any pre-defined period
(b) Ordering cheque books
(c) Ordering intra-bank and inter-bank fund transfers
(d) Instructing stop payments of cheques
(e) International remittances
(f) Opening letter of credits.

By obtaining a special SWIFT (Society for Worldwide Inter-Bank Financial Telecommunication) authentication facility in arrangement with their bankers, customers will be able to directly prepare messages in the SWIFT format by sitting in their office, and transfer the particulars in the respective templates to their bankers. The bankers will directly authenticate the transaction thereby the entire transaction is completed across the globe within minutes.

Personal Banking

By using tele-banking facility, customers can dial up the branch's designated telephone number, which is connected to the computer and, by dialing his identification number, will be able to get the connectivity to the branch's designated computer. The software provided in the machine will be interactive with the customer asking him to dial the code number of the service required by him and suitably answers him. A customer can have access to his balance, and also can place order for statement of accounts, cheque books and a few selected services through this tele(phone) banking.
The customers who have modems and a personal computer at home can have direct connectivity with the branch's computer through telephone line, and can obtain similar services, besides additional services like transferring the statement of his account from the branch's computer to his own personal computer. The number of services offered at present is however limited.
Telebanking
The function of telebanking services is based on the voice processing facility available with the bank computers. The caller, generally a customer of the bank, will be able to call the bank anytime and enquire balances or transaction history, and to transfer funds between accounts. In this system, the bank's computer is connected to a telephone link with modem. The voice processing facility provided in the software identifies the caller, by keyword and provides him services with suitable reply. Some banks use a telephone answering machine, in which case the service is not really 'tele-banking' per se, but simply a telephone answering system. Apart from tele-banking, another system, simple and for limited service is also available - known as voice mail facility. There are several foreign banks now offering very advanced touch-tone telephone answering services which route the customer's call directly to the department concerned of the bank. It also allows the customer to leave a message for the concerned desk or department if the person is not

available. In this system, each service representative has his or her 'Voice-Mail' Postbag in which massages are stored and retrieved upon his return to the desk. With the help of telephone answering system, the enquiries are most common in computerised railway reservation system.
Update Facilities
We have studied the different types of banking through electronic media. Let us study the different approaches which can be adopted for updating transactions generated in a bank. These are:
(a) Online updates (b) Batch updates
Online updates: Online may be defined as the direct linking of an operation or equipment to a computer system so that any stimulus provided by that operation or equipment is immediately accepted by the computer system. This means that when a transaction is entered by the user, the computer acknowledges it and updates the related files which are affected by the particular transaction, so that before the next transaction is produced, the files in the computer already contain the updated data.
The first application of online updation in banks is in front-office mechanisation. The following are the few cases, in which online updation is required.
(i) Foreign Exchange Transaction: When the bank enters into a contract to buy or sell foreign exchange on behalf of its clients, the transaction is immediately entered into the computer of that authorised foreign exchange dealing branch. The computer in the branch is linked to a central computer at the bank's head office. The moment the data regarding the foreign exchange transaction is entered into the branch computer, it is transmitted to the central computer, where the requisite files are updated immediately.
This online updation is very necessary as the bank must know its outstanding short or long position in each currency at any given time. This information is used by the banks to determine the action to be taken to safeguard the bank's position by entering into currency swaps as they deem necessary, (ii) Automatic Teller Machine: Some of the ATMs function on

the principle of online updation. These types of ATMs are linked to a central computer which contains the database of the customer accounts.The database is constantly updated with data from ATMs linked to it.

Batch updates: Everyday at the end of the banking hours, the computer operators start entering the data of the day's transactions into the computer. One operator takes up the entry of all the cheques debited in customer accounts and cleared that day, the other operator is given the data in the scroll book to total up the day's cash deposits, a third operator takes up the work of entering the cheques which have been credited that day in the customer accounts and so on.

After all the data is entered, it is processed by the computer. The branch officials can then access the computer for information relating to the following:

- Total cash deposits and withdrawals made during the day.
- Reconciliation of cash receipts and withdrawals with that day's opening balance to arrive at the
next day's opening balance, which should tally with the physical cash in hand.
- Check whether the balances of the bank in the customer accounts are reconciled after taking into
account all the debits and credits posted in the day.
- Take the printout of the general ledger of the branch.
- Generate statistical returns required by the Regional/Zonal or the Head Office.
- Check whether the advances and fixed deposits are being maintained at the level required by the head office.
- List of transactions entered would be taken which would be checked with the relative vouchers. The above scenario is an example of local processing with batch updates. The input data is collected in

a batch and then entered into the computer for processing. The next day again data is collected in a batch and entered into the computer for processing.

30.5.4 Internet Banking

Banks have traditionally been in the forefront of harnessing technology to improve their products, services and efficiency. They have, over a long time, been using electronic and telecommunication networks for delivering a wide range of value added products and services. The delivery channels include direct dial-up connections, private networks, public networks, etc., and the devices include telephone, personal computers including the ATMs, etc. With the popularity of PCs and easy access to Internet and World Wide Web (WWW), banks increasingly use internet as a channel for receiving instructions and delivering their products and services to their customers. This form of banking is generally referred to as Internet Banking, although the range of products and services offered by different banks vary widely both in their content and sophistication.

Broadly, the levels of banking services offered through the internet can be categorised in to three types:

(a) The Basic Level Service is the banks' websites which disseminate information on different products and services offered to customers and members of the public in general. It may receive and reply to customers' queries through e-mail.

(b) In the next level is Simple Transactional Websites which allow customers to submit their instructions, applications for different services, queries on their account balances, etc., but do not permit any fund-based transactions on their accounts.

(c) The third level of Internet banking services are offered by Fully Transactional Websites, which allow the customers to operate on their accounts for transfer of funds, payment of utility bills, subscribing to other products of the bank and to transact purchase and sale of securities, etc. The above forms of Internet banking services are offered by traditional banks, as an additional method of serving the customer or by new banks, who deliver banking services primarily through Internet or other electronic delivery channels as the value added services. Some of these banks are known as 'virtual' banks or 'Internet-only' banks and may not have any physical presence in a country despite offering different banking services.

From the perspective of banking products and services being offered through Internet, Internet banking is nothing more than traditional banking services delivered through an electronic communication backbone, viz., Internet. But, in the process, it has thrown open issues which have ramifications beyond what a new delivery channel would normally envisage and hence, has compelled regulators world over to take note of this emerging channel. Some of the distinctive features of i-banking are:

(i) It removes the traditional geographical barriers as it could reach out to customers of different countries/legal jurisdiction. This has raised the question of jurisdiction of law/supervisory system to which such transactions should be subjected,

(ii) It has added a new dimension to different kinds of risks traditionally associated with banking,

heightening some of them and throwing new risk control challenges and risk perceptions,

(iii) Security of banking transactions, validity of electronic contract, customers' privacy, etc., which have always been matters of concern, given that the Internet is a public domain, not subject to control by any single authority or group of users,

(iv) It poses a strategic risk of loss of business to those banks who do not respond in time to this new technology, being the efficient and cost effective delivery mechanism of banking services.

30.5.5 Mobile Banking

Mobile Banking comes with features like 128 bit encryption and open Internet technology, i.e. it is not dependent on any specific service provider and the handset company. The service is free of charge.

With this facility, customer - on his/her mobile screens - can check his bank balance, or order a demand draft, stop cheque payment, request for a cheque book, look at the current interest rates, or even the last three to five transactions round the clock.

30.5.6 Electronic Commerce (E-commerce)

E-commerce is a digital parlance. If you think that e-commerce, per se, is limited only to a niche segment of business-to-business (82B) transactions, think twice! No doubt, the bulk of the business done on the net would be in the business-to-business category, but this bulk will be generated by business-to-business transactions.

E-commerce translates your otherwise intangible benefits. Other exciting developments springing from e-commerce include a higher degree of personalisation, round-the-clock advantage, fast and flexible execution, immediate customer reaction, and reduction in operating cost.

E-commerce poses new challenges for all market participants. Banks face competition from non-banks and near banks, which because of low barrier to market entry can play much more easily in the electronic payment services market than in the markets for traditional bank services.

For better communication facility for e-commerce, Government of India has planned that all the state capitals and twelve major cities in the country will be provided exclusive optical fibre links.

30.6 SIGNATURE STORAGE AND RETRIEVAL SYSTEM

Technology can help in this area by the use of computers, which can be used to store and retrieve signature. The computer which contains the signatures is kept with the passing office. The procedure for storing and retrieving specimen signatures is as follows:

Each signature card is scanned using a device called scanner. The scanner is a device which takes the image of the specimen signature card and converts it to a digital from which is then stored on the hard disk in the computer. Along with the signatures, other details like account number, name, operating instructions are inputs to the computer. Each signature card is stored in the computer in this way. Once all the details of the signature and related details of the account are captured on the system, the data has to be verified, validated and authenticated. Once it is authenticated, no changes can be made without proper authorisation. Once a cheque is received by the passing officer, he can recall the signature in seconds on the monitor by specifying the account number. He/she can even rotate the signature on the monitor for any detailed verification. Many signature retrieval systems also provide the facility of magnifying a portion of the signature for a close verification, if required. In case of the fully computerised branches, the signatures stored on the main computer offers a lot more flexibility. This is because the signatures can be viewed by multiple officers at the same time. Restrictions can be introduced so that signatures and other information can be viewed only by the authorised personnel. If, during inward clearing, the number of instruments to be cleared is large, the job of verifying the instruments together with the signature can be distributed among all the officers in the branch, as all of them can access the signatures and other details of the customers simultaneously. Most fully computerised branches generally have a signature storage and retrieval as an integral part of the software.

30.7 CHEQUE TRUNCATION

Originally, Section 6 of the Negotiable Instruments Act, defined cheque as 'a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand'. This section has been amended in September 2002 to include cheque truncations and electronic cheques within the definition of cheque. The amended Section 6 reads as under:

'A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a cheque truncation and a cheque in the electronic form.'

Cheque truncation - Definition

A cheque truncation is defined by the new Section 6(b) of Negotiable Instruments Act as 'a cheque which is truncated during the course of a clearing cycle, either by the Clearing House or by the bank, whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.'

Characteristics of a Cheque Truncation

(a) It is an electronic image of a paper cheque.

(b) Only the banks involved and the Clearing House can truncate a cheque (i.e. create an electronic image of a cheque). The drawer/holder of a cheque cannot truncate a cheque.

(c) The electronic image of the 'cheque truncation' will substitute the physical cheque from the point and time of truncation onwards.

(d) Truncation is to be done only during the course of a clearing cycle to reduce the time taken for realisation.

(e) The paper cheque, after truncation, is to be kept in the custody of the bank/clearing house that truncated the cheque.

(f) Addition of digital signature of the truncating Bank/Clearing House to the electronic image of the cheque truncation is optional.

Ways in which truncation can be done

1. Using MICR data: MICR cheques have the cheque number, city, bank and branch numbers, and transaction code pre-coded. Abroad, even the account number of the customer is precoded. During encoding at the collecting bank, the amount, as well as the payee's name, is inserted in the MICR line. The entire MICR line is then captured electronically. The electronic information is then exchanged with other for clearing (Inter Bank Data Exchange or IBDE). The cheques do not move any further.

2. Using image processing: Image processing, as we have seen earlier, is the latest document handling system. Cheque image processing involves scanning of both sides of the cheque and storing the image in digital form. The cheque itself is moved to some offsite storage and the image is used for further processing.

Advantages

Cheque truncation truncates or stops the flow of cheques through the banking system. At some point after a cheque enters the banking system, information from the cheque is converted to a medium for electronic processing. The cheque itself is then stored (or truncated). Further processing of cheque is done with the electronic information rather than paper (i.e. the cheque itself).

Truncation can occur at the branch in which the customer deposits the cheque, i.e. the collecting branch. The collecting branch truncates the cheque and sends the electronic data to the clearing house or directly to the paying branch.

30.8 NOTE AND COIN COUNTING MACHINES

To reduce the n^ed of manual counting, note counting machines are available which counts a bundle of notes placed on it. Loose notes are inserted into the machine. The machine counts the notes at high speed, while simultaneously indicating the number counted on a digital display. Every time the number

FIGURE 30.4 Ban;* ,»Uic wuunnng Machine

reaches 100, the machine stops, subject to it being fixed at 100 and allows for the bundle to be taken out. This machine does relieve the drudgery involved in counting. However, one limitation of this machine is that the notes have to be in fairly good condition for the machine to able to count properly. However, the machine requires that all notes be of the same denomination.

Similarly, coin counting machines are available. These machines act like a sieve, separating the various denominations of coins into separate slots and also counting in the process. The counting of coin is basically based on the diameter of the coin.

30.9 MICROFICHE

Periodical backup of the database is required to be taken in external media for data security aspect. When the size of the data base is enormous, the type of storage becomes a concern. We use data cartridges for such purposes but their longevity in data recovery over a period is doubtful. For such ticklish data storages, microfilm or microfiche come in handy because they can retain voluminous information and the relative inability to readily ascertain their contents. Hence, it becomes necessary for any organisation to evolve stringent control measures such as physical custody, maintenance, access, etc. to the media. The following controls should be put in place for the protection of this media.

Disclosure

To procure greater security for highly sensitive information stored on magnetic media, it is to be ensured to encrypt the storage media containing highly sensitive information or to physically protect the media from unauthorised access or removal. To prevent the disclosure of sensitive or highly sensitive information on microfiche, it is advisable to attach labels indicating the highest classifications of information that is stored on a microfiche. This label should be clearly visible. {

Destruction

To prevent destruction or disclosure of information through unauthorised removal of storage media, it is to be ensured that access to areas containing a concentration of information storage media is controlled. In addition, consideration should be given to the use of electronic article surveillance security systenls.

Business Continuity

To ensure the continued availability of the information stored on microfiche, it is to be ensured that this mass storage media is included as part of the contingency and disaster recovery plan.

Environmental

To prevent the destruction of information through loss of storage media due to environ¬mental problems, it is to be ensured that adequate fire protection and environment control is provided for the sites where microfiche devices have been stored.

30.10 LET US SUM UP

With the development of modern communication facilities, electronic payment systems are becoming popular. These are teller machines available for bank customers within the bank as well as outside the bank premises.

ATMs, which are being located even at the public places, are able to provide the customers minimal banking services including cash payments round the clock. Shared ATMs are also introduced in India where the services are provided across the banks. Customers need not necessarily visit the bank to do banking transactions when their banker provides them tele-banking or remote banking facility.

We have also seen that the various electronic and electro-mechanical aids that help the modern banker to efficiently render innovative and novel customer services. We studied technological aids such as smart cards, signature storage, and retrieval. Equipments like note and coin counting machines mentioned in this chapter help the banker to take care of the tedium in his task, reduce drudgery and at the same time efficiently discharge his functions. These technological aids not only take care of some of the physical routine tasks but also contribute substantially to efficient housekeeping functions and also render services that are in tune with the customer needs and satisfaction.

30.11 CHECK YOUR PROGRESS

1. ATMs provide

(b) privacy in transaction (d) quick and efficient service

(a) round the clock service (c) anywhere banking facility (e) all of above

2. From the bank point of view the advantages of ATMs are

(a) alternative to expand banking hours

(b) cash handling and cash transportation is avoided

(c) alternative to new branches

(d) none of the above

(e) none of these

3. PIN is

(b) postal index number, (d) (a) & (c)

(a) randomly generated sequence of digits (c) stored in magnetic strip of the card (e) none of these

4. Security features available with smart cards are

(a) multiple pins (b) retinal pattern verification

(c) dynamic signature verification (d) vein recognition

(e) all of above . .

5. The advantages of the processor smart cards are

(a) security (b) reliability

(c) longer life (d) all of the above

(e) none of these

6. Electronic purse may have following number of storage space

(a) only one (b) two

(b) sending cheque by speed post (d) (a) & (c)
(b) payoff the entire amount of card usage (d) all of above
(b) payoff the entire amount of card usage (d) all of above
(b) payoff the entire amount of card usage (d) all of above
(c) several (d) no storage space
(e) none of these

7. Cheque truncation can be done by
(a) using MICR data
(c) using image processing (e) none of these

8. The Credit card offers
(a) revolving credit for certain period
(c) on-line recover of amount of card usage
(e) none of these

9. The Debit card offers
(a) revolving credit for certain period
(c) online recover of amount of card usage
(e) none of these

10. The Charge card offers
(a) revolving credit for certain period
(c) online recover of amount of card usage
(e) none of these

11. Mobile Banking offers the following
(a) Withdrawal of cash anywhere in India
(b) Statement of account for a specific period
(c) Transfer of funds from one account to another account
(d) Balance enquiry

12. Transactions of Internet Banking excludes
(a) Withdrawal of cash anywhere in India
(b) Statement of account for a specific period.
(c) Transfer of funds from one account to another account
(d) Balance enquiry

30.12 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (e), 2. (d), 3. (d), 4. (e), 5. (d), 6. (c), 7. (d), 8. (a), 9. (c), 10. (b), 11. (d), 12. (a).

30.13 KEYWORDS

ME, Imprinter, Offline ATMs, Host, WAP.

DATA COMMUNICATION NETWORK AND EFT SYSTEMS

STRUCTURE

31.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the concepts of Information Technology and its advent in Indian banking.
- Describe the essential components of data communication networks and major data communication networks in India.
- Explain the emerging trends in data communication networks.
- Describe the concept of EFT systems, their evolution and the essential characteristics of the funds transfer mechanism.
- Describe the SWIFT operations for structured message transfer.
- Explain the various automated payment systems the world over.
- Describe the electronic clearing systems in India.

31.1 INTRODUCTION

The past few years have witnessed a phenomenal advancement in computers and telecommunication technologies and their fusion has led to data communication networks. This has largely changed the bankers' strategy towards the technology absorption. Processing and execution of payment instructions is one of the statutory obligations of the banks. Conventionally, paper-based instruments like cheques, drafts, dividend and interest warrants, refund orders, gift cheques, traveller cheques, etc., have been the modes of settling payment transactions. However, the use of computers and communications has now changed the whole mechanism of funds transfer and the settlement process into the fast and automated EFT systems. An electronic funds transfer differs from the conventional transfer in that the information is processed and transmitted electronically.

31.2 ADVENT OF INFORMATION TECHNOLOGY IN BANKING

The extent of application of information technology which emerged as a fusion of computers and telecommunications in the 1990s has greatly transformed the banking operations. The use of computers and telecom technology are the main foundation around which most of the banks are today building their banking services and operations.

There were the two successive committees on computerisation (Rangarajan Committees) that set the tone for computerisation in India. The second committee set up in 1989 paved the way for an integrated use of telecommunications and computers for applying fully the technological breakthroughs to the banking operations. The comprehensive agreement with unions in 1993 has, in fact, opened the floodgates for the banks to introduce almost an unrestricted usage of IT tools.

MICR technology for speedy clearance of cheques in the four metropolitan cities was a major step towards the automated clearing houses. On the communication front, Banknet and SWIFT for transmission of messages were commissioned in India in the year 1991.

Electronic Funds Transfer (EFT) system now renamed as National Electronic Funds Transfer (NEFT) system, Electronic Clearing System (ECS), and Real Time Gross Settlement (RTGS) systems have also been introduced in all major cities in India.

The foreign banks in India have been more aggressive and have also started their operations with latest technology. A major turning point has been the birth of the fourth generation computer systems. Coupled with this was the vast improvement in the telecommunication technology and the concepts of local area network (LAN) and wide area networking (WAN) of computer systems. Now, information technology is helping the banks to cross the geographical barriers and take banking to the doorstep of the customers.

31.3 DATA COMMUNICATION NETWORKS

Data communication helps in drastically cutting costs and the time involved in transferring data from the point of origin to the computer and information from the computer to the point of use.

This brought about the concept of distributed data communication networks, wherein computer systems with the aid of telecommunication links share resources at reduced costs. The data communication networks have become an integral part of present day banking. Data communication provides the connections to computers which may be located in geographically dispersed locations all over the world.

31.3.1 Components of Data Communication Networks

Data communication typically consists of various data communication components. When the components operate together for the sharing of resources, they are said to form a network. It has three basic components.

/. Transmission Devices and Interface Equipment

The data is transmitted along the communication path between computer oriented devices using electrical signals and bit sequences to represent numbers and characters. If digital signals are to be transmitted over long distances, then the signals get deteriorate. To overcome this problem, the digital signals are converted into analogue signals for transmission over telephone lines. This conversion between the digital and analogue forms is carried out by an interface device called 'Modem' (Modulator de modulator).

Modem: This is a conversion device installed in pairs at each end of an analogue communications line (i.e. telephone line). The modem at the transmitting end modulates the digital signals received locally from a computer or a terminal into analogue signals. It sends the digital Js and 0s over standard phone lines as modulated tones.

The modem at the receiving end demodulates the incoming analogue signals converting these back to the original, i.e. the digital format. Modems come in two types, one which can be installed in the computer and those which are connected externally to the computer.

II. Transmission Medium

For communication between computers, the data has to travel through some medium during its transmission. The prevalent technologies for data communication media are terrestrial, microwave, and satellites.
(a) Terrestrial cables: Three of the most commonly used wiring techniques are the twisted pair, coaxial cables and the fibre optics.
(i) Terrestrial-wire pair: A twisted pair consists of two insulated copper wires. It is widely used
in place of parallel wires to minimise the risk of cross talk, i.e. mixing and distortion of signals. These are useful for connecting terminals to computers up to a distance of 100 metres.
Because of the low cost and ease of convenience, these are most popular cables currently in . use.
(ii) Coaxial cable: The coaxial cables consist of an inner copper conductor held in position by circular spacers. The inner wire is surrounded by insulation and covered by a protective sheath. The covering protects the conductor and prevents interference of signals. The cable can carry digital signals at very high rates of 500 mega bits per second.
(iii) Optical fibre: Optical fibre has been a technological breakthrough in communications. It supports data rate of 2 giga bits/sec. Fibre optics provide high quality (low error rate) transmission of signals at very high speeds. The fibre optics transmissions are not affected by

electromagnetic interference. The transfer of data is through a very thin glass or plastic fibres with a beam of light. The light source is a laser beam driven by a high speed high current driver. These days, for security reasons, light emitting diodes are used.
(b) Microwave .systems: These use very high frequency radio signals used in telephone systems and television transmissions. The radio waves are modulated to carry information. Antennae are mounted on towers to send wave beams from one antenna to another. Along the route, the received data is amplified and retransmitted. The microwave signals may also be passed on to the communication
satellites.
(c) Communication satellite: Communication satellites are now becoming very popular for data commu¬ nication between computers. The speed of the satellite in orbit equals the speed of rotation of the earth and thus, the satellite is stationary relative to earth. The satellite is fitted with transmitters and receiving antennas called transponders. It is used to link two or more microwave transmitters/ receivers on earth (known as earth stations). The main advantage of the satellite is that it is a single microwave relay station which can send signals to a wide geographical area. Applications such as electronic mail, distributed processing. Internet are ideally implemented with the use of satellite communication media. Moreover, the broadcast is independent of the distance between the earth sites.
The networks, the satellite medium are the fastest and have no limitation of distance. In India, Government agencies like NIC and VSNL are offering the satellite-based communication services.
///. Transmission Processors
The purpose of communication processors is to enhance data communication between two points. Communication processors can be broadly categorised as:
(i) Message Switches (ii) Multiplexers (iii) Front end processors.
Message switches. It is used for storing and forwarding data to a large number of terminals over a single communication channel. A message switches receives data from all the terminals, stores them in a queue and routes them, one at a time, to the CPU during transmission. It also distributes messages coming from the CPU to appropriate terminals during reception.
Multiplexer. It is a device that enables more than one signal to be sent simultaneously over one physical channel. It combines inputs from two or more terminals, computer ports or other multiplexers, and transmits the combined data stream over a single high-speed channel. At

the receiving end, the high¬speed channel is demultiplexed, either by another multiplexer or by software.

Front end processor. It is a dedicated communications system that intercepts and handles communication activities for the host computer. It is used to off-load communication tasks from the host computer, thus freeing it to devote its CPU to processing application programs.

31.3.2 Modes of Transmission

The methods of data transmission for communication purposes are classified as follows:

Simplex: A simplex transmission is capable of transmitting data in only one direction. The sender cannot receive and the receiver cannot send. Commercial radio broadcast is a simplex type of transmission. This type of transmission is useful in analogue sampling.

Half-duplex: A half-duplex transmission allows data movement in both the directions but in only one direction at a time. Modems, on a line, are a good example of a half-duplex. The transmitting end waits for the response from the receiving end before sending another message.

Full duplex: A full duplex commonly called 'Duplex' provides for simultaneous two-way transmission.

The transmission is faster because it avoids the delay that occurs in a half-duplex circuit each time direction of transmission is changed. Examples are the four wire full duplex modems used on telephone lines.

31.4 NETWORK SCENARIO IN INDIA: MAJOR NETWORKS

The committees on communication networks for banks, set up in 1987 under the chairmanship of Shri T.N. Anantharam Iyer, executive director, Reserve Bank of India, had strongly recommended for the establishment of a cooperative communication network especially for the banking industry.

Based on the recommendations of this Committee, a communication network, 'Banknet' was set up in the year 1991 by the RBI to facilitate inter-bank transfer of messages within India. It is primarily meant for the exclusive use of the banking industry and other financial institutions and links seven cities, viz., Mumbai, New Delhi, Kolkata, Chennai, Bangalore, Hyderabad and Nagpur through leased lines. However, Banknet has not proved quite popular with the banking community because of the unreliable uptime of the links and limitations in the communication software, COMET. In the meantime, the second Rangarajan Committee had recommended the interconnecting of these branches and interfacing them with the public data networks.

Here, we discuss some of the public data networks developed for the information processing; however, these networks were not developed for the exclusive use of the banking industry. Banknet and SWIFT are the two networks designed exclusively for the banks and other financial institutions for their communication needs.

31.4.1 INET

INET was set up by the department of telephones in the year 1991. It is a fast, reliable, flexible and quite cost effective data communication network. It is a X.25 data network based on the Packet Switched Public Data (PSPD) technology with an error detection and correction techniques. In the PSPD technology, data from each one of the sources is fragmented into packets. These packets are first stored in packet switches called nodes which are nothing but computers that buffer the packets. These packet switches, also route the packets onto the appropriate physical links. They also have a built-in logic to detect congestion or failure of links and to establish alternate routes for the packets. Packet switching allows for dynamic rerouting of the calls (in case of route failure and congestion on a particular route), and interconnection of computers/terminals at different speeds and protocols.

INET allows both way connectivity to:

- Remote Area Business Message Network (RABMN)
- High speed VSAT Network (HVNET)

- Gateway packet switching system (GPSS) of VSNL at Mumbai

Typical Applications: INET is useful for the following applications:

- Electronic Mail Services • Corporate Communications
- Information Retrieval • Database Services
- Remote Login • Credit Card Verifications
- Electronic Funds Transfers.

31.4.2 NICNET

NICNET has been set up by the National Informatics Centre (NIC), a Government of India organisation. It is India's largest Wide Area Network (WAN). The Master Earth Station is installed in New Delhi, to provide access to satellites and operates from around 650 VSAT terminals. Presently, it allows access

to about fifty networks in more than thirty countries. The access is both through leased lines as well dial-up connectivity. It was set up primarily for data collection from 480 districts and facilitates information management from geographically dispersed locations all over India. Though, it has mainly been set up to serve the communication needs of the Central/State Governments, yet banks in India have also been allowed connectivity and are using NICNET for e-mail services. It operates on various backbones, viz., Packet Switched networks, LANs and ISDNs.

31.4.3 INDONET

It was set up by CMC Ltd., in the 1980s and was among the first countrywide networks in India. It has host computers at Hyderabad, Mumbai, Delhi, Kolkata and Chennai and access points at Pune, Vizag, Bangalore and Ahmedabad. It is built around X.25 protocol which allows flexibility in heterogeneous hardware connectivity. It can be accessed via dial-up/dedicated VHF radio links. It also provides a gateway to INET for a wider geographical spread in India and connectivity to other international networks like, Telenet, Tymnet of USA, Telepack of Singapore, Datex of Germany. It has recently added fault tolerant mainframes which offer high uptime and greater processing facilities.

31.4.4 BANKNET

After recognising the pressing need to harness information technology for intra-bank and inter-bank communications in the 1980s, Reserve Bank of India commissioned the BANKNET in 1991. This is a packet switched X.25 based network with nodes at Mumbai, Delhi, Chennai and Kolkata, and a switching centre at Nagpur. In addition, Bangalore and Hyderabad are connected to Chennai through remote connection/messaging facility.

User banks access BANKNET through leased lines at the respective local centres with COMET (Computerised Message Transfer and File Transfer) software. The message transfer utility enables 400 users to login at a time at each node.

COMET has facilities for message creation, deletion, editing, ascertaining status of messages, listing and receiving acknowledgement, etc. It also permits free format messages of eight lines of forty-eight characters each.

BANKNET usage, however, fell far below expectations. The main reason for this was that BANKNET was far ahead of its time, in the sense, that a critical mass in computerisation, change in work procedures necessitating the use of communication technology had not been reached at the user end. The users did not, therefore, feel the necessity to make use of the network resources. Coupled with this was the high rate of leased line failure of both the inter-city and intra-city data circuits. The limitations of the COMET application software, which did not permit file transfer was yet another factor.

31.4.5 RBI Net

RBI Net, a communication software, allows for free format messaging and file transfer on the existing BANKNET infrastructure with the help of servers installed at the four metros. Each RBI Net user interacts with the local server connected to the X.25 switch. The UNIX servers in turn communicate with each other using TCP/IP over the X.25 protocol. The software allows free format messaging without any restrictions on the length of the message; enables file transfer (spreadsheets, data bases, programs, etc.), facilitates dial-up access, and has security features, such as end-to-end encryption, audit trail, etc.

RBI Net is also being used by several departments of the bank for various applications such as:

(i) Transmission of Sec. 42(2) of the RBI Act, 1934, data by commercial banks to regional offices of department of banking operations and development (DBOD) and furnishing of consolidated data by the regional offices of DBOD to central DBOD.

(ii) Press relations division daily news summary of important financial matters,

(iii) Department of economic analysis and policy macroeconomic indicators on a weekly basis.

31.5 EMERGING TRENDS IN COMMUNICATION NETWORKS FOR BANKING

With the availability of more reliable communication media like satellites, the financial sector is making more and more use of the networks for real-time online applications. In this context, the advent of wide area networks like the RBI's VSAT network and the banks' own networks are going to play a major role in changing the delivery systems for the banking sector. Another significant development is the use of Internet for marketing the financial services, which has still to make an impact on the Indian banking.

31.5.1 RBI's VSAT Network

As per the recommendations of the Saraf Committee, the Reserve Bank of India decided to set up a countrywide data communication network for banks linking major centres of the country. This network christened as the INFINET (Indian Financial Network) has been set up at Hyderabad.

Because of the poor quality of the terrestrial communication lines in the country, this network uses satellite communication with very small aperture terminals (VSATs) as earth stations to ensure a reliable infrastructure. VSATs provide communication channels of high quality and can be installed and operated in widely dispersed locations irrespective of the distance and the terrain. These are easy to install and also provide for an easy centralised control and monitoring of every single site irrespective of the distance. A large number of Indian banks have already installed VSATs for connecting their branches/ offices in the network. This type of network also provides a very high uptime of about 99.7 per cent.

User group network: VSAT network is a single closed user group network for the exclusive use of the banks and other financial institutions. The system involves the use of earth stations (VSATs) at different locations and a central hub station for routing data/voice/video communications through satellite. The VSATs are owned by the individual banks and the RBI. The hub is owned by the RBI and the Institute for Development and Research in Banking Technology (IDRBT). This institute was set up by the RBI at Hyderabad to look into the technological issues and solutions for the banking industry. The INFINET has since started its operations w.e.f. 19 June 1999.

Satellite services based on VSAT technology can establish reliable links to all the sites, including those where conventional telecom infrastructure is either poor or non-existent. The central hub is equipped with a network management system which is, essentially, a powerful computer to control the flow of network traffic.

Very Small Aperture Terminal (VSAT) comprises:

- An outdoor unit, which is a small dish antenna providing an interface to the satellite
- An indoor unit which is an interface to users' computer systems.

This network is a hybrid system of two different technologies (Star and Mesh). In the first case, the VSATs communicate with the central hub. Here messages travel from a sending VSAT to the hub via satellite and then from the hub to the receiving VSAT again via satellite. This type is more useful for transmission of data and less of voice grade communications. The second type which is useful for both heavy traffic of data and large amount of voice and video grade communications involves a single hop from the sending VSAT to the receiving

VSAT via satellite. The pictorial depiction of the message transmission is given in Figure 31.1.

305FIGURE 31.1 VSAT NetworK iopology for RBI Hybrid System Supporting TDM/DMA and DAMA

Applications on VSAT Network

Since all offices cannot have VSATs, an integration of terrestrial lines comprising fibre optic cables, dial-up lines, etc., with the VSATs will provide connectivity to a large number of branches/offices. A pictorial depiction Figure 31.2.

Reserve Bank has listed the following applications which can be used on the system:

- Anywhere/Any Time Banking
- Electronic Fund Transfer
- Plastic Cards Implementation
- Inter-branch Reconciliation or transfers like DD/TT/MT Advice, accounting and transfer.
- Settlement Systems
- e-mail, circulars, corporate website for employees
- Customer database
- Audit and inspection of computerised branches
- MIS for credit risk management
- Settlement of securities
- Participation in money, forex, money markets, etc.
- Reporting to RBI
- Financial EDI-STP (Straight through Processing)
- Cash management system
- Software distribution and management
- Treasury management products.

However, to start with, the banks are making use of the INFINET for free format messages and for exchange of information on cash management products, MIS for risk management and ALM, reporting and reconciliation of DD/MT/TT or remittance, funds management, circulars, etc.

It is expected that when fully operational, this network will usher in a new era of banking services through technological advents cutting across the geographical limitations of distances.

306

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VSAT Network

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THfRUVANANTHAPURAM
kbps based line
2 mbps based line
Integration of VSA i with Terrestrial Network
NMSat Hyderabad

Infinet: Integration ui eased Lines and VSAT Network FIGURE 31.2 Design of Terrestrial Network and Integration with VSAT Network

31.5.2 Internet

The internet is a global network of networks. It is a system of computers which allows user computers exchange data, messages, files, etc., with any of the millions of computers the world over having connectivity to Internet.

Internet has been around in different forms since late 1960s. Its precursor ARPANET was originally designed by the US department of defence, in association with universities and research facilities. In 1989, these networks created for military purposes were dismantled and were replaced by NSFNET, the network of national science foundation and the infrastructure for these networks was made available to public at large. Now, the Internet is available around the globe to almost everybody. There are backbone computer networks, all over the world, which operate at very high speeds and carry the bulk of the traffic. Other smaller networks are connected to these backbone systems. Therefore, Internet is not a physical place of brick and mortar but is an electronic link to the world of information through computers communicating with one another throughout the world.

The information on the internet and the opportunities to use these are growing at a very fast rate. Last few years have witnessed a phenomenal growth in its use.

The connection to the host computer of the ISP is established through the interface protocol software. In India, following two protocols are available:

- Serial Line Protocol (SLIP)
- Point to Point Protocol (PPP)

To browse through the Internet, information browser software is required. The widely used browsers are:

- Netscape Navigator ,. Microsoft Internet Explorer

Procedure to Connect

With the help of modem, the connection with the service provider is established. The access is allowed after verification of the username and password. Once, the handshaking is successful, the whole world of information superhighway is now available for access.

VSNL's GIAS Network in India

The VSNL has its main Internet access node at Mumbai. It is connected to the Internet node at USA via satellite media. This node is also connected to the Internet node in Europe via the submarine cable media.

The VSNL nodes at New Delhi, Kolkata, Chennai, Bangalore, Pune, Chandigarh, etc., are connected to the Internet access node at Mumbai through the DOT provided intercity links.

The Internet access node of VSNL at Mumbai is also connected to VSNL's "Gateway Packet Switched Service' (GPSS). Since, this GPSS is connected to DOT's 'Remote Area Business Message Network' (RABMN), 'Domestic Packet Switched Network I-NET and high speed VSAT network HVNET, subscribers to all these networks also have an access to full range of Internet services.

Facilities over INTERNET

With the use of specially created web page(s), the banks can sell their products. Interactive feedback forms can be designed and published over the web to gather customer information and feedback on various services.
Some of the banks are providing online account opening facilities to NRIs over the Internet. Recently, a new concept "cyber banking' has emerged which refers to the payments through cards, engineered by purchasers/buyers of products/ services over Internet.
Internet Access Services
Some of the common services available on Internet are as follows:
E-mail: This is one of the most widely used applications. Messages can be sent to any remote location. Messages travel in a matter of no time, without any extra charges.
Usenet: It allows sending a message/information on varied subjects on to an electronic bulletin board for anyone to refer to.
Gopher: It allows access and retrieval of information on a variety of subjects, like reference materials, magazine articles, government documents, speeches, etc.
File Transfer Protocol (FTP): FTP allows transfer of files from one system to another.
Internet Relay Chats (IRC): It allows access to forums where users can have online real-time discussions across the globe.
World Wide Web (www): This facility organises Internet-related resources which makes the information access quite easy. The documents are linked together. Anyone wishing to put certain information on Internet can do so, by creating his own web page(s).
Internet Security
The only security for a user, against unauthorised use is the password. Unauthorised access is checked only through its verification.

Another risk area is the range of potentially offensive material on the web. A user may like to restrict his access to offensive web sites. Some of the navigators like 'Microsoft's Internet Explorer' allow a certain level of filtering of information. This filtering is activated by a user by setting security ratings to prevent access to sites that exceed specific level of offensive material.
There is also a grave risk of computer viruses attached to free software travelling into user systems at the time of downloading these softwares.
31.6 EVOLUTION OF EFT SYSTEMS
The use of MICR technology for processing of cheques was the first step towards the mechanisation of the cheque clearing system, which later paved the way for introduction of EFT systems. A committee on mechanisation of cheque handling, constituted by the 'American Bankers Association' introduced MICR in the year 1954.
In 1968, the Special Committee on Paperless Entries (SCOPE) was set up in the USA to examine the concept of an automated clearing house. As a result in 1972, the first Automated Clearing House (ACH) started operating. Since then there have been rapid strides in the automated clearing house operations, the world over. With the extensive expansion of reliable communication systems, POS systems also came into existence in the 1970s. Another significant development during the period was introduction of SWIFT. By this time, banks started using networked systems and ATMs. The final development in the EFT system has been the private card systems like 'Visa Card', which employs an alternative payment system.
The widely adopted definition of EFT is given by the Section 105(5) of the Article 4A of the Uniform Commercial Code (UCC) of the USA. Funds transfer systems means a wire transfer network, automated clearing house and other communication system of clearing house or other association of banks through which payment order by a bank may be transmitted to the bank to which the order is addressed.
In this context, the EFT takes two forms - credit transfer or debit transfer. EFT system, as a means of real-time funds transfer mechanism is now a well-established concept in all the developed countries. The wire transfers, ATMs, POS and cards have become the largest

facilitators of EFT. Real time gross settlement system and cheque truncation is a landmark in the field of EFT system in India.

31.7 TELEX COMMUNICATION FOR MESSAGE TRANSFER

Nowadays, the telex systems derive advantages of storage and processing capabilities of computers for preparation and handling of tele-messages. These machines have enough memory to store a large number of incoming and outgoing messages. Powerful utilities support on the systems facilitates drafting and editing of the messages.

In the world of fast communication, telex is still finding its utility both in singular mode as well in interface with other communication channels. SWIFT directly provides an interface to the telex network and supports common procedures for handling of SWIFT and telex messages. This also facilitates automatic dialling, redialling, message routing and group transmissions. In India, most of the banks are using telex interface for transmitting their upcountry messages to SWIFT through their main servers located at Mumbai.

31.8 STRUCTURED MESSAGE TRANSFER SYSTEM USING SWIFT

Society for Worldwide Inter-bank Financial Telecommunications (SWIFTs) was founded in 1973 by 239 banks spread over fifteen countries with an objective of creating a unified international transaction

processing and transmission system to meet the ever growing telecommunication requirement of the banking industry. It is a cooperative non-profit making organisation established under Belgian law with its headquarters at Brussels.

SWIFT is wholly owned by its member banks. Swift is basically a message transmission system. All the transactions are processed without the exchange of paper, bank note, cheque, draft, etc., and as such is a true epitome of paperless banking. In India, all nationalised banks are members of SWIFT. Bank locations are connected to the SWIFT regional processor at Mumbai.

Main Features of SWIFT

- It is operational throughout the year twenty-four hours a day.
- Transmission of the messages to any part of the world is almost immediate.
- All the message formats for inter-bank transactions are standardised. At present, about 400 different standardised formats are used by SWIFT for message transmission.
- All messages are acknowledged (either accepted or rejected).
- Information is confidential and is protected against unauthorised disclosure and tampering.
- SWIFT assumes financial liability for the accuracy and timely delivery of all validated messages from the point they enter the network to the point they leave the network.
- Method of transmission is cost-effective.

Major Message Types

Standard message formats have been developed by SWIFT to handle the following business areas:

- Customer transfers and cheques,
- Financial institution transfers,
- Financial trading,
- Collections and cash letters,
- Documentary credits and guarantees,
- Securities,
- Precious metals and syndications,
- Traveller cheques,
- Cash management and customer status,
- Supporting system messages.

In addition, free format messages are also permitted, enabling any sort of message.

31.8.1 Security in SWIFT

The responsibility of SWIFT with respect to security of data messages is between the regional processors. SWIFT does not assume any responsibility of the messages between the regional processor and the banks. The security features in SWIFT provides for protecting the network against unauthorised access and protection of transmission against loss or mutilation of messages, errors in transmission, loss of privacy and fraudulent change.

Key authentication mechanism: The SWIFT authentication mechanism is an improved and automated version of the telegraphic test keys, traditionally used for the authentication and confirmation of amounts in messages between banks. It is automatically calculated on the entire message text. This ensures that any change in the message text would be detected.
Encryption: Encryption is a security control to ensure data confidentiality. It is done on the SWIFT network and is available to the users.
Checksum: It is a security control to prevent automatic changes during transmission. It uses, as a part of mechanism, both the text and the receivers address.

31.8.2 Developments in SWIFT

SWIFT has helped in standardising and automating the international payments messaging. SWIFT has also allowed its facilities to non-banking financial institutions.

31.9 AUTOMATED CLEARING SYSTEMS

Most of the large banks in the European countries and USA have their independent communication networks. Other banks are also members of some of the network, on a sharing basis. The banks there use distributed data processing techniques with a central system acting as the main database server. This has helped them to provide certain specialised functions like transfer of funds, automated teller systems, and credit card systems in an online real-time mode. CHIPS, CHAPS, CHATS are some of these networked systems which allow direct funds transfer facilities in the USA, UK and Hong Kong respectively and are largely responsible for bringing about the true concept of Electronic Funds Transfer in these countries.

31.9.1 Clearing House Inter-bank Payment System (CHIPS)

The CHIPS started operating in 1970, run by a New York clearing house, the world's premier system for transfer of payments internationally. Settlement failures in the history of CHIPS operation have never been reported and the operational time is claimed to be 99.9 per cent to 100 per cent. Most of the international fund transfers go through CHIPS, as most of the international trade is transacted in US dollars. The financial transactions such as - foreign and domestic trade services, international loans, syndicate loans, foreign exchange sales and purchases, eurodollar placements, sale of short-term funds, etc., are done through CHIPS. Domestic EFT payments are also made on CHIPS. The settlement of payments carried on CHIPS is done through Federal Reserve Bank. CHIPS have dual computers at two different sites with a high-speed line link. The participating banks are also required to maintain a dual system with a dual link channel. To protect from fraud, full payment-message authentication has been implemented. The CHIPS have a direct interface with the SWIFT system.

31.9.2 Clearing House Automated Payment System (CHAPS)

The CHAPS system set-up in the UK provides almost instantaneous service for settlement of payments and the payments are guaranteed on receipt and cannot be recalled. The network has been built around the most advanced computer and communication systems and offers a guaranteed payment system. Major clearing branches are equipped with CHAPS terminals, which allow payments to be sent to the system through several diverse locations. Its format has been devised from SWIFT and the system allows direct transmission from SWIFT system. The main system of the participating banks is connected to the CHAPS, which uses the packet switched stream (PSS) for the communication network. CHAPS network protects the high value payments and the messages by passing it through encryption and authentications techniques.

31.9.3 Clearing House Automated Transfer System (CHATS)

CHATS provide the inter-bank funds transfer facilities in Hong Kong, which has long been regarded as the hub of financial activities the world over. The success of this system depends largely on the superb and reliable communication networks. CHATS provide same day inter-bank settlement, instant online confirmation and enquiry facilities. All the inter-bank entries are first validated at the point of entry before transmission to the CHATS central system for settlement. All POS transactions are also supported and settled over this network. The network can be switched fully to alternate routes for transmission, in case of failure of a particular route. The integrity of message travelling over the network is ensured through authentication and encryption techniques.

31.10 TWO-LEVEL FUNDS TRANSFER SYSTEM

During the past few years, Fedwire, Bankwire and POS have established themselves as some of the major systems for electronic funds transfer and settlement facilities as well.

31.10.1 Fedwire

The Federal Reserve Wire System, in operation since 1956, is used by the member banks for EFT and is the main funds transfer system in the USA. Presently, about 800 banks are linked together over a computer-based telecommunications networks for transmission of funds and statements. It is used primarily for transferring reserve account balances of depository institutions and Government securities, high value domestic payments, bank to bank and third-party transfers and corporate-to-corporate payments made through banks.

To carry out the functions of the Central Federal System, the country has been divided into twelve districts/regions, each served by a Federal Reserve Bank and their twenty-five branches. All the twelve banks put together, constitute the Federal Reserve System in the USA. Each of these Federal Reserve Bank controls the commercial banks in its region. The inter-region funds are transferred through FEDWIRE access is made through three modes:

- Direct access computer-to-computer connectivity for major banks.
- Direct terminal access through leased lines for online transmissions.
- Dial-up terminal facility for transmission as per requirements and needs.

The Fedwire is an X.25 protocol-based packet switched network and has a large number of alternative routes for transmission of messages. Fedwire makes use of CHIPS also. To check fraudulent activity, authentication and encryption procedures are implemented over the network.

31.10.2 Bankwire

Bankwire is the pioneer private sector electronic telecommunication network, owned by an association of banks in the USA and used to transfer messages between the subscribing banks. It was originally conceived for reducing the cost of transmitting messages between participating banks. It supports standard message formats through the telex network. Bankwire also allows connectivity to its network to the non-member banks. The transmission pertains to both funds transfer as well as administrative messages. It has started providing a clearing facility known as 'CASHWIRE' that also undertakes settlement facility.

31.10.3 Point of Sale (POS) Systems

The POS system allows payments to be made at the point of sales by the way of EFT. With the advent of cards, the concept of POS has become synonymous with the EFT Point of Sales (EFTPOS). The system can handle not only the records of the sales, inventory level, accounting entries and related functions of the retailers but also are connected to the financial institution for effecting a transfer of funds to make payments. In POS, the retailer's terminal is directly connected to the bank's network and the transaction can be communicated online. The transactions can be processed in two ways:

Where both the retailer and the customer has an account with the same bank; First, the PIN is verified, which is stored on the magnetic strip of the card and the information is passed to the banks computer, which verifies that the fund is sufficient. Then transaction is processed.

When different financial institutions share the POS network, the transaction first travels to a switching centre, which directs it to appropriate bank, and the information is processed.

The EFTPOS system is very beneficial. It benefits the retailers of reducing the cash handling cost and a instant credit to their accounts. Banks get an excellent customer base.

31.11 DEVELOPMENT IN INDIA

The introduction of MICR clearing was the first step towards the process of automated settlement. The Use of electronic media is one of the prerequisites for a true EFT system. However the application of technology in India is largely directed towards improving procedures rather than deriving the advantages afforded by it. Now some progress has been made with the introduction of ECS and EFT system in the country.

31.11.1Electronic Clearing System in India

The RBI has introduced a special variant of EFT in the form of ECS, which is an up gradation of the paper-based payment system. Due to the absence of infrastructure, the processing is not entirely based on the principles of EFT. It combines:

Electronic credit clearing: It was launched by the RBI in 1995, to provide an alternative to bulk payment transactions passing through the clearing houses which has greatly obviated the need for issuing large number of paper-based instruments. This system facilitates the transactions which has single debit and multiple credits. The details of the transactions are furnished on magnetic media for processing and the banks are getting credit data on magnetic media duly encrypted.

Electronic debit clearing: This payment system works on the principle of multiple debits and single credits. The consumers willing to participate in the scheme, give a mandate to debit their account on receipt of a debit clearing advice from the debit clearing system and the subscriber has an option to indicate a maximum limit for each debit entry. In February 1997, the RBI introduced the ECS-RAPID (Receipt and Payment of Instrument/Document) in Mumbai for payment of service charges to the service provider from the consumers. In this system, a MICR reader captures the details of payments from a specially designed bill and the schedules are prepared on magnetic media for onward processing.

Floppy input clearing: This is another mode of electronic clearing introduced by RBI in 1995, for the clearing house managed by it. The participating banks submit their inter-bank claim statement in electronic format on floppies. At the clearing house, this data is consolidated and the settlement statements are generated. This is more accurate and fast settlement process.

31.11.2National Electronic Fund Transfer (NEFT) System

With the availability of integrated technology consisting of computers and communication facilities, distances no longer remain a constraint in providing better customer service and expediting the funds transfer mechanism. EFT facilitates quick movement of funds through electronic media. EFT mechanism involving inter-bank funds settlement at the national level has come up only recently as an aftermath of the recommendations of the Saraf Committee on technology issues in the payment and settlement system constituted by the RBI in 1994. The basic infrastructure at various branches/offices, at present, however, is not capable of supporting such system, which is dependent upon sophisticated communication systems integrated with computers. Due to these factors, the EFT system introduced by RBI is largely built around the existing infrastructure for cheque clearing. The Saraf Committee had suggested a hybrid system, both paper and electronic media for message transmission. It had suggested that high value institutional funds transfer should be batched every hour. The batch system has since been implemented in 1996. The RBI acts as the service provider as well as the system regulator.

Reserve Bank of India has introduced a system called 'The Reserve Bank of India National Electronic Funds Transfer System' which may be referred to as 'NEFT System' and shall include the set of procedural guidelines detailed hereunder, for the participating banks and institutions with the required computer system and communication network through which funds transfer operation would take place.

Coverage

To facilitate quick transfer of NEFT messages, it is essential that only networked branches of banks are part of the systems. Banks' own networks could be used for inter-branch communication.

NEFT Characteristics

NEFT transactions may be made for amounts inclusive of paisa component. There is no upper value limit for putting through an individual NEFT transaction. NEFT - Process Flow

The parties to a funds transfer under the NEFT system are the sending bank, the sending NEFT service centre, the NEFT clearing centre, the receiving service centre and the beneficiary branch.

Role of Customer

A bank customer (i.e. sender or originator) willing to avail of the remittance facilities offered by a sending bank shall submit a NEFT application form authorising the sending bank to debit the sender's account and transfer funds to the beneficiary specified in the NEFT application form.

Role of Sending Bank

The sending bank shall prominently display at its premises the cut-off time schedules up to which it shall receive the NEFT application forms from its customers. The sending bank branch would prepare the 'Structured Financial Messaging System' (SFMS) message as and when the application for the funds transfer is received and sends the message to sending service centre, for processing /data upload.

The sending service centre shall transmit the NEFT SFMS message to the NEFT clearing centre by using the communication network designated by Reserve Bank.

The SFMS messages would be transmitted to national clearing centre. Role of Clearing Centre

The National Clearing Cell (NCC), of the RBI at Free Press House, Nariman Point, Mumbai, will be the data processing NEFT clearing centre. SFMS messages generated for the banks will be transmitted to the receiving service centre of each of the receiving banks using SFMS after data validation at receiving NEFT Clearing Centre.

Role of Receiving Bank

On receipt of the NCC SFMS message, the receiving NEFT service centre shall process these files and forward them to the destination branches using SFMS. Alternatively, the receiving NEFT service centre may use the 'Straight through Processing Interface' (STPI) available in SFMS and upload these SFMS messages to their internal banking solution directly, to give the credits to the beneficiary account centrally. The beneficiary branches would make payment to the beneficiaries instantly on the same day by crediting the specified account of the beneficiary or otherwise placing funds at the disposal of the beneficiary.

Acknowledgement for NEFT

No acknowledgements are envisaged under NEFT scheme. A message that is not returned unaffected before the next settlement day is treated to have been completed and credit afforded to the beneficiary's account by the beneficiary branch. It is, therefore, vital that unaffected credits are re-transmitted back as fresh NEFT transactions immediately.

Sender to be Advised in Case of Refund

If the beneficiary specified in the sender's payment order fails to get payment through the NEFT system for some valid reasons, the sender shall be informed immediately after the sending bank gets the returned NEFT. The sending bank shall also arrange to make payment to the sender by crediting the account of the sender or otherwise placing funds at the disposal of the sender.

Beneficiary Bank to Advise the Beneficiary of the Payment

After crediting the account of the beneficiary, the beneficiary bank shall advise the beneficiary of the payments made. The statement of account, pass book entry or any online messaging system shall indicate briefly the source of funds as well. In case of a holiday at beneficiary branch, they have to effect the credit as on the same day or latest at commencement of business on the next working day.

Settlements for NEFT Transactions

Every participating bank shall open and maintain in the NEFT centre, Mumbai, a settlement account for settlement of payment obligations arising under the funds transfer executed under the NEFT system.

Advantages of the NEFT

1. NEFT facilitates an efficient, secure, economical, reliable and expeditious system of funds transfer and clearing in the banking sector throughout India, and
2. NEFT relieves the stress on the existing paper based funds transfer and clearing system.

31.11.3 Real-Time Gross Settlement (RTGS) System

- RTGS is an electronic payment environment where Payment instructions processed on a 'continuous' or 'REAL-TIME' basis; and settled on a GROSS or Individual basis without netting the debits against credits Payments so effected are 'final' and 'irrevocable' settlement is done in the books of central bank - the ultimate liquidity depository of the country. RTGS uses the INFINET and SFMS.
- Each bank will be having a single gateway interface called Participant Interface or PI for the RTGS System. The payment message/enquiry/ clearing settlement originates from the participant's host system (Branch/Treasury).
- The message is passed on by the participant and clearing system interface (PI) to inter-bank funds transfer processor (IFTP), which acts as a broker. Communication between the PI and RTGS systems will be through IFTP only and not directly.
- IFTP stores the message and in case of payment messages construct settlement message containing a core subset of the information required for settlement (settlement message) and is routed to the RTGS System at RBI.
- On receipt of the subset, RBI checks whether the sending bank has sufficient covering funds in its account and informs the IFTP of the status of transfer, queued or settled.
- The settlement message is processed and fate is advised to IFTP.
- Based on response, IFTP enriches the message received from RTGS system by adding back the corporate details and sends settlement advice to both the originating and beneficiary participant in case of successful settlement or failure advice to the originating participant in case of failed settlement.
- Thus, the business information, which is exchanged between sending and receiving bank, is not known by settlement agent.
- Thus, the RBI acts as only a settlement agent.

RTGS Business Day

The RTGS business day is divided into four phases:

- RTGS Open Phase - All normal transactions are accepted and processed.

. IDL Shut Phase - All transactions are processed as in RTGS open phase but no new IDL will be nested . IDL Close Phase - Restriction on fresh IDL continues and no transaction which debits a member with an outstanding IDL will be settled. . RTGS Close Phase - Transactions reversing outstanding IDL will only be permitted. Outetand.ng

multilateral net settlement batch (MNSB) transactions for settlement (provided the member is designated as a clearing entity) and MNSB return transactions are also permitted. • The existing clearing system will also continue.

The phase change notifications will be sent by RBI to the members having the participant interface (PI). Any changes in timing in these phases will also be broadcast to all the members.

Future Perspectives

There are about 48,000 public sector bank branches in the country, of which over sixty-three per cent are in semi-urban and rural areas. Though over seventy per cent of the branches have attained hundred per cent computerisation, Real Time Gross Settlement (RTGS) is available only in 23,500, while the national electronic funds transfer covers less than 5,000 branches. Hence, integrating semi-urban and rural areas into the electronic clearing system was critical.

Hence, the coverage of the RTGS undoubtedly needs to be expanded over a period. This would require up scaling of its operations in terms of capacity and speed, for which efficient and effective transition to the RTGS system and its stabilisation would be essential. It is necessary to explore all the issues in a comprehensive manner that would arise in rapid upscaling of RTGS in our country.

31.11.4 Digital Signature

Digital signature is a new concept brought under the ambit of legislation in India with the enactment of the Information Technology Act, 2000, which comprehensively addresses the legal issues concerning the electronic messaging and the electronic payment system. The role of digital signature is going to be important for e-commerce, because e-commerce heavily relies on the electronic transmission of messages carrying digital signatures. It is a common belief that a digital signature is just a digital image of a signature (hand drawn). In fact, a digital signature is not the replica of the manual signature captured through a scanner or otherwise. Digital signature is a key and must be applied in a manner to satisfy the following critical features of any digitally signed electronic message.

Authenticity: The validity of the source of an electronic message should be ascertained through the digital signature by verifying the source or the originator of the message.

Integrity: Integrity of a message transmitted electronically is of paramount importance. The message has to be received intact and should not have been altered in any way during transmission.

Non-repudiation

From the bankers' point of view, non-repudiation is very important to act upon a fund transfer message. There should not be an opportunity for a sender of the message to deny that he has sent the message at all and in the form in which it has been received.

The digital signature is unique to each message and any change to the message changes digital signature.

The most common manner of signing electronically is with the help of the public key cryptography as contemplated by the Information Technology Act, 2000. Cryptography is usually based on the use of algorithmic functions to generate two different but mathematically related keys (i.e. large numbers produced, using a series of mathematical formulae applied to prime numbers).

There are two parts of the keys:

(i) Public key (ii) Private key.

Both keys are issued to the user by the designated authorities of the Government. Before a sender can digitally sign an electronic message, the sender must first get a public-private key pair. The 'Private Key' is kept confidential and is used only by signer to create the digital signature. The 'public key' is used by a relying party to verify the digital signature.

One such key is used for creating a digital signature or transforming data into a seemingly unintelligible form, and the other one for verifying a digital signature or converting the message back to the original form. Encryption does not necessarily imply to make any information confidential, the encrypted digital signature may be merely appended to a non-encrypted message.

To sign an electronic message:

- The sender first delimits precisely the borders of what is to be signed.
- A hash function in the signers software should compute a hash result, which is for all practical purposes is unique to the message.
- The signer's software should then transform the hash result into a digital signature using signer's private key.
- The resulting digital signature is thus, unique to both the message and the private key used to create it.

31.12 LET US SUM UP

The computerisation efforts in the banking industry started in the early eighties. Back office functions and batch processes involving voluminous data were the first activities wherein computers found their application. The developments in the communication technologies and their application in data communication network have changed the whole concept of information generation and its use for banking services.
Wire cables, fibre cables and satellites are the major media for data communication. The satellites cover a wide geographical area for transmission and are hence being increasingly used by the banking sector. Fibre optics is a fast and reliable terrestrial, but a costly medium. Some of the public sector communication networks like INDONET, INET and NICNET have also not found favour with the banking industry for its financial applications.
RBFs satellite-based countrywide communication network uses the VSAT technology exclusively for the financial institutions and shall be used as a carrier for NEFT, EDI, interactive transaction-oriented applications, etc. Internet is the global network affording newer opportunities to the banks to market their services in addition to other wider applications for general users.
There have been great strides in the field of EFT and the last three decades have revolutionised the total concept of banking. Starting with computerisation of clearing houses, instant fund transfers have now become possible due to the globally networked systems. SWIFT with its well-standardised and structured message formats have become the undisputedly most reliable system of message transmission for foreign exchange business. CHIPS, CHAPS and CHATS are the automated clearing houses in the USA, UK and Hong Kong respectively. Bulk of the funds transfers there are taking place through these clearing houses.
In India, the concept of EFT has still to take its proper shape. The Reserve Bank of India has introduced a variant of NEFT system which is a hybrid of the paper-based and electronic-based payment systems. It has to take firm roots before a true real-time NEFT system can be introduced in the country. Globally, point of sales terminals, ATMs, Fedwire and Bankwire have emerged as the major systems of electronic funds transfers.

31.13 CHECK YOUR PROGRESS
1. MODEM does the following:
(a) modulates digital signals into analog
(b) demodulates analogue signals into digital

(c) converts data into image (d) both (a) and (b)
(e) none of these
2. A twisted pair cable consists of,
(a) two insulated copper wire
(b) an inner copper conductor held in position by circular spacers
(c) single copper wire
(d) all of these
(e) none of these
3. A coaxial cable consists of
(a) two insulated copper wire
(b) an inner copper conductor held in position by circular spacers
(c) single copper wire
(d) all of these
(e) none of these
4. In an optical fibre data is transmitted through
(a) a very thin glass or plastic fibres with a beam of light
(b) satellite
(c) laser beam driven by a high speed high current driver
(d) both (a) and (c)

(e) none of these
5. In a microwave system
(a) radio waves are modulated to carry information
(b) wave beams are sent from one antenna to another
(c) along the route, the received data is amplified and retransmitted
(d) microwave signals may be passed on to the satellite
(e) all of above
6. A message switcher is used to
(a) store and forward data to large number of terminals over a single communication channel
(b) send more than one signal simultaneously over a single communication channel
(c) intercept and handle communication activities for the host computer
(d) all of above
(e) none of these
7. Multiplexer is used to
(a) store and forward data to a large number of terminals over a single communication channel
(b) send more than one signal simultaneously over a single communication channel
(c) intercept and handle communication activities for the host computer
(d) all of above
(e) none of these
8. Front End Processor (FEP) is used to
(a) store and forward data to large number of terminals over a single communication channel.
(b) send more than one signal simultaneously over a single communication channel
(c) intercept and handle communication activities for the host computer
(d) all of above
(e) none of these
9. A simplex transmission is capable of
(a) transmitting data only in one direction

(b) data movement in both the direction but only in one direction at a time
(c) providing a simultaneous two way communication
(d) data communication only
(e) none of these
10. A Full-duplex transmission is capable of
(a) transmitting data in one direction only
(b) data movement in both the direction but only in one direction at a time
(c) providing a simultaneous two way communication
(d) data communication only
(e) none of these
11. The upper value limit of an individual national electronic funds transfer (NEFT) transaction is
(a) Rs. 20000 (b) Rs. 50000
(c) Rs. 100000 (d) None of the above

31.14 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d), 2. (a), 3. (b), 4. (d), 5. (e), 6. (a), 7. (b), 8. (c), 9. (a), 10. (c), 11. (d).

31.15 KEYWORDS

Authentication, Data Communication, EFT (Electronic Funds Transfer), Electronic Clearing House, Encryption, Front End Processor (FEP), Funds Transfer, Gateway, Packet Assembler/Dissembler (PAD), Packet Switched Network, Payment Order.

UNIT

32

ROLE OF TECHNOLOGY UPGRADATION AND ITS IMPACT ON BANKS

STRUCTURE

32.0 OBJECTIVES

After studying this unit, you should be able to:

- understand the trends in information technology
- describe the concepts of data warehousing and data mining
- explain the new delivery systems of bank services and products
- understand the concepts of electronic data interchange
- describe the impact of technology on banking systems globally
- understand the impact of IT on organisational behaviour in banks
- describe the impact of technology on human resources in banks
- discuss the training needs of banks under the impact of IT
- explain the impact of IT on data privacy.

32.1 INTRODUCTION

Technology has, in fact, given new dimensions to the banks' service delivery mechanism, and the banks are enthusiastically absorbing the latest technological innovations for devising new products and services. It is in this context, that the conventional brick-mortar banks are giving way to virtual banks from customers' perspective.

32.2 TRENDS IN TECHNOLOGY DEVELOPMENTS

The advancements in software tools, computer hardware and telecommunications have shifted the focus of the banks towards computerisation from data processing to information services.

The breathtaking advances in computers and telecommunications have enabled the banks to adopt these technologies for banking applications to derive competitive advantages. There is a marked shift in the technology now available, which has transformed the concept of branch banking to anytime anywhere banking. The computational capacity of technology roughly doubles every eighteen months. The trend is towards shared satellite-based communication systems and networking technologies. The banks are adopting wide area networks inter-linking their main branches. Providing interactive terminals to customers with the use of multimedia is another phenomenon which is likely to gain wide acceptance. At the branch level, the client server technology, use of graphic user interfaces (GUI) and interactive access to information are the indicators of future trends.

Some of the large banks are working on the concept of having a very large data base system for centralised storage of the customer information at one place. Another alternate strategy being adopted by some banks is to have distributed data processing at different branches with the updating of a central data base in batch mode.

32.2.1 Data Warehousing and Data Mining Data Warehousing

Data warehousing is the emerging trend, in the corporate world including banks, which has been made possible by the application of information technology. Databases known as data warehouses are designed, wherein data from heterogeneous sources is stored to generate critical information for the decision support systems. The main characteristics of the data stored in a data warehouse are:

- It is subject-oriented, e.g. in a banking environment, it may be customer-oriented, storing all informa¬
tion including transactions of all types pertaining to the customer.
- It is integrated, and there are no inconsistencies.

The data in a data warehouse is non-volatile. The operational data is regularly accessed and manipulated; a record at a time but in a data warehouse, the data is usually accessed in mass and is also not updated (in general sense of update).

- It is time variant. The time zone for data in a data warehouse is significantly longer of say five to ten years.

Data warehouse can be established even across multiple computer platforms as long as the transaction details are made available to the data warehouse in a standardised format.

The Vasudevan Committee has also recommended that the Reserve Bank of India should establish a data warehouse on banking and finance for the data collected under the regulatory provisions.

Data Mining

Data mining is a technique to reveal the strategic information hidden in the data warehouse(s). It is the process of automatically finding patterns and relations in large databases. The patterns and relations can be:

- Organised into a concise model • Used to refine a previously existing model
- Provide summaries of large quantities of data

It helps in exposing the patterns that are critical to business and provide an advantage through insight and knowledge of:

- Sound predictions of customer behaviour • Highly targeted market focus
- Maximised operational effectiveness • Optimal return on investment

Properly applied data mining techniques allow banks to capitalise on the investments made in constructing and managing data warehouses.

Storage of data in data warehouses and their extraction through data mining techniques can be applied in:

1. Loan risk analysis: To analyse the performance of a set of loans that have been previously issued by the bank.
2. Credit risk analysis, by the issuer of credit cards using database mining to:

- determine whom to solicit as client, possibly with pre-approved credit limits
- determine whether to approve each particular credit card transaction.

3. Stock portfolio creation and analysis to analyse the performance of a set of securities and fundamental data of the companies that issue the securities.
4. Data analysis of the demographic information about customers to help banks focus on particular segments.
5. Risk analysis by insurance companies and banks.

32.3 ROLE AND USES OF TECHNOLOGY UPGRADATION

Technology has allowed banks to offer much more to their customers like the facilities of card and telephone access, any time and anywhere banking through twenty-four hours Automated Teller Machines (ATMs), credit cards, debit cards and POS (Point of Sale) access. In fact, the technology has made it possible for the customers to have fingertip access to their accounts worldwide.

The currents trend is towards home banking, fully exploiting the technological innovations in the field of communications. Cyber banking leading to a cashless society is the direction towards which the technology is driving the banks today.

The computers and particularly the networks, in a nutshell, are finding their application in the fund

transfer/payment messages, inter-bank settlements, netting of foreign exchange payments, inter-branch reconciliations, quick disposal of loan/investment proposals, FOREX information among branches and offices, e-mail services, design of organisational/customer databases, MIS systems and decision support systems.

32.3.1 Data and Message Transferring

The transmission of data and messages is one of the fundamental activities of any business system. Whereas computers facilitate the processing of data, the communication technology helps in transmission of the data. With the combined application of the two, embodied as information technology, the banks are able to reduce the operational time in data and information communications. A personal computer, a telephone line, a modem and interface software is all that is required for breaking the distance barriers. Whereas e-mail has found its application in sending unstructured free format messages, the newer concept of electronic data interchange refers to the transmission of structured and formatted messages for further analysis and use in business applications.

Electronic Data Interchange (EDI)

Electronic data interchange is the inter-organisational exchange of business documentation, which can be processed by computers. It takes the form of interchange of standard formatted data between the computer application systems of the trading partners with a minimal manual intervention. Banks have been using EDI in the form of SWIFT messages. In India, Videsh Sanchar Nigam Ltd. (VSNL) provides Gateway for Electronic Data Interchange Services (GEDIS) worldwide.

EDI is usually referred to as electronic funds transfer (EFT). Credit clearing and debit clearing are different forms of EDI, for making transfer of funds electronically. The credit card network is another EFT system using EDI standards. Because the EDI is designed to allow processing by the receiver without human interpretation and rekeying, the information must be in a format that is readable and understandable by the computer. Electronic data interchange for administration of commerce and transport (EDIFACT) is the universal set of standards and guidelines for communication by EDI.

EDI Formatting Standards Provide Guidelines Covering

- The documents that can be communicated electronically.
- The information to be included in each electronic document.
- The sequence in which the information should follow.
- The meaning of individual pieces of information.

Communication Standards

The EDI guidelines are called communication standards and address such items as:

- The type of electronic envelope to be used.
- The transmission speed and the protocols on which the messages are to be sent.
- The time slots during the day which are acceptable for sending and receiving the messages.

Electronic Mail

Electronic mail provides nearly instantaneous communication between different users, regardless of the system they are using at their location, for any type of information imaginable. Electronic mail has made the concept of the paperless office a reality and many offices now use it extensively for inter¬office and intra-office correspondence.

In banks, electronic mail is used for correspondence between departments and offices and has dramatically reduced the time taken from the use of the previous physical delivery methods. Standard e-mail software packages also offer additional facilities like sending the same copy to different offices with a single

command only. E-mail is basically used for transmitting unstructured messages. Banks are also using the e-mail facility to transmit important data files.

32.3.2 Corporate Websites

Internet has opened new avenues for the banks to market their products and services. Many banks are now having their own web sites on the internet as a platform for service delivery. The banks are using the web generally for the following end uses:

1. Dissemination of information: Here banks offer information about themselves and their products. Common types of information include highlights of the banks' financial statements, descriptions of account products, loan products, card products, etc.
2. Financial advice: Some banks use the web to offer more general financial advice interactively. As for example, the site may allow customers to answer questions about themselves and their tolerance for risk, and give advice on how best to allocate their assets.
3. To highlight non-banking activities: Some banks use the site for giving details of their charitable or community aid endeavours, or the events that they sponsor.
4. A node for commerce: Some of the virtual shopping malls on the Internet are run by banking institutions. One such site is that of Barclaycard, the largest Visa issuer in the UK.
5. Selling financial products: Some banks are using websites to sell financial products through the Internet. The common strategy is to allow customers to fill in an application form for an online credit card and complete the transaction by more mundane methods such as the post. However, it is expected that in future, banks may sell more complex products entirely online.
6. Gateway to the Internet: Some of the banks are routing customer calls to bank's website onto the Internet and thus, work as a sort of internet service providers to their customers who are given proprietary software. The customers connect to the bank through direct telephone link. Once connected, a screen appears which comprises navigational facilities for banks' services including an access to the Internet itself.
7. Account services: The banks use the net to offer routine transactions such as balance enquiry, transfer between accounts and bill payments. This is also one of the most important areas in which a bank can use online delivery to serve its customers.

32.3.3 Management Information Systems (MIS)

The concept of MIS places particular emphasis on the availability of data and the ease, with which it can be analysed and turned into meaningful information for managerial decision making. Thus, the key element in any MIS is the transformation of data into information. Another factor that assumes significance is the timeliness of information, lest it loses its significance. As such, the system has to be such which furnishes the management with current information.

Computer-based Information Systems

As a control mechanism, the banks including the Reserve Bank ask for extensive information covering varied types of activities under various parameters. In a computerised system, with the added advantages of fast and accurate processing, the data is expeditiously recorded and processed for operational and control purposes, problems are isolated and referred to the management for decision making.

The computer-based information systems offer following advantages:

Data is consistent and hence, the processed information is more accurate and relevant for decision

making. Data redundancy is minimised, reducing a lot of labour in data reporting.

The computer-based information systems are more flexible and can suitably be modified with ease to match the changing requirements.

These computerised systems not only help in the generation of a large number of statutory and control returns, but also help in generating a wealth of information to aid in decision making.

Several banks have also developed excellent management information systems, which analyse their customer base and assist them in making more scientific decisions in areas such as marketing and product development. Customer demographics, spending habits and savings patterns can be monitored by means of advanced transaction monitoring systems, which give account managers a more detailed profile of the customers and their financial requirements.

Decision Support Systems (DSS)

There could be situations requiring decisions which cannot be predicted. The timing, as to when the need to make such a decision will arise or the nature of such decisions may not be predicted. These situations are best addressed by the use of decision support systems (DSS) which are easy to use, flexible and interactive computer-based systems designed to facilitate decision making. These systems allow for the creation of simulations under various conditions and help the management in analysing situations under different conditions. The DSS provides the end user with decision- making information, when such a decision making situation occurs.

The decision support systems provide the management use of query languages, ad hoc report generators, statistical analysers, graphics, etc. They also provide the management with tools that can test the what-if situations to pre-test the potential outcome of different decisions. Spreadsheets are one such tool, which assists in testing of various situations. In simulations, the DSS make use of complex mathematical models to aid decision making.

For example, the impact of any change in CRR/SLR requirements can be easily ascertained to help the management decide on different investment options for available funds. Similarly, in the competitive market, the DSS helps the bank managements in precisely generating the information for pricing their products and services.

32.4 GLOBAL TRENDS IN BANKING SYSTEMS

Globally, the banks are recognising the need to embrace technology in the area of products and services to compete successfully in the years ahead. In fact, the commercial banks, the world over, are among the largest consumers of information technology. The banks perceive the future of the financial services industry as becoming heavily dependent on electronic delivery mechanism and are working towards bringing banking right into their customer's homes.

Not only at the global level, but also in India, Real Time Gross Settlement (RTGS) system has been thrown open to customers. In fact, the general belief is that the absence of these services could affect the banks' ability to retain critical segments of their customer base. However, as a strategy, most of the banks are targeting home banking facility at the top ten to twenty per cent of banks' customers that deliver eighty to ninety per cent of the banks' profits, and as such, are investing heavily to develop and market high-tech services.

There has been a noticeable tilt towards technology-driven products and services. Following trends are visible in the banking systems:

1. Most of the banks are installing more and more ATMs for banking transactions.
2. To give the customers more choices for collecting their cash, the banks are resorting to have non-
traditional branches such as supermarkets and video kiosks.
3. Telephone banking and debit cards are finding increased acceptance of the customers. Credit cards
also find a significant usage.

4. The smart cards are currently offered by only a very few of the banks, but almost all the banks plan to offer these in the future.
5. PC banking is another service which is finding wider acceptance.
6. Banks are tapping new sources of revenue and finding ways to differentiate themselves from other banks and non-banks and are increasingly venturing into the fee-based services like the:

- marketing of insurance and annuity sales
- mutual funds
- financial planning
- trusteeship services

Additionally, the following activities are also finding technology as an able ally:

1. Automated clearing systems
2. Customer information databases
3. Imaging of paper documents
4. On-line access to regulatory agencies
5. Use of the Internet and mobile for customer services
6. RTGS
7. Cheque truncation

Another impact is in the globalisation of banking services. Large banks are shifting their focus away from the domestic market to the global arena, pursuing global expansion, and emphasising those products and services that are globally oriented.

Technologies, currently being developed and tested, range from a new generation of more sophisticated stored value and smarter smart cards, to the execution of commercial transactions over the Internet. An alternative form of e-cash will soon develop which does not require a traditional paper-oriented payments system by using technologies that will enable such smart cards to transfer value through the Internet.

The technology has also found many other practical uses in Europe and Canada. Certain banks are facilitating banking transactions through smart phones, which are sophisticated electronic devices that can also deliver e-mail, carry out home shopping and home banking. These phones have a built in credit card reader that provides access to these facilities. Banks are using digital signatures for more secure banking transactions. The advances in technology will also have dramatic effects on the payment systems. Globally, the banks are poised to use technology that will gradually give new dimensions to the banking products, services and delivery systems.

32.5 IMPACT OF IT ON BANKS

Under the impact of technology, the organisation structure of the banks, the role of various functionaries and the approach of banks to customer needs are undergoing a perceptible change. The technology has helped the banks to strategically look at customer needs to offer newer and more efficient banking services, at the same time gearing its staff to cope with the stresses of technology.

Here, we discuss, at length, the impact of information technology on the important components of banking, viz., the organisation, the customers, the personnel and lastly the data. Data privacy, involving individuals' rights and privileges about personnel information is a very sensitive issue being debated and examined, the world over.

32.5.1 Changes in Organisational Structure and Orientation

Information technology is a means for increasing organisational productivity. IT, in fact, is much more than a series of new machines for organisational efficiency, since it brings about a new concept of self-regulating systems and principles in the organisation.

Some of usual changes brought about under the impact of IT relating to organisational structure and orientation of the banking sector are illustrated as follows:

(i) The need for faster information and better control has a direct impact on reducing the hierarchical tier systems in the banks. This has resulted in establishing a direct liaison between the top management and the field functionaries.

(ii) As the technology helps in collection, processing, interpretation and transmission of information, the need for middle tiers of management vanishes and more of self-managing groups with autonomy and access to information emerge strongly.
(iii) The management processes and the controlling mechanism characteristics also undergo a change. The decision maker needs to be vested with greater powers to cope with the stresses of time factor. Several traditional jobs no longer remain relevant and several new jobs come up.
(iv) Managerial attitudes also undergo a change under the impact of IT. This is reflected in the way the top executives look at IT as a functional requirement and apply it for improving organisational efficiency and effectiveness. IT helps in engineering a change of mechanism in the overall orientation of the management.
(v) The organisational change can facilitate the increased involvement of information systems in the mainstream product offerings in the banking and financial sector. In addition, to these technical and organisational changes, a psychological repositioning of the information technology function takes place.
(vi) In addition to the changes in organisational structure and orientation, the operating procedures also witness a direct impact of the IT. The systems and procedures within banks have to adapt themselves in accordance with the IT needs without sacrificing secrecy and security.

32.5.2 Impact on Service Quality

Banking, which is primarily a service industry, has been, over the years, becoming more and more technology dependent. The most visible impact of technology is reflected in the way the banks respond strategically for making its effective use for efficient service delivery. This impact on service quality can be summed up as follows:

1. Small and relatively new banks with a limited network of branches become better placed to compete with the established banks, by integrating IT in their operations. Technology is helping the banks irrespective of their size to have a level playing field for pricing their products.
2. The technology has helped in commoditising some of the financial services. The technology is forcing the banks to develop a strategy for an on-line delivery system to broaden the customer relationship and to retain customer loyalty.
3. The depersonalisation can have a negative effect on relationship banking. The advent of home banking fast changes the banks into shopping malls. This greatly reduces the personal element in the services. It is an established fact that the human interface is the most vital aspect of any service industry, irrespective of how advanced the adopted technology is. A decade of computerisation can probably never substitute a simple smile or a warm handshake.
4. The advent of IT democratises the information in the sense that bank customers, particularly the corporate customers, have access to the same real-time information over which the banks earlier had control. This results in greater competition for the banks. Another competition to the banks stems from the advent of non-banking financial institutions who, armed with technological capabilities, are vying with the banks to capture their retail customer base. The advent of virtual banking in the form of Internet banking will remove barriers for entry of these non-banking financial institutions to compete with the conventional banks.
5. In banks, the technology pushes the delivery of services out of the bank and the focus shifts from cost reduction to maintenance of market position. However, when properly adopted, the technology helps in accelerating the service delivery to customers providing control over account relationships.

Changes in Customer Aspirations

Today, the customers are demanding fast, accurate and reliable services. The customers expect a reasonably high standard of services. The absorption of technology, therefore,

becomes inevitable for the banks to enable them to respond to customers needs at all times and at competitive prices.
In the changed socio-economic conditions, the customers, individual or corporate, no longer want to be restrained by the physical place where their funds and information are stored and wish the banking facility to come to their home/business place rather than in branches of banks. This has given rise to the concept of 'Anywhere Banking' facility which offers access to banking services at a place and time convenient to the customers.
The use of improved telecommunication technology like leased lines, VSAT, etc., has made unhindered information flows possible in real-time, on-line, and industry wide.
However, as the facilities provided by the banks increase, so does an increase in the demands of the customers. The business compulsions, steered by telecommunications breakthroughs, are putting tremendous pressures on individual banks to continuously evolve newer techniques, for making business transactions better, faster and more efficient than that of others. In fact, the technological prowess of the banks and other financial institutions are likely to determine the future of how money and financial information will be transmitted for satisfaction of customer needs.
32.5.3 Impact on Human Resources
Information technology has resulted in improved efficiency, innovative products and effective delivery systems for the banks to help them succeed in the marketplace. In fact, the emergence of new players in the financial sector has brought home the hard reality that computerisation, as an exercise for modernisation, is now not a matter of choice but has become a need for survival in the competitive environment and the bank employees have no choice but to accept it or be left with the prospects of total organisational decay. The technology has also brought about a visible impact, as discussed below, on the human resources, which is the most vital component in the banking business.
1. The foremost impact of technology on the existing manpower is manifested in the resistance to the new systems. Such resistance is not unique to the banking industry, but stems from the basic instinct in human beings to view any change with an element of suspicion. The fear of change gives rise to anxieties, inhibitions and scepticism, which can be overcome only with the spread of awareness at all levels. These fears may be described as follows:
(i) Job content: Fears, such as whether the technology will mean losing ones' expertise, or will the personal skills will be adequate to meet the challenges of the new job, or whether it would mean a change in the way one used to handle a job.
(ii) Job security: Fears whether the change will mean a loss of the job itself, or whether it would be possible to retrain oneself in the new scheme of things, or would it mean a transfer from the existing work place, or whether the new computer literate employees will have better job profiles or whether it would mean a hindrance in the career growth.
(iii) Authority dilution: Fears such as whether the change in job requirements would mean erosion in one's authority within the organisation, and would it be possible to continue commanding respect.
2. Technology, when introduced in a planned manner, results in enhanced productivity with better placement of employees. With the increased use of information technology, there is an ever increasing demand of the specialised personnel in the fields of IT management
3. Another impact of IT on human resources is the high turnover rate of computer-skilled manpower.
This may necessitate the banks to formulate their own manpower policies to retain these professionals within the organisations.

In a nutshell, the application of IT affects the functional responsibility of every individual involved in the organisation and proper training will help in preparing them for this transition.

Role Transition
Information technology is a self-regulating system and its use entails a redefinition of work which manifests itself in the following areas:
l.
2. 3.
With the application of IT, the job profiles and role definitions undergo a complete transformation. With the shift of decision making powers to the point of information, there is also a visible change in the responsibility structure in banks.
The increased competition, stemmed by the use of IT in banks, has underlined the need for technically literate and managerially competent persons to help the line management understand their own needs and build their own systems.
Training Needs
The most important element in this process involves the organisation-wise training for attitudinal changes and skill developments, commensurate with the requirements of changed role of individuals. Dissemination of knowledge about the new developments in technology and its application is also required for the up gradation of skill levels.
In India, computer literacy, at the work force level is at a very low level. For a successful integration of information technology by the banks as a business strategy, the training of staff and the continuous up gradation of their skills is of paramount importance.
The changes in attitudes can be brought about if adequate information is provided on the capabilities as well as limitations of the information technology tools. This can be done through the process of training of staff, which can be broadly categorised as follows:
(i) Orientation and development of awareness amongst all sections of employees will help to overcome the resistance to change and solicit cooperation not only from individuals but also in overcoming organised resistance.
(ii) At the systems level, extensive training is required for persons performing the duties of specialised positions, like:
(a) System administrators, to administer computer systems, and monitor their operational performance.
(b) Systems analysts/designers, to analyse the existing systems and design improved computer-
based systems.
(c) Programmers, to write computer programs.
(d) Database administrators, to design and maintain databases.
(e) Network administrators, to monitor and administer computer networks.
(f) Communication administrators, to set up and maintain computer networks.
(g) Computer auditors, to audit the computerised environments.
(h) Information system security managers, to safeguard the bank's assets.
The staff for some of these specialised activities may have to be pooled from outside the banking area. Most of the banks have gone in for grooming their own staff for performing the different roles in the IT environment.
There is a great gap between the demand and availability of trained manpower in the banking industry particularly in the systems area. Some of the banks have formulated long-term training plans to meet the challenges of intense competition triggered by technologicaJ invasion of the banks. Some banks have already established their own training institutes with the twin objective of designing training to meet specific end user requirements and also to involve their staff in software developmental activities.

32.5.4 Impact on Privacy and Confidentiality of Data
The concern for the misuse of the stored data becomes more profound when the stored data pertains to financial transactions of individuals. Customers feel threatened about the inadequacy of privacy being maintained by the banks with regard to their transactions and look at computerised systems with suspicion. Whereas inadvertent disclosure may occur

when a system crashes and the contents of a user's files get publicly displayed at a terminal, the serious problem is that of unauthorised disclosures when a person having access rights uses the data for unintended purposes.
Therefore, data privacy assumes two significant dimensions, viz.:

- the authority to access data
- the authority to use data only for specified purposes.

The following principles are broadly common in the privacy laws:

1. The individuals should be able to discover the existence and ownership of automated personal data
systems and infer whether information about them exists in a system.
2. The data about individuals which is held for processing must have been obtained fairly for a specific
lawful purpose only.
3. The data must be accurate, up-to-date and kept no longer than necessary.
4. The data collection on some individual attributes like racial origin, political philosophy, religious
views, sex life details, etc., should be prohibited.
5. Special measures over and above the normal computer security procedures should be taken to
preserve the privacy of personal data.
6. Data must be used only for the specific purpose and may be disclosed in accordance with the
specific purpose only.

With the adoption of information technology by the banks, the issue of data privacy becomes more relevant particularly in the context of transactions carried through the electronic funds transfer systems and settlement taking place through RTGS system.

32.6 LET US SUM UP

Computers and communication technology has not only increased the competition among the financial institutions in general and the banks in particular, but have also opened new vistas for them to innovate themselves and come up with newer products and services. Globally, the trend is towards using computer technology for designing customer need-based products and services.
The information technology has a direct impact on the vital aspects of banks. All the major components of a bank, viz., its organisational structure, the customers, the personnel and the data evolve under the impact of the technology and react to the changes it brings about.
Information technology has stiffened the competition and the banks have come out with newer products and service delivery systems. Training and retraining of staff and retention of highly specialised staff have become critical factors for banks for successful utilisation of IT.

32.7 CHECK YOUR PROGRESS

1. The committee which has recommended for establishment of data warehouse is known as
(a) Vasudevan Committee (b) Rangarajan Committee
(c) Saraf Committee (d) Shere Committee
(e) None of these
2. Data mining techniques can be applied in
(a) Predicting future trends based on information available

(b) Credit risk analysis
(c) Analysing demographic information about customers
(d) All of the above
(e) None of these
3. Communication technology
(a) facilitates the processing of data (b) helps in transmission of data

(c) enables decision support system (d) is a tool for data mining
(e) All of the above
4. Which of the following is the gateway in India for EDI services worldwide?
(a) Satyam online (b) BSNL
(c) MTNL (d) VSNL
(e) None of these
5. The universal set of standards for EDI is known as
(b) EDI (d) BIS
(a) EDIFACT
(c) ISO
(e) None of these
(b) financial advice (d) selling products
- 6. Banks can use a corporate website for
(a) dissemination of information (c) accounts services (e) All of these
(b) data redundancy (d) All of the above
7. Computer-based information systems offer
(a) data consistency
(c) flexibility and ease for modification (e) None of these
(b) adhoc report generator (d) graphics
8. Decision support system (DSS) uses
(a) query language
(c) statistical analyser (e) All of the above
9. Impact of IT on banks can be
(b) change in organisational orientation (d) change in customer aspiration
(a) change in organisational structure (c) change in service delivery channel (e) All of the above
(b) innovative products (d) enhanced productivity
10. Information technology has resulted in

(a) improved efficiency

(c) effective delivery system

(e) All of the above

32.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a), 2. (d), 3. (b), 4. (d), 5. (a), 6. (e), 7. (d), 8. (e), 9. (e), 10. (e).

32.9
KEYWORDS

Compartmentalisation, Database, Fault tolerant computer systems, Graphical user interface (GUI), Inadvertent disclosure (of data), Leased lines, Organisational decay. Static data, Technological prowess, Turnover, Website.

UNIT
33SECURITY CONSIDERATIONS

STRUCTURE

33.0 OBJECTIVES

After studying this unit, you should be able to:

- describe the risks in a computerised environment
- examine the effects of these risks to banking operations
- discuss the various controls to prevent and contain these risks
- define the concept of computer audit
- examine the need for evaluation of various components in IT based banking operations

33.1 INTRODUCTION

Banking operations have always been exposed to the risks of errors and frauds. It is debatable, whether the application of information technology has changed the scale of these risks but it is certain that the manner of risks has certainly undergone a change. So is the case with the types of security and control procedures necessary to contain these risks to acceptable levels. The successful management of computer and telecommunication risks requires the employment of an effective system of controls within the banking operations. This unit discusses at length, various types of risks in the computerised environments, controls available to prevent and contain these risks and the approaches for evaluation of these controls within an organisation. Lastly, the chapter discusses various components requiring special evaluation as a part of computer audit for ensuring compliance to management objectives related to the application of information technology in banking applications.

33.2 RISK CONCERN AREAS

The customer demands have triggered a fierce competition amongst the banks and financial companies for the application of computer and telecommunication technology in their operations to help them offer innovative products and services at reduced costs. This also helps them entering new geographical areas. The technology itself is highly self-evolving leading to periodic inventions. Competition has driven the banks to experiment with technology thus, increasing their dependence upon it. The quality of information technology comprising computers and telecommunication systems, their application to evolving business and customer needs determines the productivity of a bank. However, the risks associated in use of IT and the deficiencies in security and controls within the banking procedures may pose a significant threat to the banking operations.

A typical computerised environment constitutes of three interdependent but separate components, viz., software, data and hardware. All these three components are continuously exposed to computer operators, programmers, customers and even to the public. The nature of financial transactions is such that banking operations can become vulnerable to the risks of errors, omissions and frauds.

These risks are not specific to banking but are encountered in all types of business activities. The risks broadly lead to:

1. Incorrect decision making leading to a setback to business.
2. Interruption in activities, due to the loss of data, hardware, software, peopleware.
3. Violation of privacy.
4. Direct financial loss due to computer frauds.

We discuss below the major components in computerised environments which require special concern.

33.2.1 Data and Software
Data is a critical resource, necessary for an organisation's continuing operations. Incorrect data can have serious implications on decision making, as well. The increasing availability and use of expert systems and the potential impact of erroneous data on them can result in playing havoc with the organisation's business. For example, at the operational level, an incorrect interest calculation may result in over payments leading to financial loss.
A lack of control over data can lead to frauds by unscrupulous elements. Inadequate control over data is the single largest factor which promotes the scope of frauds. Since, the data is usually stored on magnetic media, in the absence of adequate control, any tampering with the data cannot be detected easily.
Much of the information stored in a bank's computer systems or passed over the telecommunication lines is confidential. In case it falls into wrong hands, it can damage the customer relations, the reputation of the bank and also can give rise to claims for damages. In computerised systems, a person may not have to move from his or her normal place of work to access the information and there may be no trace of an unauthorised access having occurred.
Similarly, unauthorised changes and modifications in the application software can directly lead to frauds. The availability of utility software on operational systems can bypass many controls in affecting modifications in the programmes as well in data. The errors due to modifications in software cannot be detected easily.
33.2.2 Infrastructure
Banks have to invest heavily for implementing technology-based tools and solutions. In addition to software and data, some hardware components are required for operations of the computer and communication systems. Following are the major components of infrastructure in a computerised environment.
(i) Computer hardware: Computer servers, terminals/workstations, disk/tape/cartridge drives, printers,
controllers, modems, switches/multiplexers, etc. (ii) Power supply and other related equipment like uninterrupted power supply units (UPS), constant voltage stabilisers (CVT), generators, etc. (iii) Computer site including computer furniture, fire extinguishers, smoke detectors, etc.
All the above components are required to be in the proper place for efficient utilisation of technology for banking operations and are exposed to the risks of malfunctioning, breakdowns, fire, obsolescence, etc., which may lead to interruption in services and/or loss of assets.
33.2.3 Peopleware
Peopleware refers to the group of person(s) directly or indirectly involved in establishing and running the computerised systems. The peopleware is exposed to the risks of:
(a) Stagnation in knowledge and skill levels affecting the efficiency of the newer systems
(b) High turnover due to inappropriate match of tasks with capabilities or on account of allurements of
better remunerations and career. It affects the operations of the systems and the banks may find it
increasingly difficult to get suitable replacements.
It is not necessary that a turnover of persons from within only may affect the organisation. The banks are concerned with all persons associated with them in IT related critical solutions. These persons may be the trained staff from within the banks or from the software houses supplying software solutions to the banks. However, the direct impact is usually felt in case of the above risks to the technical staff,

handling highly specialised functions, whereas in other case there may be a short-lived slow down of services.

33.3 DIFFERENT TYPES OF THREATS

The threats to risk prone components in a computerised system manifests in the form of business interruptions:

- Errors and omissions in data and software
- Unauthorised disclosure of confidential information
- Computer abuse and mis-utilisation of banks assets
- Frauds

Some of the threats to the computerised systems may be caused accidentally or due to reasons beyond one's control. However, the damages caused due to malicious intentions and human errors are of usually more serious nature.

33.3.1 Accidental Damages

Computers and communication systems have found their applications to be quite extensive in banking and other financial organisations. However, at the same time, these systems are vulnerable to damages caused accidentally, both due to human failures and natural calamities. In the long run, the systems which have not been properly tested also lead to a higher failure rate of errors in their processing and operations.

Environmental Hazards

Environmental hazards are one of the most common causes of accidental damage to computer installations, equipment and data. Computer equipment and storage media can be put out of action by natural disasters and improper management of the system environment. Following are the major environmental hazards to computerised systems:

- Fire is the single most common cause, of complete or partial destruction of computer installations
- Unstabilised power causes extensive damage to the sensitive electronic components
- Spikes in power and improper grounding (earthing)
- Excessive humidity, water seepage and floods
- Radio transmissions affecting data transmissions.

Human Errors and Omissions

Errors creeping into computerised systems may result in affecting drastically the customer service and operational efficiency. Errors also dilute the management control of the systems. Errors in computerised environment can occur at the time of:

- Systems design and process development
- Programme maintenance and while carrying out correction procedures
- Data entry at the time of terminal operations.

The cause in most of these cases is the human failure. Machine failure is rarely the cause of errors in computer data.

The complexity of computer systems significantly contributes to the incidence of errors. Even when programmes are well tested, errors can remain, that may lie dormant for months or years until a particular set of circumstances occur. When this happens, the results can be unpredictable. Often new errors are introduced during successive system changes.

Errors may also be introduced into standard software packages, when these are customised, i.e. adapted to meet the needs of a particular user.

Excellent standards of error controls are, therefore, required to maintain the accuracy of transactions, balances and management information.

Unreliable Systems

The quality of banking services and the efficiency of banking operations have become increasingly dependent upon the application of information technology to the extent that any failure in the planning or developing the proper IT systems may have significant commercial consequences. As for example, a failure to anticipate the headways made in the use of technology by the competitors may lead in development of inadequate and inappropriate systems. To avoid these situations, the banks are required to pay a particularly close attention to the planning of computerised systems.

Another aspect related to this issue is the opportunity of fraud which may arise because of a poor system design. At the time of designing a system, the potential user, frequently defines only half the problem, as he believes that the computer will do everything for him. Particularly in a multi-programming or multi-user environment, it is very difficult to ascertain what the system is doing. These types of systems are, therefore, prone to risks of error, as well intentional frauds.

33.3.2 Malicious Damages

Risks of malicious damage to computerised systems can be from disgruntled employees who wish to disrupt the services or from individuals with malafide intentions, to use the technology for perpetrating fraud for financial gains. The systems are exposed to greater risks from computer professionals and any unauthorised act committed by them may be very difficult to detect. As such, controls are required to limit their access to operational programmes and sensitive data.

Special programmes such as utility programmes can be used to make unauthorised changes to computerised records in a way that bypasses the normal control and audit trail facilities built into the computer systems.

Interruption in Services

Malicious damage to computer systems can cause an interruption in banking services. Once the banking operations have been computerised, few banks can operate for long without their computer systems. These systems may consist of large number of hardware components and software programmes working in unison and damage to any one of these may bring down the system partially or completely.

In most banks, a considerable proportion of these components are in one place. However, with the extensive use of telecommunications, these components are increasingly being used in an integrated manner at dispersed locations, making them particularly vulnerable to damages, both malicious and accidental.

As the systems go out of action, the damaging effects on banking services increase rapidly. Particularly, damaging effect is on the environments wherein IT is being used for on-line, real-time processing. In such cases, services may get affected immediately, as the links to automated teller machines, POS or other electronic networks are brought down. An insufficient processing capacity to cope with the additional load may also lead to a suspension of the banking facility unless adequate contingency plans have been specified and tested beforehand. The consequential costs of a serious systems failure, therefore, can far exceed the costs of replacing damaged equipment, data or software.

Backup arrangements can help in restoring the services. The protection of the bank's software and data acquires utmost importance since the equipment can eventually be replaced. But, where all copies of

programmes and data are destroyed/damaged, a very considerable time might elapse before normal banking operations can be resumed.

Frauds

There are several ways in which fraudulent transactions in computerised systems can be generated by unscrupulous elements. For example:

1. Special programmes such as utility programmes may be used to make unauthorised changes to computerised records in a way that bypasses the normal control facilities built into the computer systems.
2. An unauthorised manipulation to programmes or data in a way that bypasses the password is to remove the relevant files from the primary location, transport these to another computer and returned after manipulations. In case, this manipulation has been done on backup files, these are brought to normal operation by deliberately causing a failure on the primary files.
3. Unauthorised amendments may be made to the payment instructions prior to their entry into the computer system.

4. Unauthorised changes to programmes may be made during routine development or maintenance which may cause the programme to generate fraudulent transactions automatically, to ignore control checks on selected accounts or to remove records of specified transactions.
5. In networked systems, amendments may be made in transactions by intercepting them during transmissions.

It would be observed that the causes that facilitate computer frauds are inadequate control over data/ media, easy access to system, total reliance upon computer systems and inadequate control over outputs.

Most banking systems contain control facilities and produce reports designed to assist in the prevention or detection of frauds. These controls can be implemented by identifying and protecting the vulnerable points in each system.

33.4 CONTROL MECHANISM

Implementation of effective control mechanism is required for successful management of risks associated with the use of IT tools. Preventive controls stop errors or irregularities from occurring; for example, good form design/screen layouts reduce the likelihood of making an error while coding data or entering data from the source document. Detective controls identify errors and irregularities after they occur, e.g. an input validation programme identifies data beyond the permissible limit. Corrective controls remove or reduce the effects of errors and irregularities after they have been identified, e.g. communications software may request that data be retransmitted if it has been corrupted during transmission. In fact, the objective of applying these controls always remains that in the first place the errors and irregularities should be prevented from occurring. But given that these do occur, then there should be a mechanism to detect these and correct.

It is, however, to be noted that security and control procedures cannot be expected to provide absolute protection irrespective of their quality. There is always a residual risk of problems that occurs affecting banking operations and their competitive performance.

The nature of controls also depends upon the timing as to when these are exercised during data flow through the computer system and can be categorised as physical, internal and operational controls.

33.4.1 Physical Controls

In computerised systems, the control of access becomes very critical in view of concentration of information, at the site of data processing.

Control over access to assets, i.e. restricting entry to authorised persons only to the computer room and allowing access to computer media, documentation and other computer components, etc., to authorised persons/users only. Similarly, protection should be provided against unlimited attempts through software techniques. Only authorised persons should be allowed to undertake repairs/ maintenance of computer hardware with a proper log and no access to data or software. Access to the system and a particular application can be controlled through a mechanism of passwords. Personal identification numbers (PIN) or fingertip image verification depending upon the system. Access log is also maintained to keep a record of system access by various users. Another access control is not to allow any software developmental work on the system earmarked for regular operational work to avoid risks of errors and fraud.

Control over outputs, i.e. hard copies of all important reports generated on a periodic basis should be preserved properly and access made available to authorised persons only. Routine checks should be carried out to ensure that all protections, like smoke detectors, fire extinguishers are effective and operational, and wherever necessary appropriate steps should be taken. Similarly, protection against hardware failures should be ensured. Source code of a running system should not be available on the system to avoid tampering.

33.4.2 Internal Controls
In order to check the accuracy and reliability of accounting data, ensure operational efficiency, and safeguard assets, a system of internal controls are built in the computerised systems. These controls also encourage adherence to banking procedures and managerial policies. Primarily, there are two types of internal controls:

- Accounting controls
- Administrative controls

Accounting controls are introduced in the application software and take the form of:

- Dual controls and authorisations
- Validation checks on data
- Numerical sequencing, etc.

Administrative controls could be on the well-defined lines of responsibility, and formal policies and procedures.
Some of the other controls applicable to customer accounting are:

- Validation of each transaction against limits and balances and its authorisation before affecting it.
- Validations on stop payments, post-dated cheques, stale cheques and cheques with invalid dates.
- Verification of sensitive parameters such as due dates, maximum/minimum days allowed, maximum/
minimum rates, drawing limits, stop instructions, etc., before feeding into the system.

33.4.3 Operational Controls
These controls are embedded in software, whereas access controls may be enforced by both the system software as well as application software at different levels. The operational controls are usually provided in the application software to ensure data integrity, consistency and processing. For example, verification of checksum and checking of file/database integrity as part of day-begin functions are usually built in all banking applications.
Audit Trails
An audit trail is a chronological record of all events occurring in a system. This record is maintained for tracing of irregularities and to detect the consequences of error. It also facilitates the monitoring of the system. There are two types of audit trails.

- Accounting audit trail: It maintains a record of processes that update the data and information.

- Operations audit trail: It maintains a record of attempted or actual consumption of resources within a system.

Usual audit trails containing details of both the successful and unsuccessful transactions with terminal number, user-id, transaction details, time stamp and authentication particulars are generated by the system. As a security measure, this audit trail should be properly authorised and particular care should be taken to ensure that transaction numbers are in running sequence and no number is missing.
Checksum
Checksum is generated to ensure the integrity of data stored in a computer file. Checksum is a number calculated on the basis of certain key data items of the file. In branch banking environment, the checksum generated at the time of close of application on previous day is tallied with that generated at the time of day-begin function on the next day. Checksum usually involves at least, the account number, balances and names of the account holders.
Data Encryption
Data encryption is the process of systematic encoding of data before transmission so that an unauthorised person cannot decipher it. The process employs an algorithm which remains fixed and a keyword, which is usually changed periodically. To protect the integrity of a message transmitted, a suitable error propagation code is used. At the receiving end, the data is decrypted. End-to-end encryption protects the integrity of data passing between a sender and receiver, independent of the nodes that the data traverses. Important information may be transmitted randomly at intervals between common messages.

In the electronic fund transfer systems, a control mechanism which applies a message authentication code (MAC) is used to identify changes to a message in transit. MAC is a secret key applied to selected data items, in a part or whole of the message. MAC is recalculated by the receiver on the basis of the message received. In case the calculated code and the received code are not equal, it signifies that the message has been altered in some way during transit.

33.5 COMPUTER AUDIT

Banks normally achieve effective, secure and reliable computer systems only through the use of appropriate balance of different control techniques discussed above. The control techniques selected, varies from bank to bank, reflecting the particular risks within each bank and the costs of related security and control procedures. The objective is to safeguard assets and use these effectively.

A regular programme of independent tests of security and control procedures by auditors help in identifying lapses before the banking operations are seriously put to risk. The generic organisational function aimed at evaluation of the asset safeguarding, data integrity, system effectiveness, and system efficiency in computerised systems is termed as 'Computer Audit'.

33.5.1 Scope of Computer Audit

The computer audit covers:

1. Review of operations to establish if there is a compliance to the established policies, standards and
procedures.
2. Review of the quality of formal policies, standards, procedures and efficiency of operations and
the adequacy of procedures and controls.
3. Integrity review, focused at fraud detection/prevention, application programme and operating system
integrity, system design and implementation strategy and monitoring of employees activities.

Within the above, functions like the data entry controls, computer operations, system development, HatH communication controls, etc.. are covered as part of review.

33.5.2 Audit Approaches

Auditors are required to perform review of computer applications to evaluate accuracy of IT processing. Computer audit approaches depend upon the technical skills of the auditor and sophistication of the computer system being audited. The audit procedures may consist of manual testing processes or computer audit programmes. These different methodologies are termed as audit around the computer and audit through the computer. Quite often a combination of the two is used. Extensive use of computer as a tool to assess the controls is another technique adopted by the EDP auditors.

Audit around the Computer

In this approach, the auditor examines the internal control system of the computer installation and the input and output of the application system. Based on the above, the auditor infers about the processing carried out. He does not do a direct examination of the application software and for him the computer is a black box. The normal assumption is that if the output generated from a given input is correct and other physical controls are properly implemented, then the processing through the computer is presumably correct. However, the systems under scrutiny in these cases have to be simple, and:

- the systems should be using well-tested software,
- there should be a clear audit trail generated by the system,
- there should be proper physical controls and segregation of duties.

In all these cases, the auditor needs to examine and satisfy himself that the installation has not modified the programmes at its end. The auditors having little technical expertise can be trained easily for performing an audit around the computer. However, this approach does not

work well with systems that are complex in terms of size and volumes and the auditors cannot anticipate any problems that may come up in future due to deficiencies of software.
Audit through the Computer
This approach involves the use of computer for testing of:
1. Logic and controls existing within the system, and
2. Records produced by the system.

For adopting this approach, the auditors require, technical competence and the level of examination depends upon the complexity of the application system being audited. In the following situations, audit through the computer is quite useful:

- Where the application system is complex and handles large volumes of input.
- Where the audit trail has substantial gaps due to cost considerations.

Usually, auditing gathers evidence after the application has processed the data. However, there may be a need for collection of evidence on still more timely basis. In some of the computerised financial systems, it may be necessary to take up computer auditing at the time of processing for faster identification of errors, than through the postauditing techniques. The method involves capturing of an image of a transaction as it races through the different logic parts within a system. The technique collects evidence as follows:
1. Special audit modules are embedded in the application systems or the system software to generate
the audit evidence.
2. Special audit records are tagged and the processing is examined from an audit angle.

Most of the computer systems can behave unreliably with large increase in the volumes of data and changes in business requirements. In such situations, errors may come up, if the testing had not been proper at the development stage. The audit through computers can help in the identification of such errors at an early stage for taking remedial action.

Audit with the Computer
The auditors also make use of audit software consisting of computer programmes as part of the auditing procedures to process data of audit significance. 'Computer Aided Audit Tools and Techniques' (CAATTs) have evolved as one of the more efficient and effective ways to audit computer-generated files, records and documents and to evaluate internal controls over processing in a computerised environment.

33.6 INFORMATION SYSTEM AUDIT (IS AUDIT)

33.6.1 Introduction

Continuing from the above aspect of computer audit, the information system (IS) audit has gained the importance in the context of accelerated pace of computerisation taking place in banking sector world¬wide. Information technology is changing the nature of accounting activities. The replacement of manual operations by automated systems has brought out drastic changes in the banking operations. It has largely influenced the banks, whose activities are largely in the nature of financial transactions. While the computerisation brings in the advantages of efficiency, speed and economy in transaction processing and minimises the risks and the opportunities of frauds, it places new challenges before the auditors in the era of paperless on-line transaction processing environment.
This audit is carried out through the IT systems with the aid of 'Computer Aided Audit Tools and Techniques' (CMTTs). CMTT is a readily available user-friendly software and various types are used, with relevance to the purpose of IS audit.

33.6.2 Objective

The objective of audit does not change whether it is a manual or a computerised environment, only the approach of audit changes. IS audit is a process of collecting and evaluating evidence to determine whether a computer system could safeguard its assets (hardware, software, and data) through the adoption of adequate security and control measures, maintain data integrity, achieve goals of the organisation effectively and result in the efficient use of resources available. A control is defined as a system that prevents, detects or corrects undesirable events. An undesirable event is an event, which arises if unauthorised, inaccurate, incomplete, ineffective or inefficient input enters the system.

33.6.3 Controls to be Looked into IS Audit

Control consists of a set of inter-related components that function together to achieve some overall purpose. Control is defined as the policies, procedures, practices and organisational structures designed to provide reasonable assurance that business objectives will be achieved and that undesired events would be prevented or detected and corrected. Consider an example of access control. Here, access control itself is not a control. It becomes a control only if a system ensures that unauthorised person is prevented to access the system by means of physical and technological-based controls like use of user ID and password and permissions to assess particular database or application or part of it. All these components of access control should be in place and effective. Thus, we must consider the reliability of a control from the system's point of view. Hence, it is utmost important for IS auditors to understand the nature of the controls.

33.6.4 Controls to be Evaluated in IS Audit

Each organisation should identify the events and circumstances whose occurrence could result in a loss to the organisation. These are called exposures. Controls are those acts, which the organisation should implement to minimise the exposures. There are four types of controls:

(a\ Deterrent controls: Deterrent controls are designed to deter people, internal as well as external,

from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.

(b) Preventive controls: Preventive controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.

(c) Detective controls: When a case of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or minimise the extent of the damage. Thus, detective controls limit the losses, if an unlawful event has occurred. Certain fire precautions like smoke detectors and heat detectors fall into this category. Even an IS auditing function can many times be treated as a detective control.

(d) Corrective controls: Corrective controls are designed for recovery from a loss situation. For example, business continuity planning is a corrective control. Without corrective controls in place, the bank has risk of business loss and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

33.6.5 Benefits of IS Audit

The IS audit assesses the strengths and weaknesses of the information system. It also assesses if the information system actually translates itself into an effective tool to meet business goals. Major benefits of IS audits are as under:

> It would identify the risks of exposure to an existing computerised environment. On identification of the risks, remedial measures can be taken to protect the interests of the organisation. Thus, it

would act as a preventive tool.
> It would deter people/employees/users from indulging in corruption/ manipulation of data, frauds,
etc., as any unlawful activity will be prevented, controlled and detected through implementation of
IS audit.
Security features and controls in computerised information system could be improved-based on the suggestions made during the course of an IS audit. Any laxity in controls/security of the information system could be eliminated if an IS audit is conducted at regular intervals.

- ♦ IS audit can verify whether the information system safeguards the assets of the bank.
- ♦ It conveys to the management, reasonable assurance regarding functionality and security related
performance capability of the system.
- ♦ It indicates health of the information system.
- ♦ Conclusions and recommendations emerging out of an IS audit influence the decision making
process of the management.

33.7 INFORMATION SYSTEM SECURITY (IS SECURITY)
33.7.1 Introduction
The computer systems are at the centre of the information. The computation power, provided by these systems, allows the organisations more flexibility and processing capability than ever before. The complex array of computer capabilities offers operational advantages and at the same time, raises security concerns as well. Checks and controls will require to be implemented to protect the integrity of the computer systems which include, amongst others, mainframes, mini-computers, microcomputers, laptops, notebooks, palmtops, servers, workstations and personal computers in use in the organisation.
33.7.2 The Need for IS Security
(a) While the challenges related to physical security are those which can be confronted with relative

ease, the position is much more complicated with respect to IT security. It is widely accepted that security is as effective as the weakest link in a chain. The weakest link does not relate to the components of technology (which do have an implication though), but on the person who is part of the information supply chain, and is typically the insider in the organisation itself. Studies have indicated that a substantial portion of the breach of security in financial institutions have occurred on account of or have been triggered with the aid of internal exposures or internal controls being compromised. Against this backdrop, the security requirements need to be assigned high levels of priority.
(b) Information security is something which is best experienced than explained. With networking and access to information being available at rates much larger than before, information security is an activity which provides some comfort to both the policy makers and the users of data.
(c) Security in payment systems cannot be addressed in isolation. It requires the integration of work processes, communication linkages and integrated delivery systems and should focus on stability, efficiency and risk control.
33.7.3 Objectives of IS Security Policy
In view of the needs spelt out as above for IS security, any organisation, the banking sector in particular, requires a well-documented IS security policy having the following objectives:
To prevent unauthorised disclosure of information stored or processed on the bank's information systems (CONFIDENTIALITY) . To prevent the accidental or unauthorised deliberate alteration or deletion of information (INTEGRITY) S To ensure that information is available to authorised persons when required (AVAILABILITY).

The guidelines carved out of the aforesaid aspects, shall be drawn as the yardstick to assess the level of IS security compliance. Each activity mentioned below shall be evaluated in terms of risk parameters by the officials drafted for inspection of compliance to the Policy guidelines. Depending upon the severity of the risk vis-a-vis the compliance noticed, the LOW or MEDIUM or HIGH or EXTREMELY HIGH grades will be assigned and the findings will be put up to the top governing body of the organisation. The activity pursued to evaluate IS security guidelines is known as information system audit (IS audit).

33.7.4 Controls Required for IS Security

User ID and Password: The common level of entry is the use of validation of authorised access (in the form of authorised user-Ids) to be further authenticated by correctness of passwords keyed in by the authorised users.

Authorisation: Authorisation of users is another activity that needs to be closely regulated and monitored.

Access Control: Access to databases in computer systems and to the data contained therein have to be strictly restricted

Alternate authentication control: To have more control on the access being given to the genuine users alone, biometrics is interpolated in all access cards to identify the correct user based on some physical characteristic, such as fingerprint analysis, hand geometry, or retina scanning. This technology is advancing rapidly, and offers an alternative means to authenticate a user.

Strengthening of controls in the modern financial transactions: Financial messages in the form of plain text, encrypted messages, SFMS are used to convey transfer of funds. For such transactions, it would be advisable to build the following security features at the application level, because of the critical nature of financial data transfer.

(a) Authentication (to verify the identity of the sender of the message to the intended recipient to prevent spoofing or impersonation)

(b) Authorisation (to control the access to specific resources for unauthorised persons)

(c) Confidentiality (to maintain the secrecy of the content of transmission between the authorized parties)

(d) Integrity (to ensure that no changes/errors are introduced in the messages during transmission)

(e) Non-repudiation (to ensure that an entity cannot later deny the origin and receipt and contents of the communication).

33.7.5 IS Security in Banking

Customers of banks can now look forward to a large array of new offerings by banks. From an era of mere competition, banks are now cooperating among themselves so that the synergistic benefits are shared among all the players. This would result in the formation of shared payment networks (a few shared ATM networks have already been commissioned by banks), offering payment services beyond the existing time zones.

The Reserve Bank is also facilitating new projects such as the multi-application smart card project which, when implemented, would facilitate transfer of funds using electronic means and in a safe and secure manner across the length and breadth of the country, with reduced dependence on paper currency. The opportunities of e-banking or e-power in general need to be harnessed so that banking is available to all customers in such a manner that they would feel most convenient and if required, without having to visit a branch of a bank. All these will have to be accompanied with a high level of comfort, which again boils down to the issue of IS security.

33.7.6 Threats to IS Security

As increasing dependence on information systems develops, the need for such systems to be reliable and secure also becomes more essential. As growing numbers of ordinary citizens use computer networks for banking, shopping, etc., network security is potentially a massive problem. Over the last few years, the need for computer and information system security has become increasingly evident.

(a) as web sites are being defaced with greater frequency,

(b) more and more denial-of-service attacks are being reported, credit card information is being stolen,

(c) there is increased sophistication of hacking tools that are openly available to the public on the Internet, and

(d) there is increasing damage being caused by viruses and worms to critical information system resources.

It would be helpful if the organisations share information about threats and vulnerabilities, and implement procedures for rapid and effective cooperation to prevent, detect and respond to security incidents. As new threats and vulnerabilities are continuously discovered, there is a strong need for cooperation among organisations and, if necessary, to consider cross-border information sharing.

E-mail Viruses

Antivirus software should be installed to scan any attachment before opening it. Users should not open e-mail attachments unless they are sure about its contents and they know their senders well.

Phishing Attacks

Phishing is a recent forms of cyber attack in which scammers/attackers make the Internet users divulge sensitive information about their bank accounts and personal details. The tactic of using e-mail to solicit sensitive information from users is called phishing. The attackers are able to target Internet users due to some inherent weakness in web browsers and other technical aspects of the Internet.

345

E-mail can be used to obtain sensitive information from unsuspecting users. The information may be passwords for websites, credit card information, and online financial information such as bank account numbers.

In a typical attack, user receives an e-mail message from the attacker with the address and logo or image of a bank or financial institution, making one to believe that the message has come from that bank/financial institution which tries to convince the user to part with personal information and use them for wrongful purposes.

The aforesaid threats can be warded-off by maintaining an ongoing study of the IS security requirements in the light of hardware/software/communication equipments deployment.

1. IS security assessment: The security assessment must include the following aspects for putting in place a comprehensive policy document:

(i) To understand threats and dangers that could be vulnerable to and the steps that need to be taken to mitigate these vulnerabilities (ii) To understand access control systems and methodology, telecommunication and network security, and security management practice (iii) To deploy personnel well versed in the area of application and systems development security, cryptography, operations security and physical security

2. Firewalls for data integrity: At the minimum, organisations should use the proxy server type of firewall so that there is no direct connection between the Internet and their system. It facilitates a high level of control and in-depth monitoring using logging and auditing tools. For sensitive systems, a stateful inspection firewall is recommended which thoroughly inspects all packets of information, and the past and present transactions are compared. These generally include a real-time security alert.

3. Change management of computer hardware and software: This is another aspect that needs to be viewed from the security angle. Hardware needs to be specified with vital security features and the controls are of high order even when updating to the system is done. Software undergoes frequent updating and version control and levels of software in use

across offices is an issue which needs to be examined in its totality for practicable implementation.

Greater thought is to be given to all the issues connected with actual implementation of IS security. The security is actually not built over any existing block; in today's world, it has to be an integral part of the block itself. This is where the need for implementation of IS security from the stage of manufacture - of the hardware, software, during its integration and final implementation - assumes significance. In this context, putting in place a rigid IS security policy and ensuring its compliance is the only option for all risk mitigation measures.

33.8 EVALUATION REQUIREMENTS

The IT resources continuously undergo changes in the form of development of new applications, acquisition of new hardware, turnover of trained employees, etc. Therefore, there is a need for a standard plan of evaluation of various IT components, viz., feasibility studies, specification of systems requirements, selection of equipment, software development/acquisitions and project controls, etc., on a continuous basis. Lack of attention to one or more of these aspects can lead to serious developmental delays, increased costs and failures in computer projects.

Apart from regular audit checks on existing systems, auditors' involvement at an early stage in the specification and design of new systems can contribute significantly to not only the quality and effectiveness of security and control facilities but also a more efficient utilisation of computer resources.

33.8.1 Computer Hardware

Obsolescence of computer hardware is a major problem with IT users. Acquisition and replacement costs are quite high. Therefore, the banks need to have proper hardware purchase policies directed at a balance between technology and cost of acquiring it. The components of the existing systems to replace damaged parts may not be available with ease and the banks may have to phase out the hardware gradually. Moreover, the competition may drive the banks to adopt the latest technology without bothering about the costs involved. All this requires for a proper long-term plan and budget for hardware replacements. It is to be noted that in case where it is difficult to replace some hardware, the losses due to denial of services to customers may lead to loss of goodwill and reputation. In case where the hardware can be replaced immediately, the loss may be in terms of cost of replacement. Therefore, an evaluation of various assets and the manner in which these are being used should be done on periodic basis.

33.8.2 Computer Software

Software, comprising both the application software and system software, is vital to the operations of a computerised system. The system software comprising operating systems, compilers, utilities, etc., have to be objectively procured to drive the software applications for meeting banking needs. Vendor policies and technological breakthroughs result in development and availability of newer software directed at efficient utilisation of the hardware. It changes the quality of banking products and methods of service delivery. As for example, the banks are making a shift from TBA to networked online centralised banking solutions (CBS).

Application software also undergoes change with the passage of time to conform to changed banking requirements. Frequent changes to the application software result in its patching which makes the system less efficient, requiring a fresh development of software. All this requires a proper change management policy for software.

33.8.3 Data

Information is the power source of the banking business. The data in its various forms is one of the most critical assets of a bank. Accidental loss of data may be less serious than the loss due to irregularities. Whereas a customer file destructed accidentally may still be recovered, the problem assumes seriousness if it is stolen by a competitor and may be used against it. The application of technology has also changed the concept of data storage and data retrieval techniques. Any changes to the banking data stored on magnetic media may not be easily detected. This underlines the need for proper management policies for data storage, and the archival methods for ensuring protection, security, and privacy of data.

33.8.4 Communication Channels

Banking operations now make extensive use of communication channels for data transmission. The banking framework has geographically spread out with linkages being established through communication lines. In fact, the communication systems are the backbone of electronic banking which is spreading at enormous speed. It calls for a well-defined technological competence and clear policies for absorption of the right type of communication systems for individual bank's needs. Associated with it, is the risk of the tapping of data over the telecommunication channels as well the need of building secured methods of transmitting financial transactions.

33.8.5 Disaster Recovery Management for Computer Environment

Objective

- The main objective of the disaster recovery policy is to safeguard Information.

- System assets with least damage in case of any disaster and to maintain business continuity at the optimum level within the shortest possible time.

Disaster - Definition

In simple terms, any event which results in direct denial or stoppage of essential business functions for a considerable period of time may be defined as a disaster.

Before defining and declaring any event as a disaster, it must be ensured that the event results in direct stoppage of business, resulting in loss that can be quantified either in terms of money or time. For instance, stoppage of services after business hours without disrupting customer service at any point of time, disruption in services for short intervals, etc., that do not result in denial of service need not be considered as a disaster and it can be considered as disruption. Thus, a judicious decision must be arrived at in this regard.

Business Impact Analysis

Before devising any disaster recovery plan, a complete business impact analysis (BIA), must be carried out by the functional units to identify the critical areas and systems affecting the business based broadly on the lines of the business continuity plan, the maximum time up to which services/business can be stopped, the minimum time within which the services can be restored either directly or through backup mechanisms, the lead time between complaint and response with vendors etc. Wherever the loss can be quantified, the value of the impact can be calculated and a comparison with past occurrences/standards and recovery time objective and recovery point objective can be arrived at.

Disaster Recovery Planning

Information is a crucial aspect of businesses all over the world. However, the organisations are vulnerable to threats of different kinds that can destroy information and sever links of communication. The following are some such threats:

(i) Natural disasters, such as fire and earthquake (External factors)
(ii) Hardware and software failures
(iii) Virus attack
(iv) Acts of terrorism

To counter these disasters with the minimum possible disruption to business operations and loss of valuable data, organisations must plan beforehand. In addition, an organisation must constantly monitor the environment for threats to the assets of the organisation. After these potential threats are identified, the organisation must analyse whether the safeguards currently in place are sufficient to mitigate the risk posed by the threats. If the safeguards are insufficient, the organisation must consider implementing additional safeguards.

Need for Disaster Recovery Planning

Disasters arising out of external factors such as earthquakes can significantly damage the equipment, systems, and data of an organisation and inflict huge financial losses. Therefore, organisations must plan for disasters to ensure that they can successfully recover from them. The process of planning for disaster recovery is divided into four phases as shown in Figure 33.1.

Awareness

Preparation

Testing

Recovery

348

Awareness

To create a disaster recovery plan, the awareness about the critical activities, systems and processes of the organisation must be of the highest order. Financial services oriented organisations like banks must sustain critical business activities and systems even at the cost of less important activities. The back-end processes in banks may be treated as less important, while the front-end operations must be identified as the critical business activities. Then the resources, viz., trained manpower, infrastructure like electricity, furniture, computer hardware, communication equipment and links etc., that are necessary for sustaining these activities must be identified and kept ready for commissioning at very short notice. In addition to these, the financial and legal issues as detailed below are also to be considered.

Financial and Legal Issues

All the information assets carry a monetary value and any loss to these assets will in turn influence the profit and loss of the institution. Thus, it becomes mandatory for any unit holding the Information assets to maintain;

(a) A proper inventory of all the hardware, software and other equipments, data storage devices, etc., and to insure against any loss to these assets.

(b) The warranty/AMC terms and conditions must be properly documented, filed and secured in safe custody with due knowledge of the persons concerned.

(c) Only licensed versions of the software for use as copyrights.

(d) All the licensed version of the software, like CD, floppy, etc., with proper records and storage. Proprietary rights and unless permitted by competent authorities in writing, no copying of such licensed software must be done.

(e) The assets must be transported only through an authorised mode of transport.

Preparation

For ensuring full preparedness to carry out the critical activities and processes, the following are necessary:

(i) Core and support teams consisting of skilled and trained personnel.

Human resources are the most valuable assets of the information systems. They are equally the most vulnerable. Proper and adequate training for the field level functionaries in their respective fields apart from general computing techniques will go a long way in avoiding disaster situations and maintaining business continuity.

(ii) Alternate recovery sites known as 'disaster recovery sites' to take over in case of need with proper outsourcing arrangements, if needed.

Financial service organisations like banks must strive for business continuity at all times. Hence, they must have in place, requisite outsourcing arrangements, wherever, it is applicable. The organisation, as a first line of defence, must be clear in its objectives and enter service level agreements (SLAs) with its interests as the foremost in picture. In any such contravening situations, the impacts and the responsibilities of the service providers must be foreseen and SLAs must be arrived to ensure complete security to the organisation interests.

(iii) Back up of data on a daily basis.
(iv) Documentation for disaster recovery plan.
Testing
Different types of tests like mock testing (simulating a disaster condition), announced testing to check the efficacy of the disaster recovery plan must be carried out on an on going basis with suitable improvements thereon.

Recovery
Disaster or work disruption can happen due to the following factors and the recovery steps to be taken are mentioned against each.
Arising out of external factors
1. a. Disaster due to breakdown or fire.

b. disaster due to floods/ tsunami.

c. disaster due to earthquake

2..Disaster due to power failure.

3. Disaster due to communication/ connectivity failure

The possible causes of fire in and around the location must location must be analysed in detail and all preventive measures required, for the protection of assets from fire accidents must be taken.
In a flood/tsunami prone area, adequate care has to be taken for location of the building and for proper structural design to avoid damage due to flooding.
Earthquake can cause considerable damage to assets, resulting in the loss of data. Adequate safety measures suggested by the ! local Government must be strictly adhered to.
Suitable alternate arrangements to overcome the disaster due to power failure are to be kept ready.
Redundancy measures must be made available and periodically | checked to ensure that there is no interruption in connectivity.

B. Arising out of data corruption/non-availability/unauthorised access of data
1. Disaster due to lack of data access control mechanism.

2. Disaster due to lack of data consistency

3. Failure of regular data backup and verification of verification of backed up data periodically.

4. Use of unauthorized programmes to access data   Proper logical access controls and user level privileges must be established and documented with due control mechanism in place.

Direct modification / updating of data must be prevented. In case of exigency, such modification / updating of data must be done with proper authorizations only and must be documented. Logs must be made available.
Any disaster recovery plan can be effective only with a sound backup procedure adopted and meticulously followed by the institution.
Authorised programmes only must be used by branches / offices and they must be suitably protected from unauthorized access, alteration and misuse.

C. Arising out of failure of hardware and networking (LAN)

1. Disaster due to breakdown of file server and damage to nodes and other hardware peripherals, connectivity, equipments, communication channels
2. Non-availability of hardware components
Compatible with the available systems due to obsolescence, mismatch of specifications, etc.

3. Loss of connectivity/ unauthorised connectivity in LAN environment
To obviate work disruption due to total damage to the file server, nodes and other systems suitable backup measures are to be adopted.
Hardware requirements in the changing environment , at all levels, must be periodically reassessed and the required upgrades/ add-on components must be taken up on need, taking cost into consideration.
The LAN environment must be optimally utilised multi-LAN and inter-LAN environment must be monitored properly with adequate security aspects.

D. Arising out of technology changes in software including operating system, application software, executables and packages

1. Change in operating system, network operating system architecture due to up grade /development

2. Lack of version control in application packages/ programmes

3. Unsecured exposure of

software to external
environment

4. Lack of bacKup and library of programmes/data

5. Non-availability/inadequate documentation

6. Corruption/collision/conflict of executable programme files resulting in system hanging denial of service Periodical upgrades/patches released by operating system/ network operating system vendors must be procured and loaded into all the systems as a first-line security measure and such actions must be properly documented.
Any change effected in the application package or programme must be with a proper approval/ authorisation only and due documentation. End users must be made aware of functional changes, if any.
All executable application programme files must be secured from exposure to external environment. Use of external programmes to penetrate such executables must be totally curtailed. User rights must be properly defined on such executable files with access restrictions.
Proper backup and library of source codes and executables with compatible operating system versions must be maintained and recorded.
Documentation for all application packages/programmes must be prepared with due consideration for the end-user and their knowledge levels
Due care must be exercised when changing the programmes/over¬writing the executables. It must be ensured that whenever new executables are loaded, they are compatible with the earlier version and all the executables are compatible with a single version.

E. Arising out of human factors

1. Lack of knowledgeable and trained professional

2. Sabotage created out c. intentional or unintentional acts

Lack of knowledge must not be a reason for disaster. Adequate training has to be given to all personnel involved, to have a 'First and Second line' and to ensure business continuity and their knowledge must be refreshed periodically.
. Access to the computer room/site must be strictly controlled. Proper vigilance measures must be in place to prevent network intrusions, hacking, etc.

Disaster due to virus attacks

. Instances relating to lack of physical access control, piggy backing, social engineering, etc.

Other risks such as burglary, fraud, etc.	All computer systems in use must be loaded with authorised 'Anti Virus' software and must be kept operational always.
Prudence in handling humanware must be undertaken and staff integrity must be encouraged.

All safety and security measures required to safeguard the assets against a burglary and preventive measures to avoid commission of a fraud must be taken.

The aforesaid recovery measures come into action, after a disaster has occurred. During this phase, activities such as damage assessment and salvaging take place. Depending upon the impact of the disaster, critical activities are shifted to an alternate location or disaster recovery site which is kept ready always for resuming business activities at short notice. Thus, a well-documented disaster recovery plan as outlined above, can guide an organisation to overcome any type of disaster with confidence.

33.8.6 System Development Process

Development of computer applications involves many procedures. Each application has a life cycle and with the passage of time, a system may require a complete changeover. In order to have a proper system embedded with a well-defined control mechanism, aimed at safeguarding the banks' assets, a proper system development methodology has to be adopted while developing any computerised system. Development of this system involves adherence to certain well-defined standards. These standards pertain to project initiation, requirement analysis, system design, programming, testing, implementation, evaluation and maintenance.

33.9 LEGAL FRAMEWORK FOR ELECTRONIC TRANSACTIONS

At present, many legal provisions recognise the paper-based records and documents that should bear signatures. Since, electronic commerce eliminates the need for paper-based transactions; therefore, to facilitate e-commerce, there was a need for legal changes. With the increased use of electronic means, it is imperative that evidence of these activities should be available to demonstrate the legal rights and obligations that flow from them. Taking cognition of these, the United Nations Commission on International Trade Law (UNCITRAL) adopted, in 1996, the 'Model Law on Electronic Commerce'. India is a signatory to the Model Law. In its endeavour to give thrust to the Government's IT Policy, the Indian Parliament enacted a comprehensive Information Technology Bill, which received the President's assent on 9 June, 2000. This IT Act, 2000 provides legal recognition for transactions carried out by means of electronic communication.

The act inter-alia deals with the following issues:

1. The Act provides a legal framework by validating and authorising the use of 'Electronic Data Interchange' (EDI), 'Electronic Records', and 'Electronic Signatures'. It, further, provides that once a message leaves the information system of the originator of the message, it is attributed to him. Thus, repudiation of a secured electronic message has been checked.
2. The Act identifies a new set of information technology offences, which are delineated in the Chapter XI of the Act. These offences have been listed as follows:

- Knowingly or intentionally concealing, tampering, destroying or altering or causing another
to conceal, destroy or alter any computer source code used for a computer/network, when the computer source code is required to be kept or maintained by law for the time being in force.
- Hacking, i.e. destroying, deleting or altering any information residing in a computer resource
or diminishing its value or utility by any means, with the intent to cause wrongful loss or damage to the public or any person.
- Obscenity, i.e. publishing or transmitting or causing to be published in electronic form, any

material which is lascivious or if its effect is such, as to tend to deprave and corrupt persons who are likely to read, see or hear the matter contained or embodied in it.
• The Government of India, by notification, can declare any computer system or computer
network as a protected system. Only authorised persons can have access to the protected system. Any access or attempt to secure access to a protected system in contravention to the provision shall be construed as an offence.
• Any misrepresentation or suppression of facts for the purpose of obtaining any licence or
digital signature certificate.
• Breach of confidentiality and privacy, i.e. disclosure of any electronic record, book, register,
correspondence, information, document or other material accessed/obtained without the consent of the person concerned.
• The Act describes special procedure for investigation and further proceedings, in respect of
information technology offences and provides that a police officer not below the rank of Deputy Superintendent of Police can investigate any offence under the Act.
3. Consequent upon the recognition given to the electronic records, electronic documents and electronic signatures, incidental amendments have also been made in the following Acts: (i) The Indian Penal Code, 1860 (ii) The Indian Evidence Act, 1872 (iii) The Banker's Books Evidence Act, 1891 (iv) The Reserve Bank of India Act, 1934
• The Act purports to include the word 'electronic record' along with the word 'record'/'document' appearing generally in various sections of these acts. The amendments also purport to include electronic records for the purpose of evidence and impart credence to digital signatures and digital certificates.
• The amendment to Indian Penal Code, 1860, also states that for the purpose of the Section 466 (dealing with forgery of records), a 'register' shall include any list, data or record of any entries maintained in the electronic form as defined in the IT Act.
• Similarly, the Bankers Books Evidence Act, 1891, redefines banker's books as ledgers, daybooks, cash books and account books, and all other books used in the ordinary business of the bank, whether kept in written form or as printouts of data stored in a floppy, disk, tape or in any other form of electromagnetic data- storage device.
• The RBI Act, 1934 has been amended by the IT Act, 2000, empowering the central board to make regulations for fund transfers through electronic means between the banks or between the banks and other financial institutions.
It will be seen that this enactment of Information Technology Act, 2000 shall usher in a new era for e-governance and e-commerce as it provides rules for validation and recognition of contracts formed through electronic means and also supports the admissibility of computer evidence in the courts of law. The act will also facilitate electronic filing of documents with the government agencies.

33.10 LET US SUM UP

Computer installations in banks represent assets valuable to the banking operations. Data, hardware, software and manpower are the vital components. The technological breakthroughs and their application to banking operations have greatly affected the security considerations, to counter the threats to these assets, computer security and control procedures must, therefore, form an integral part of the system of internal controls within a bank.
Most of the physical, operational and internal controls are designed to prevent events that may threaten banking operations. Due to complex nature of the banking operations, even properly designed security and control systems can fail and leave a bank exposed to losses, if the laid down procedures are not followed in practice. Therefore, containment controls are

designed to detect and limit the effect on the business and contingency plans are provided to minimise the losses in case the preventive controls fail in preventing the threats.
However, a regular programme of audits can help in identification of lapses, before the banking operations are seriously put to risk. It requires a proper audit strategy by the banks.

33.11 CHECK YOUR PROGRESS

1. A typical computerised environment constitutes three interdependent but separate components,
(a) Software, hardware and data (b) Hardware, software and UPS
(c) Software, modem and networking(d) Software, people ware and data
(e) None of these
2. The risks broadly lead to:
(a) Incorrect decision making leading to setback to business
(b) Interruption in activities due to loss of data, hardware, software, people ware
(c) Violation of privacy
(d) Direct financial loss due to computer frauds
(e) All of these
3. The phases of disaster recovery planning are:
(a) Awareness (b) Preparation
(c) Testing (d) Recovery
(e) All of these
4. The consequences of errors in computerised systems are more serious than in manual systems
because:
(a) Computer systems process more data
(b) Errors in computer systems are generated at high speed, and the cost to correct may be high
(c) Users of computer systems perceive the computer outputs to be always correct
(d) All of above
(e) (a) and (c)
5. Compared to a manual system, in a computer system:
(a) The methodologies for implementing controls change
(b) Basic controls objectives change
(c) Control objectives are more difficult to achieve
(d) All of above
(e) (a) and (b)

6. IS audit for the software used is carried out by CAATT. This type is known as:
(a) The audit around the computer (b) The audit through the computer
(c) The audit with the computer (d) All of above
(e) None of these
7. Risk prone component(s) in computerised systems are:
(a) Errors and omissions in data and software
(b) Unauthorised disclosure of confidential information
(c) Computer abuse and mis-utilisation of banks assets
(d) Frauds
(e) All of above
8. Effective control mechanism(s) in computerised environment are:
(a) Preventive (b) Detective
(c) Corrective - (d) All of above
(e) (a)and(c)

Integrity All of above
(b) (d)
9. Objective of IS security is to ensure; (a) Confidentiality (c) Availability (e) None of these
10. Audit trail is:
(a) A chronological record of all events occurring in a system is:
(b) Report submitted by auditors
(c) A collection of record generated by database administrator
(d) All of above
(e) None of these

33.12 ANSWERS TO CHECK YOUR PROGRESS'
33.13 KEYWORDS
Data, Access Control Systems, Algorithm, Online, Password, Real time, Disaster.

MODULE -D
SUPPORT SERVICES - MARKETING OF BANKING SERVICES/PRODUCTS

MARKETING
An Introduction

STRUCTURE

34.0 OBJECTIVES

In this unit, we seek to know and understand the:

- Concept of marketing
- Significance of marketing in general and as applicable to Indian banks
- Difference between services and physical goods
- Importance of 4Ps in deciding the marketing mix

34.1 INTRODUCTION

Generally, marketing is understood as selling of products or services. Some consider advertising or promoting a product as marketing. The idea of marketing is much broader. It essentially is related to customer. The earliest attempts at marketing can be traced to the barter system.

The barter system can be looked upon as a reflection of the realisation that exchange adds value to both the parties to the transaction. This indeed marked the dawn of marketing. Since then, the evolution of commerce through various stages has led to the development of marketing into a philosophy of business.

Marketing is both a concept and a practice. The understanding of marketing is in its entirety a decision on appropriate marketing mix and strategies, has to be looked upon from the customer's angle to make a product successful in the market.

34.2 MARKETING CONCEPT

34.2.1 Market

The word "market" in common parlance refers to the place where goods can be bought or sold.

A market consists of all the potential customers sharing a particular need or want who might be able to engage in an exchange to satisfy that need or want.

Market implies:

- A situation where buyers and sellers of a commodity interact
- Coming together of buyers and sellers of the same or similar commodities

It is possible for sellers to be dealing in one variety of soap and the buyers being interested in another variety, which can be substituted by the one available with the sellers.

Market is not necessarily a geographical area. Groups of buyers and sellers can be located widely apart from each other. With the advancement in communication and transport facilities, the buyers and sellers can easily contact each other even if they are physically at long distances. A market may comprise any of the following situations like one/many seller(s) and buyer(s) that might give rise to different market types, marketing and strategies.

34.2.2 Types of Market:

Markets, can be grouped into different types as indicated below.

Basis of Classification

Types of Market

Geographical Area

Product

Nature of Transaction

Volume of Transaction

(a) Local Market; (b) Regional Market; (c) National Market; (d) World/Global Market.

a) CottonlTeaA/egetable Market; (b) Share Market; (c) Bullion Market; (d) Capital Market; (e) Real Estate Market; (f) Retail Loan Market.

(a) Cash/Spot Market; (b) Futures Market; (c) Commodity Market.

(a) Retail Market; (b) Wholesale Market.

In the case of banks and financial institutions, market may be local and/or global, wholesale or retail, primary or secondary, etc.

34.2.3 Marketing

Marketing is a concept, which has developed over a period of several centuries. As far back as in 1776, in his famous work "The Wealth of Nations", Adam Smith wrote: Consumption is the sole end and purpose of all production and the interests of the producer ought to be attended to, only so far as it may he necessary for promoting that of the consumer. This statement contains the essence of marketing concept. The operating word is consumer. The identification and satisfaction ofa consumer's requirements form the basis of marketing. Marketing, has also been defined, as "meeting needs profitably". Various scholars have further described marketing in different ways:

- Marketing is the process of determining consumer demand for a product or service, motivating its sale and distributing it into ultimate consumption at a profit. (Brech)
- Marketing is concerned with the creation and maintenance of mutually satisfying exchange relationships. (Baker)
- Marketing is the business function that identifies the current unfulfilled needs and wants, defines and measures their magnitude, determines which target markets the organisation can best serve, and decides on appropriate products, services, and programmes to serve these markets.

Thus, marketing serves as a link between a society's needs and its pattern of industrial response. (Kotler)

A reflection on the foregoing definitions reveals:

- Focus of marketing is on the consumer.
- A human need is a state of deprivation of some basic satisfaction, which results in desire for specific satisfiers of these needs, namely wants. Wants for specific products, backed by an ability and willingness to buy them, results in a demand.
- Gradually, marketing concept has become more comprehensive - moving from assessing and fulfilling consumer demand to identifying needs and wants and determining products and services. Indeed, in the present age, marketing includes not only anticipating the consumer needs but kindling needs and providing new products and services to fulfil them.

34.2.4 Evolution of Modern Marketing

Over the centuries, the world economies have changed radically; beginning from the hunting stage, commerce has passed through the stages of barter exchange, village economy, town economy, national economy and has reached globalisation. The world has also witnessed two major technological revolutions, namely, industrial revolution and digital revolution. Market place has witnessed Darwinian situation of survival of the fittest.

In the early stages, the human beings procured the goods they needed themselves by hunting or exploring them in nature. Then somewhere took place the first transaction of exchange of goods, maybe a goat or a sheep with a cow or some grains and the barter system came into existence. With the monetisation of economy, trade and commerce flourished. However, in the early stages of development of commerce, the businesses believed that the consumers would buy what was available and that the producers knew best what the consumers needed. Ford, the largest automobile manufacturer of USA, proclaimed: 'The customer could have a car of any colour, as long as it was black!' The focus in the initial stages was on the demand for products. As the development progressed at a faster pace and the competition increased among the businesses, the firms adopted the concept, that the companies need to be customer-arid*

market driven, which was the beginning of the modern marketing phenomenon. The businesses started looking at the situation from the customer's perspective. The firms sought to know the customer's requirements and direct their efforts to provide them goods or services, suitable to fulfil these requirements. The focus shifted to the wants of customers. Marketing, therefore, is not an activity confined to either sales or promotion of the goods and services of the businesses.

The changes ever since have brought about radical developments in the field of marketing. The focus today is on Customer Relationship Management. Marketing is an organisation wide undertaking, driving the vision, mission and strategic planning of the firms. The objective of maximising the firm's profit is subordinate to the objective of maximising customer satisfaction. The crucial need to retain customers and simultaneously to acquire new customers amid intense competition and vanishing product differences have driven the firms to be aggressively market driven. The firms now take a holistic view of the customer; try to anticipate his/her needs even before the customer feels the same and proactively offer solutions to meet the same. The approach is to develop and nurture a mutually fruitful bond between the firm and the customer.

The present-day environment is characterised by globalised economy, fast pace, rapidly changing technologies, and an empowered consumer. The consumers are experiencing a wider choice of goods and services, increased purchasing power, availability of information on anything and everything, convenience of transacting purchases anytime anywhere. Companies are also better positioned with new information and delivery channels, comprehensive market and customer information, faster communication - both internal and external, customised and target communications and offerings to individual customers, improved business processes of purchases, recruitment, logistics, and operations with cost savings, better accuracy and service quality. All this certainly has a profound impact on modern day marketing.

Modern business enterprises recognise very well the importance of customer satisfaction. In the words of Edgar Woolard, CEO, DuPont - 'Nothing is worthwhile unless it touches the customer'. If their customers are not satisfied, firms run the risk of losing them to competition. It is also difficult to attract new customers without the ability to satisfy customers. These are the only two sources of revenue and hence, it is necessary to attract new customers and retain them. This underlines the importance of marketing, which now even touches upon functions like the production line, which can affect customer satisfaction apart from the traditional marketing functions like branding.

Certain studies in the United States have revealed that the level of customer satisfaction generally increased during 1980s and early 1990s, as it was the urgent goal of most businesses. However, during the mid-nineties, several studies revealed a declining trend of customer satisfaction. This was thought to be the result of a shift in the focus of the management to change management, downsizing, mergers and acquisitions. This has helped in cost-cutting and higher corporate earnings and in satisfying the stockholders in the short term. But, with the growing customer dis-satisfaction, this approach endangers the long-term prosperity of businesses. It is important for businesses to adopt customer-oriented management.

The scope of marketing in modern days covers, besides goods and services, other entities like experiences, events, persons, places, properties, organisations, information and ideas. Marketing is a combination of business management and the philosophy^of business. Marketing has seen great changes in its journey to today's times. From the barter system to the system of plastic money, from localised markets to globalised markets, from inventory-based marketing to future markets, from marketing through technology-to-technology created markets. In the modern marketing, firms cannot afford to lose the customer. So, an attempt is made to win over the customer, creating an intoxication effect for the service or the product the firm offers. The Customer Relationship

Management has become the "Hub" of all activities of the firms. In modern marketing, the focus has shifted from existing products to products the customer may expect from the firm. This led to customer oriented mergers and acquisitions, corporate agencies, strategic alliances, business partnerships, etc. It has also redefined the corporate goals, mission and vision and the total attitude of the firms. The firms are now attempting to cross-sell the products to fulfil the customer needs and create a win-win situation. Thus, in modern times the marketing concepts have undergone great change and become more complex.

34.2.5 Marketing - A Management Function

From one perspective, it is & functional area of management and is within the firm using various developed techniques for achieving specific objectives. Its major role is to identify the current and future needs and wants of specifically defined target markets. The organisation acts upon this information to produce goods and services to satisfy customer requirements. Marketing provides entrepreneurship by identifying opportunities in customer requirements and driving mobilisation of resources to capitalise on them. Marketing forms an interface with the existing and potential customers. It passes through the management functions of analysing, planning, implementing and controlling.

34.2.6 Marketing - A Business Philosophy

From another perspective, marketing is much more than a management function. It is a way of thinking about business and a way of working, running through every aspect of the firm's activities. It is a customer and profit-oriented approach permeating the entire business. It is, therefore, an attitude of mind and hence an overall business philosophy.

34.2.7 Selling vs. Marketing

There is a conceptual difference between selling and marketing. Firms sell their goods or services to customers who buy them and attempt to induce them in buying through advertisements and promotions. Marketing relates to producing or creating goods or services needed by the customers. In the former case, the objective is to sell whatever is available with the firms. While in case of marketing, the objec¬tive is to meet the customer's need. Marketing function starts much before actual selling of the product.

TABLE: 34.1 Comparison between Selling and Marketing

Selling	Marketing
Selling is an operational activity	
Selling is product focused	
Selling is oriented to the needs of the seller (the firms)	
Selling encashes profitable opportunity	
Selling aims at earning profits by maximising sales volume	

Marketing is a total management concept comprising identification of customer needs, developing suitable products to meet those needs, delivering (selling) the products to the customers and facilitating the consumption for ultimate satisfaction of those needs. Thus, selling is a part of marketing.

Marketing is customer focused

Marketing is oriented to the needs of the buyer (the customers).

Marketing converts customer needs into such opportunities

Marketing aims at earning profits by maximising customer satisfaction.

It is shown in Figures 34.1 and 34.2.

Selling = Factory —> Products -> Selling and promotion —» Profits

FIGURE:34.1

362

Marketing = Target market -> Needs —»Integrated marketing -» Profit by customer satisfaction

FIGURE 34.2

34.3 MARKETING MANAGEMENT

A study of the evolution of marketing brings forth its development into a management function using various advanced techniques for achieving specific objectives. Marketing management encompasses the entire range of activities, from the identification of business opportunities in the customer needs to the customer satisfaction through consumption of goods or services, leading to fulfilment of the need.

34.3.1 Definition

"American Management Association" has adopted the following definition of marketing management:

"Marketing (management) is the process of planning and executing the conception, pricing, promotion and distribution of goods, service, and ideas to create exchanges with target groups that satisfy customer and organisational objectives."

34.3.2 Functions of Marketing Management

Marketing management comprises four key functional aspects, viz., Analysis, Planning, Implementation and Control.

(a) Analysis: There is a need to understand customers, competitors, trends and changes in the environment and internal strengths and weaknesses for drawing out effective marketing plans. This requires collection of information related to these areas using systematic marketing research and marketing information systems, and scientific analysis of the data.

(b) Planning: It covers both strategic planning for the long-term marketing direction of the firm (for example, selection of target markets), and marketing programmes and tactics to be used to support the strategic plans. The plans should include the goals and targets in measurable terms, and also the estimates of resources, and the actions required for their implementation.

(c) Implementation: The implementation of strategic and tactical plans requires staffing, allocation of tasks and responsibilities, budgeting, and securing financial and other resources needed.

(d) Control: Measurement and evaluation of progress against the goals and targets spelt out in the plans is an important function for determining the future course of action. This may prove to be problematic due to difficulties in measuring the performance criteria and ascertaining the cause and effect. It is a complex function requiring use of both qualitative and quantitative techniques
including budgetary control, control of marketing mix, and even marketing audit.

34.3.3 Importance of Marketing for Indian Banks

Banking organisations are newcomers to marketing. It was the banks in the UK and US, which were the first to begin applying the marketing concepts during the 1960s.

!n India, the banking industry has passed through major transformations during the twentieth century. At the time of independence, India had 558 commercial banks, of which 459 were non-scheduled banks. The Imperial Bank of India was converted into State Bank of India in 1955 and was given the mandate to cover the rural areas, cater to the needs of agriculture and small-scale industries, besides serving as agent of Reserve Bank of India in places, where it did not have offices. In 1967, the number of banks was reduced to ninety-one, due to several liquidations and amalgamations followed by nationalisation of fourteen major banks of the country in 1969. Indian banking system transformed itself from class banking to mass banking. The banks promoted the banking services to inculcate the banking habits among the public. It indeed was a situation, which illustrated the relevance of marketing in a monopolistic situation. During the 1970s, the number of bank branches of public sector banks

increased at a very rapid pace. As a result, the banks started feeling the competitive forces, especially in the urban areas. Besides, in the 1980s, there were other changes like development of small savings instruments, corporate sector tapping the primary market through public deposits, equity shares, and debentures. The banks thus faced competition both on the assets and liabilities fronts. At that point, the need for marketing was realised not only by the individual banks but at the banking industry level. In his statement at the AGM, in April, 1987, the then chairman of the Indian Banks' Association, Mr. M.N. Goiporia said, "The relevance of aggressive marketing in banks has come to the fore as never before... The banking system in the country has built-up a vast infrastructure, at a substantial cost and unless aggressive efforts are made to market their deposit and credit schemes, as well as the wide range of facilities and services offered, there could be under-utilisation of the banking infrastructure."

The following decade saw the Indian banking witness another major transformation - the emergence of liberalisation process that brought about two most eventful changes. One, the regulatory framework for banks, which was highly restrictive, was changed into a rigorous but broader control system. Two, the banking sector reopened to the private sector. Hence, while the banks got more freedom, they also had newer forces to reckon with.

In retrospect, it is seen that the banks, after nationalisation, had the necessity of catering to a wide spectrum of customers, with different needs. They responded by developing a new range of services. Although the customer orientation as a marketing concept was talked about at a much later stage, the bank management displayed marketing acumen in their practices. The largest bank of the country, State Bank of India, reorganised itself in 1970s, on the lines of market segments, viz., commercial and institutional, small industries and small business, agriculture and personal; and having a distinct development wing which had the primary function of marketing. As the economy developed and the customers were exposed to the sophisticated products offered by the banks abroad, the banks in India were faced with the demand for similar products. The banks have, therefore, to be continuously acquiring the capabilities for and have to be innovative in offering new varied services.

One major cause for concern for the banks has been their profitability. The social responsibilities thrust upon them, which also required them to extend their network in remote rural areas rendering such branches non-viable, affected their bottom lines adversely. Evolving suitable strategies for improving the profitability, particularly in the deregulated and liberalised environment is one major challenge, and it underscores the need for marketing for banking organisations.

The new generation private sector banks started with technologically superior systems and took to aggressive marketing of their products. They started segmenting the customer base and offered products suitable to each segment.

The entry of new generation private sector banks in India has inter-alia brought to the fore two major aspects. One, the use of information technology for delivery of banking services, which has not only affected the banking products but also facilitated new outlets, for example, ATMs, Internet, etc. Two, it renewed focus on the high net worth customer, which

has created a different type of private banking in the Indian banks. This proved to be a catalyst, which brought into play a rapid reaction across the entire banking sector. The computerisation of bank branches took place at fast pace thereafter not only among the public sector banks, but even among the old private sector banks and cooperative banks. These developments have underlined the marketing orientation of banks. The banks are now not only conscious of the customer needs but are focused on customer relations management.
34.4 PRODUCTS AND SERVICES 34.4.1 Whafis a Product?
Philip Kotler defined a product as "anything that can be offered to a market for attention, acquisition.
364
use or consumption. It includes physical objects, services, personalities, places, organisations and ideas." So, the product can be a physical goods or a service product.
34.4.2 Characteristics of Physical Products
- Tangible
- Homogeneous
- Production and distribution separated from consumption
- Core value produced in factory
- Customers do not participate in the production process
- Can be stored
- Transfer of ownership possible.

What is a Service?
Kotler and Bloom defined service as "A service is any act or performance that one party can offer to another that is essentially intangible and does not result in the ownership of anything. Its production mayor may not be tied to a physical product."
34.4.3 Characteristics of Service Products
- Intangibility: Refers to the aspects not associated with any physical form or characteristics. It is very much, pronounced in the pure service element like the lecture given by a professor.
- Inseparability: It means that the production and consumption of the service are inextricably intertwined. Hence, the consumer's presence is in most cases necessary at the time of production.

Goods are usually purchased, sold and consumed; whereas, services are usually sold and then produced and consumed.
- Heterogeneity: The services offered are not similar all the times to all the customers. This feature of service is called "Heterogeneity". The quality of a service depends on the person, who provides the service, or the time, when provided. Even though standard systems may be used to handle a flight reservation, book a car for service, each "unit" of service differs from other "units".
- Perishability: This means that the service "units" cannot be stocked. If a seat is unfilled when the plane leaves or the play starts, it cannot be stored and sold next day or next week; that revenue is lost forever.

The above mentioned characteristics do not apply in equal measure to all services. Some services are highly intangible (e.g. education); others are highly tangible (e.g. fast food restaurant); some may be highly variable (e.g. dental treatment); some highly standardised (e.g. automatic car wash). The notion
TABLE 34.2 Difference between Physical Goods and Services

Physical Goods	Services
1. Tangible 2. Homogeneous 3. Production and distribution separated from consumption	

4. A thing
5. Core value produced in factory
6. Customers do not participate in the production process
7. Can be kept in stock
8. Transfer of ownership Intangible

Heterogeneous
Production, distribution and consumption are simul¬taneous processes
An activity or process
Core value produced in buyer-seller interactions
Customers participate in the production
Cannot be kept in stock
No transfer of ownership

of a continuum of tangibility, inseparability, heterogeneity and perishability is helpful in understanding the effects of these characteristics on the marketing strategies.

Christian Gronroos (1990) presents the differences between physical goods and services as in Table 34.2.

Services now account for more than seventy per cent of employment and GNP of most industrialised countries. Many industrial corporations also owe their revenue and profitability to the peripheral services they add on to their products. However, the marketing literature is concentrated mostly on physical products, because it was applied first and most intensively to these. Services markets are now attracting greater attention.

How Different Actually are Services?

There is no clear-cut line between services and physical goods. Many products, which are primarily physical goods, include large elements of service in their delivery. Services may form a vital part of the total bundle of benefits which is sought, particularly in industrial markets.

Many services, on the other hand include a large contribution from hardware: hotels, airlines, fast food outlets are all classed as services, but the physical elements in the offering are a large part of what customers buy. The difference is that as a buyer we do not receive the ownership of the physical elements of a service, but only rent them for a period.

Levitt has suggested: . . . "there are no such things as service industries. There are only industries, whose service components are greater or less than those of the other industries. Everybody is in service."

If the absolute tangible and intangible elements are taken as two ends of a continuum, it will be observed that all goods and services occupy different positions in the continuum as shown in Figure 34.3.

Advertising Agencies
Salt
Detergents
Soft Drink
Automobiles
Automobiles
Fast Food Outlets
Airlines Consultancy Teaching

TANGIBLE DOMINANCE
INTANGIBLE DOMINANCE
FIGURE 34.3 A Goods Service Continuum: G. Lynn Shostack

Search (or tangible) goods are generally those which are packaged, and can be seen, evaluated and tried by the buyers before the purchase. Experienced (or intangible) goods are those which can be seen or evaluated only after the purchase. There could be product, which fall between these two extremes (Figure 34.4).
According to an improved classification of Philip Kotler, the offerings to the marketplace may be:

- Pure tangible goods: Primarily a tangible good and no service accompanying it.
- Tangible goods with accompanying services: Tangible goods + one or more services.
- Hybrid: Equal parts of goods and services.
- Major service with accompanying minor tangible goods.
- Pure service: Primarily of a service nature.

The original idea of a single continuum of tangibility for understanding the differences between goods and services has been extended recently to suggest that all four characteristics of services (Figure 34.5) can be described and related in this way. (Payne)

GOODS

Search goods Experienced goods

Prior to Purchase/ use Buying consumption
Tangible Intangible

Salt Soft Drink Refrigerator Airlines Meditations
FIGURE 34.5 Continuum of the Characteristics of Services

Intangibility

Inseparability The Service Hetrogenity

Perishability

Thus, while legal service is less tangible, varied and can be performed away from the customer, a fast food service is highly tangible, generally standardised and usually performed near the customer.

34.4.4 The Servuction Process

In many cases, the production and consumption of services take place at the same moment. Production and consumption occur simultaneously; they cannot be separated. So, the consumer and service provider interact during the service experience.
Eiglier and Langeard developed the concept of the "servuction process". This word is a combination of services and production, indicating the simultaneous production and consumption of services.
In general, the servuction process differs from a production process of a tangible good, in the following respects:

- Interaction between the front office personnel and the client. The direct contact between service provider and customer is essential. During these events, the actual service delivery takes place. These are the decisive moments - moments of truth, where the organisation actually shows what they can do and how they meet expectations set.

367

- Certain degree of relevancy of the physical surrounding to the customer.
- Mutual interaction between customers, during the production process. Customer A will be affected by the presence of customers B and C.

The borderline between front office and back office is not fixed forever within a particular service organisation. It may change overtime. It may be subject to the marketing policy of a service provider.

The servuction process refers to human encounters to both a profit and a non-profit setting. People interact with one another, unless machines (like the automated teller machines in banks) substitute a (large) part of the service encounter. This offers the opportunity for people to start building some kinds of relationships with one another in these service encounters. Building these relationships is important for several reasons:

- First, it offers the opportunity to learn about each other's wishes, whims, preferences, capabilities, opportunities, etc. This may sharpen the knowledge of the expectations about the other "party involved in the transaction".
- Second, existing relationships may function as a means to keep customers.

34.4.5 Marketing of Financial Services

The characteristics of services, viz., intangibility, inseparability, heterogeneity and perishability are all present in financial services, too. Some assume special meaning in the context of financial services. Intangibility has two aspects:

(i) At one level, it is concerned with the fact that services are impalpable in the sense that they have no physical form.

(ii) Many services are intangible from a conceptual point of view, in that they are not easily defined and may be difficult to understand. (Bateson)

The presence of inseparability tends to imply that consumers themselves play a significant role in the production of services. For a service to be provided, the physical presence of the consumer or some contact with the consumer is required to obtain the information necessary for rendering the service to be performed. The consumer making a loan application need not be in the physical presence of a loan assessor, but must supply the assessor with the information required to evaluate the application.

Financial services display an additional feature, which affects the marketing process namely, the fiduciary responsibility. It refers to the implicit responsibility which financial services organisations have in relation to the management of funds, and the financial advice they render to their customers. Marsh establishes that although any business has a responsibility to its customers in terms of quality, reliability and safety of the products it supplies, this responsibility is perhaps much greater in the case of a financial services organisation. This is partly because consumers of such services often find the precise details of the services difficult to comprehend and are, therefore, place their trust in the organisation they deal with. Equally important is the fact that the "raw materials" used to produce many financial products are consumers' deposits; thus, in producing and selling a loan product, the bank has a responsibility not only to the person taking the loan but at the same time, it also has a responsibility to the individuals whose deposits have made that loan possible.

The implications of intangibility, inseparability and heterogeneity manifest themselves at both strategic and tactical levels in services marketing. Thomas Stresses the importance of a clear understanding of the nature of the business and the establishment in order to formulate a distinctive basis on which to compete. It is important to formulate the basis on which to compete, given the difficulties of competing-based on offering a service with distinctive attributes or features.

The need for marketing of financial services has arisen due to various external factors like "Deregulation" that has removed the traditional restrictions on the types of product which a particular institution could supply, and has created the opportunity for expansion into new markets. Globalisation of financial markets and now the capital account convertibility will bring more complications to the marketing of financial services in India. Intensive use of IT, growth of products and technology enabled transactions have drastically reduced the cash transactions, thus volumes in financial markets have increased. Volatility and risk perception in financial products have further added to the complexity of the market. These present the financial services sector with a number of new opportunities and threats. As the environment facing suppliers of financial services has become increasingly competitive and uncertain, the importance of marketing in guiding the business development has increased.

34.4.6 Types of Financial Markets in India

The following are the types of financial markets in India. Today the banks are involved in most of the listed activities of these markets, as a customer expects all financial services to be offered to them under one roof:

The credit market	The money market
Equity and term lending market	Debt market
Gilt-edged securities market	Leasing and hire purchase
Insurance market	foreign Exchange market
Mutual funds	Stock markets
Consumer finance market	

34.4.7 Marketing of Banking Services

One definition of bank marketing, as referred to by the NIBM, Pune, is as follows:

Bank marketing is the aggregate of functions, directed at providing services to satisfy customers' financial (and other related) needs and wants, more effectively and efficiently than the competitors keeping in view the organisational objectives of the bank.

This definition highlights the following points:

(i) Banks provide services

(ii) Aim is to satisfy customers' needs and wants of specific nature (iii) The nature of needs and wants of the customer is primarily financial, while some may be incidental to or related to these

(iv) The competitive element, efficiency and effectiveness are major factors in the process (v) Organisational objectives are still the driving force.

The aggregate of functions mentioned in the definition is the sum total of an integrated effort to discover, create, arouse and satisfy customer needs. Each individual working in the bank is a marketing person who contributes to the total satisfaction of customers.

Bank marketing deals with providing of services to satisfy customers 'financial needs and wants. Banks have to discover/ascertain/anticipate the financial needs of the customers and offer the services, which can satisfy those needs. Banks may be required to satisfy the customers' other related needs and wants. The individuals and corporate bodies have certain financial needs in relation to money commodity. To satisfy these financial needs customers want specific services. Different banks offer different benefits by offering various schemes, which can take care of the wants of the customers.

Marketing helps in achieving the organisational objectives of the bank. This means that marketing is equally applicable to achieve commercial and social objectives of the banks. Indian banks have dual organisational objectives:

(i) Commercial objective to make profit

(ii) Social objective, which is a developmental role particularly in the rural areas. The marketing concept points to the following essentials, which contribute towards a bank's success:

(i) The bank cannot exist without the customers, (ii) The purpose of the bank is to create, win and keep a customer. The customer is and should be the central focus of everything the bank does.
(iii) It is also a way of organising the bank. The starting point for organisational design should be the customer The bank should ensure that the performance and delivery of the services are done in the most effective way. Service facilities also need to be designed for customers' convenience. (iv) The ultimate aim of a bank is to deliver total satisfaction to the customer. (v) Customer satisfaction is affected by the performance of all the personnel of the bank.

34.4.8 Implications of Service Characteristics for Marketing

Table 34.3 depicts the major implications of the characteristics of services for marketing activities.

TABLE 34.3 Characteristics of Services - their Implications for Marketing Activities

Service Characteristics	Some Marketing Implications	Some Remedial Approaches
Intangibility	(a) Consumers may have difficulty in evaluating	Make the offerings more tangible, e.g. use clues like uniforms, use of image, brand names focus on benefits of service.
	(b) Sampling a service - Difficult due to intangibility the relationship could suffer	Need to manage effectively the organisation-consumer relationship, to lessen the effect intangibility.
	(c) Difficult to judge price/value	Develop a price "reputation", reinforce value during and after service, "explain" price.
	(d) Places strain on promotional element of marketing mix	Increase tangibility of service through: Visualisation - Utilise experience in advertising. Association - Connect service with a tangible good, object or place. Physical Representation - Use items to represent the services (e.g. dress standards, documents).
	(e) Development of new service becomes difficult	Devise means for conceptual testing prepare detailed service specifications/processes.
Inseparability	(a) Requires presence of the producer of service	■ Customer contact personnel key and require careful selection, training support for service - "encounters".
	(b) May require presence of the consumer	Integrate consumer's presence into the delivery process.
	(c) Opportunities for continuous and quick feedback of consumers	Exploit presence of consumer to monitor service process and quality.
	(d) Where personal service limits scale of operation	Seek solutions, which simplify process, regulate supply demand, schedule transactions, subcontract work, use technology, use consumer as a "producer" in process (e.g. self-service).

{Contd

(Table 34.3 contd. . . .)

Service Characteristics	Some Marketing Implications	Some Remedial Approaches
Heterogeneity		

Perishability   Services difficult to standardise and harder to control design, production

Services cannot be stored   Develop performance standards, performance indicators, and reduce perceived risk of purchase and use and delivery through control of service encounter (e.g. use of standard procedures and technology).
Specify service quality: remind customer of the service quality delivered, use internal marketing to reinforce standards, emphasise bespokeness where uniformity not sought, "pre-package" the service.
"Manage" supply and demand through peak/off-peak pricing, reservation systems. Create flexible excess capacity (e.g. part-time employees). Offer alternative uses of unused facilities. Promote off-peak use.

34.5 MARKETING MIX

Brodens concept of marketing mix: Marketing mix is one of the key concepts in the modern marketing theory. In practice, the marketing mix is considered to be the core of marketing. Marketing mix is the set of marketing tools that a firm uses to pursue its marketing objectives in the target market.

34.5.1 Tools of Marketing Mix

There are several marketing-mix tools. McCarthy popularised a four-factor classification of these tools called the four Ps: product, price, place (i.e. distribution), and promotion.
The particular marketing variables under each P are shown in Figure 34.6.
A marketing mix is selected from numerous possibilities. Marketing-mix decisions must be made for both the distribution channels and the final consumers. Figure 34.7 given by Kotler is a representation of a company's marketing-mix strategy. It points to the interplay of various factors and players in the market, which can affect the results of the marketing efforts.
A company may not be able to adjust all the marketing-mix variables in the short run. Normally, the firm can change its price, sales force, size and advertising expenditures in the short run. Development of new products and modifications in its distribution channels, are more feasible in the end. Thus, the firm typically makes fewer period-to-period marketing-mix changes in the short run than the number of marketing-mix variables suggest.
The most basic marketing-mix tool is the product, which stands as the firm's tangible offer to the market, including the product quality, design, features, branding and packaging. The

company could also provide various services, such as delivery, repair, and training, as well as running an equipment-leasing business.
Price is a critical marketing-mix tool. The company has to decide on wholesale and retail prices, discounts, allowances and credit terms. Its price has got to be commensurate with the customers' perceived value of the offer or else, they will turn to competitors for choosing their products.
Place is another key marketing-mix tool. It facilitates the various activities the company undertakes to

371
MARKETING MIX
PRODUCT PLACE
variety
channels
quality
coverage
design
Assortments
Features
Locations
Brand Name TARGET MARKET
Inventory
Packaging
Transport
sizes
Services
Warranties
Returns
PRICE PROMOTION
List Price Sales Promotion
Discounts Advertising
Allowances Sales Force
Payment Period Public Relations
Credit Terms Direct Marketing

FIGURE 34.6 Marketing Mix Variables

Promotion Mix
Sales
Other Mix Promotion
► Advertising r
Products
—> Distribution P, Target
COMPANY ■Services j ► Sales Force Channels
Customers

Public

Prices Relations
Direct Mail/

Telemarketing

FIGURE 34.7 Interplay of Factors on Marketing

make the product accessible and available to target customers. The company must identify, recruit and link various intermediaries and marketing facilitators so that its products and services are efficiently supplied to the target market. It must understand the various types of retailers, wholesalers, and physical-distribution firms and how they make their decisions.

Promotion as a marketing-mix tool stands for the various activities the company undertakes to communicate and promote its products to the target market. Thus, the company has to hire, train and motivate sales people. It has to set up communication and promotion programmes consisting of advertising, direct marketing, sales promotion and public relations.

It may be noted that the four Ps represent the sellers' view of the marketing tools available for influencing buyers. From a buyer's point of view, each marketing tool is designed to deliver a customer benefit. Robert Lauterborn's suggestion was that the four Ps correspond to the customer's four Cs:

4 Ps 4 Cs

Product
Price
Place
Promotion Customer needs and wants
Cost to the customer
Convenience
Communication

Winning companies will be those who can meet customer needs economically and conveniently and with effective communication.

How these four Ps and four Cs are relevant to marketing?

• Promotion: How the awareness is created among the customers.

- Place: Where the customer wants delivery of product.
- Price: What the customer is ready to pay for this product.
- Product: What are the features of the product.

Kotler says that the starting point of marketing is segmentation, targeting, positioning and then the role of four Ps starts. However, we have to first convert the four Ps into four Cs that are

1. Customer value 3. Cost 2. Communication 4. Convenience

Renowned management consultant of US Prof. Jagdish Sheth and Prof. Rajendra Sisodia have recently introduced the concept of four As against four Ps these are:

- Accessibility • Affordability
- Acceptability • Awareness

The market value coverage = acceptability x affordability x accessibility x awareness. The four Ps focus on the means while four As focus on the ends. Four As are not mere semantic to four Ps. You may notice that the "Product" and "Acceptability" may be used alternatively but acceptability may be created in many ways like changing the brand of existing product, using appropriate channel, etc.

34.5.2 The Services Marketing Mix

The original marketing-mix was developed for manufacturing industries which required that the services offered by service companies ought to be changed to be more product-like so that the existing marketing tools could be applied. This was practically difficult. The marketing practitioners in the service sector

Product Price Promotion Place People Physical Process
(Service) Level Evidence
Range Discounts Advertising Location Service
Employees Environment Furnishing Policies
Quality Payment Personal Accessibility Atmosphere Procedures
standards Terms selling Coverage Training Layout Systems
Level' Perceived Sales Channels Discretion Facilitating Goods Use of
;
Branding value promotion commitment Tangible cues technology !
Service lines Price/ Publicity Incentives Warranty Customer
Warranty Quality Public relations Appearance Visual corporate
identity involvement!
After sales Relationship Interpersonal behaviour Peripheral
evidence Customer direction
service Credit terms Direct marketing Attitudes Essential evidence
Workflow standardization
Differentiation Customer contact Employee discretion

373

found that the marketing-mix did not fully address their needs. They observed that the basic characteristics of services had definite marketing implications. For example, the nature of services is not conducive to standardisation of quality; services cannot be inventoried,

patented or transferred. Hence, specific marketing models and concepts needed development to take care of the needs of the services sector.
Booms and Bitrier suggested a "7 P" marketing mix model arising out of the above three observations. Mcgarth and others endorsed such an approach and a number of marketing research studies supplement the relevance of each of the "7 Ps". It will be observed that the original four Ps continue, in addition, there are three more sets, viz., People, Physical evidence and Process.
Figure 34.8 shows the market mix for services.

34.6 LET US SUM UP

Marketing concept is the essence of the process of exchange for mutual satisfaction of the parties. It is a much broader concept than selling or advertising. With increasing competition, it has evolved and developed from an activity of the firms to a management function and further to a business philosophy.
Classification of markets is done into different types, based on the geographical area, product, nature and volume of transaction. The composition of the numbers of buyers and sellers gives rise to different types of market situations.
Marketing management comprises four functions namely, analysis, planning, implementation and control.
Post-nationalisation, banks adopted marketing practices for meeting the competition and the varied demands of different consumer groups. In the liberalised environment coupled with advent of IT, banks are adopting a more aggressive and progressive marketing approach and are now moving to customer relationship management.
Products comprise physical goods and services. There is a continuum of a combination of the two elements in different proportions. Services have certain distinct features (intangibility, inseparability, heterogeneity, perishability) which make them different from physical goods and have a bearing on their marketing. The simultaneous production and consumption of services, is known as "Servuction Process". Financial services have added feature of fiduciary responsibility, mainly due to complexity of their nature.
The set of marketing tools used for marketing is marketing-mix, which essentially comprises variables concerning four Ps, viz., Product, Price, Place and Promotion. The marketing mix for services has three more Ps, viz., People, Physical Evidence and Process. First, the four Cs should be understood and then four Ps could be applied. The newly devised concept of four As focuses on ends.

34.7 CHECK YOUR PROGRESS

A.I. State whether following statements are True or False:
(a) Geographical place where goods can be bought or sold is also a market.
(b) The scope of marketing is limited to physical goods.
(c) Marketing is selling.
2. Fill in the blanks:
(a) Marketing implies 'meeting needs
(b) The businesses became customer and market driven due to increased
(c) Marketing identifies and the customer requirements.

B. Fill in the blanks -
1. Unless aggressive efforts are made to
Banks' deposits and credit schemes, there
2. 3. 4. 5.
and
could be under-utilisation of the banking infrastructure.
The new generation private sector banks have focused on
Product can be a or
In service products the
and.

takes place simultaneously.
Bank marketing is aimed at providing services to satisfy customer's needs.
C. Match the followings:

(i) Product
(ii) Price
(iii) Place
(iv) Promotion
(a) Convenience
(b) Communication
(c) Cost
(d) (d)Customer value 1. Affordability
2. Awareness
3. Acceptability
4. Accessibility

34.8 ANSWERS TO CHECK YOUR PROGRESS'
A. 1. (a) T, (b) F, (c) F; 2. (a) profitably, (b) competition, (c) satisfies
B. 1. market, 2. technology, high networth customers, 3. physical object, service, 4. production,
consumption, 5. financial.
C. (i)-(d)-(3), (ii)-(c)-(l
34.9 KEYWORDS
Market, Exchange, Marketing, Customer Relationship Management, Services, Servuction Process, Marketing Mix.

CONSUMER BEHAVIOUR AND PRODUCT

STRUCTURE

35.0 OBJECTIVES

In this unit, we seek to know and understand (in the context of marketing):

- Consumer behaviour, customer relationship management and gap analysis
- Product and its categories
- Process of product development
- Concept of product life cycle
- Strategies for product management

35.1 INTRODUCTION

Customer is the king of the market. All activities are cantered on the customer. Product, the most important component of marketing-mix, is a key element in the market offering. The product is the pivot around which the other elements revolve. It does not undermine the importance of the other elements, nay, these elements, in fact, facilitate the acceptance of product by the market. So, distribution strategies aim to make the product available when and where the market wants it. Pricing is concerned with making the product available at a price that is attractive to the customer and profitable to the firm. Finally, promotion element seeks to communicate the potential benefits available to the market from the product arising from its design, distribution and price attributes. Planning of a marketing-mix commences with formulating an offering to meet the target customer's needs or wants.

The success of marketing lies in managing the products in a manner, which would result in a product having the desired effect on the customers. It requires understanding the nature of products and their relationship with the customer's needs. It also requires understanding how the customer response changes over a period to the products and its impact on marketing strategies. In bank marketing, the service product is developed around the consumer choice/needs/preferences. The marketing strategy also depends upon the customer needs. Hence, an understanding of consumer behaviour is a necessity before understanding the product development and management. Marketing is an approach to exchange relationships, which provides the driving force for formulation of strategies by every type of organisation. It is an important socio-economic activity.

35.2 CONSUMER BEHAVIOUR

35.2.1 Maslow's Hierarchy of Needs

While considering the marketing of a product, whether a physical or a service product, we must understand the customer's need as per Maslow's theory of hierarchy of needs and human behaviour:

Physiological needs	fo od, drink, oxygen, sleep
Safety needs	avoidance/protection from threatening situation and economic security
Social needs	friendship, affection and sense of belonging
Esteem needs	self-respect, recognition, status and success
Self-actualisation	self-fulfilment

35.2.2 Family Life Cycle

Every thing has a life cycle during which changes keep taking place. Similarly, for a human being, the study of life cycle is important from the angle of marketing. The family life cycle is divided into four stages and the financial status vis-a-vis banking needs are given in the Table 35.1.

TABLE 35.1 Financial Situation versus Banking Needs

Stage Financial Situation Banking Needs
Young Bachelor Per capita income high, as no dependants. Few financial burdens.
Credit cards, auto loan, low cost banking services
Mortgage loan, credit card, overdraft, durables loan
Half nest (married with young children) Home buying priority, low liquidity

Full nest (older couple, grown up children) services Income stabilised, good financial position Home improvement, equity invest¬ment, flexi-deposit, investment
Social security services, some loans
Empty nest (older couple) Significantly reduced income

35.2.3 Learning and Habit Development

An individual's buying behaviour is influenced by his perception of himself and the things around him. His perception is affected by his self-concept, needs, motivation, and knowledge, past experience, feelings, attitudes and personality. The consumer behaviour is also influenced by the learning and developing new habits. As an objective of marketing, the consumer is taught the use of the product. Learning is a trial and error process whereby needs, motives or drives are triggered by some cue to cause the individual to respond in an effort to satisfy the need. The advertisement may work as a cue while purchase is a response to the cue. The repeated advertisement reinforces the learning process. When learning is reinforced a lot and repeat behaviour is produced, it may result in a purchasing habit.

The marketers break habit by giving free samples, introductory trial offer and special discount on opening and generate new clientele. In habit acquisition, an attempt is made to build a product preference habit. Once consumer makes the purchase, the habit reinforcement is done to get them to remain habitual users.

35.2.4 Influence on Decision-making

Man's attitude and behaviour are influenced by several levels of society culture, sub-cultures, social classes, reference groups and face-to-face groups. The most enduring influences are from culture. Man tends to assimilate his culture's mores and folkways until he interacts with members of other culture. Subcultures are regional entities, religion, nationality, fraternal order provide broad identification to the person and thus influence his decision-making process for buying product. The individual at times needs to identify himself with a reference group even though he may not be a formal member of such group. The behaviour of the group influences his buying decision.

Face-to-face group many a time gives an individual the support for decision-making. This group consists of friends, colleagues, neighbours, family members, etc.

35.2.5 Customer Relationship Management

Relationship marketing is the attracting, maintaining and nurturing relationship with customer in a multi-service organisation aimed at customer relations.

Objectives of Relationship Marketing

- long-term customer retention
- relationship with external market who influence or provide referrals
- integrating marketing activities, customer service and quality standards

CRM concept and the database becomes the focal point for all marketing activities from customer loyalty programmes to internal communication.

TABLE 35.2 Comparison Between Transaction Marketing and Relationship Marketing

Transaction Marketing
Single Sale Focus Relationship Marketing
Customer Retention Focus
Product Feature Oriented Product Benefit Oriented
Short-time Frame Long-time Scale
Low Emphasis on Customer Service Moderate Customer Contact Moderate Quality Concern
High Emphasis on Customer Service High Customer Contact High Quality Concern

Activities under CRM

1. Establish and maintain a customer information database
2. Planning customer contact points
3. Analysing informal customer feedback
4. Conducting customer satisfaction survey
5. Managing communication programmes
6. Hosting special events
7. Auditing and reclaiming lost customers

35.2.6 Gap Analysis

The CRM tries to close the gap in the customer perception and the firm's perception by finding and analysing the "GAP".

The first gap is between the service expected by the customer and company perception of consumer expectations. It occurs due to inadequate market research orientation, lack of upward communication and insufficient relationship focus.

Expected Services
Gap 5

Perceived Delivery
Gap 4
Gap1 Service Delivery External Communications to Customer
Gap 3
Customer driven service
designs and standards
Gap 2
Company perceptions of
Customer expectations

379

The next is between the customer driven service designs and standards vs. company perception of consumer expectations about the service designs and standards. This occurs due to an absence of customer driven standards, inadequate service leadership and poor service design.

The third gap is about delivery of service perceived by the customer and the firm's perception about customer expectations. This, is caused by deficiencies in HR policies, failure to match supply and demand and customers not fulfilling roles.

In the next stage, there lies the gap between the service delivery to the customer and external communication to the customer by the firm. This is the result of ineffective management of customer expectations, over promising and inadequate horizontal communication.

Fifth gap is the ultimate gap between expected service and perceived service, which is the result of all the above gaps.

The gap analysis is exhibited in the Figure 35.1.

35.2.7 Changing Loyalty

In banking services, retaining the existing customer has become a big challenge. The more the banks are improvising their systems and mechanism for better relationships, the more the customers are losing loyalty to the bank. Earlier the customer hesitated to move to other banks and preferred to wait for months together for a simple loan sanction from its bank, but now even for the deposit product, the customer does not mind shifting his business to other bank where he gets better-returns. The customer has become more informative about the products, rates, rights and obligations and has become cost conscious. The relationship marketing will help bankers to live up to the expectations of the customers and retain the existing customers.

35.3 UNDERSTANDING "PRODUCT"

35.3.1 Definition

Kotler has defined product thus:

A product is anything that can be offered to a market for attention, acquisition, use or consumption that might satisfy a want or need.

Theodore Levitt has described product as:

To the buyer, a product is a complex cluster of value satisfactions. ... A customer attaches value to a product in proportion to its perceived ability to help solve his problems, or meet his needs. . . . The product is the total package of benefits the customer receives when he buys it. ...

Product Personality

Products comprise several components, which impart meaning to it and project its distinct images. Thus, products have a personality.

The Core Features
The Associated Features
The Brand Name and Logo
The Package and Lebel

FIGURE 35.2 Components of Product Personality

For example, savings bank account has a core feature of operational convenience and fetches some interest income. Associated features, like chequebook facility comes with it. Every bank has given a distinct brand name to the SB product such as "Suvidha Bachat Khata". The transactions in the attractive passbook of the account are neatly printed is equivalent to the packaging of physical product.

Product Levels

A product has a customer value hierarchy - emerging from the five levels of the product, namely, core benefit (soap implies "cleanliness", convenience of operation and some interest earning), basic product (a business centre includes a cabin, a table and chairs, telephone connection, lights, air-conditioning, savings bank account with cheque book facility), expected product (bank customers expect correct accounting of their transactions, getting withdrawals of their money on demand, correct and timely interest receipts) augmented product (an airlines offers executive waiting lounges at the airports with facilities for shower, refreshments, newspapers and periodicals, internet and fax connections; savings bank account with anywhere banking facility, debit card at no cost, demat accounts at discounted fees), and potential product (possible future augmentations, like electronic cheques, access through a special display telephone that dispenses a snapshot statement). Today, success in marketing is not merely satisfying the customers but delighting them with unanticipated benefits. The competition today essentially takes place at the augmented product level and the firms strive to reach the potential product level. The product levels are exhibited in Figure 35.3.

Potential Product
Augmented Product
Expected Product
Basic 1
Product
Core
Benefit

FIGURE 35.3 Five Product Levels Product Categories
Based on different aspects like durability, tangibility and use, products can be classified in various categories, which determine the appropriate marketing strategy. Thus, we have one set of categories non-durable goods (tangible goods which are consumed during uses - shampoo, hair oil), durable goods (tangible goods which have longer use - cooking range, computer) and services (massage, courier, bank loans). Another set of categories is consumer goods (bought by the individual users) and industrial goods (bought by the organisations).
Product Item, Product Line and Product Mix
A seller offers to the buyers a range of products which is referred to as a Product Mix, which may comprise different groups of products that are closely related called Product Lines. Each product line

consists of several specific Product Items. Example of product mix, banks have assets products (advances) and liabilities products (deposits). Within these divisions, banks have different product lines namely, consumer lending, vehicle finance, corporate finance, trade finance, term deposits, etc. Each of these product lines will be offering several products or product items, like fixed deposit, reinvestment plan, recurring deposit etc. The number of items gives each product line Length and the number of lines in a product mix gives it the Width. The number of variants of each item gives the Depth packaging to that item. Say, if "Surf Excel" is available in three pack sizes, and in two types of packaging, then it has a depth of six. The extent to which various product lines are related in end use, product requirements, etc., determines the Consistency of the product mix.
The Banking Product
Banks are in the business of accepting deposits for lending or investment. The distinguishing feature of banking from the finance companies is the payment and settlement facility it provides to its customers. What constitutes a banking product? Is it each individual service in which bank is engaged say clearing of cheques, execution of standing instructions, etc., or the entire package of services provided by the bank is a single product? While there can be several views on this issue, one generally accepted view is that a banking product is:
"a service or a package of services that -
(i) is typically provided for anyone consumer by one bank only, the customer may buy different product items or product lines from different banks but the bundle or package under one product item cannot be purchased from different banks. Customer cannot keep account in one bank and obtain chequebook from another bank.
(ii) is aimed at a particular market."

A banking product may alter according to changes in purchasing preferences or the promotional emphasis. A typical retail banking product mix is given in the Table 35.3.
TABLE 35.3 Retail Banking Product Mix

Regular Account Deposits Loans Other Services
Saving Account Fixed Deposits Vehicle Loan Telephone Bill Payment
Current Account Cumulative Fixed Deposits Housing Loan Safe Deposit Lockers
Anywhere Banking Account Recurring Deposits Personal Loan Demand Drafts
Senior Citizens' Accounts Multiple Unit Deposits Credit Card Gold Credit Card
Festival Loan Holiday Lone Bankers' Cheques Mail Transfer Cash Remittances Demat Accounts

35.3.2 Product Planning

Product planning comprises the process of developing and maintaining a portfolio of products, which satisfy the needs and wants of customers from different segments. Such product planning has to ensure maximum utilisation of skills and resources of an organisation. The process of product planning consists of determining the strategies in respect of various elements: Product Line, Product Mix, Branding, Packaging and New Product Development.

382

The following are main tasks in managing the product mix:

- Appraisal of each product line and each product item
- Decisions on packaging '
- Product differentiation and positioning
- Managing brands and developing brand equity
- New product development
- Managing the product life cycle of products/brands
- Managing product quality

Product Life Cycle

An ardent observer will notice that over a period, most products disappear while new ones emerge. Products, like living beings, have a life cycle. This concept of product life cycle is one of the fundamental notions and affects the marketing strategies substantially. This concept implies that:

- Products have a limited lifespan
- Sales of a product during its lifespan passes through distinct stages
- Each of the stages poses different challenges, opportunities and problems
- Profits rise and fall at different stages
- Different marketing strategies are required for each of the four stages

Typically, the sales curve of any product during its lifespan is bell shaped as shown in the Figure 35.4.

Introduction Maturity

Growth

Decline

s
A L
E S

TIME j

FIGURE 35.4 Sales Curve

The stage of conception and product development comes before it is launched in the market; hence, four stages are considered in the life cycle, which are:

(a) Introduction: Period of initial low sales and slow pick up in the market where the habit and learning of product is taking place so there is slow growth in sales, with no profits due to heavy development and introductory expenses incurred. Net banking and mobile banking are two examples of banking products that are in introductory stage.

(b) Growth: Sales grow rapidly due to fast increasing market acceptance resulting in substantial

improvement in profits. Many retail loans are still in growth stage. RTGS and NEFT products for remittance of funds are in the growth stage.

(c) Maturity: A slow down in sales growth rate leading to peaking of sales, due to the potential buyers having been fully tapped. Profits may stabilise or may decline due to increasing marketing expenses. Traditional products are in maturity stage in banking services.

(d) Decline: Sales at this stage experience a declining rate of growth and profits erode. Demand draft is in the decline stage as better-featured remittance product is already a hit the market.

Not all products pass through all these stages. Again, the lifespan of different products varies significantly. Certain products witness a very fast increase in sales and face a rapid decline; such products have a very short lifespan. In the recent past, the pager was one such product, which saw decline and ultimately death before it could get well into the growth and maturity stage due to introduction of cellular phones. In banking also, there are examples of products, which fail to grow fully. The cash certificate, education loan schemes of individual banks are examples from banking industry. There are some products having prolonged maturity stage. Landline telephone is an illustration from telecom industry. This was possible because the physical design of the telephone instrument underwent many changes. The product improvement is necessary for prolonging the maturity stage.

The banking industry in India has also witnessed the products of varying life cycles. Core products like savings bank accounts, fixed deposits have been for a long period and are continuing in the maturity stage. On the other hand, some of the deposit schemes like cash certificates and annuity deposits appeared on the scene in the wake of intense competition for deposit mobilisation and rapidly declined. With the advent of technology, some of the age-old veteran products have become or are on the verge of becoming extinct. Traveller's cheque, mail transfers are no longer on the active product shelf because of Core Banking Solution and card products.

Marketing Characteristics of Different Stages

Each stage of the product life cycle has certain peculiar characteristics related to marketing of the product. A brief overview of this is given in the Table 35.4.

There are certain product-based marketing strategies, which the firms adopt to address the challenges arising out of the passage of a product through its life cycle. Some of the important marketing strategies are discussed in this chapter.

Marketing Mix in Different Stages

At different stages a product will need different marketing mix for achieving the desired objectives. Table 35.5 shows the marketing mix for various stages to give an idea about the distinction among various stages.

The life stages of same product may be different in different markets. Hence, the marketing strategies to be adopted should be product and region specific keeping in mind the consumer behaviour aspects of that market.

35.3.3 New Product Development

The fact that products have a distinct life cycle leads to the need for product development by the firms. A firm, which after having begun with one or more products, continues to depend on them and does not add new product will soon find itself in a situation when its sales will first stagnate and then start falling, as most of its products enter first the maturity stage and then the decline stage. Ultimately, it will find that its market is taken over by the competitors and its product will die. An example is that of the "Fiat" car in the Indian market. Thus, in order to have a healthy growth in sales and even to maintain the sales at a level, it is essential for the firms to continue to add new products to their portfolio. The

TABLE 35.4 Life Cycle Stages

cHgracteristJc		Introduction	Growth	Maturity	Decline
	Sales	Low	Fast Growth	Slow Growth	Decline
	Profit	Marginal or even loss	Rapid rise	Falling margins	Low margin
	Strategic thrust	Need to develop market	Expand market by penetrating deeper	Protect market share by retaining customers	Cut costs, and reposition product to revive sales or withdraw the product
	Customer targets	Non-users willing to try new products	Tapping different customer groups and form segments	Shed segments	Selective, explore new markets
	Competition	Competitors are few, and less known	growing with time	J Intensive and Many efficient ones	Limited
	Differential advantage	Superior performance, new benefit and features	Brand name, corporate identity	Price, unique service	Business experience, low cost producer

TABLE 35.5 Various Stages for Marketing Mix

Stages
Sales 1 Introduction f Growth Maturity Decline
M Product Unique offering Improvement in Different variety
Rationalise
a the offering range
r Price Low or premium (Low with high Maintain margin Low margin
k volume
e Promotion Incentive to use Intensive Parity, loyalty Reduced to
t formation threshold level
(for reminder
n Advertising To create and Brand name, Value for money Rationalise
y Focus build awareness performance
M Distribution Building network Fast spread out Create niche Limit coverage
I territory or enter new
market and build
X network

customers will want new products and the competitors will strive to provide them thus creating competitive pressures.

In this scenario, the firms face risks on two fronts. One, as mentioned above, the firms runs a great risk from the competition, if they do not develop new products. On the other hand, new product development is risky. Most of the products entering the markets fail and it results in heavy losses. In the USA, certain

researches have shown that the failure rate of products is around 75 to 80 per cent This has been found not only in the case of packaged goods but also in the case of financial products and services, like credit cards, insurance plans, etc. Today, retail banking is the mantra of banking industry and the consumer loan products are in growth stage. But, nearly two decades ago the "Big Buy Scheme" of State Bank of India, providing loan for consumer durables, met with a dismal fate.

The process of product development comprises of following five main stages:

(a) Idea screening (b) Concept testing
(c) Product development (d) Test marketing
(e) Commercial launch

Idea Screening

Ideas are necessary for a firm to develop a new product. These can come from various sources: customers, technical experts, employees, competitors, channel members, and top management. There are also other specialised sources like inventors, research institutions, advertising agencies and consultants. The needs and wants of the customers should generally form the basis for the ideas. For example, the idea of a loan product for upgrading the kutcha school buildings to concrete buildings based on the Kumbakonam incidence. The technology also provides a basis for product development: Auto conversion and reversion of balance in savings bank account into/from fixed deposit. Generating a large number of ideas is important to be able to strike at an idea, which will lead eventually to developing a new product. Various techniques could be used for generation of ideas - like brainstorming sessions, surveys for need/ idea identification, suggestion scheme for staff or others, etc.

The large number of ideas pooled is then reduced to a more manageable size. The criteria generally adopted for this short listing are:

- Should fit into the overall strategy of the firm
- Should build on the resources and the skills (technological, financial and managerial) of the firm
- Should have sufficient market potential

Screening of ideas is an important function as an error at this stage has long-term implications. There are two types of possible errors:

- DROP-error, when an otherwise good idea is dismissed.

• DO-error, when a poor idea graduates to development and commercialisation stage.
Both types of errors prove to be costly. Concept Development and Testing
The selected idea has to be developed into testable product concept. Several product concepts may emerge from an idea. Different product concepts may fall into different category concepts. Depending on the category, the competing products are determined, which influence the positioning of the product. Before a product can be developed based on the concept, it needs to be tested in the market. Consumer reactions are obtained by using a verbal description or a physical product. Candid opinions of the consumers are sought. Based on the responses, it is judged whether the concept has a strong appeal. It also helps in determining the competitor products and the target customer segment.
The concept is also put through a business analysis to evaluate its commercial attractiveness. Based on the analysis, it is determined whether, on business considerations, the firm's objectives are met. The business analysis besides including the assessment of sales and profits also includes an assessment of the risk involved in introducing the new product. The extent of risk is proportional to the degree of newness. The amount of risk is lower if existing production facilities and marketing capabilities can be used.

386
Product Development
The product concept is next developed into the product. Prototype of the product is made embodying in it, as many of the attributes as possible which the final product will have. The information on consumer preferences needs to be communicated to the team making the prototypes. The packaging and other associated aspects like distribution, etc., are also developed at this stage. These prototypes are subjected to use by some sample consumers to ascertain their reactions to the product. Launching the financial Inclusion scheme in one district and later extending it to other districts will form a perfect example to this.
Test Marketing
The next stage is to introduce the product to the market and know the real-life reactions. Usually, a new product in the final stage of development is promoted in a small market area. This is the stage of test marketing. Its objectives are:
• To test the product in authentic consumer settings
• To learn the size of the market
• To know how the consumers and dealers react to handling, using and repurchasing the actual
product
The extent of market testing and its manner are influenced by certain factors. If the product involves high capital investment for production and/or distribution facilities and high risk due to novel features or a new-product category, the need for market testing is greater. Cost of market testing is another factor which affects the extent of testing and its kind.
The product may be test marketed in only one area or in two or more areas. Where test marketing covers more than one area, different promotional strategies may be adopted in each area so that these are also pre-tested. The benefits of test marketing are:
• More reliable forecast of future sales
• An opportunity to decide about launching or dropping the product
• Determining the better promotional strategies
Launching
The final stage is that of full-scale launch in the market. This is a stage which requires committing resources to the largest extent. The two functions which involve substantial costs are manufacturing and marketing. Decisions on the following aspects need careful scrutiny for launching a product:
• Timing of launch • Geographical reach
• Prospect consumer groups • Market strategy
Growth Strategies

One of the objectives of the firms is to continuously increase their sales and profit. At some point of time, a firm faces a situation that the expected sales and profit from its existing businesses do not reach the desired levels. The firms need to adopt suitable strategies to fill this strategic gap. The firms can adopt three possible approaches:

- Identify opportunities for further growth within the existing businesses (Intensive Growth)
- Identify opportunities to build or acquire businesses related to the existing businesses (Integrcitive Growth)
- Identify opportunities to add attractive businesses, unrelated to the existing businesses {Diversification Growth)

387

A useful device for identifying growth opportunities is the market/product expansion grid shown in the following Figure.35.5.

Products

Existing New

Market penetration Product development

Market Development Diversification

Existing

New

FIGURE 35.5 Market/Product Expansion Grid

This grid may also be used to make an analysis of the marketing personality/outlook of the individual/ firm. This is exhibited in Figure 35.6.

Products

Existing New

Immobile non-innovative Immobile Innovative

Mobile non-innovative Mobile innovative

Existing

New

FIGURE 35.6 Analysis of the marketing personality / outlook of the Individual/firm

35.4 PRODUCT STRATEGIES

Marketing strategies which are based on the product element are called product strategies. Product strategies are of two types:

(a) Strategies based on "Product Mix"

(b) Strategies based on "Product Life Cycle"

There are several strategies which firms adopt falling under the above categories. Some major strategies are product modification, product elimination and diversification.

35.4.1 Product Modification

In the maturity stage of its life cycle, the sales of a product decline. At this stage, efforts to stimulate sales of the products are made by modifying the product's characteristics. This is achieved through improvement in: quality and performance, and features or style of the product.

(a) Quality improvement: This is done with the objective of improving the functional performance (durability, reliability, speed) of the product.

(b) Feature improvement: This implies addition of new features for expanding the products' versatility, safety or convenience.

(c) Style improvement: This is aimed at increasing the aesthetic appeal of the product. The purpose of making such modifications is to get more consumers interested in using the product and to retain the customers likely to switch to competing products. The advantages of product modification are:

- Builds the firm's image of progressiveness and leadership.
- Addition or deletion of features can be done in a short time and the new features could even be
made optional at extra cost.
- Helps in winning loyalty of certain segments.
- Serves as a promotion vehicle.
- Helps in building up the enthusiasm of the sales personnel.

At the same time, there are some risks associated with product modification. The consumer may not like the new style or changes made. A modification implies either the old product is discontinued totally or it is discounted, thereby alienating the old customers of the product.

35.4.2 Product Elimination

In the decline stage, the sales of a product are low but the costs are high. Weak products demand more resources in terms of the time management and marketing personnel. These also require greater marketing efforts and higher expenses. Some products may reach a stage that their demand reduces to almost nil level, in spite of marketing strategies and programmes. In such cases, the firms need to take a view on the continuation of the product. One of the strategies is to drop a weak product from the product line. The major reasons for product elimination are:

- Sales keep declining continuously and there is no possibility of increasing sales.
- Profits keep declining continuously and there is no possibility of improving profits.
- Product prices are declining continuously and it may be difficult for the firm to supply at the prevailing market price.
- Product is no more effective in achieving the desired objective, and there is no possibility of this happening in future.
- Emergence and growth of substitute products may drive the product out of market
- Excessive administration expenditure and time.

35.4.3 Diversification

Diversification refers to entering attractive opportunities which are outside the existing businesses of the firm. When a firm identifies a highly attractive industry and when the requisite business mix strengths are already present in it, it has an attractive business opportunity for diversification. Three types of diversification are generally observed:

(a) Concentric diversification: The new products have technological and/or marketing synergies with existing product lines, though the target groups of customers are entirely different, e.g. an audiocassette manufacturer introduces computer tape manufacture.

(b) Horizontal diversification: The new products appeal to the existing customers though the products are technologically unrelated to existing product lines. An audiocassette manufacturer starts manufacturing cassette holding trays, though it requires different technology and process.

(c) Conglomerate diversification: The new products or businesses have no relationship to the existing technology, products or market of the firm. An audiocassette manufacturer enters into fax machines or diet products businesses.

35.5 OTHER ASPECTS OF PRODUCT DEVELOPMENT

A product comprises, apart from the core physical product or service, a brand name and some packaging.

35.5.1 Branding

A brand is a name, term, sign, symbol or design or a combination of these. Brand has become an important part of the product as they import a perceived value to the product. In the present age, not only the manufactured goods but even farm products like wheat, rice, fruits and vegetables have been branded. Branding of service products is not new to us. Life Insurance Corporation brought out its products with brand names even when there was no competition. Banks brand their products and customers are being familiarised with these brand names. Consumers buy brands and brands generates income for the firm. One does not ask for toothpaste but asks for Colgate; not for a fruit salt but Eno, and not for salt but TATA salt. Often brands take the position of generic names, especially when it was the introducer of the product. For example, Xerox (for photocopying machine and process, it has almost become a verb and a noun and an adjective in the English language) and Dalda (for vegetable oil).

The branding practice has resulted in certain benefits to both the buyers and the sellers. Buyers can identify the products easily and tells them something about the quality. Buyers know they can expect the same features, benefits and quality each time they buy a brand. The sellers can link the qualities of the product to its brand. Sellers can segment the markets by having similar products catering to these segments, under different brands. It also helps in legal protection in respect of the unique features of the product.

Brands represent consumers' perceptions and feelings about a product and its performance. The value of a brand is its power to capture consumer preference and loyalty. The positive differential effect that knowing a brand name has on consumer response to a product or service, is called as the brand equity. A brand with strong brand equity is a valuable asset. It also carries economic value. A powerful brand enjoys a high level of consumer brand awareness and loyalty. The focus of marketing is on building customer equity with brand management. Coca-Cola paid for acquiring Parle's brands, Thumps Up and Limca. Godrej paid for acquiring Good Knight and Hit from Transelektra.

Seven financial institutions found place in the list of top 100 brands. Most of them were from North American and European region. Branding in the banks used to display the trust and confidence because the customers' preference was security of money. But, with the deregulation, competition and technology revolution, the banks are not looked upon merely as a place to keep money safe but more as financial convenience. Banks have identified themselves with catchy slogans to create the brand. "The citi never sleeps" (Citi Bank), "The world's local bank" (HSBC), "Trusted family bank" (Dena Bank), "Building Relationship Beyond Time" and now "Taking Technology to the Common Man" (Indian Bank), "Good people to grow with" (IOB), "India's International Bank" (Bank of Baroda) - are some of the examples of branding bank services. There are four stages of branding in banking services as shown in Figure 35.07.

In the first stage, the customers based on brand identify the company. Then, a new product branding takes place which is completely different from the company's brand. In the third stage, the brand is given a strategic role to focus on the company's vision or core competence. In the last stage, the company becomes a brand driven organisation where the management team leads the subordinates to brand vision in all regular activities.

In their journey through these stages, banks have attempted to create a brand image for themselves and also for their products. In this process, they have also used brand ambassador like Amitabh Bachchan, Rahul Dravid, Hema Malini, Juhi Chawla.

Major initiatives with regard to branding and marketing include: creating unique customer ambience, cross-selling of products, linkage with service providers and payment of utility bills and value-added services.

Co-branding is defined by Philip Kotler as a combination of two or more well-known brands in an offer. Each brand expects to strengthen the business by reaching new customers. Co-branding of credit/ debit cards by banks or insurance and banking companies are examples of how the co-brands work in

390High

Role of Branding
within

Business
Strategies Centre-Piece of Corporate Strategy
Catalyst for Corporate Change
New Subsidiary Development

Identification

Low High

FIGURE 35.7 Value of brand to business

banking sector. Even the names of lead mangers, syndicate managers and bankers to the issue work as co-brands in the minds of customers.

Building a brand involves brand positioning, brand name selection and brand development. Brands can be positioned in the minds of the consumers on product attributes, benefits and beliefs and values. A brand becomes the firm's promise to the consumer in respect of features, benefits, services and experiences a product will deliver to them. A good brand name aids product's success greatly. Hence, selection of a brand name is important. It should be easy to recall, should suggest some product benefits and be distinctive. There are several options for brand development depending on the mix of product category and brand name as indicated in the Figure 35.8.

(a) Line extension: It is introduction of additional items in an existing product category under the same brand name, say with new ingredients, form, flavours or package size. It is a low-cost low-risk way of introduction of new products to meet desires for variety. HLL launched Surf Ultra, Surf Excel, Surf Excelmatic and International Surf Excel as line extensions of Surf. No-frills savings bank account, multi-city chequebook facility, sweep facility are variants of savings bank account.

Product Category
Existing New
Line extension Brand extension
Multi brands New brands
Existing
Brand Name

New figurE 35.8 Brand Development Strategies

(b) Brand extension: It is use of an existing brand name to launch new or modified products in a new category. It provides immediate recognition and quick acceptance to new products. Enfield brand was used for motorcycles. It later was used for television and gen-sets. Vehicle loans were available to transport operators, now they are made available with modifications to retail and agri-customers also.

(c) Multi-brands: It is introducing additional brands in an existing product category. This facilitates catering to different buying motives and distinguishes different features. RTGS and NEFT are new brands in remittance product category.

(d) New brands: It is in using a new brand name for a new product, either when entering a new product category or when it is felt that the existing brand power is waning. With the relaxation in norms for remittances abroad, the new products with new brand names have emerged in the market.

(e) Co-branding: It is seen in the credit card business of the banks. Banks have co-branded their cards with Airlines (Indian/Jet) Oil companies (HP/IOC) and major retail outlets. Co-branding helps in making the bank's brand more visible, at the same time it gives good fee income.

35.5.2 Packaging

Products need to reach the consumer from the factory in a convenient manner. For this purpose they need to be packaged. The function comprising the activities of designing and producing a suitable container for the product is called packaging. A product may need several layers of packaging:

- Primary package: The products primary container (say, a plastic or glass bottle containing shampoo.)
- Secondary package: A package in which the container is kept and which is usually thrown away just before the use of the product, (say, cardboard box containing the toothpaste tube.)
- Shipping package: A package necessary to store, identify and ship several units of a product (say, cardboard carton containing twelve dozens of toilet soap cakes.)

Packaging also includes printed information appearing on or with the package termed as label.

The package currently performs more than the traditional functions of containing and protecting the product. It has become a potent marketing tool. It performs several tasks including attracting customer attention, describing the product and making the sale. A well designed "package" creates convenience value for the customer and promotional value for the manufacturer. Innovative packaging can give an advantage over competitors. Besides the marketing functions, packaging also serves two other important functions. These are consumer safety and tamper prevention.

The first step in developing a package is evolving the packaging concept. It lays down the basic functions of the package for the product. Next, the decisions on other elements like the size, shape, materials, colour, text, etc., are taken. The package is subjected to certain tests from engineering and marketing viewpoints, which include engineering tests, visual tests, dealer tests, and consumer tests.

Packaging also has an important social aspect of environmental concern. It can relate to the disposal of packages (disposal of non-returnable glass or plastic containers causes severe solid waste disposal problem - the ubiquitous "dabba batliwala" deserves to be fecilitated for rendering an important social service) or use of natural resources (excessive use of paper).

Faced with increasing competition, marketers are adopting innovative packaging to give their products a distinctive position. Innovations in packaging have also been prompted by some felt need of the consumer like convenience in use, ease of opening or carrying, longer shelf life, etc.

There are numerous examples from daily life of fast moving consumer items where major changes in packaging have transformed the products to a great extent. Shampoos were earlier coming only in bottles. After introduction of shampoo sachets, it has reached a wider section of consumers and also it ;« nnw ako fniind on the stalls at railwav stations. With cold cream becoming available in tubes, it has

392

become a carry along item, instead of a dressing table item. Refill packs, now being used for several food products like tea, coffee, health drinks, cooking oil, etc., have added to convenience and reduced costs significantly. The packaging is equally important in the service industry. The bank passbook containing transaction details, the fixed deposit receipt is the primary packing while plastic folder in which it is delivered may be treated as secondary packing.

35.5.3 Labelling

A label is an integrated part of packaging, but it is very significant and of vital importance. The main functions performed by labels are:

- Identifying the product or brand
- Describing information about the product, manufacturer, user instructions and other prescribed particulars
- Promoting the product through attractive graphics

Labels need to be reviewed and redesigned periodically as they become "stale" over a period of time, so that the consumer interest is revived. This can be an easy and low cost method of giving a touch of "freshness" to the product itself.

Labels need to conform to the regulatory requirements of the information contents, and text sizes, etc. After the recent legislation requiring all food products to display a specific "dot" symbol, to indicate whether or not they are vegetarian, numerous manufacturers were required to make modifications in labels of innumerable food products.

35.6 LET US SUM UP

The Maslow's need theory and family life cycle are important tools to identify customer need for focussed marketing of products and positioning the right product in the right target market. Customer develops a perception about the product under the influence of needs, knowledge, motivation or experience, feelings, attitudes and personality. Habit development is an important exercise in marketing. The decision to buy or not to buy is influenced by the various social groups in which the customer moves, hence, relationship marketing is preferred over the transaction marketing. Customer relationship management is a very important part of marketing. The gap analysis helps us to understand the customer perception and firm's perception so that an attempt is made to close the gap in the world of fast changing loyalty. Anything which can satisfy a want or a need and can be offered to a market is a product. Product includes physical goods, services, persons, places, organisations and ideas. Offerings generally have a goods-service mix. A product personality comprises, besides the core product, associated features, brand name and logo and package and label. Product has customer value hierarchy of five levels covering the core benefit, basic product, expected product, augmented product and potential product. The focus of the businesses, shifted from selling the products to understanding the requirements of the customers and now, to knowing and anticipating their needs and striving to satisfy these needs. The approach is of taking a holistic view of the customer relationship and its management.

Products are classified into several categories based on different aspects. The range of products offered by a seller is known as product mix, which comprises several product lines, each containing different product items. These determine the characteristics like length, width, depth and consistency of a product mix.

Products have a life cycle with four phases of introduction, growth, maturity and decline. The product life cycle operates on three levels - product, product sub-category and brand. Product modification is a widely used strategy for marketing especially in maturity stage. Product elimination is an appropriate strategy for dealing with products in their decline stage.

New product development is another strategy adopted by the firms with a view to providing customers with products that will satisfy the customers' needs and wants. This becomes necessary because of the competitors' actions, changing consumer preferences and technological advancements. The process of new product development is intricate involving idea generation, concept development and testing, product development, test marketing and commercial launch.
A related strategy is diversification in which a firm enters attractive business opportunity outside its existing businesses based on some of the requisite business strength being available with it. Diversification is of three types - concentric, horizontal, conglomerate. Branding of products is an important function of product management. A brand represents consumers' perceptions and feelings of the product and its performance. It is the firm's promise to the consumer in respect of features, benefits, services and experiences a product will deliver to them. The positive differential effect that knowing a brand name has on consumer response to a product or service is called as brand equity. Several options for brand development are line extension, brand extension, multi-brands, new brands and co-branding.. Finally, products need packaging and labelling for protection, storage, delivery, identification and information conveyance. Packaging comprises primary package, secondary package and shipping package. Labels are a part of packaging and they contain brand names, product name and information as also statutorily required information. Packages and labels are important marketing tools.

35.7 CHECK YOUR PROGRESS

A 1. Out of the items mentioned below   is not a physical product.

(a) Pilgrimage tour to Badrinath.   (b) Dosa and chapatti

(c) Clothes   (d) Drinking water

2. Match the items from column A to column B

A

(a) Single sale focus

(b) Half nest

(c) Young bachelor

(d) Empty nest   B

(i) Per capita high income

(ii) Social security service

(iii) Consumer durables

(iv) Customer retention focus

B 1. In a term deposit, product core feature is

2. Match the items from column A to column B

A

(i) External Commercial Borrowing availed by your bank's customer

(ii) Writing paper bought by your bank

(iii) Petrol bought for your car

(iv) Compact Disks (CDs)

B

(a) Consumer Product

(b) Industrial Product

(c) Non-durable Goods

(d) Material Supplies

3. A product has a life cycle comprising   (number of) stages.

4. Match the items from column A to column B

A

(i) Low Sales, Marginal Profit

(ii) Fast Growth, Rising Profits

(iii) Failing sales, Low margins

(a) Maturity
(b) Decline
(c) growth
C 1. Product modification includes -----------, -------------- and ------------- improvements.

2. Production elimination is done due to (give any one reason)
3. There are types of diversification.
4. Consumers buy brands and brands generate----- for the firm.
5. The positive differential effect that knowing a brand name has on consumer response is called ------------.
6. Bank passbook or fixed deposit receipt may be treated as -------------packaging.

35.8 ANSWERS TO 'CHECK YOUR PROGRESS'

A. 1. (i); 2. (i)-(d), (ii)-(c), (iii)-(a), (iv)-(b).
B. 1. interest income; 2. (i)-(b), (ii)-(d), (iii)-(a), (iv)-(c); 3. Four; 4. (i)-(a), (ii)-(c), (iii)-(b).
C. 1. quality, feature & style; 2. high carrying cost; 3. Three (3); 4. income; 5. brand equity; 6. primary.

35.9 KEYWORDS

Customer Relationship Management, Family Life Cycle, Goods-services Mix, Product Personality, Customer Value Hierarchy, Product Categories, Product Mix, Product Lines, Product Items, Product Life Cycle, Product Modification, Product Elimination, Diversification, Brand, Brand Equity, Packaging, Label.

UNIT
36PRICING

STRUCTURE

36.0 OBJECTIVES

In this unit, we will try to know and understand:

- Importance of pricing
- Objectives of pricing
- Factors influencing price
- Methods for determining price -
- Pricing strategies with special reference to banking products

36.1 INTRODUCTION

Price is the second major element of marketing mix. Price is the only one that generates revenue, while other elements incur cost. We have seen that marketing involves an exchange of transaction. One side of the exchange is the product or offering and the other is price. Other three elements, namely the product development, promotion, and distribution create value; in price, some of this value is captured to enable the businesses to earn profit. Thus, price is a vital element of the marketing mix. The impact price has on the success of a product makes its determination very important for the firms. Several factors influence price and hence, its determination is a complex process. It is, therefore, crucial for firms to understand the dynamics of pricing in the marketing mix and adopt appropriate pricing strategies to derive the optimum benefit out of their offerings.

36.2 IMPORTANCE OF PRICING

In the simplest words, price is the amount of money charged for a product or service. All business entities set a price for their products. Prices exist in different forms for products of different nature. We find price for goods bought, hire charges for goods taken on hire, tuition fee for education, medical fee for physician, fare for a journey by rail/bus/aeroplane, premium for insurance cover, commission for funds remittances, interest for loan, rent for house, and so on. In a broader sense, price is the sum value of all the values that consumers exchange for the benefits of having or using the product or service. From the consumer's viewpoint, price is what he agrees to pay for a product which should be up to his expectation and give satisfaction. From the seller's view point, price should be such that it not only recovers the cost but also generates some expected income with repeat orders.

In a free market, the process of demand and supply determines prices. Under monopoly conditions, the seller may adopt the system of fixed price. With the use of different marketing strategies and advent of Internet, the practice of dynamic pricing is adopted, where the buyer bids his offer price, and seller decides on accepting any of the offers, though at varying prices. The variable price is also offered for different geographical markets or different types of customers. Even for the public offer of shares, the companies give a band of prices and subscribers bid. On board the flight, you may be surprised to find that the passenger seated next to you has paid different price for the ticket.

Price serves, at least, two purposes for the consumers:

(a) It helps buyers to allocate their purchasing power among various products to meet their needs and wants.

(b) It gives information to consumers about the quality or value of the product, particularly so in case of new products and intangible products.

Pricing is significant for firms as it determines the revenues and the profits generated by the firms. It also affects the level of funds available for other elements of marketing mix. Mistakes in pricing affect the profit, growth and future of the firm, and hence it is a very risky area.

It is more difficult to determine the prices for service products. In banking industry, the prices were earlier regulated by Reserve Bank of India and banks were having very little autonomy for determining prices of some services. Now, prices for most of the banking products are more or less determined by market forces.

36.3 OBJECTIVES OF PRICING

There are several objectives, which firms have in pricing. These would normally be determined by or emanate from the corporate and marketing objectives of the firm. A firm normally will have certain short-term and certain long-term objectives, of these, some will be primary objectives and some secondary.

The objectives generally pursued by firms in setting prices of their products can be broadly summarised in the following seven objectives:

(a) Profit: All commercial activities aim at earning profits. Profits accumulate to build the stakeholders' net worth and give strength to the business. One of the major objectives of the firms (except non¬ profit firms) is profit. Profitability is an area of concern for banks these days. With intense competition, banks are finding their net interest margins and operating profits under pressure.

Pricing of both fund-based and non-fund-based products has, therefore, become crucial, especially, as banks have now new types of costs (for example, cost of risk-based capital requirements and higher prudential provisioning) to be reckoned with. There is a shift in orientation. Earlier the focus was on deposit growth but now branches are given profit targets.

(b) Survival: Firms facing intense competition find that they need to adjust prices for increasing the sales volume to levels that will help recover the costs and avoid losses. With the interest rate war in the banking industry, the margins are thinning down day by day. The banks have to strategically price their asset products and non-interest products to generate sufficient income and at the same time, the pricing of liability products should be cost effective.

(c) Market share: Businesses, these days are not merely pursuing an increase in business in absolute terms, but are keen in their relative positions as reflected by criteria like market share. In the competitive era, marketing is more of warfare and firms aim to occupy as large a territory as they can. Maintaining or increasing the market share is an important objective, especially for the major players. For this, the pricing strategy plays an important role. Banks have not only to earn profits

but also to improve business so pricing at acceptable levels would bring volumes.

(d) Cash flow: Price results in revenue and hence cash flows. Any adjustment to cash inflows is possible through a suitable modification in price, and it is an important objective for firms either when cash inflows assume particularly greater significance for meeting some larger cash outlays or when faced with cash crunch. In banking industry, the product pricing should aim at reducing the

gap between maturing its assets and liabilities in a particular time bucket.

(e) Status quo: Firms may seek to stabilise demand and sales of their products by setting suitable price levels. This could be the objective for the market leaders in respect of the products in the maturity

stage of the life cycle. Some of the products like bank guarantee and letters of credit could be considered at the maturity stage of their life cycle, are to certain extent priced by banks with an objective to have a stable demand for such products, and for earning a desired level of revenue from these.

(f) Product quality: Improvement in product quality requires expenditure on research and development, which is recovered through pricing, also establishes a high quality image. Firms, which are market leaders, need to be continuously engaged in enhancement of their offerings to the market. Banks also make huge investments in research and development and launching of new products. Besides, with information technology becoming the driver of banking operations, the modern day banks are

required to make huge investments in technology acquisition and upgradation and training its staff. Banks need to generate adequate profits to take care of their ongoing investment requirements, (g) Communicating image: Price often communicates an image of the value and quality of a product. In their communications, firms often use the information on pricing, to create an image of the value of the product in the minds of the buyers. This is one of the main objectives for new firms or in case of new products introduced by existing firms. Typically, foreign banks are seen to be pricing their products in a manner that there is an exclusivity perception. Similar trend has been seen in case of the new generation private sector banks. This is more evident in the pricing of liability products, the fixed deposit interest rate by a Citibank or a Standard Chartered Bank are seen to be lower than that of others. Similarly, in case of charges for sundry items, like chequebooks, cheque returns, duplicate statements, balance inquiry, etc., reflect higher levels for such banks.

Generally, firms will pursue more than one of the abovementioned objectives. Within the broad objectives described above, firms have several objectives of more specific nature in respect of pricing. These objectives could be for either a short term or a long term. Some of the common objectives pursued by firms are enumerated in Table 36.1 below:

TABLE 36.1 Short-term Objectives versus Long-term Objectives

Short-term Objectives	Long-term Objectives
Profit maximisation	Profit optimisation
Minimum return on sales turnover	Minimum return on investment
Achieving a particular sales level	Achieving a particular market share
Deeper penetration of the market	Entering new markets
Keeping parity with competition	Providing commodities/services at prices that will stimulate economic development
Fast turnaround or early cash recovery	Stabilising prices and margins in the market

36.4 FACTORS INFLUENCING PRICING

There are various factors which influence the approach firms adopt in determining the price of their products. These factors can be broadly categorised in two groups, namely those internal to the firm and those external to the firm. Besides, some of these factors relate to the economics of the activities, while others are psychological in nature. Some of the factors relate to quantitative parameters but others are qualitative in nature. A table enumerating the factors (not exhaustive) is given in Table 36.2.

TABLE 36.2 Factors-Internal and External Influencing Pricing

Internal Factors	External Factors
• Objectives of the firm - both corporate and marketing.	• Market characteristics - pertaining to demand, customer, competition.
• Characteristics of the product.	• Buyer's behaviour and bargaining power.
• Life cycle stage of the product.	• Competitors' policy.
• Usage characteristics - use pattern, turnaround rate - of the product.	• Government controls and regulations.
• Price elasticity of the demand of the product.	• Social considerations.
• Costs of manufacturing and marketing the product.	• Bargaining power of suppliers.
• Composition of the product line of the firm.	• Understanding with price cartels.

399

36.5 PRICING METHODS

Based on the three Cs as inputs (Fig. 36.1), the firms are required to determine a price for the product. This task can be enunciated as arriving at an optimum level for the price within the range of a price that is neither too high for generating any demand for the product, nor too low to give any profit over the life cycle of the product. The competitors' pricing, gives an orientation to be considered by the firm while setting its price. However, where a new product is developed, the reference price will not be available.

Low Price
No possible
profit at this
price Floor Price Costs

Orienting Point
Competitor's
Prices and Prices
of Substitutes Ceiling Price
Customers'
Demand
Schedule High Price
No possible
demand at
this place

FIGURE 36.1 Three Cs Model for Pricing

Various price-setting methods used have one or more of these three considerations included. By using these methods, firms can determine a range of prices, which is suitable for them based on these considerations. Some of the more common methods are shown in the Table 36.3.

TABLE 36.3 Considerations for Setting Price

Cost-based Pricing Value-based Pricing Competition-based Pricing

Mark-up Pricing Absorption Cost Pricing (Full Cost Pricing)
Target-return Pricing Marginal Cost Pricing
Perceived-value Pricing
Value Pricing
Going-rate Pricing
Auction-type Pricing
Group Pricing

(a) Mark-up pricing: The price is determined by adding a standard mark up on costs (including both variable costs and contribution for fixed costs). The quantum of mark up varies for different types of products; it varies between a very wide range say, from a low of even say 10 per cent to as high as 1000 times the costs. The prices of loan products in banking industry today vary over a wide range, being as low as a few basis points above or even below call market rates for the loans to top corporate borrowers at one end and as high as 30 per cent for withdrawals on credit card line to individuals at the other end. The difference in costs (including cost of funds, risk premium, capital charge, operational costs, statutory costs, marketing expenses and distribution expenses) of these products is much narrower. Thus, the mark up in the latter case is much higher. On seasonal items, speciality goods or goods involving high research and development costs have a high mark up.

(b) Absorption cost pricing: The price is arrived at by adding the required margin for profit to the total costs of the unit. It ensures profit as long as the production is fully sold at the determined price. It ignores the demand factor and the underlying calculations would go wrong if the sales and production do not take place at the assumed levels. Due to variation in costs in comparison to the standard costs, the desired profit will not result. Banks also price some of their products on cost plus-basis.

(c) Target-return pricing: Often firms base their price on the required rate of return on their investment. Under this method, the price is fixed on a certain level of sales as the basis. If the sales do not reach the assumed level, then the realised profit or return will be less than the targeted level. In fact if the sales were lower than the break-even point, there would be a loss. Thus, the firms need to consider different prices and assess their impact on the sales volume and profits.

(d) Marginal cost pricing: Under this method, the direct variable costs are fully realised while only a portion of the fixed costs may be realised. In this way, some flexibility for determining different prices depending on the situation is available, by recovering a varying amount towards fixed costs.

It takes into account the demand aspect too to some extent. It is, therefore, useful for competitive situations. Banks often use this concept in pricing their short-term loans to the top blue corporates, when they have liquid surplus and offer the loans at a very low interest, which just covers their cost of funds. This could be useful in case of new services. This strategy is based on certain assumptions about the costs and revenue behaviour that may undergo change over a period of time, which can turn out to be incorrect. It does not take into account the classification of semi-fixed and semi- variable costs. This method is useful only in the short run.

(e) Perceived value pricing: Firms base the price on the buyers' perception of value. For this purpose, the non-price variables in the marketing mix are used to build up the perceived value in the buyers' minds. Price captures this value. Costs are not used to determine price under this method, but they are only used to verify whether adequate profit will be earned at the chosen price level. It is important to determine correctly the markets' perception of the offer's value, to avoid either overpricing of the product leading to lower sales or under pricing it leading to lower realisation. Certain banks fix up higher minimum balance for savings account, pay a lower rate of interest on fixed deposits, which is based on the consideration that having accounts with such banks has greater value in terms of convenience and experience of banking and hence the customers will be willing to pay a premium for it

Potential price Product Surround Benefits Premium for
Value
surround
benefits based
Commodity Price Product Core Benefits Price for Core Benefits
price for
Cost
TotalPerceived Benefits

FIGURE 36.2 Perceived Value-based Pricing

(f) Value pricing: Certain firms set a price under this method by offering a product (with high value) to buyers at a low price. Thus, the customers are offered the product at a price that offers them value. The perceived value of the offer is higher than the price, giving a feeling to buyers that of realising full value of their money. This tactics is usually employed by banks in their offerings to credit cardholders for transfer of the outstanding under the credit card line to personal loans. The interest on personal loans could be priced around 13 per cent p.a. as against around 30 per cent p.a. interest on credit card drawings. The consumers thus compare the interest rate on personal loans to that paid under credit card and see a significant value in the offering.

(g) Going-rate pricing: Often, the firms base their prices primarily on the market price. In case of certain products, the prices charged by different sellers are similar, and the leading sellers initiate the changes in the price with others following them. The differential between the prices of various sellers usually is kept unchanged. The going price reflects the collective perception of the market, and provides an easy solution in the circumstances where other parameters are difficult to ascertain. This is typically the situation in case of the interest rates paid on fixed deposits or interest rates charged on the housing loans by various banks. Both of these products have almost become

401
commoditised and the prices of various banks are within a narrow range. Besides, the prices on these products are well publicised and hence known to the market clearly.
(h) Auction-type pricing: Another competition-based pricing method is auction type pricing. This method is one of the oldest and has gained more popularity with the advent of Internet. There are three types of auction pricing systems.
(i) English auctions: The situation where there is one seller and many buyers, say in case of antiques, real estate, used equipment. The buyers bid their offer price for the item put up on sale and the prices go on increasing, till the top price is reached. The seller may often set a minimum (floor) price.
(ii) Dutch auctions: This system is followed in two situations - one seller, many buyers; and many sellers, one buyer. In the first situation, the seller announces the high price for the product and then slowly goes on reducing the price till a bidder accepts it. In the second situation, the buyer calls for bids from the sellers for a particular item and accepts the bid at the lowest price with other things being similar.
(iii) Sealed-bid auctions: In such a system, each seller is permitted to bid only once and they are not aware of the bid submitted by other sellers. Hence, the sellers tend to keep their bids low enough so as not to lose the contract. On the other hand, the seller's own costs serve as the floor in order not to make loss on the deal. Several well performing PSUs and Goverment. departments have adopted this practice of calling for bids from banks for loans or bank guarantees, quoting their interest rates or commission charges respectively. Due to the fierce competition among banks, even the top public sector banks submit their bids, and the PSUs are able to get rock bottom prices.
(i) Group pricing: This is a new development in pricing methods made feasible by the Internet. The buyers can join a group to purchase a product at a lower price, which is available for a specific volume purchase. Web sites exist, which facilitate transactions based on this method. Consumers can see on the web site the current price for the product. They can also know the likely price in case of further orders, being added to the pool. The banks offer vehicle loans at concessional rate to the employees of a company where recoveries are made directly by the company.
Having determined a suitable price range, there are a few other factors, which the firms need to consider before setting a final price. There are various other entities, apart from the buyers, who are affected by changes in price. The impact of price changes on them, namely, dealers, distributors and sales force needs consideration. Similarly, the likely reactions or responses of the competitors, the Government and the suppliers, need to be thought of while determining the price. The regulatory and legislative stipulations regarding the pricing methods and price levels need observance. Still now, to some extent, banks have to observe the regulations of Reserve Bank of India in respect of interest rates on advances and deposits. Besides, the guidelines of Indian Banks' Association, Banking Codes and Standards Board of India for service charges and of Foreign Exchange Dealers' Association of India in respect of foreign exchange transaction have been the bases of several service charges of the banks, particularly public sector banks.

36.6 PRICING STRATEGIES

While pricing methods help the firms in fixing a price for a product, they are required to review and decide the price for specific situations based on several other aspects, which cannot be fully integrated into the price set under pricing methods. Firms adopt several strategies to arrive at a pricing structure taking into account such other variables. These are:

- Geographical pricing
- Price discounts and allowances

402
Psychological pricing Promotional pricing
Discriminatory pricing Product-mix pricing
Market-skimming pricing Market-penetration pricing

(a) Geographical Pricing

This involves deciding upon the prices for customers in different locations, regions or countries. It concerns issues like the incidence of higher transportation cost in respect of customer at a distant location, whether it should be passed on to the customer or absorbed by the firm as an incentive to the customer. Banks have different pricing for different geographical areas like Metro, urban, semi-urban and rural areas like consumer goods companies offer varied prices for products like biscuits, paper, petroleum products, medicines, etc.

(b) Price Discounts and Allowances

Discounts and allowances' on list price is adopted for various occasions like early payments, volume purchases and off-season buying, etc. The discounts and allowances can be of various types:

(i) Cash discount: For payment of instalments promptly banks offer concession in rate,

(ii) Quantity discount: For large volume purchases - there are different rate of interests for bulk depositors. Even State Bank of India has come out with bid pricing for bulk deposits of Rs. 50 crore and above,

(iii) Functional discount: Discounts (trade discounts) by producers to trade channel members for performing certain functions. Like commission to recovery agents, deposit collectors, etc.

(iv) Seasonal discount: Discounts given during off-season or festival offer- waiver of processing fee for loans during festival season,

(v) Allowances: Extra payment at the time of promotions for participation. Dealers get promotional allowances for participating in advertising campaigns. Trade-in allowances are given for turning in an old item, (vi) As regards banking, it is seen that banks adopt discounts and allowances to attract customers. It is common to see the discount and allowance waived for processing cost, in case of home loans and retail loans. Some of the banks also allow fee waiver for high net worth individuals in credit card and other card offerings.

(c) Psychological Pricing

To many consumers, price reflects the quality of the product; they consider higher priced products to be of better quality. Particularly in the absence of any other information about quality, the price acts as a signal of quality. Buyers often base their information about the current prices and past prices tend to form a reference price of the products mentally. By setting a price in a particular range, sellers can create an impression about the product belonging to a particular class. Often one finds different sections for premium price goods and economy price goods signalling that the former are of a higher quality. Another practice under psychological pricing is that of price set at an odd number rather than a round figure, as buyers tend to see such prices at the lower level.

(d) Promotional Pricing

For stimulating early purchases, several techniques are used by firms. These techniques are likely to be copied by the competitors, thus reducing their effectiveness. Some of the techniques are:

(i) Loss-leader pricing: Supermarkets often reduce the price on well-known brands, with a view to increasing the traffic at the store. They expect to cover the loss on the sales of these items from the additional sales of other items to these buyers.

(ii) Special-event pricing: In certain seasons, like a festival, school reopening, etc., special prices are

offered by sellers. Around Diwali, most consumer durable goods carry some discount or a free gift,

(iii) Cash rebates: These are offered for a limited period for purchases made during the period, especially with a view to clear the inventory. Usually leather footwear sellers have stock clearance sale campaigns during monsoon,

(iv) Low-interest financing: Sellers offer low-interest (even no interest) financing for a short-term during a certain period, in lieu of a discount or reduction in list price. Automobile sellers conduct sale campaigns with the payment facility over twelve to thirty six months at low interest,
(v) Longer payment terms: When the buyers find the monthly repayment liability more relevant than the interest, sellers offer a longer period for payment. Housing loans for a term of fifteen years and even twenty years, carrying higher rates of interest, are offered by some banks,
(vi) Warranties and service contracts: Low-cost or free warranty or service contract is added to the offer during a particular period for promoting sales. Usually producers of automobile, refrigerator, etc., offer free service contracts for two years at no extra cost,
(vii) Psychological discounting: It involves setting an artificially high price and offering a substantial discount on it. A technique often resorted to by various sellers, and buyers today are suspicious of the original prices displayed for a product during sale offer, (viii) Promotional pricing is adopted by banks in the new products brought out by them. For example,
it is seen that introduction of credit cards is combined with fee waiver, additional card use points, etc.
(e) Discriminatory Pricing
When different prices are charged to different buyers, it is discriminatory pricing. There could be different types of price discrimination. These are as follows:
(i) First degree: A different price to each customer, depending upon their intensity of demand. In case of made to order products, say some component for equipment, when required urgently may be priced higher than that for normal delivery period. Laundry services often charge more for urgent delivery for same day service for washing clothes.
(ii) Second degree: A lower price for buyers of a larger volume. For most goods, especially commodity goods, the prices for bulk quantity is lower. Hotels offer special rates to the corporate sector, who assure certain minimum room nights in a year, or to guests who stay for a few months.
(iii) Third degree: Different prices for different classes of buyers. The classes could be based on various factors such as:
- customer groups (students, senior citizens) (most banks offer additional interest on deposits
to senior citizens);
- product form (different versions of product) (Maruti has two different versions of its Alto VX
and LX at different prices);
- image pricing (same product sold with different image and name);
- channel (restaurant, fast food stall, vending machine) (in certain countries it is a common
practice for cafeterias to charge more for sit-in eating than for carry packs, some banks in India have introduced charges for cash transactions effected through teller at branch with no charge for those conducted at ATMs);
- location (different sections of an auditorium);
- time (rates for STD calls at different time of the day).

This can be adopted in those situations when market segments with different demand intensities exist, resale of lower-priced products at higher price should not be possible and underselling by competitors should not be possible. It is also necessary to examine the legal provisions in respect of discriminatory pricing.

Discriminatory pricing is seen in the banks offering finer rates of interest for customers with better risk rating and the corporate sector who have a relationship with the banks. Another discriminatory pricing practiced by banks is the additional rate of interest offered to bulk deposits as also senior citizens. The former is a business decision while the latter adds value to the bank on account of social responsibility.

(f) Product Mix Pricing

In case of, products which are a part of product mix, the pricing becomes more complex. This involves developing a set of prices for optimising the profit for the entire mix.

(i) Product line pricing: Developing a product line with distinct pricing steps,

(ii) Optional feature pricing: Optional features offered at additional cost, keeping the basic product to bare minimum at the base price,

(iii) Captive-product pricing: For products requiring captive or ancillary products, the latter could be priced with high mark up and the main product could be priced low.

(iv) Two-part pricing: The price is split into a fixed component and a variable component linked to the usage,

(v) By-product pricing: By-products obtained in production of other products can be priced at the value they have for consumers, which helps in charging a lower price on the main product,

(vi) Product-bundling pricing: Seller may bundle products and features and offer them together only as a bundle. Alternatively, while offering individual products seller may also offer a package including all these at lower cost.

(g) Market-skimming Pricing

This is a strategy particularly adopted for new products. In this system, the product is initially priced higher and over a period of time it is reduced to attract more buyers, with a view to "skimming" the revenues layer by layer from the market. This requires the product quality and image to be of the required level, the buyers attracted at the high price, feasible economics at low scale of production and barriers to the entry of other competitors. The amount of product sold is less affected by its price when the product is new than it will be at a later stage when competition has more influence. It allows attracting less price sensitive customers in the initial stage and the more price sensitive ones at the later stage. It helps in testing the demand and it is safer to begin with a higher price and then lower it rather than the other way round. The mobile telephone services are typical example of this strategy. Initially, the charges for mobile services (and of course, the handsets too) were very high and it catered only to the higher strata of the society and businesses. (Mobiles were status symbols) Gradually, as the price of mobile calls reduced, its usage expanded rapidly. And with handsets becoming very much affordable, it is now a convenience (and for some, a business necessity) product. Now, with its pricing much closer to landline services with the added convenience, it is driving out the latter. In case of credit cards, it has been observed that banks have introduced credit card variants with lower entry fees and annual fees in the past few years so as to widen the base.

(h) Market-penetration Pricing

Another strategy for new products is of setting the price low initially in order to penetrate the market quickly and deeply attracting a large market share. High volumes give benefit of lower costs, allowing further reduction in price. This strategy is useful when the quantity of the product sold is highly sensitive to its price, even in the introductory stage, the economies of scale for production and distribution are quite substantial, and there is no group of customers who will be willing to pay a premium to obtain the product early. Some banks used this strategy at the time of introduction of money market instruments, offering higher interest rates so as to attract higher market share and also expecting to retain the first

customers even after others increased their rates, as long as they were competitive. For banks, typically most products are volume driven and they soon get commoditised, except for some highly specialised products like in case of private banking and typical structured deals. Hence, banks usually find market-penetration pricing more suitable.

36.7 BANK PRICING

There are two major costs, which have to be considered while pricing bank products:
(A) Interest cost (B) Servicing cost
Normally interest cost constitutes 67 per cent of the price and service cost is around 33 per cent in any bank product. Banks now price each of their services. The services, which are associated with the product, are also priced now. Traditionally, banks have been adopting pricing (ROI) on the basis of values of loan or based on the development of priorities. But these days, the ROI offered on the deposits and charged on the loans and advances is (a) cost of fund based and (b) market related. Banks have also

TABLE 36.4 Charges Banks Charge for Some of the Services

For not maintaining minimum quarterly average balance in Savings Bank a/c Rs. 300/- per quarter
SB chequebook Rs. 3/- per leaf in excess of 20 leaves in a year
Multi-city chequebook Quarterly average balance Rs. 50,000/- Per cheque leaf 5/-, penalty 500/-transaction charges Rs. 100/- per Rs. 50,000/-
Inter-city charges 0.35% Above 20,000/- with a minimum of Rs. 50/-
Charges for not maintaining minimum quarterly average balance in CA For individuals 750/- per quarter for others Rs. 1350/- per quarter
A/c closure within a year SB 220/-, firm 500/-
Transactions Rs. 20/- per transaction beyond 60 transactions a year
Standing Instructions Registration Rs. 110/-, Rs. 25/- per transac¬tion for other than branch accounts
Cash handling CA, CC above Rs. 10,000/- to Rs. 50,000/-Rs. 10/-, Rs. 25/- and Rs. 50/-
Inoperative account where balance is below minimum required Rs. 75/- per year
Old entries beyond 12 months Rs. 150/- per entry
Attestation of photo Rs. 100/-
Signature verification Rs. 50/-
DD issue charges Rs. 30/- up to Rs. 10,000/-, 0.35% above Rs. 10,000/-
Revalidation of DD Rs. 100/-
Issue of Duplicate DDRs. 110/-

started levying a fee for all the services. In the past, these fees were at times included in the rate of interest. In the previous paragraph, we have indicated pricing strategies adopted by the banks. It can be inferred, therefore, that strategy of the banks and competition is more apparent in retail products. Banks have also started using competitive pricing in their traditional business. Table 36.4 gives certain examples of charges banks charge for some of the services.

Other factors which impact in bank pricing:

1. Risk and return: The banks are required to assess their risk in credit (loans and advances), operations and market exposure. Banks have developed (and are now fine tuning) the internal mechanism to capture these risks and relate to their products. Now banks would be in a position to quantify the revenue and cost associated with each product line. These risk factors play an important role in price determination.
2. Monetary policy: Based upon the Govt. priorities, the RBI announces monetary policy annually and reviews the same every quarter. In this policy, if RBI changes CRR, SLR, Repo rate, Reverse repo rate, etc., it affects the pricing decision of the bank. The Government may also set.national priorities for boosting growth of a specific sector and banks may be directed to provide soft loans. Banks would be left with no other alternative but to alter the prices of those products.
3. Capital adequacy: The assets of the banks (investments, loans and advances) are assigned different risk weights based upon their risk. Based upon these risk weights ranging from 0 per cent on loan on own deposit to 150 per cent on exposure to commercial real estate, banks have to provide for the capital based upon the aggregate value of their risk-weighted

assets. Hence, the higher the risk weight the higher is the capital required, so the higher is the product price.
4. Cost-benefit analysis: Banks conduct cost benefit analysis for a customer/product for differential pricing. This analysis helps them to price the product based upon the margin and other benefits it gets from that customer/product.
36.7.1 Case Studies
Case 1 The Case of P&G's New Tide Bar
P&G's New Tide Raises Detergent Bar for HLL
The battle just got bigger in the detergents' market. Hindustan Lever (HLL) and Proctor & Gamble (P&G) are already locked in a no-holds-barred contest in the detergent powder market, and P&G's entry in detergent bars may mean some sleepless nights for HLL managers. P&G has not offered the product at a discount though, with the New Tide Bar being launched at prices similar to that of Rin Supreme.
Will P&G's entry set-off another price war? At the moment, P&G seems to be testing the waters, analysts said. Its success in the initial months will determine if a price reduction will happen. HLL's reaction to the launch is also awaited.
The Rs. 5,000 crore detergents' market is broadly divided into bars, which make up 57 per cent of the market, and powder, which accounts for the rest. HLL, with brands like Rin Shakti and Rin Supreme, holds a major share in this market. It has a 38 per cent share by value of the total detergents' market and about 41 per cent of the detergent bar market. Some of the other major players in the bar segment are Nirma and Henkel.
Rin Supreme's market share is 14 per cent while that of Rin Shakti is 6.7 per cent. Rin is one of the mega brands of HLL, with sales in excess of $100 m or Rs. 450 crore, but this includes powder sales too. P&G is targeting the segment which includes Rin Supreme with its new product. P&G's earlier launch in this segment, Ariel bar, did not do well and the company will discontinue the product.

"People will try out P&G's new product once, but one has to give time to see if the product is a success," said an analyst. Tide has managed to build an association with whiteness and the product will try and capitalise on that.
P&G's entry into detergent reinforces the belief that it is really serious about its Indian operations, according to analysts. P&G has not launched the product with a discount to the competing product though. A 125 gm bar is priced at Rs. 8.5 while a 200 gm bar has been priced at Rs. 13. P&G believes this price point to be appropriate. "Our research shows that the current price of Tide Bar is what the consumer will find affordable," said Chester Twigg, Director - sales and marketing, P&G, India.
Another view is that P&G will wait and watch for sometime before making any move on the price front, instead of launching with a discount. Launching a brand at a discount could also give a wrong impression to consumers about quality, said an analyst. Whatever be the reason, one will have to wait for HLL's reaction.
(Press report appearing in The Economic Times, Mumbai edition, issue dated 19 November, 2004.)
Please read the press report appearing above. If you were the Chief Marketing Officer of HLL, what would you do in response to this development? What pricing strategy is P&G having in mind at this stage? Do you concur with P&G's approach of not offering a discount at the time of the launch? Do you agree that a lower price would give a wrong impression to consumers about the quality?
Do you think that similar scenario applies in banking sector, say to the pricing of housing loans? As a marketing student, how do you see this press report? In which areas does it provide learning points?
Case 2 The Case of Home Loan - Competition and Best Rate on Home Loan
There are number of players in the home loan markets. PSU giants like SBI and PNB, Private bank like ICICI Bank and specialised institutions like HDFC are in the fray. In addition there

are number of banks and private institutions like Dewan Housing Catering to the needs of prospective borrowers.
Each lender is trying to enhance his share in the loan market. While these lenders keep publishing their interest rates for various loan products, there is more to the published interest rate than meets the eve. Two loan applicants to the same bank may get a different rate. There is no such thing as a "standard rate" for a particular bank. The rate published by banks is a "rack rate" on which significant discounts are usually available.
Surinder, a prospective home buyer wants to get best rate on home loan. As competitive offer depends upon certain factors, he should present himself and convince lender on following counts.
(a) Profile: The greater the bank's interest in Surinder's profile, the higher the chances of them offering
a discount to him.
(b) Bargaining power: Surinder should talk to multiple banks. In general, loan applicants who talk to
three or more banks - are effectively lining up alternatives. Softly playing one bank against another
often helps, but the key is to not to carry too far. After all, the threat of losing business to a competitor
must look realistic and credible to the bank for it to lower its rate.
So, the key question for Surinder now is: How he should go about getting the best rate:
1. Surinder should enquire at all possible banks offering the kind of loan he is looking for.
2. When the bank approaches Surinder, he should provide documents on proof of income such as
income tax returns, bank statements, form 16 and salary slip.
3. It is likely that the rate offered, after his documents are looked at by the bank would often be lower
than what he was offered at the first meeting. So, he should not take any decision before the bank
reverts to him after examining his income document.

4. Surinder should shortlist at least two banks (who offer the best possible rates and other terms relevant to him).
5. Surinder should scrutinise the draft loan agreement, to ensure that there are no hidden clauses, that could affect him adversely.
After weighing the comparable annualised percentage rate of two short listed banks, he should select the bank which is offering the lowest rate.

36.8 LET US SUM UP

Price, the amount of money charged for a product or service, is the only revenue generating element, of the marketing mix. Initially, the prices were settled by negotiation between the buyers and sellers, which was followed by the system of fixed price. Internet has again brought dynamic pricing into active zone. Price helps consumers to allocate their purchasing power and gives them information about the product quality. For firms, it affects profits hence is an important and risky area. Intense competition creates a tremendous pressure for a downward revision of prices.
Pricing has several objectives: profit optimisation, survival of the firm, increasing or maintaining the market share, getting suitable cash inflows, stabilisation of demand supply balance, product quality maintenance and communicating the image of the product value and quality. Some of the objectives are of short-term nature and others of long-term nature.
Pricing is influenced by several internal and external factors. These factors are not constant and hence price needs reviewing periodically. Three principal inputs affecting the pricing

decisions are: customers' demand schedule (setting a ceiling), cost functions (fixing a floor), and competitors' prices (providing the orientation). Government regulations also influence price. Various pricing methods include one or more of these three Cs. Thus, there are three main types of pricing methods: cost-based, value-based and competition-based. Different methods have suitability under different conditions. In case of banks the regulations of RBI, Govt. priorities, capital adequacy requirement, guidelines of ISA and FEDAI have some bearing on pricing the products.

Firms can arrive at a range of feasible prices by using pricing methods. However, for fixing the final price, several other factors need consideration. For this purpose, several pricing strategies are adopted to determine specific price under a given situation. These strategies take into account the geographical, customer segment, competition conditions, buyers' perception, stage of product life cycle and product characteristics into account.

36.9 CHECK YOUR PROGRESS

1. Please choose the correct alternatives for each of the following statements:

(a) Out of the following, is not an objective of pricing.

(i) Profit

(ii) Stabilising demand and sales of the product

(iii) Improvement in product quality

(iv) Expansion of business

(b) Of the following pricing methods, _ . is not based on competitors pricing.

(ii) Sealed bid auction

(iv) Group pricing

is not ideal for new products.

(ii) Discriminatory pricing

(iv) Promotional Pricing

(i) English auction

(iii) Going-rate pricing

(c) Of the following pricing strategies,

(i) Market-skimming

(iii) Market-penetration

2. Please state for each of the following statements whether it is True or False.

(a) Price for any product is a constant.

(b) One of the objectives of pricing is getting cash inflows at the required time.

(c) Perceived value pricing takes the buyers' perception into account.

36.10 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a)-(iv), (b)-(iv), (c)-(ii); 2. (a) False, (b) True, (c) True.

36.11 KEYWORDS

Dynamic Pricing, Pricing Methods, Cost-based Pricing, Value-based Pricing, Competition-based Pricing, Perceived Value Pricing, Value Pricing, Group Pricing, Pricing Strategies, Discounts, Allowances, Psychological Pricing, Promotional Pricing, Loss-leader Pricing, Cash-rebates, Discriminatory Pricing, Market-skimming Pricing, Market-penetration Pricing, Cost-benefit Analysis, Risk Weighted Assets.

DISTRIBUTION

STRUCTURE

37.0 OBJECTIVES

In this unit, we shall seek to know and understand:

- Functions of distribution channels
- Types of distribution channels
- Distribution channels for banking services
- Intermediaries in banking services
- Physical distribution

37.1 INTRODUCTION

One of the four Ps of marketing mix is "Place" or "Distribution". In the economic terms, any product, being capable of giving customer satisfaction needs to have "place" and "time"' utility. This is provided by the "Distribution" function of marketing mix. All endeavours of production will come to nought, if the products do not reach the consumers for consumption. In the normal goods distribution process, entities other than the producers are also associated and there is a chain between the producer and the consumer. For an effective conclusion of marketing, the functioning of other elements in the chain is as important as that of the producer. Hence, marketing mix decisions also include distribution strategy decisions. The distribution function, in the case of services, differs substantially due to the special characteristics of services. In fact, it is the distribution function, which bears the greatest impact of these peculiarities. However, it is easier to understand the dynamics of distribution by studying it in the context of physical goods and then study the distribution function in respect of services.

37.2 DISTRIBUTION CHANNEL

The goods reach from the producers to consumers through a chain of entities, associated with the process directly or indirectly. These entities form what is called as a distribution or marketing channel. It is in the simplest manner as follows:

Marketing channels are sets of independent organisations involved in the process of making a product or service available for use or consumption.

As one can imagine, the process of distribution involves more than one independent entity to take care of various tasks, besides the job of selling of the product to the ultimate consumer. Mostly producers do not handle the task of selling to the ultimate consumer on their own, but use the services of intermediaries for the purpose. This makes the function of distribution a little complex for the producers, in as much as, they are required to build relationships, not only with the consumers but also with key suppliers and resellers in the firm's supply chain or what is better termed as value delivery network. This is the network comprising firm, suppliers, distributors and ultimately customers who work with each other to create the value for the customer.

Distribution channels involve long-term commitments on the part of the producer to various firms. It is, therefore, not possible to replace the channel readily and hence, it needs designing carefully.

37.2.1 Functions of Distribution Channel

The channel members add value or utility to products and services they make available to the consumers. Members of a distribution channel are required to perform the following functions:

(a) Market Information: They gather intelligence and information about potential and current customers, competitors and other forces in marketing environment and disseminate it to the producer. The channels provide to the producer the feedback about consumer reactions and the reactions of

other entities, including their competitors' actions. In fact, the dealers and distributors serve as "the eyes and ears" of the producers.

(b) Promotion: They develop and spread persuasive communication about the offer for stimulating the purchases. The personal selling task, especially in the case of new products, launch or relaunch of an existing product is performed by the dealers/retailers who come in direct contact with the customers. They also provide pre-sales and post-sales service to the consumers.

(c) Contact: They serve the function of locating and communicating with the prospective buyers. It is possible for some manufacturers to have their own network to reach the customers. Most manufacturers, especially those producing mass consumption goods, find it difficult to do so because of the large number of widely scattered consumers and the high level of resources required. The distribution channel due to its physical proximity to consumers helps in smooth sales process and brings together consumer and producer efficiently.

(d) Matching: The distribution channel partners shape and fit the offer to the buyer's needs, including alterations, grading, assembling and packaging. They also help in providing varieties of offerings from different sources to the consumer. The consumers find it convenient as they can buy different complementary items from the same source, rather than shopping from different outlets. The consumers get the convenience of seeking some minor alterations/additions made at the outlet to meet their specific requirements.

(e) Negotiation: They negotiate and settle the final price and other terms with the buyer so that ownership and possession can be transferred. They also provide the producer, the customers' reaction to the price.

(f) Product Information: The distribution channels not only sell the products to the consumers, but provides them the required technical information about the products. This enables the consumers to get the optimum results from the products.

(g) Physical Distribution: The channels perform an important role in physical distribution. They transport and store the goods for reaching ultimately to the consumer.

(h) Financing: They acquire and use funds for financing the channel operations. The intermediaries provide the deposit or buy the goods in bulk from the producer on cash basis. They also extend credit to the retailer.

(i) Risk Taking: They assume the risk of carrying out the channel tasks.

37.2.2 Channel Types

The above mentioned functions need to be performed for completing the marketing transaction between the producer and the consumer. These functions involve certain costs. Depending on whether any or all of these functions are performed by the producer, its costs will be higher. Where these are performed by other intermediaries, they have to add their costs for the same to the producer's cost of goods or services. The channel, which gives the least total cost and adds greatest value for the consumer will be most suitable.

A distribution channel comprises several channel levels, which is a layer of marketing intermediaries that performs some work in bringing the product ownership and possession to the final buyer.

The number of intermediary levels indicates the length of a channel. Figure 37.1 shows several channels for consumer goods.

Channel 1 shown in Figure 37.1 has no intermediary level and is called as zero-level channel. It is also called as the direct marketing channel, as the producer sells the products directly to the consumer.
Other channels shown in Figure 37.1 are indirect marketing channels of different lengths containing one or more intermediaries.

Channel 1 Zero Level
Channel 2 One Level Direct Channel

Manufacturer

Indirect Channel

Manufacturer
Retailer

Channel 3 Two Level Manufacturer Wholesaler ► Retailer

Channel 4 Three Level Manufacturer Wholesaler Jobber -
Retailer

FIGURE 37.1 Consumer Distribution Channels

Channel 1 Zero Level Manufacturer

Channel 2 One Level Manufacturer
Business Distributor | ^

Manufacturer's Representatives or Sales Branch

Channel 3 Two Level Manufacturer

Manufacturer's Representatives or Sales Branch

Channel 4 Three Level Manufacturer
—» Business Distributor

FIGURE 37.2 Business Distribution Channels

In case of business distribution channels (Figure 37.2), the producers either use their own sales force and network to sell directly to the customers or they can sell to intermediaries who in turn sell to the customers.

37.2.3 Factors Influencing Channel Selection

Producers have to decide the types of channels for distribution of their products. The major factors influencing this decision are discussed below:

(a) Product Characteristics
The nature of product is a major factor determining the selection of marketing channels. The main classes of products requiring different types of channels are: (i) Perishable products: These are food products like fruits, vegetables, milk, sweets, etc., which can be sold through direct channel.
(ii) Consumer durables: Products like television sets, refrigerators, etc., need to be sold through dealers and authorised showrooms, which serve the purpose of display of the products, conveying the specialised information about the product to the prospective customers and also offer after sales service.

(iii) Industrial products: Industrial products like raw materials, machine tools, computers, etc., direct sale to the industrial users is most suitable. Sometimes, distributors are appointed for promoting the sales.
(b) Market Characteristics
The nature of market for the product, i.e. location of market, size of market, number of potential customers, buying habits of consumers and elasticity of demand, affects the choice of channel. For a product with a local market, a direct channel is suitable. However, in case of products having a regional or national market a chain of intermediaries is required for distribution of the product. For consumer goods like soaps, soft drinks, etc., the consumers are widespread and have different types of needs and buying habits. For such products, it is better to have two- or three-level channel for reaching a larger number of buyers. For industrial products, the buyers are located at few specific centres and hence covered by the producers directly. For new products, a wider reach is possible through a longer channel. But, in case of a new or a small producer, wholesaler or retailers may not be willing to accept the products. In that event, direct selling or sales through a sole selling agent may be adopted.
(c) Customer Characteristics
Customers may belong to different age group, sex, income group, etc., and would have different buying habits, preferences and needs. The customer convenience is another important criterion for channel selection.
(d) Company Resources
Firms with strong financial resources and a capable managerial talent can select the direct channel. If the firm is new with very little financial resources, it is preferable to have an indirect channel with a minimum number of intermediaries.
(e) Competition
Where the competition is strong, a longer channel of two or three levels will be suitable for increasing the sales. In case where competition is limited, a shorter channel would suit. The method adopted by the competitor may also affect the choice of channel. One strategy is to avoid the channel used by the competitor and instead concentrate on an alternative channel where there is no other competition.
(f) Product Lines
Producers with several product lines and each line with several items find it more suitable to hand over the distribution functions to other intermediaries.
37.2.4 Channel Management (Discussed in a separate chapter)
37.3 CHANNELS FOR BANKING SERVICES
Service products have distinct characteristics, hence, the distribution of service products is complex. Banking services mainly depend upon direct distribution, i.e. through their own branch network. With the technological revolution in banking, in addition to branches, many more delivery channels are used by the banks to make their products reach the customers. The fierce competition in banking has compelled the banks to come out of their shells and reach the customers with newer distribution channels.
37.3.1 Branches

Branches are the primary distribution outlets for banking services. These are fixed in location and the consumers are normally required to visit the branch for transacting their business. Hence, the location

of branches is very important and it should be in a place convenient to the customers. Banking is a convenience business, and for consumers availing routine day-to-day services, the location is the principal criterion for choosing a bank. As per the survey conducted by IBA, 46 to 65% of customers choose a bank branch for the convenient location.

A well-spread branch network covering the major business centres of the country or region, depending on the area covered by the banking firm, is one of the fundamental requirements for the growth of banking business. The existence of a branch outlet determines the capability of the bank to extend various services, especially those related to remittances, collection services, trade facilities, etc. The number of branches and location of a branch are determined by several factors. The business policies of the bank like the niche activities, focus customer groups, area to be covered, etc., are the basic criteria in this respect. The business potential of various locations satisfying the requirements of business policy forms the basis of short listing the locations for setting up the branch. As per the new branch licensing policy of the Reserve Bank of India, the banks have to submit their projections for opening new branches/ ATMs during the next financial year and obtain the requisite licence from the RBI accordingly.

Besides the location, the layout of the branch and its internal decor also make an impact on the customer. The branch has to be functionally convenient for customer movement for transacting their business; it should be physically comfortable and environmentally pleasing so as to give a totally good experience to the customer during the branch visit. A good aesthetic and comfortable environment also keeps the staff in a better state of mind to render a more pleasing service. Being a service activity, the quality is judged to a great extent by the "experience feeling" apart from the absolute service criteria. Waiting lounge, light music, drinking water, newspaper, magazines and proper queue system make customer feel better during the waiting time for the transaction.

Types of branches: Branches offer different types of services for different types of customers and can be broadly classified as follows:

1. General branch: This type of branches provides their customers almost all banking services with big range of deposit and loan products and remittance facilities as well.
2. Speciality branch: The general branches are not well equipped with the skills required to handle a specialised business hence speciality branches are created to focus on the specific type of clients,

(a) Personal banking, (b) International business, (c) Trade finance

37.3.2 Other Channels

Other than branches, banks have also adopted certain electronic and telecommunication-based outlets.

(a) Telephone Banking and Call Centres

With the advent of telecom services and the evolution of using telecommunication facilities for customer services and relations, banking services have also adopted this channel. This has been possible, particularly, due to computerisation of banking operations, thus making the basic database accessible across the organisation. Certain basic banking transactions, like balance inquiry, requisition for a cheque book, etc., are offered through telephone banking. In phone banking, some of the services are made available round the clock, thus giving the "customer" the benefit of 24 x 7 service.

(b) Automated Teller Machines

These have made the banking services particularly cash related services more accessible and convenient for the customers. They are available round the clock and hence the customer can transact business at his convenient time. ATMs located at the branch premises facilitate self-service by the customers, which makes the bank staff free for other high-end functions. The customers get the satisfaction of participating in the process of service delivery. Off site ATMs provide a value addition and enable

branches to tap business from a wider area. ATMs located in residential colonies to a certain extent remove the disadvantage of longer distance from the branch premises. ATMs at the railway stations and petrol pumps provide the convenience of delivery of the service at a location most suitable to the customer. Further, banks forge linkages with ATM networks of other banks to provide a wider access to their own customers over a larger area and at more number of points. The objective is to make the basic services available to the customer 'at hand at any point of time'.

(c) Personal Computer

Computerisation of the banking operations and the spread of personal computers (PCs), which is now fast becoming a household good, have opened up yet another channel. Banking transactions are now also being provided through PCs. Apart from carrying out routine transactions on their accounts through net banking or home banking, customers can also make remittances and request for opening of LCs. Under home banking, customer is provided a dedicated connectivity and a limited access to the bank's database and systems to enable them to transact certain types of business. Under net banking, the customer is provided access through the internet, which is accessible from anywhere and is permitted to conduct certain limited types of business.

(d) Plastic Cards

Credit cards and debit cards facilitate the banking transactions of a certain nature, to be done outside the banking premises and at a time suitable to the customer. These serve as a means for credit services becoming available at the merchant establishments located away from the branches. Thus, these devices have helped in removing the restrictions arising due to inseparability and also in enhancing the capacity of the organisation.

(e) Virtual Branches and Automated Video Banking

Banks, in certain countries, create what looks like a branch in any public place like a hotel lobby, etc. These branches have ATMs, phones and interactive two-way video monitors and communication systems. Customers can transact certain types of businesses through these virtual branches.

37.3.3 Intermediaries in Banking Services

While in banking, intermediaries of the conventional types are not found, certain banks have started availing the services of external agencies for extending some of the banking services. These agencies may be looked upon as intermediaries because they:

- Increase the availability or convenience of a service
- Increase its use or the revenues from its use
- Help maintain existing users, increase use among existing users or attract new users

Following types of intermediaries are found working for banks:

- Direct sales agents: Certain banks avail the services of marketing agencies for selling some of their products say housing loans, auto loans, etc. (Separate chapter on DSA/DMA follows)
- Automobile dealers: They enter into a tie-up with a certain bank and then start selling its auto loans.
- Merchant establishments: These establishments at their points of sale accept the credit or debit cards of banks, thereby facilitating banking transactions to be effected at their end.

37.4 LET US SUM UP

Distribution function refers to the set of activities which make the goods reach from the producers to the consumers. Several intermediaries, forming the distribution channel, typically perform it. These

channels perform various functions such as market information, promotion and negotiation, customer service, financing and risk-taking, apart from physical distribution of products.
The channels vary in the number of levels and the channel comprising only the producer and the consumer is called a direct marketing channel. The selection of channels is influenced by several factors like, the characteristics of products, markets and customers; resources of the company; nature of competition and product lines.
The distinctive nature of services has an impact on the distribution channel for services. Consequently, banking services have typically used the direct channel for distribution. These characteristics have placed certain limitations on the distribution function, however, with the advent of the use of information technology for banking, some of these limitations have been worked around.
The principal channel for banks is the branch network. The customers are required to visit the branch to avail of the services and hence their location is important. The branch network is influenced by various factors including the banks' own business policies and the branch licensing policy of RBI. The branch layout affects the customers' experience feeling and hence is important.
Telecommunications and computing facilities have enabled several outlets for banks like telephone banking and call centres, ATMs, home banking, net banking and virtual branches.
Physical distribution covers the activities of transport, distribution, and storage of goods between the stages of production to purchase by the consumer. This is affected by several factors like nature of product, place of production, etc. Several costs are associated with this function, which now are one of the major cost components. Considerable scope exists for reduction in distribution costs. Various tasks involved in this function include demand forecast, order processing and inventory management covering storage, protective packaging and transport.

37.5 CHECK YOUR PROGRESS

1. Please choose the correct alternative for the following statements:

(a) Marketing channel refers to

(i) a physical channel for movement of goods from the seller to the buyer, (ii) a set of firms who handle the physical movement of goods from one point to another, (iii) different departments of the producer firm which are associated in ensuring delivery of
goods to the buyer, (iv) a set of independent organisations involved in the process of making a product or service
available for use or consumption.

(b) The functions of distribution channel do not include

(i) gathering and providing market information.
(ii) marketing research.
(iii) assisting the consumer in understanding and using the goods, (iv) promoting the sales of goods.

(c) Which of the following characteristics is found only in some services like banking and not
found in case of many services.

(i) inseparability (ii) variability
(iii) client relationship (iv) perishability

2. Please state whether these statements are True or False:

(a) The maximum number of entities at any of the levels in a distribution channel is called the
length of the channel.

(b) In selection of the marketing channel, the product characteristics are relevant and market
characteristics are of no consequence.

(c) Banking is a service industry, however, as it is experience oriented, the layout of the branch along with the interior decor make an impact on the customer.

37.6 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a)-(iv), (b)-(ii), (c)-(iii); 2. (a) False; (b) False, (c) True.

37.7 KEYWORDS

Distribution Channel, Intermediaries, Credit Cards, Debit Cards, Exchange Points, Orders, Warehouse, Inventory Management, Just-in-time, Distribution Centre.

CHANNEL MANAGEMENT

STRUCTURE

38.0 OBJECTIVES

A Study of the unit will help you to:

- understand the concepts of channel management
- appreciate the channel levels and channel dynamics
- know the benefits of channel management

38.1 INTRODUCTION

Channel management is also called as IT channel management, distribution channel management, channel sales management and sales channel management. To reach a target market, the marketer uses three kinds of marketing channels, viz., the communication channels, the distribution channels and the service channels. Channel management is the development of policies and procedures to gain and maintain the cooperation of various institutions within the sell-side distribution channel.

38.2 MEANING OF MARKETING CHANNEL SYSTEM

Most producers do not sell their goods directly to the final users; between them stands a set of intermediaries performing a variety of functions. These intermediaries constitute a marketing channel. Some intermediaries such as wholesalers and retailers buy, take title to and resell the merchandise. They are called merchants. Others - brokers, manufacturers' representatives, sales agents - search for customers and may negotiate on the producer's behalf, but do not take title to the goods. They are called agents. Still others - transportation companies, independent warehouses, banks, advertising agencies — assist in the distribution process but neither do they take title to goods nor do negotiate purchases or sales and they are called facilitators.

Marketing channels are sets of interdependent organisations involved in the process of marketing a product or a service available for use or consumption. Marketing channel decisions are the most critical decisions facing management. The company's channel decisions involve relatively long-term commitments to other firms, company's pricing, advertising decisions, etc.

38.3 CHANNEL LEVELS

All channel functions have three things in common: They use up scarce resources; they can often be performed better through specialisation and they can be shifted among channel members. It can be classified as follows:

Zero level - Direct marketing channel, e.g. Internet sale, door to door sale. One level - Contains one selling intermediary such as a retailer. Two level - Contains two selling intermediaries, viz., wholesaler and a retailer. Three level - Wholesaler, who sells to jobbers, who in turn sell to retailers.

The concept of marketing channels is not limited to distribution of physical goods. Service sector has also to ensure that their output is made available and accessible to the target population. As internet technology has advanced, service industry like banking, insurance, travel, security trading etc. have started selling their products through these new channels. For instance, People's Bank, based in Connecticut uses its web site as a key channel for reaching individuals, business customers and prospects. Not only can customers e-mail the bank with questions; they can click on a link to have a bank representative call them with further information or choose another link if they want to chat online. In addition, prospects can open new accounts online, print out

423

and fax account applications and even order printed cheques with a few keystrokes apart from having access to insurance products - say an auto, home and other personal insurance, as well.

38.4 CHANNEL DYNAMICS

Distribution channels do not stand still. New wholesaling and retailing institutions emerge, new channel systems evolve. Channels swell vertically, horizontally and through multi-channels. Today's banks are multiplying the number of "go-to-market" or hybrid channels, i.e. they use all the channel alternatives for marketing their services.

Vertical marketing system (VMS): It implies that the producer, wholesaler and retailer acting as a unified system. In a service sector like banks, it can be a corporate or administered VMS where the different products like deposits and advances are channelled through the branch offices, who act on behalf of the management. The customer is assisted by various levels to finally market the required product as per his choice.

Horizontal marketing system: It is one in which two or more unrelated companies put together resources or programmes to exploit an emerging marketing opportunity. For instance, many supermarket chains have arrangements with local banks to offer in-store banking. Trends have already seen in banks where they shake hands with insurance companies to market their products, viz., policies along with the various loan products like educational loans, housing loans, etc.

Multi-channel marketing systems: With the proliferation of customer segments and channel possibilities, more companies have adopted multi-channel marketing. It occurs when a single firm uses two or more marketing channels to reach one or more customer segments. For instance, a bank may try to sell its products through internet, marketing officials, outsourcing, opening ATM counters, branch banking, maintaining liaison with stock broking companies to accommodate their trading deals offering credit limits, etc., The chain goes on and on and on.

38.5 ADVANTAGES

Channel management helps organisations improve their bottom line by increasing the efficiency of internal and channel partner teams. It helps the sales team attract and retain customers, reduce administrative time, provide robust account management and drive higher revenues. Channel management helps you to develop your partner network with important functions like lead sharing, channel training, programme and fund management and the electronic procurement of products and services from the vendor to partner.

The Interwoven channel management (ICM) connects businesses with their direct and indirect channels through information, business processes and sales applications to streamline the sales process and realise more profitable channels. ICM integrates with market leading and custom developed web portals, mobile devices and e-mail systems to expand the profit potential of agents, account executives, resellers and distributors, while reducing the cost to support them by up to 70 per cent.

The solution enables organisations to develop specialised intranets for direct sales channels and extra nets for indirect sales channels to fuel sales momentum. Further, enterprise application connectors enable customers to combine powerful content management capabilities with portal technology from vendors such as IBM, SEA, and SAP. These portals empower the enterprise's extended sales team through self-service delivery of the most relevant sales information-including marketing collateral and presentations, product information and documentation, training materials, competitive intelligence and catalogue data. The results are lower costs for channel support and greater productivity for direct and indirect sales people.

In short, the advantages of channel management, though beyond quantification, can be summarised to definitely cover three benefits that can be easily noticed:

1. Increased market coverage.
2. Lower channel cost - for instance activating mobile banking rather than corresponding individually with customers.
3. More customised selling - using the technological advancement to mutual advantage and using the technical/marketing personnel to sell more complex products.

38.6 LET US SUM UP

An effective channel management warrants research in value perceptions and needs of the target customers, examination of company's and competitor's performance, identification of gaps and implementation of corrective measures, monitoring of constraints and implementing a suitable design. Channel management may comprise channel marketing, channel sales, channel service or channel commerce.

Channel management provides a source to the companies when they lack financial resources to carry out direct marketing. Marketing channels are characterised by continuous and sometimes dramatic changes. Deciding on which type of channel to use calls for analysing customer needs, establishing channel objectives, identifying and evaluating the major alternatives, including the types and the number of intermediaries involved in the channel. It is applicable to the service sector as well. The company/ management must determine whether to distribute its products exclusively, selectively or intensively and must clearly spell out the terms and responsibilities of each channel member. The primary purpose of channel management in marketing is to sell more products to more people more often for more money/better margin in order to make more profits. However, channel arrangements are up to the company, but there are certain legal and ethical issues to be considered with regard to practices such as tying agreements, dealer's rights, etc.

38.7 CHECK YOUR PROGRESS

1. Say whether the following statements is True or False:

(a) Channel management concentrates on more productivity than profitability.
(b) Channel management is free from legal issues.
(c) Hybrid and multi-channels have opened up due to changes in market scenario.
(d) Decisions of channel have a critical role in deciding a company's vision.
(e) Channel management paves a way for effective physical, title, payment, information and promotion flow in an organisation.

38.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) False, (b) False, (c) True, (d) True, (e) True.

38.9 KEYWORDS

Marketing Channel System, Intermediaries, Vertical Marketing System (VMS), Hirizontal Marketing System (HMS), Multi-Channel, Channel Dynamics

PROMOTION

STRUCTURE

39.0 OBJECTIVES

In this unit, we shall seek to know and understand:

- Role of promotion
- Promotion mix
- Components of promotion mix
- Promotion-mix strategies
- Factors influencing promotion mix
- Promotion mix integration

39.1 INTRODUCTION

Promotion is the fourth and last P of the marketing mix, but in no way the least important of these. While a good product at a reasonable price delivered at the appropriate place and time are essentials of the marketing mix, these need the support of an attractive promotion mix, so that the consumers become aware of the offering. The prospective customers needs to be informed about the features of the offering and the needs it would satisfy. Traditionally, the communication process with the customer was confined to the promotion mix. However, now other elements of the marketing mix are also used as communication tools. Thus, the promotion mix has enlarged to cover the other elements also. The ultimate success of the marketing endeavours is dependent on how effective the promotion strategy has been in reaching the market and influencing the consumers appropriately.

39.2 ROLE OF PROMOTION IN MARKETING

Promotion is the exercise of communicating the properties of different elements of marketing mix to the customers with the intention of influencing them. The promotion efforts aim to encourage the customer to move through various stages of the decision-making process towards buying the offerings made by the firm. This involves the following aims:

(a) Persuasion: Promotion aims at persuading the consumers so that they start acting in favour of the firm. Persuasion seeks to bring about a change in attitude.

(b) Inform: Promotion aims at conveying information about the properties of products to the prospects, to influence their desires and transform them into action.

(c) Reminding: Promotion seeks to remind the customers about the offerings of the firm with a view to retaining their business and to have a higher share in it.

(d) Reinforcing: Promotion also aims at reinforcing the customer satisfaction. This helps in increasing the number of habitual customers.

Promotion thus is an exercise of maintaining the contact with the consumer at different levels and in different manners to build, maintain and enhance the customer relationship, which is the ultimate objective of marketing. When a bank organises a seminar addressed by a distinguished management thinker and invites its customers to this event, it is not talking about its services, yet it is communicating with its customers and nurturing the relationship with them. Similarly, a bank by sponsoring a social awareness campaign relating to AIDS, though it has nothing to do with banking services, communicates to its customers, its concern for issues of importance to the society and individuals.

39.3 PROMOTION MIX

Promotion means activities that communicate the merits of product and persuade target customers to buy it. Promotion is a mix of several tools. The objective of the promotion activities is to deliver a clear.

consistent and compelling message about the organisation and its products. The promotion mix comprises the following tools, as shown in Figure 39.1.

Blended Mix of Promotion Tools

Advertising Pers Seonal

ling

i 1

Sales Promotion

Public Relations

Direct

Marketing

FIGURE 39.1 Integrated Marketing Communications

Besides the above-mentioned tools, which form the part of promotion mix specifically, certain aspects of other elements of market mix (product, price and place) also communicate something to the buyers. Thus, the design of the product, the shape and colour of packaging, the price, and the stores that sell the product also communicate about the product.

The role of promotion mix has changed significantly, as the complexion of markets has changed. Mass markets have fragmented. Improvements in information technology is speeding the movement towards a segmented marketing. Nevertheless, there is a need for each of the element of marketing mix to be blended so that integrated marketing communications take place.

39.3.1 Components of Promotion Mix

Let us briefly discuss each of the components of marketing mix.

(a) Advertising

Advertising is an important paid form of non-personal presentation and promotion. It is a means of reaching the masses at a relatively low cost per exposure. It reaches people geographically dispersed and can be repeated several times. Advertising through print media, radio and television has a wider reach. The use of colour, visuals, sound and print make advertising very expressive. Consumers carry a positive image of the seller and the success of the product in case of large-scale advertising. However, advertisements are impersonal as they address a large audience. They permit only a one-way communication. Some forms of advertising require a large budget. These are generally useful for a nationwide launch of a new product or for building up long-term image. The larger banks, which are operating on a national level (the public sector banks, foreign banks, and larger private sector banks), advertise in national dailies, periodicals, television, etc., and find advertisements in national dailies, periodicals, television, etc., useful. Besides, they also use the local advertisement media like hoardings on roads, railway stations, bus stands, railway platforms, etc., which have a reach to the masses. Smaller banks like urban co-operative banks, small regional banks on the other hand prefer the regional or local press media, hoardings in local markets, etc. This suits them better as their target market is restricted to a smaller area and these match their low budgetary resources.

(b) Personal Selling

It includes personal presentation by the firm's sales force to the prospective customer(s) for the purpose of making sales. It involves a personal interaction between the buyer and the seller. It is most effective at a certain stage of the buying process. During the process of personal selling, the buyer's needs better understood and quick adjustments can be made in the offerings to satisfy these. It helps in developing the long-term relationship between the sales personnel and the consumer. It is, however, a costlier method and a sales force has to be maintained, which cannot be resized quickly. Personal selling is gaining significance for banks. It is used in both wholesale segment and retail segment.

Ask any person scouting for a housing loan, one simply has to telephone some banks and their representatives will call at one's home or office at the customer's convenience (be it a holiday or a Sunday; late evening or early morning) with the necessary forms, literatures, etc. For corporate customers, banks make presentations at various levels. The top executives of banks make sales calls on the CEOs and other senior executives of the corporate. Besides, banks often develop specific solution strategies for meeting certain specific needs for some of the corporate (for example, a payment collection system for a utility organisation) organisation and make a presentation of these strategies to the concerned decision-making authorities of the customer organisation.

(c) Sales Promotion

It is a campaign to encourage the purchase or sale of a product by offering short-term incentives like coupons, contests, premiums, cents-off deals, etc. These help attract consumer attention and offer strong incentives to purchase and reward quick response. Thus, the consumer is attracted to "act NOW". Though the sales promotion results in a quick increase in sales, during the campaign period, they have not been found to be as effective for building a long-term brand preference or image. Sales campaigns have been used by banks for many years. "Deposit Mobilisation Fortnights" were conducted feverishly by the public sector banks, even before the setting up of the new generation private sector banks could be imagined. During such campaigns, banks would present some giveaways to the depositors. Non-monetary incentives were also used, signing the deposit receipts or passbooks. We now find sales promotion for consumer loans like auto loans or housing loans which are accompanied with an offer of special rates of interest, waiver of processing fee, etc., during festival season.

(d) Public Relations

Public relations is building of good relations with various entities like consumers, suppliers, shareholders, etc., by obtaining favourable publicity, building up a good corporate image and handling unfavourable rumours, events, etc. News stories, features, sponsorships have a greater credibility than the advertisements. It can be very effective and economical, if used appropriately. A common exercise of public relations, nowadays, is the practice of a press statement of the chairman or the managing director of the bank appearing at the time of announcement of the quarterly results of the bank. Besides, press statements of top executives of banks appear frequently in press on occasions like opening of new branches, centenary year celebrations, announcement of credit policy by RBI, Central Government budget, any new initiative taken by bank in adoption of technology or new process, for example, migration to CBS. Banks also sponsor certain events may be cultural (like stage performances by classical music artists, painting exhibitions, college/university annual fete), social (say blood donation camps, eye test or dental check up drive), charitable (say programmes in the aid of institutions of blind, orphanages, Tsunami rehabilitation works, etc.). While such associations do not directly impinge on the banking business, they serve the purpose of enhancing the recognition of banks among various sections of the society. And let us remember that the customer group of banks is the entire society.

(e) Direct Marketing

It is the process of making direct connections with the individual prospective customers to obtain immediate response and to build up lasting relationship. It is non-public and is addressed to a specific person. It is immediate, customised and interactive. It is well suited to highly targeted marketing efforts.

Direct marketing is a relatively new approach for the goods producers, but for banks, direct marketing has always been there, although minus the focus on customer (due to lack of appreciation of need for marketing in banking). While the trend in banking during the recent past has been the opposite, banks are using the services of direct sales agents (DSAs) for their financial products. Direct marketing is gaining significance particularly with the advent of Internet and web-based businesses. Direct marketing in banks will continue to be important and will acquire new dimensions.

The case of Dell Computers of USA is a pioneering success story of direct marketing approach. The direct marketing and selling is now practised by many companies in very innovative ways. Take the case of Tupperware, Amway or even the Grameen Bank of Bangladesh, who make consumers the members, further, these members do the marketing for the organisation.

The different platforms available for promotion under different components are listed in Table 39.1. Each of these platforms has different characteristics and they have different criteria for determining their suitability. A discussion on these aspects is beyond the scope of this presentation.

TABLE 39.1 Different Platforms Available for Promotion

Advertising	Sales Promotion	Public Relations	Personal Selling	Direct Marketing
Print Ads	Contests, games, sweepstakes, lotteries	Press Kits	Sales presentations	Catalogues
Broadcast Ads	Premiums and gifts	Speeches	Sales meetings	Mailings
Packaging-outer	Sampling	Seminars	Incentive programmes	Telemarketing
Packaging inserts	Fairs and trade shows	Annual reports	Samples	Electronic shopping
Motion pictures	Exhibits	Charitable donations	Fairs and trade shows	TV shopping
Brochures and booklets	Demonstrations	Sponsorships		Fax mail
Posters and leaflets	Coupons	Publications		E-mail
Directories	Rebates	Community Relations		Voice mail
Reprints of ads	Low-interest financing	Lobbying		
Bill boards	Entertainment	Identity media		
Display signs	Trade-in-allowances	Company magazine		
Point-of-purchase displays	Continuity programmes	Events		
Audio-visual material	Tie-ins			
Symbols and logos				
Videotapes				

39.3.2 Promotion Mix Strategies
There are two basic promotion mix strategies - push strategy and pull strategy.
(a) Push strategy: In this, promotion efforts are directed at the channel members to induce them to purchase the products and sell them to the final consumer. This is done through personal selling and trade promotions.

(b) Pull strategy: In this, the promotion efforts are directed to the final consumer to induce them to buy the product. Consumers will then demand the product from the retailer, who, in turn, will demand from the wholesaler and the producers. Thus, the product experiences the "pull" of demand.
There may be some companies who use only the push strategy, while some others who use only the pull strategy. However, in most cases a combination of the two is generally used.
In case of banks, however, the pull strategy is the one which is more relevant as its services cannot generally be "pushed" down to the customers through the channel members except for the annual business targets for channel members. Banks are adopting the "push" strategy in a different way -credit cards being offered on telephone or upgraded cards even mailed to the consumer without being applied for, personal loans being offered without even an inquiry being made by the consumer are a variant of push strategy or the hard sell tactics. The retail loan products were pushed in the market by the banks and the customers were attracted by them, this way, creating the market using push strategy.
39.3.3 Factors Influencing the Promotion Mix
Three major factors affecting the choice of promotion mix are type of product, buyer readiness stage, and life-cycle stage of the product.
(a) Type of Product/Market
The promotion mix chosen by the firms depends to a large extent on the nature of product. Consumer goods producers lay greater emphasis on advertisements followed by sales promotion, personal selling and then public relations. In case of industrial goods, manufacturers personal selling gets the greatest emphasis followed by sales promotion, advertising and public relations. Banks, for garnering fixed deposits typically use advertisements and press statements whenever there is a change of interest rates for promotion. Personal selling of fixed deposits is more in the nature of cross selling to the savings account holders (especially those with large balances in their accounts or having higher transaction volume). However, in case of certificate of deposits or cash management services targeted at corporate customers, personal selling is more suitable.
(b) Buyers' Readiness Stage
The buyers pass through various stages before they finally decide to buy a product. Various stages of the buyers' readiness are shown in the Figure 39.2. Depending on the stage of the buyers' readiness, various promotion tools have different effect on them. In the early stages when the buyers are not aware of the product, the advertisement and public relations have a major role in creating awareness and knowledge. At a later stage, it is necessary to influence customer liking, preferences, and convictions. For this purpose, personal selling is more useful.

For promoting a new variety of fixed deposits, a bank may find a mix of advertisements and public relations supported by some personal selling by the front office staff suitable. However, for sale of technology products, the buyers' acceptability is yet in infancy (a very small percentage of pensioners use ATM) and these would need more emphasis on personal selling to the customers (individual or groups). Kellogg, when it launched the cereal breakfast products in India, realised that in India, it is first needed to sell the concept of "cereal breakfast" to sell the products.

(c) Product Life Cycle Stage

Product life cycle is an important factor which influences the promotion mix. This is so, because of the peculiar characteristics of the different stages of product life cycle requiring different approaches in promotion. Thus, in the introduction stage of a new product, there is a need to create a high level of awareness, for which advertising and public relations are suitable. Consumers need to be attracted for trying the new product, for which sales promotion would be useful. Further, for trade intermediaries, personal selling will be required. At the growth stage, while advertisement and public relations, will impact on the market considerably, sales promotion is not necessary as incentives would be less relevant. But, at the maturity stage, the position reverses and sales promotion gains significance to attract more buying decisions. Advertising, serves the purpose of a reminder at the decline stage, but public relations is irrelevant at this stage and sales persons do not need to devote much time to the product. Sales promotion can help in reducing the decline rate and thus prolonging this stage.

39.3.4 Promotion Mix Integration

Firms need to implement promotion programmes with various elements of promotion mix, in a manner, which reflects an integrated cohesive approach. Firms need to analyse the trends and identify areas in which promotions can help the most and develop promotional tactics based on the strengths and weaknesses of each communication. The contact points for the company and its brands need to be identified and it is necessary to ensure that communications at various points are consistent with the overall communications policy. The communications effort should be evolved according to the expectations of the customers in this regard. The communications across different media should carry unique primary messages and selling points. The themes, tones and quality across various media should be compatible.

Integrated promotion communications produce stronger message consistency and greater sales impact. It makes the firms think about the way the customer comes in contact and the way in which the firm communicates with the customer. It improves the ability to reach the right customers with right messages at the right time and the right place.

39.4 LET US SUM UP

Firms need to communicate with the consumers. Promotion mix, primarily serves this function, although product, distribution and price also communicate. Promotion encourages the customer to move through various stages of decision-making through persuasion, information, reminder and reinforcement. Promotion mix helps in building and maintaining contact with the customer at various levels and thus enhances the customer relationship. Promotion mix has five components namely, advertising, sales promotion, public relations, personal selling and direct marketing. Advertising is a paid and non-personal communication which is useful in creating or increasing knowledge and awareness. Public relations are also useful in creating or increasing awareness and in building good relations. Sales promotion is a campaign for attracting consumer attention and induces buying decisions through strong incentives. Personal selling and direct marketing are

personal communications with the customer and address his specific needs. They are useful in creating a great influence in the final stages of decision-making.

Promotion mix is determined by the type of market/product, the stage of the buyers' readiness and the life cycle stage of the product. Strategically, the promotion mix can have two approaches "push strategy" directed at the channel intermediaries and "pull strategy" directed at the consumers.

These components need blending to give an integrated marketing communications. Integrated marketing communications create a strong message consistency and great sales impact.

39.5 CHECK YOUR PROGRESS

1. (a) The tools for communications with the customer are

(i) Promotion mix (ii) Product and price (iii) (i) and (ii) (iv) (i) and other three elements of marketing mix

(b) Promotion seeks to influence the buyer in decision-making through

(i) Persuasion

(ii) Compulsion

(iii) Reminding

(iv) (i), (iii), information and reinforcement

(c) Promotion is an exercise of maintaining contact with the consumer at different levels so as to

(i) enhance customer relationship

(ii) lure the customer in to buying the products

(iii) prevent customer from being critical of the firm

(iv) none of the above

2. State whether the following statements are True or False.

(a) Promotion mix of a firm includes public relations.

(b) In integrated marketing communications, the elements of promotion mix are blended.

(c) Buyers' behaviour stage is not relevant for determining the promotion mix.

39.6 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a)-(iv), (b)-(iv), (c)-(i); 2. (a) True, (b) True, (c) False.

39.7 KEYWORDS

Promotion Mix, Advertising, Sales Promotion, Public Relations, Personal Selling, Direct Marketing, Integrated Marketing Communications, Promotion Mix Strategies - Particular Combinations of Elements of Promotion Mix with a Common Objective, Push Strategy, Pull Strategy, Buyers' Readiness Stages -The Stages Consumers Normally Pass through on their Way to Purchase, Including Awareness, Knowledge, Liking, Preference, Conviction and Purchase.

ROLE OF DIRECT SELLING AGENT/DIRECT MARKETING AGENT IN A BANK

STRUCTURE

40.0 OBJECTIVES

After going through the unit, we will be able to:

- understand the concepts of direct selling and direct marketing.
- appreciate the role of direct selling/direct marketing agent, with reference to the bank.
- comprehend the delivery channels in a bank.
- evaluate the utilities and benefits of direct marketing/selling.

40.1 INTRODUCTION

Bulk of the goods and services are sold through stores. Non-store retailing falls into four major categories: direct selling, direct marketing (which includes telemarketing and internet selling), automatic vending and buying services. The non-store jobs have slowly diversified to the service sector, like banking and insurance companies.

40.2 DIRECT SELLING (PS)

It is also called as multi-level selling or network marketing. In this, the company sells door-to-door or at home sales parties. A salesperson goes to the home of a host who has invited friends. The salesperson demonstrates the products and takes orders. The marketing sales system consists of recruiting independent business people who act as distributors. The distributor's compensation includes a percentage of sales of those that the distributor recruits as well as earnings on direct sales to customers. These direct selling firms, now finding fewer consumers at home, are developing multi-distribution strategies.

Examples: Amway, Tupperware, etc.

40.3 DIRECT MARKETING (DM)

It is an interactive marketing system that uses one or more media to affect a measurable response or transaction at any location. Direct marketing, especially electronic marketing, is showing explosive growth. Direct marketing has roots in direct-mail and catalogue marketing which includes telemarketing, television direct-response marketing (home shopping network) and electronic shopping (Amazon.com).

Direct marketing is the use of the consumer-direct (CD) channels to reach and deliver goods and services to customers without using marketing middlemen. These channels include direct mail, catalogue, telemarketing, interactive TV, kiosks, web sites and mobile devices. Direct marketing is one of the fastest growing avenues for serving customers. Today, many direct marketers use direct marketing to build a long-term relationship with the customer (customer relationship marketing). They send birthday cards, information material or small premiums to select customers.

40.4 RELEVANCE OF DS/DM TO BANKS

Gone are the days when the people working in a bank went out for a mass deposit mobilisation campaign giving mere conventional loans, etc. There has been a paradigm shift in the way the banks have been functioning over the past decade. From being branch centric, they have become totally technology centric. This has helped the sector from being highly supply driven to being customer-oriented and totally demand driven by offering highly focused customer services and products. Channels are not only direct but are available online or at work site. Banks have transformed from a totally computed environment to core banking system linking all the bank branches as a single branch, data being maintained at a nodal point termed as "Centralised Data Centre" (CDC).

Banks are also forming strategic alliance with other companies like insurance companies and other banks for diversification in the market. Multifarious deposit products are available to the customer with various tags of his choice for convertibility, transfer, etc. Retail loan products and other loan products swelling day in and day out. Banks, even though they belong to the service sector, build strong customer relationships through frequent award programmes and club programmes. Banks mine their database to identify the prospects who would have the interest in an offer. They use their interaction as an opportunity to up-sell, cross-sell and deepen the relationship. The extraordinary growth of direct marketing is the result of many factors. Higher costs of driving, traffic congestion, parking headaches, lack of time, shortage of retail sales help and lines at checkout counters all encourage at-home shopping. The growth of Internet, e-mail, mobile phones has made product selection much simpler.

40.5 BANKER AS A PSA/DMA AND HIS JOB ROLE

In a bank branch, the "Direct Selling Agent/Direct Marketing Agent" (DS A/DMA) is the branch manager, officer/managers, marketing managers, the front line people and the substaff who offer various services. Banking offers the various non-conventional services to the customer through its various delivery channels.

The job of the DMA/DSA is to collect the information about the customer, with all details and create a database, create awareness among the customers, educate them about the user friendliness of the system, convince them about the security aspects as well, generate reports to accommodate the needs of the customer and management, improvise the system to cater to the needs of the customer and watch out for optimum utilisation of the available resources to reach effective customer service. The challenging technological revolution also calls for reorientation and re training to combat the growing demands.

40.6 CHANNELS OF DELIVERY IN A BANK

The channels through which a bank offers its services are:

1. ATM Counters: They serve as worksite channels for customers for withdrawal of cash from their account maintained with any bank, take a printout of the same, know the balance in their account,
etc. Now some ATMs are enabled to do transfer transactions also.
2. Net Banking: It facilitates customer to access his account and do transactions on line from his own place where he has a computer with a net facility.
3. Phone Banking: Customers are given a T pin which enables them to access their account and give instructions for carrying out the transactions.
4. Mobile Banking: Customers are given an M pin which helps them to do transactions like instructions to issue cheque book, know the balance, receive SMS alerts, etc.
5. Real time Gross Settlement System/SWIFT: Enables customers to transfer funds to another account within the shortest time.
6. Single Window System: Customers can reach a bank branch counter to have all his needs satisfied in the same counter viz., receipt/payment of cash, transfer of funds, etc.
7. Online Trading Accounts: This enables customers to view their account and buy/sell securities as per their choice.
8. Cash Management Scheme/CMS: This enables customers to realise the outstation cheques
immediately or within 1/2/3/4 days as per their wish.
9. Linking Banking and Insurance Related Products: Customers not only transact with bank products but also take the relevant insurance policies to take care of their investment and interest requirements.

10. Convertible Accounts/SWAP Facilities: Customers can instruct the banker to transfer the surplus funds in their savings/current account to deposit account and vice versa, if funds are required for immediate use.
11. Credit Cards: These enable customers to make any purchase at any point of sales using bank funds and make payment after 45 or 50 days.
12. Debit Cards: These enable customer to debit his deposit account and make payment whenever purchases are made.
13. Kiosks: These are small buildings or structures that might house a selling or information unit. The term describes free standing carts or computer-linked vending machines and "customer order placing machines" and these form part of direct selling tool.

Day in and day out the cluster products are fast increasing with optional diversities making many new products available to the customer. When a customer tenders an application form for opening a normal savings bank account, the various options/facilities available with it are taken care of. A customer is able to access to his account through the various channels as mentioned above and give instructions to the bank for issue of chequebook, transfer funds to another account with the same branch or anywhere else or to his distribution centres that maintain accounts with various branches, use the ATM counters for cash withdrawal, take a print out of his statement of accounts, do a shopping using his credit/debit cards (also called plastic money), use the kiosks at his will and wish to get to know the details, down load deposit and loan application forms, know about the various facilities and schemes available in the bank. A customer is also free to transact his account and transfer funds to his supplier's account maintained with another bank that is a member of the gateway.

40.7 BENEFITS OF DIRECT MARKETING

1. It saves time and introduces customer to the various selection of products.
2. It is convenient, easy and hassle free for the customer.
3. Various products are available at customer's disposition.
4. It opens various delivery channels to the customer.
5. Banks can offer a real time, customised and personalised marketing.
6. It reduces the operational cost.
7. It saves man hours and manpower in banks.
8. It enables the banker to cater to the needs of individuals, both the commoner and the-techno savvy.
9. It enables the banker to use his available time for doing marketing jobs.
10. It enables deployment of available manpower for other jobs.
11. It relieves the banker from the mundane jobs of book adjustment, reconciliation, etc.

Code of Conduct for Direct Selling Agents/ Direct Marketing Agents

1. Tele-calling a Prospect (a prospective customer): A prospect is to be contacted for sourcing a bank product or bank related product only under the following circumstances:

- When prospect has expressed a desire to acquire a product, through the bank's internet site/ call centre/branch or through the relationship manager at the bank or has been referred to by another prospect/customer or is an existing customer of the bank who has given consent for accepting calls on other products of the bank.
- When the prospect's name/telephone no./address is available and has been taken from one of the lists/directories/databases approved by the DSA manager/team leader, after taking his/her consent.

Telephonic contact must normally be limited between 0930 Hrs and 1900 Hrs. However, it may be ensured that a prospect is contacted only when the call is not expected to inconvenience him/her. Calls earlier or later than the prescribed time period may be placed only under the following conditions:

When the prospect has expressly authorised DSA/DMA to do so, either in writing or orally.

DSA should respect a prospect's privacy. The prospect's interest may normally be discussed only with the prospect and any other individual/ family member such as prospect's accountant/secretary/ spouse, authorized by the prospect.

2. Leaving messages and contacting persons other than the prospect: Calls must first be placed to the prospect. In the event the prospect is not available, a message may be left for him/her. The aim of the message should be to get the prospect to return the call or to check for a convenient time to call again. Ordinarily, such messages may be restricted to:

- Please leave a message that XXXXX (Name of officer) representing XXXBank called and requested to call back at ZZZZZZ (phone number).

As a general rule, the message must indicate:

- That the purpose of the call is regarding selling or distributing a bank product of XXXBank.

3. No misleading statements/misrepresentations permitted: DSAIDMA should not:

- Mislead the prospect on any service/product offered;
- Mislead the prospect about their business or organisation's name, or falsely represent themselves.
- Make any false/unauthorised commitment on behalf of XXXbank for any facility/service.

4. Telemarketing Etiquettes:
PRE-CALL
No calls prior to 0930 Hrs or post 1900 Hrs unless specifically requested.
- No serial dialling.
- No calling on lists, unless list is cleared by team leader.
DURING CALL
- Identify yourself, your company and your principal.
- Request permission to proceed.
- If denied permission, apologise and politely disconnect.
- State reason for your call.
- Always offer to call back on landline, if call is made to a cell number.
- Never interrupt or argue.
- To the extent possible, talk in the language which is most comfortable to the prospect.
- Keep the conversation limited to business matters.

- Check for understanding of "Most Important Terms and Conditions" by the customer if he
plans to buy the product.
- Reconfirm next call or next visit details.
- Provide your telephone no, your supervisor's name or your bank officer contact details if
asked for by the customer.
- Thank the customer for his/her time.
POST-CALL
- Customers, who have expressed their lack of interest for the offering should not be called for
the next three months with the same offer.
- Provide feedback to the bank on customers who have expressed their desire to be flagged
"Do Not Disturb."
- Never call or entertain calls from customers regarding products already sold. Advise them to
contact the "Customer Service Staff of the bank.

5. Gifts or bribes: DSA/DMA must not accept gifts from prospects or bribes of any kind. Any DSA/ DMA offered a bribe or payment of any kind by a customer must report the offer to his/her management.
6. Precautions to be taken on visits/contacts:
DSA/DMA should:

- Respect personal space - maintain adequate distance from the prospect.
- Not enter the prospect's residence/office against his/her wishes.
- Not visit in large numbers - i.e. not more than one DMA and one supervisor, if required.
- Respect the prospect's privacy.
- If the prospect is not present and only family members/office persons are present at the time of the visit, he/she should end the visit with a request for the prospect to call back.
- Provide his/her telephone number, supervisor's name or the concerned bank officer's contact details, if asked for by the customer.
- Limit discussions with the prospect to the business - Maintain a professional distance.
7. Other Important Aspects - Appearance and Dress Code: DSA/DMAs must be appropriately dressed -

For men this means
- Well ironed trousers;
- Well ironed shirt, shirt sleeves preferably buttoned down.

For women this means
- Well ironed formal attire (Sari, Suit, etc.);
- Well groomed appearance. '

Jeans and/or T Shirt, open sandals are not considered appropriate. Handling of Letters and Other Communication

Any communication sent to the prospect should be only in the mode and format approved by the Bank.

40.8 LET US SUM UP

We have dealt with the concepts of direct selling and direct marketing and its relevance to the banking industry in the current scenario. Banks have to, necessarily, diverge their functions owing to changing and challenging customer needs, competition and international market conditions. Likewise, the role of the banker has drastically changed, from desk functioning to making available the various delivery channels through various technology coupled functions. Though the task of creating and retaining customer relationship management through a robust database is tough, it offers delightful benefits to the customer and widens the market scope for the banker.

40.9 CHECK YOUR PROGRESS

I. Fill in the Blanks:

1.
2.
3. 4.
5.

and are the channels of non-store retailing.

There has been a paradigm shift in the functioning of industry over the past decade from branch centric to customer centric.

to combat the

and.

The challenging technological revolution calls for

growing demands.

Banks are able to maintain an effective customer relationship management as a tool for direct selling/direct marketing by creating and maintaining a full-fledged

Direct selling, is also called as - or __.

II. Say if True or False:

1. Service industries like banks and insurance companies have joined hands to market their products to the customers directly.
2. The term "kiosks" refers to vending machines where a customer can draw cash any time.
3. Direct selling and direct marketing have reduced the opportunities of expansion in bank business.
4. All banks in India are using all the delivery channels as a part of the direct selling/marketing services.
5. Core banking is an important technique for enabling a customer to use the various e-banking channels as a direct selling/marketing tool.

40.10 ANSWERS TO 'CHECK YOUR PROGRESS'

I. 1. Direct selling, Direct marketing; 2. Banking; 3. multi-level selling or network-marketing;

4. re-orientation and retraining; 5. database. II. 1. True, 2. False, 3. False, 4. False, 5. True.

40.11 KEYWORDS

Direct Selling, Direct Marketing, Multi-level Selling.

UNIT
41MARKETING INFORMATION SYSTEMS
A Longitudinal Analysis

STRUCTURE

41.0 OBJECTIVES

After a study of the unit, we shall be able to:

- understand the concepts of Marketing Information System (MKIS)
- appreciate the link between computer usage and marketing
- evaluate the effective use of models as a tool of decision support systems
- rationalise the performance of MKIS

41.1 INTRODUCTION

Any organisation is studded with different Ss, Management Information System (MIS), Computer Information System (CIS), Marketing Information System (MKIS), all of which aid as a proactive tool for Decision Support System (DSS). In order to carry out marketing function effectively, firms would need information and data in respect of various aspects impacting the market of the product or service. Today, the problem is not of paucity of information but oversupply of information, but this information is not of the type that is required and not of assured accuracy and it becomes all the more difficult owing to the ongoing activity and the dynamic nature of the market environment.

The marketing function of a business entity includes many activities. It is "the process of planning and executing the conception, pricing, promotion and distribution of ideas, goods and services, to create exchanges that satisfy individual and organisational objectives and systematic management of the process of collecting, evaluating and disseminating market information."

According to Samuel Smith and others, "A marketing information system is an interacting, continuing future-oriented structure of people, equipment and procedures designed to generate and process an information flow, in order to aid managerial decision-making in a company's marketing programme. In a nutshell, its main purpose is to satisfy customers, wants and needs, at a profit". A successful organisation must integrate its functional elements into a smoothly operating unit. In marketing, this integration is best achieved through the satisfaction of customer's objectives. Firms that are unable to outperform their competitors in satisfying the customers are destined to fail. To be able to stay in business, a company must gather and analyse pertinent information to plan for its marketing actions.

Marketing information system (MKIS) has been the nerve centre of a marketing organisation. To measure its strengths and weaknesses, one may use its overall status in industries as a yardstick to identify the progress of MKISs. Apparently, MKISs today are more sophisticated than before and its usage has increased. However, many companies are not utilising the latest information technologies and many marketing managers are not satisfied with their MKISs. The study further discusses possible reasons for the progress and recommends several actions through which the companies may shape the future of their MKISs.

41.2 FUNCTIONS OF MKIS

Marketing information system is a tool for dealing with data pertaining to marketing management. Hence, its functions are related to the process of database management. The principal functions of MKIS are briefly discussed below:

(a) Collecting and assembling data: Information needs to be collected on a continuous basis from numerous sources, both internal and external. For the information from internal sources, various reports or statements are designed (like sales report, accounts report), which periodically provide information covering the relevant operational aspects. For the information from external sources, the major part of information flow is from the secondary sources, including newspapers, trade

journals, magazines, reports of market research agencies. Besides, some information is also procured from the primary sources like, consumers, suppliers, dealers and retailers.

(b) Processing of data: Information collected from various sources is required to be classified, tabulated,and summarised for facilitating study and critical analysis.

(c) Analysing the data: The collected information is evaluated to find out its accuracy and reliability. Further the information is processed using various statistical and operations research tools so that conclusions are drawn for decision-making.

(d) Storage of data: The collected and processed data needs to be stored in a manner that ensures its preservation, and its ready availability for reference as and when required.

(e) Dissemination of information: The information has to reach the decision-makers for solving marketing problems and take management decisions.

41.3 COMPONENTS OF MKIS

MKIS consists of four subsystems, which facilitate the entire system. These are:

(a) Internal records system (b) Market intelligence system

(c) Marketing research system (d) Marketing management and science system

Let us briefly discuss the first three mentioned subsystems. The functions of these subsystems are carried out in every organisation in one way or other.

(a) Internal Marketing Information

The information available from the internal sources is covered by this component. It typically includes data on sales turnover, cost, cash flows, accounts receivable, etc. The reports of salesmen on their sales calls contain valuable information relating to company's sales, consumer behaviour, likes, dislikes and competitors. Certain types of internal data can be available almost on real-time basis. For example, Wal-Mart the US retail giant tracks the stock levels on a daily basis and the replenishment orders are sent to its vendors by the computers. A fully networked bank will know the amounts of aggregate deposits and advances at the end of the day. Firms need to maintain several databases, data from which can be combined for'specific purposes.

(b) Marketing Intelligence System

This component covers information from external sources regarding happenings. The information about developments in marketing environment and changing consumption patterns of the market is provided by these sources. For this, the major source is the published information available through the newspapers, magazines, television, trade journals, etc. Annual reports of trade associations, chambers of commerce, the leading firms in the industry or trade, etc., include information on market trends. Various research organisations like Central Statistical Organisation, National Council of Applied Economics and Research, Thompson consumer Index of Market, etc., are other important sources. Various intermediaries and players in the market, like selling agents, brokers, dealers and suppliers have valuable information relating to market and product trend. There are professional market research agencies like ORG, MARG, IMRB, etc., who can render services of collecting and providing specific information.

(c) Marketing Research System

Marketing research system concerns with obtaining information pertaining to specific marketing problems. It is useful for solving present marketing problems related to consumer behaviour, consumer likes and wants, channels of distribution, competition, product development, packaging, etc. Normally, data for market research is collected specifically for the exercise at hand and techniques like field surveys, consumer interview, dealer survey, etc., are employed for this purpose. Based on analysis of

444

A good MKIS should satisfy certain basic requirements which are shown below:

- Unified and centralised system
- Support system to marketing decision-makers
- Matching with the level of progress of the organisation
- Cost-effective in maintaining
- Selective in information processing
- Provide information regularly and quickly

(d) Marketing Management and Science System

This combines the effect of the above components, use of the computerised data to the best advantage in the various sectors, in meeting the needs of MKIS, viz., complex marketing activity, knowledge/ information explosion, and bridges the communication gap, by taking a prompt decision, making use of the competitive advantage.

41.4 THE MKIS MODEL

In the 1960s, an MKIS was merely an outgrowth of marketing research. As competition became increasingly intense, the gathering and management of marketing information became important. The data needed to make informed decisions exceeded the physical processing capabilities of most firms. More and more businesses began to establish MKISs. Typically, a marketing manager uses them to learn about the needs of the marketplace for new or improved products and services. The MKIS makes it possible for a firm to react rapidly to the customer needs. Once the product or service has been provided, the marketing manager may use the MKIS to determine how well the needs are being satisfied. The MKIS provides managers with marketplace information and this may be used to modify, improve, or delete products and services. If a company does not have an MKIS, its efficiency and effectiveness are likely to be severely degraded, weakening its competitive edge. Therefore, to be able to compete

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Marketing Management Activities
Decisions

FIGURE 41.1 Framework of a Marketing Information System (Source: Information & Management, 28(1), 1995, 13-31)

445

today, business organisations must have an MKIS. To gain a perspective of MKISs, researchers have conducted survey studies in 1000 US companies.

In retrospect, the very first descriptive model of MKIS proposed almost thirty years ago may be attributed to Philip Kotler in the industry. In fact, an MKIS is like a decision support system (DSS): it is generally unique to the company it serves.

For the purpose of this study, the MKIS model of McLeod and Rogers is shown in Figure 41.1.

In this, there are two general subsystems which are fairly consistent with the others: they are the input and output subsystems. The input subsystems are internal accounting, marketing intelligence, and marketing research. They gather internal and environmental data for the databases. The output subsystems utilise the databases to produce marketing management information. Marketing managers will not only receive routine reports but enquires are also made interactively to produce ad hoc reports. Through this information, marketing managers can make their decisions on pricing, products, advertising/promotion, distribution and packaging, under the constraints imposed by economics, the government, competitors and the customer needs. This process should be integrated into organisational strategies and decision-making processes to support all levels of marketing functions - planning, organising, staffing, directing and controlling.

41.5 OBSERVATIONS

Any business should process some marketing-related information (e.g. customer addresses, sales orders, merchandise returns, etc.). As McLeod and Rogers suggested, the perceived MKIS support might be of such a low level that it did not seem to exist, which resulted in losing its identity. Alternatively, managers might rely on external MKIS services for marketing information. For the purpose of this study, the companies having no MKISs are excluded from further analyses.

41.6 USAGE OF COMPUTERS IN MKIS

The majority of the companies that had MKISs also had company-wide computer information systems (CISs). Of the companies with CISs, two-thirds had formal written company-wide CIS plans, while for some, their CIS plans were influenced by marketing strategies. In addition, most had formal written marketing plans.

Hardware Usage: MKISs are more useful, when computer assisted; for the breakdown. Interestingly enough, little use is made of supercomputers.

Software Usage: There were three main categories of corporate-wide software (i.e. decision modelling and spreadsheets; conventional programming and database management). Apparently, expert systems and artificial intelligence languages are not meeting their assured demand.

Frequency of Computer Usage: The respondents are able to access personal computers (PCs) or terminals in their job functions. Many use PCs or terminals on a daily basis.

Purposes of Computer Usage: Earlier, the major use of computers was to retrieve data. When asked what they first considered useful in their marketing information systems, statistics reveal that 31per cent of the results were "reports," with 23 per cent "different managers' information needs," and 18 per cent "data/file retrieval". Obviously, marketing managers focus on their means (the information) and not their ends (the needs).

Communications of Information: Communications between branches and their main office are of vital importance to the success of a marketing organisation. Traditionally, these communications were through the phone (or voice mail). Other communication channels included electronic mail (68 per

446

cent) and electronic bulletin boards (26 per cent).' The use of computer conferences (9 per cent) and video conferences (10 per cent) was limited. Surprising? .wwafiWAim. uuTisca any nypertext or hypermedia technology for their inter-branch conferences. Moreover, many of these firms routinely routed marketing intelligence information to those managers with a need to know.

Sources of Information: Internal accounting was regarded as the most important source of MKIS information. This is a good sign for customers, since marketing research is, primarily, designed to identify market demands and preferences. This seems to confirm the reviving interest of customer-driven programmes.

Information Content: The environmental data maintained in the MIKS shows that most (93 per cent) customer data were computerised but lesser of national economy was computerised. With regard to pre-processed information, such as sales forecasts, distribution trends, market share, inventory statistics, etc., companies can make them available to managers on a real-time basis. Companies can have the economic-trend estimates included in their marketing forecasts. Many firms use corporate annual reports, sales call reports, purchase reports and clipping services as the source of their competitor information. Nonetheless, most of these were not computerised.

41.7 SUPPORTS FOR MARKETING MANAGEMENT

Initially, MKISs were mostly supporting middle-level management. However, more companies thought that low-level management were receiving more MKIS support than the top-level. The distribution has changed significantly.

Regarding management functions, planning and controlling were the two areas receiving the most support from the MKIS - sequence: planning, controlling, directing, organising and staffing. On the positive side, MKIS had attracted more marketing managers to use the system for planning, but on the negative side, marketing managers may have focused too much on planning and too little on implementation and controls.

41.8 SUPPORT FOR MARKETING MIX DECISIONS

A marketing program typically involves decisions on the marketing mix ingredients: product, price, place and promotion. Earlier, product-related decisions were receiving the most MKIS support. Later, support for price-related decisions took a small lead ahead of that for product related ones. Also, product and promotion related decisions have significantly changed. MKIS supports marketing mix decisions on a more balanced basis.

41.9 USE OF DECISION MODELS

There are several decision models available to a marketing manager. Most of them were developed to aid in price and product decisions. Furthermore, the use of models had shown various levels of increase in less-structured tasks such as product deletion, advertising media selection, salesperson assignment and delivery routing. One particular task, selection of advertising media had more than doubled in its use. On the contrary, the well-structured tasks such as computing economic order quantities, determining reorder points and approving customer credit had shown significant decreases in model use. The decision models, most likely to be computer-assisted, are for formulating pricing strategy, computing operating budget, evaluating new products and deleting products.

41.10 PERFORMANCE OF MKIS

MKIS is a group of subsystems - some gather data and others process it. The data gathering subsystems

are; marketing research, marketing intelligence, an internal accounting. The processing subsystems produce information about the product, price, distribution and promotion.

It can also be stated as a group of subsystems that gather information from the environment and use it to help the manager answer certain basic questions. MKIS also serves as a data bank that stores data from the environment and makes that data available to a set of computer programs. Only few managers thought that the MKIS was "a group of subsystems - each representing an area of marketing activity -product, price, distribution channels and promotion." The subsystems help the manager formulate and execute marketing programmes.

41.11 RECOMMENDATIONS

The specific patterns of MKIS usage includes:

1. Computers are needed by marketing managers, for retrieving data and then storing and processing
it.
2. Internal accounting continues to be the most important source of MKIS information while the use
of marketing intelligence and marketing research, as information sources, are more balanced.
3. Most companies collect data about their customers. Collection of data about competitors and
prospective customers is also popular, but this is less computerised.
4. The major users of MKIS are the middle-level managers.
5. Planning and controlling are still the management functions using most MKIS support.
6. Price and product related decisions consume most of the MKIS resources. However, support for
marketing mix ingredients is likely to become more balanced.
7. Decision models are used mostly for product and price decisions. Computer-assisted decision models
reflect this.
8. Mini and microcomputers are, now, used as much as mainframe computers.
9. The computer software, being used in an MKIS, includes modelling/spreadsheets, conventional/
third-generation programming languages and database management systems. Statistical analysis
software, logic programming languages and expert system shells are not used very much.

41.12 ADVANTAGES OF MKIS

MKIS gives several advantages in managing information for marketing function. Some of these are discussed:

- The MKIS framework provides a set of procedures and methods for regular, planned, purpose-oriented and systematic collection of data, its analysis, storage and retrieval.
- It helps in improving the data capture process, checks for reliability, consistency and quality of data.
- The operation of collecting, processing and transmitting data becomes smooth and the information flow to the decision-makers takes place in a ready for decision form.
- Provides tailor made information for specific needs.
- It facilitates repetitive use of the same information for different purposes.
- It also helps in sorting out conflicting information, which otherwise would lead to confusion and misdirect the decisions.
- It results in integration of information obtained from various sources regarding different aspects. It also helps in providing instant access to company wide information and cross-sharing of data enabling better service to the customer.
- It creates customer insights from routine transactional data. This helps in developing and delivering customer-oriented offers and building of better customer relations.

- It serves as a total knowledge-management mechanism. It supports capture of knowledge, makes the knowledge flow where it is required and ensures its availability in readily usable form.

Although many of the surveyed companies have sophisticated CISs and MKISs, most of them are limited in nature. There seems to be a deficiency in computerising information about governments, economy, competitors and prospects across companies. Such information cannot be used effectively if it is not computerised. Nor can it be communicated between branches and the main office efficiently. In today's global marketplace, the success of a company does not depend on how much the company uses latest technologies but on how well it can gather, manage and utilise pertinent information and integrate it into the marketing managers' decision-making processes. To achieve a successful MKIS, implementing new information technologies is not enough. It is necessary to focus more on the information needs of marketing managers to balance the MKIS support for all management functions and to integrate business plans with CIS plans in order to exploit the available information resources. This will probably create a competitive advantage for the company and, in turn, increase the level of satisfaction perceived by the managers.

41.13 LET US SUM UP

The marketing functions require, on a continuous basis, relevant information about various aspects, including the marketing environment, the consumers, the competitors, various intermediaries and the firm's market position. For collecting, collating, evaluating, analysing, storing and disseminating the required information, a marketing information system is required, which is well-coordinated, computer-based master plan for managing the flow of information analysed, using the analytical tools.

The need for MKIS has become more acute due to the increased complexity of marketing activity, information explosion need to bridge the communication gap between the producer and the consumer as also several intermediaries and the importance of prompt decisions to ensure an effective marketing endeavour. MIS encompasses the information on market forces, the information on the firm's market behaviour and the internal information of the firm. To be effective, MIS comprises four component subsystems namely internal records system, marketing intelligence, marketing research and marketing management and science system.

A good MIS is a unified and centralised system, which is selective in information processing and provides information regularly and quickly. It helps in systematising the information processing and integrating the information obtained from various sources, validating its accuracy and consistency. It provides tailor-made information to the decision-makers to meet their specific requirements.

41.14 CHECK YOUR PROGRESS

I. Choose the correct alterative for the following statements.

(a) Firms need to collect and analyse the data pertaining to marketing for _

(i) projecting their organisation as knowledge-oriented (ii) enabling the top management to keep control over the sales force (iii) taking the required steps for effective marketing of their products (iv) for utilising their information technology capabilities

(b) An effective MIS fulfils these:

(i) Analysis of quantitative information (ii) Coordination among functional and specialists executives (iii) Limited to the current scenario (iv) Both (i) and (ii) above

(c) The components of Marketing Information System do not include

(i) Marketing intelligence system (ii) Internal records system

(iii) Information technology system (iv) None of above

(d) The ultimate users of the Marketing Information System are

(i) the customers of the firm

(ii) the competitors of the firm (iii) the decision-makers in the firm (iv) both (i) and (ii) above

(e) Which of the following situation falls under the purview of Marketing Research System?

(i) Riddhi Vriddhi Bank wants to send Diwali greeting cards to all its fixed deposit account holders with deposits of Rs. 10,000 or more.

(ii) Money Honey Bank wants to have a profile of Kalahandi District to decide about opening a new branch there.
(iii) Get Rich Fast Bank wants a comparative business statistics with other ten peer level banks in the country.
(iv) Baroda branch of Prosperous Customer Bank is twelve-year-old and it recorded a compounded annual growth rate of 20 per cent in deposits during the first ten years, which has been better than the industry average. However, during the last two years the branch has witnessed a significant decline in its deposits. Managing director of the bank desires to know the causes for this reversal in the business trend and suggestions for ameliorating the situation.
(f) The purpose of computer usage in MKIS is primarily to:
(i) Generate reports (ii) To meet specific user needs
(iii) Retrieval of data (iv) For day to day operations
II. State whether the following statements are True or False.
(a) Marketing information system is not concerned with the evaluation of information collected
from either primary sources or secondary sources.
(b) The marketing information requirements of a firm are very limited and for one-time need.
(c) Marketing information system collects and analyses the information as per the system initially
prescribed and is not concerned with the type of information required by management.
(d) Typically, most of the information for the marketing information system is collected from
secondary sources.
(e) Consumer is of no relevance for the marketing information system, since almost entire
information is collected from independent sources.
III. Match the following items between column "A" and column "B"
A B
(a) Marketing Research System
(b) Marketing Intelligence System
(c) Marketing Information System
(d) Customer database
(e) Data analysis
(i) Major source - published information (ii) Database management (iii) Business information about
customers
(iv) Data collected specifically (v) Geographic, demographic, psychographic, and behavioural data on customers and prospects (vi) Conducting research for new theories in marketing (vii) Adopting detective or intelligence gathering
technique on competitors (viii) Operations research tools

IV. State if True or False:
1. Super computers are used in MKIS.
2. Inter branch communication makes use of hypertext/hypermedia technologies.
3. MKIS deals with integration of organisation strategies and decision-making process.
41.15 ANSWERS TO CHECK YOUR PROGRESS
I. (a)-(iii), (b)-(iv), (c)-(iii), (d)-(iii), (e)-(iv), (f)-(i).
II. (a) False, (b) False, (c) False, (d) True, (e) False.
III. (a)-(iv), (b)-(ii), (c)-(i), (d)-(v), e-(viii).

IV. 1. False, 2. False, 3. True.

41.16 KEYWORDS

Marketing Information Systems, Marketing Functions, Marketing Activities, Information Explosion, Marketing Management, Computer Usage, Decision Support, Information Technologies, Competitive Advantage.

ABBREVIATIONS

ADR - American Depository Receipts
ALCO - Asset Liability Committee
ALM — Asset Liability Management
AMC - Asset Management Company
ATM - Automatic Teller Machine
ATS - Automatic Transfer Service
BCBS - Basel Committee for Bank Supervision
BIS - Bank for International Settlements
BPO - Business Processes Outsourcing
BRA - Banking Regulation Act
CAMELS - Capital Adequacy, Asset Quality, Management, Earnings, Liquidity & Systems
CAR - Capital Adequacy Ratio
CBN - Core Banking Network
CCIL - Clearing Corporation of India Limited
CCO - Chief Credit Officer
CD - Certificate of Deposit
CEO - Chief Executive Officer
CFO - Chief Finance Officer
CHIPS - Clearinghouse Interbank Payments System
CIF - Cost, Insurance, Freight
CMS - Cash Management Services
CRD - Cash Ratio Deposit
CRO - Chief Risk Officer
CRR - Cash Reserve Ratio
DA - Deliverable against Acceptance
DPG - Deferred Payment Guarantee
DSA - Direct Selling Agent
DSCR - Debt Service Coverage Ratio
ECB - External Commercial Borrowing
EFT - Electronic Funds Transfer
EMI - Equated Monthly Instalments
EU - European Union
FIU-IND - Financial Intelligence Unit - India
FATF - Financial Action Task Force
FDIC - Federal Deposit Insurance Corporation

FII - Foreign Institutional Investor
FIs - Financial Institutions
FOB - Free-on-Board
GAAP - Generally Accepted Accounting Principles

GDR - Global Depository Receipts
HBO - Head of Branch Operations
HRD - Human Resources Development
HSBC - The Hongkong and Shanghai Banking Corporation Ltd.
HUF - Hindu Undivided Family
IA - Internal Audit
IBA - Indian Banks' Association
ICAI - Institute of Chartered Accountants of India
IDBI - Industrial Development Bank of India
IFC - International Finance Corporation
IOSCO - International Organisation of Securities Commission
IPO - Initial Public Offer
IRA - Individual Retirement Accounts
IRB - Internal Rating Based
IRDA - Insurance Regulatory and Development Authority
IRS - Interest Rate Swaps
KYC - Know Your Customer
LC - Letter of Credit
LGD - Loss Given Default
LIBOR - London Interbank Offered Rate
ME - Merchant Establishments
MICR - Magnetic Ink Character Recognition
MIS - Management Information System
MMD - Money Market Deposits
MMDAs - Money Market Deposit Accounts
MODS - Multi-Option Deposit Scheme
MSME - Micro, Small and Medium Enterprise
NABARD - National Bank for Agriculture and Rural Development
NACHA - National Automated Clearing House Association
NBFCs - Non-Banking Financial Companies
NDS - Negotiated Dealing System
NDTL - Net Demand and Time Liabilities
NGO - Non-Governmental Organisation
NIA - Negotiable Instruments Act
NOW - Negotiable Order of Withdrawal

NPAs - Non Performing Assets
OCT - Operation Control Terminal
OECD - Organisation for Economic Co-operation and Development
OFAC - Office for Foreign Assets Control
OMO - Open Market Operations
OTC - Over-The-Counter
PO - Primary Dealer
PIN - Personal Identification Number
POS - Point-of-Sales
QIBs - Qualified Institutional Borrowers
RBI - Reserve Bank of India
RCC - Risk Control and Compliance
REPO - Repurchase Agreement
RMC - Risk Management Committee
RMG - Risk Management Group
RRB - Regional Rural Bank
RTGS - Real Time Gross Settlement
SEBI - Securities and Exchange Board of India

SEBPs - Simplified Employee Benefit Plans
SLR - Statutory Liquidity Ratio
SPNS - Shared Payment Network Systems
STP - Straight Through Processing
SWIFT - The Society of Worldwide Inter-bank Financial Telecommunication
TAD - Terminal Access Device
T-Bills - Treasury Bills
TR - Treasurer
VaR - Value at Risk

GLOSSARY Banking Terms

4 C's of credit: The four key elements a borrower should have to obtain credit: character (integrity), capacity (sufficient cash flow to service the obligation), capital (net worth or owned funds), and collateral (assets to secure the debt).

acceleration clause: A provision in a loan agreement which enables a lender to recall the entire amount of loan in case there is a default in even a single instalment payment by the borrower.

acceptance: The contractual agreement which comes into force when the drawee of an instrument writes "accepted" on the document and specifies a payment date. The drawee, thereby known as the acceptor, is responsible for making the payment at maturity.

account: A record of financial transactions in the books of accounts for an asset or individual, such as at a bank. For example, a savings account would show all deposits and withdrawals of money by the account holder over a period.

accounts receivable: Money which is owed to a company by a customer for products and services provided on credit. This is treated as a current asset in the company's balance sheet.

accrued expense: Is an expense that is incurred, but not yet paid for, during a given accounting period. An example of this is wages due to workers, but not paid fully or partly due to various reasons such as liquidity crunch or so.

accrued interest: Interest that is due on a bond or other fixed income security since the last interest payment was made. This is an example of accrued income.

accumulated depreciation: Is the depreciation of a particular asset up to the present time. That is, the sum total of yearly depreciation on an asset, which is carried to the balance sheet as liability against the asset in question.

administrator: An individual appointed by a probate court to handle the estate of a person who died intestate. They have the same duties as an executor.

affidavit: A statement written and sworn to in the presence of someone authorised to administer an oath, such as a notary public. The document may be required for legal purposes.

amortization: The gradual elimination of a liability, such as loan, by regular payments over a specified period of time. Such payments must be sufficient to cover both principal and interest. EMIs are an example of this.

appraisal: A professional opinion, usually written, of the market value of a property, such as a home, business or other asset whose market price is not easily determined. Usually required when a property is sold, taxed, insured or financed.

appropriation: Funds set aside for a specific purpose. For example, a debenture redemption reserve is created for which funds are periodically set aside to facilitate repayment of the debenture at a pre¬determined date.

APR: Annual Percentage Rate. The yearly cost of a loan, including interest, insurance, etc., expressed as a percentage.

articles of association: For a limited company, it is a document which defines relationship between shareholders and directors and between shareholders and so on. Along with the memorandum of association, it forms preamble for a body corporate.
asset: Any item of economic value owned by an individual or corporation, especially that which could be converted to cash. Examples are cash, securities, accounts receivable, inventory, equipment, real estate, a car and other property. On a balance sheet, assets are equal to the sum of liabilities; viz., equity, preferential equity and retained earnings and loans if any. From an accounting perspective, assets are divided into the following categories: current assets (cash and other liquid items), long-term assets (real estate, plant, equipment), prepaid and deferred assets (expenditures for future costs such as insurance, rent, interest) and intangible assets (trademarks, patents, copyrights, goodwill).
asset management account: A single account at a mutual fund or bank which provides both banking and brokerage service. Modern banking has progressed beyond mere traditional services and provides management of assets such as securities, property.
at par: A bond or preferential equity which is selling at a price equal its face (or par) value. Typical values of par are Rs. 100/- or Rs. 10/-. Par value is opposed to market value. Par value is decided by the issuer of the instrument, while market value is arrived at by market forces.
ATM: Automated teller machine, a machine at a bank branch or other location which enables a customer to perform basic banking activities (checking one's balance, withdrawing or transferring funds).
attachment: The act of seizing a debtor's property and placing it under a court's control. This is in case of default in repayment of debt.
authentication: Verification that a legal document is genuine or valid, such as through a seal from an authorised public official.
back-end load: A sales charge or commission paid when an individual sells an investment, such as a mutual fund. It is Intended to discourage selling.
bad debt: Accounts receivable that will likely remain uncollectable and will be written off. Bad debts appear as an expense on the company's income statement, thus reducing net income.
bad debt reserve: Is an amount that a company sets aside to offset the estimated total of amount that will not be repaid by creditors.
bailment: The delivery of an asset by its owner (bailer) to another person (bailee) or persons for temporary care and safe custody. An example of this is securities kept with bank for safe custody by customers.
balloon payment: A large, lump-sum payment scheduled at the end of a series of considerably smaller periodic payments. A balloon payment may be included in the payment schedule for a loan, lease or other stream of payments.
balance sheet: A quantitative summary of a company's financial condition at a specific point in time, including assets, liabilities and net worth. The first part of a balance sheet shows all the productive assets a company owns and the second part shows all the financing methods (such as liabilities and shareholders' equity).
bank: An organisation, which does most or all of the following: receives demand and time deposits, honours instruments drawn on them, pays interest on them; discounts notes, makes loans and invests in securities; collects cheques, drafts, and notes; certifies depositor's cheques; and issues drafts.
bancassurance: Selling of insurance through the vast network of banks. It is part of what is today

bank credit: The borrowing capacity provided to an individual by the banking system in the form of credit or a loan. The total bank credit the individual has is the sum of the borrowing capacity each lender bank provides to the individual.

bank discount: The bank charge made for payment of a note prior to maturity, expressed as a percentage of the note's face value. In short, front-end interest discounted on an instrument or the amount paid to the holder/bearer of the instrument (borrower) after interest is deducted. The full amount expressed in the instrument is collected as repayment.
bank draft: A cheque drawn by one bank against funds deposited into its account at another bank, authorising the second bank to make payment to the individual named in the draft.
bank rate: The floor interest rate (least interest rate) charged by banks to the borrowers or the discount rate set by a central bank or the rate at which RBI lends to member banks.
bank reconciliation: The process of adjusting balance in an account reported by a bank to reflect transactions that have occurred since the reporting date. For instance, cheque issued by account holder may not yet reflect in the bank's books but accounted for by the issuer. Hence, the need to know the likely balance.
banker's acceptance: A written demand accepted by a bank to pay a specified amount at a future date.
banking: In general terms, the business activity of accepting and safeguarding money owned by other individuals and entities and then lending out this money in order to earn a profit.
bankrupt: A person, firm or corporation that has been declared insolvent through a court proceeding and is relieved from the payment of debts (or allowed to do so) after the surrender of all assets to a court-appointed trustee.
bearer: The holder of a negotiable instrument. That is, a person who is entitled to receive payment on the instrument as a payee in a cheque.
bearer instrument: A negotiable instrument which is payable on demand to the holder, regardless of whom it was originally issued to.
bill of exchange: An unconditional order issued by a person or business which directs the receiver/ acceptor of the bill to pay a fixed sum of money to a third party at a future date. The future date may be either fixed or negotiable. A bill of exchange must be in writing and signed and dated.
bill of lading: An instrument which carries a description of goods, sent by sea as part of trade. It is a receipt issued by the shipping company, which is ferrying the goods in question.
blank endorsement: An endorsement consisting only of a signature on the back of a cheque or a bill of exchange. This endorsement enables subsequent holder of the cheque/bill of exchange to be the bona fide holder.
bona fide: Any act done in good faith and is genuine.
bond: A debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing. The central and state governments, corporations and many other types of institutions sell bonds. Generally, a bond is a promise to repay the principal along with interest (coupons) on a specified date (maturity). Some bonds do not pay interest, but all bonds require a repayment of principal. A bond might be sold at above or below par (the amount paid out at maturity), but the market price will approach par value as the bond approaches maturity since redemption or repayment of the bond is at face/par value.
book profit: Profit which has been made but not yet realised through a transaction. For instance equity, which has risen in value but is still being held. Also called unrealised eain or unrealised profit or paper gain or paper profit.

book value: The value of an asset as it appears on a balance sheet, equal to cost minus accumulated depreciation.
bounced cheque: A cheque which a bank returns because it is not payable due to insufficient funds in the account of the drawer of the cheque ro such other reasons.
bridge financing: Financing extended to a person, company or other entity, using existing assets as collateral in order to acquire new assets. Bridge financing is usually short-term and extended during the period leading up to the disbursement of the sanctioned loan.

bullion: Gold, silver, platinum, in the form of bars or ingots. Some central banks use bullion for settlement of international debt, and some investors purchase bullion as a hedge against inflation.
bye-laws: The official rules and regulations which govern a corporation's management. They are drawn up at the time of incorporation or setting up.
call money market: Market in which banks and dealers borrow money to satisfy their credit needs or their short term needs of liquidity to cover their reserve ratio requirements. The money is returnable on call.
CAMELS: It is an assessment of member banks by RBI to ascertain the "capital adequacy, asset quality, management, earnings appraisal, liquidity, systems and controls". It is an assessment of the intrinsic strength of banks.
capital adequacy: Ability of a bank to provide cushion to the risk weighted assets and meet these obligations in case they arise.
capital market: A market where debt or equity securities are traded.
capitalisation: The sum total of a corporation's long-term debt, equity and retained earnings.
cash credit: A short-term cash loan to a company to meet working capital requirements. cash discount: A credit or discount offered if the buyer chooses to pay early and/or with cash.
cash flow statement: A summary of a company's cash flow over a given period of time. It gives the net position of inflows and outflows of funds during the course of business.
cash reserves: Cash, money market instruments, and Treasury Bills.
central bank: The generic name given to a country's primary monetary authority, such as the RESERVE BANK OF INDIA. Usually has responsibility for issuing currency, administering monetary policy, holding member banks' deposits and relating the banking industry.
certificate of deposit: It is an usance promissory note issued by bank enabling the investor to negotiate it. It is short-term surplus kept with the bank. It can be negotiated thirty days after issue.
certificate of incorporation: Certificate issued by Registrar of Companies (ROC) that brings a company into existence.
chequebook: A booklet of blank cheques which enable a bank account holder to draw money from his/ her deposit account.
Clayton's rule: The first item on debit side is discharged by first item on credit side and so on chronologi¬cally. This arises in case of default in payment or business. The rule is based upon the simple notion of first-in, first-out to determine the effect of payments from an account and will normally apply in the absence of evidence of any other intention. For the banker, it is important to reconstitute the defaulter to avoid complete loss because the liability is thus crystallised and future credits are not adjusted against old liabilities/dues.

clearing house: cheques drawn on all banks are collected here, their respective balances debited/ credited and returned to the banks on whom they are drawn.
closed-end fund: A fund with a fixed number of shares outstanding and one which does not redeem shares the way a typical mutual fund does. Closed-end funds behave more like equity than open-end funds.
collateral: Assets pledged by a borrower to secure a loan or other credit and subject to seizure in the event of default. Also called as security.
collecting banker: Bank which collects the negotiable instrument on behalf of its customer.
commercial bank: An institution which accepts deposits, makes business loans and offers related services with a profit motive. Commercial banks also allow for a variety of deposit accounts, such as current, savings and time deposit.
commercial paper: An unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory. Commercial paper is usually issued by companies with high credit ratings, meaning that the investment is almost always of relatively low risk. These papers are bought by organisations or even high net worth individuals on short-term basis to provide liquidity to otherwise sound companies.

commission: A fee charged by a broker or agent for his/her service in facilitating a transaction, such as the buying or selling of securities or real estate. In the case of securities trading, brokers can be of two broad categories depending on the commissions they charge. Some brokers charge higher commissions, but provide research and investment advisory services.

commitment fee: A charge by a lender for holding credit available for a borrower. Simply put, the penalty charged for not availing credit sanctioned.

compound interest: Interest which is calculated not only on the initial principal but also the accumulated interest of prior periods. Compound interest differs from simple interest in that simple interest is calculated solely as a percentage of the principal sum.

consideration: Something of value, such as money or personal services, given by one party to another in exchange for an act or promise.

contract: A binding agreement between two or more parties for performing or refraining from performing some specified act(s) in exchange for lawful consideration.

conversion: If there is a happening inconsistent with owner's right of possession which may be unlawful, then conversion is said to have taken place. An example is of a third party cheque by fraudulent endorsement transferred into the customer's account. For this, a banker needs protection u/s 131 as provided by a formal introduction of the customer to the bank.

convertible bond: A corporate bond that can be exchanged, at the option of the holder, for a specific number of shares of the company's equity on a specified date at a pre-specified price. Convertibility affects the performance of the bond in certain ways. Convertible bonds tend to have lower interest rates.

corporation: The most common form of business organisation with many legal rights as an entity separate from its owners (perpetual existence). This form of business is characterised by the limited liability of its owners, the issuance of shares of easily transferable stock and existence as a going concern.

coupon: The interest rate on a fixed income security, determined at the time of issuance and expressed

as a percentage of par value or face value. It is called coupon since the interest cheques are given in advance along with the bond document and appear like coupons.

credit agency: Is a company which collects information about the creditworthiness of individuals and corporations and provides it for a fee to interested parties.

credit analysis: The process of evaluating an applicant's loan request or a corporation's debt issue in order to determine the likelihood that the borrower will live up to his/her obligations.

credit card: Any card that may be used repeatedly to borrow money or buy products and services on credit. Issued mostly by banks.

credit limit: The maximum amount of credit that a bank or other lender will extend to a customer or the maximum that a credit card company will allow a card holder to borrow on a single card.

credit rating: A published ranking, based on detailed financial analysis by a credit bureau, of one's financial history, specifically as it relates to one's ability to meet debt obligations.

credit risk: The possibility that a bond issuer/borrower will default, by failing to repay principal and interest in a timely manner. Sovereign bonds issued by the government for the most part, are immune from default (if the government needs money it can just print more). Bond, issued by corporations are more likely to be defaulted on, since companies could go bankrupt. Quasi govt. bodies occasionally default as well although it is much less common. Also called default risk.

creditor: A person or organisation which extends credit to others.

creditworthiness: A creditor's measure of an individual's or company's ability to meet debt obligations.
crossed cheque: A form of cheque which has two parallel or transverse lines across the face so that the bank on which it is drawn may not pay to any other party than to a bank where the payee has an account.
current account: A deposit account at a bank which does not pay interest but can be withdrawn any time. It is basically for operating a business.
custodian: is an organisation, which holds in custody and safekeeping the securities and other assets of another organisation or individual.
DA bills: They are bills which have a usance period and require acceptance by the drawee.
DP bills: They are bills where delivery of goods is against payment by the drawee.
debenture: Debt mostly unsecured backed only by the integrity of the borrower, not by collateral, and documented by an agreement. One example is an unsecured bond.
debit card: A card which allows customers to access their funds immediately, electronically. Unlike a credit card, a debit card does not have any float.
debt: An amount owed to a person or organisation for funds borrowed. Debt can be represented by a pro-note, bond, mortgage or other form stating repayment terms and, if applicable, interest requirements. These different forms all imply intent to pay back an amount owed by a specific date, which is set forth in the repayment terms.
debt financing: Financing by selling bonds, bills or notes to individuals or institutions.
debt instrument: A written promise to repay a debt. Examples include bills, bonds, notes, CDs, commercial paper and banker's acceptances/ L/Cs.
debt market: The market for trading debt instruments.
debt/equity ratio: A measure of a company's financial leverage. Debt/ equity ratio is equal to long-term debt divided by shareholders' equity. Typically, the data from the prior fiscal year is used in the

calculation. Investing in a company with a higher debt/equity ratio may be riskier, especially in times of rising interest rates, due to the additional interest that has to be paid out for the debt.
debtor: An individual or company that owes debt to another individual or company (the creditor), as a result of borrowing or issuing bonds.
deed of trust: A deed in which title is conveyed to a trustee.
default: Failure to make required debt payments on a timely basis or to comply with other conditions of an obligation or agreement.
deferred credit: Revenue received by a firm but not yet reported as income.
deferred payment: A debt which has been incurred and will be paid back at some point in the future.
demand deposit: An account balance which can be drawn upon on demand, i.e. without prior notice. Savings deposit is an example.
depreciation: Is the decrease in the value of equipment from wear and tear and the passage of time. It is notional charge/debit to the profit and loss a/c, which helps build cash reserves for replacement of existing assets at a future date.
derivative: A financial instrument whose characteristics and value depend upon the characteristics and value of an underlying commodity, bond, equity or currency. Examples of derivatives include futures and options. Investors sometimes purchase or sell derivatives to manage the risk associated with the underlying security, to protect against fluctuations in value or to profit from periods of inactivity or decline. These techniques can be quite complicated and risky.
discharge: To satisfy or dismiss the obligation of a debt. Simply put, it is the full repayment of a debt or an obligation.
disclosure: The release of relevant information.

dishonor: To not pay, such as for a bounced cheque. It is also failure to meet/pay legitimate demand raised by a bill of exchange made in normal trade.

dissolution: The end of the legal existence of a corporation, by shareholder vote, acquisition by another corporation or order of a legal authority.

dividend: A taxable payment declared by a company's board of directors and given to its shareholders, usually annually, out of the company's current or retained earnings. Dividends are normally given as cash (cash dividend). It is the shareholders' earning on his investment in the company.

drawee: The party directed to pay the amount of a draft or cheque or a bill of exchange.

drawer: The party who draws the draft, cheque or bill of exchange upon another party for payment.

due date: Date on which an obligation must be paid.

effective annual interest rate: The actual annual interest rate that accrues, after taking into consideration the effects of compounding (when compounding occurs more than once per year).

electronic funds transfer (EFT): Any transfer of funds that is initiated by electronic means, such as an electronic terminal, telephone, computer, ATM or magnetic tape.

encumbered: Owned by one entity but subject to another person's valid claim. endorsement: A signature used to legally transfer a negotiable instrument.

equity: Ownership interest in a corporation in the form of equity capital. It also refers to total assets minus total liabilities, in which case, it is also referred to as shareholder's equity or net worth or book

value. Simply put, it is the money brought in by the owners/shareholders and over time could also include accumulated profits.

equated monthly instalment (EMI): An equal amount repaid periodically comprising of interest and principal over the period of the loan or debt. The composition of interest (declining) and instalment of principal (increasing) changes, while the amount remains the same.

escrow account: A trust account held in the borrower's name to repay obligations such as borrowing. Credits to the account are first appropriated to discharge the borrower's liability.

exchange: Any organisation, association or group which provides or maintains a market place where securities, options, futures or commodities can be traded.

executor: An individual or institution nominated in a will and appointed by a court to settle the estate of a deceased.

export-import Bank: An independent bank which encourages exports by providing credit and insurance. Also called Eximbank.

face value: The nominal amount assigned to a security by the issuer. For an equity security, face value is usually a very small amount that bears no relationship to its market price. For a debt security, face value is the amount repaid to the investor when the bond matures. In the secondary market, a bond's price fluctuates with interest rates. If interest rates are higher than the coupon rate on a bond, the bond will be sold below face value (at a "discount"). If interest rates have fallen, the bond, will be sold above face value.

factor: A firm engaged in the business of financing accounts receivable, an activity known as factoring. The firm so buying the receivables become the creditors to the receivables. This helps the liquidity of the selling entity.

factoring: The selling of a company's accounts receivable, at a discount, to a factor, who then assumes the credit risk of the account debtors and receives cash as the debtors settle their accounts. Also called accounts receivable financing.

financial institution: Institution which collects funds from the public and places them in financial assets, such as deposits, loans and bonds, rather than tangible property.

floating rate: Any interest rate that changes on a periodic basis. The change, usually tied to movement of an outside indicator, such as the prime interest rate. Movement above or below

certain levels is often prevented by a predetermined floor and ceiling for a given rate. For an individual taking out a loan when rates are low, a fixed rate loan would allow him or her to "lock in" the low rates and not be concerned with fluctuations. On the other hand, if interest rates were historically high at the time of the loan, he or she would benefit from a floating rate loan, because as the prime rate falls to historically normal levels, the rate on the loan would decrease.
forfeiture: A loss of money, property or privileges due to a breach of legal obligation, which serves as compensation for resulting losses. An example is of equity shares issued on part payment basis. When the calls for payment of the balance is not heeded then the amount initially paid is forfeited or lost by the prospective investor and the shares are said to be forfeited.
front-end load: A charge paid when an individual buys an investment, such as a mutual fund. The load is clubbed with the first payment made by an investor, so the total initial payment is higher than the later payments. The purpose of a load is to cover administrative expenses and transaction costs at the beginning.
garnishee order: Monetary judgement by the court against defendant by ordering third party (garnishee) to pay money owed by the defendant (judgement debtor) to the plaintiff (judgement creditor). This is so when there is default in debt repayment.

general lien: A lien applied to all goods, not just the goods giving rise to the debt, owned by the borrower.
government securities: Securities issued by a government to raise the funds necessary to pay for expenses/investments.
guarantee: To accept responsibility for an obligation if the entity with primary responsibility for the obligation does not meet it. That is the guarantor pays when the debtor fails to do so.
guarantor: One who guarantees an obligation and has a legal duty to fulfil it.
hedging: Protecting assets from currency fluctuations. This is generally done by taking positions or doing things, which will offset the adverse effects on the original investment. For instance, a weak rupee leads to the purchase of shares of the export oriented companies, who will benefit from a falling rupee. This will provide a hedge against fall in value of other assets, if at all.
holder in due course: is a person who is in possession of an instrument for which consideration has been paid and who believes that there is no defect in the title.
hybrid debt: Instruments which are similar to equity, which absorb losses without forcing/causing liquidation.
hypothecation: The pledging of securities or other assets as collateral to secure a loan. The act of pledging is often without transfer of goods, as in funding of inventory of raw materials/finished goods. There is charge on the inventory whose value at any point in time not fall below the amount specified by the bank. The working capital cycle will ensure healthy movement of goods.
inactive account: A bank account in which there have not been any transactions for an extended period of time. Such accounts are often charged a fee if there are no operations.
initial public offering: IPO; the first sale of shares by a company to the public. insolvent: Unable to meet debt obligations. Opposite of solvent.
interest cover: A company's pre tax operating income (or occasionally, cash flow) divided by its interest obligations, for a given period. Mathematically, it is the ratio of earnings before interest, tax and depreciation divided by the amount of interest payable. A ratio of 1.5 to 2 per cent is considered ideal by lending institutions.
interest rate: A rate which is charged or paid for the use of money. An interest rate is expressed as an annual percentage of the principal.
Internal Rate of Return (IRR): The rate of return that would make the present value of future cash flows of an investment or business opportunity plus the terminal value of the business equal the current market price of the investment or opportunity. Simply put, it is the discount

rate, which makes the current investment in a business equal to the present value of future cash flows arising out of the business plus the terminal value of the business, i.e. the NPV of the business equals zero.
introduction: Introduction of a potential customer to a bank by an account holder, employee or a well known person. It is necessary for a bank seeking protection under Sec. 131 of the N.I. Act. This formality is necessary for opening of accounts.
irrevocable: Not able to be undone. There are certain terms in a negotiable instrument or a legal document or a document whose tenor cannot be overlooked/avoided/bypassed and have to be adhered to.
joint account: Any account owned by two or more people.
joint and several liability: An obligation for which multiple individuals are liable for payment as in case of obligations of a partnership concern.

judgement creditor: Under garnishee order, the creditor or person to receive its benefit is called so. judgement debtor: Under garnishee order the debtor or the person liable to the creditor is called so.
Law of limitation: Law that sets out a period after which a legal document cannot be enforced unless revalidated before the said date.
lease: A contractual arrangement whereby the lessor grants the lessee the right to use his asset for a fixed period in return for periodic (lease) rentals.
ledger: A book/folder/file of accounting entries where transactions are listed in separate accounts.
lender of last resort: A function of a central bank, such as the Reserve bank, in which it lends money to a bank which is facing unusually heavy withdrawals.
lessee: A person who obtains a property on lease from its owner.
lessor: An owner of property who rents it to another party.
letter of credit (L/C): A binding document that a buyer can request from his bank in order to guarantee that the payment for goods will be transferred to the seller. Basically, a letter of credit gives the seller reassurance that he will receive the payment for the goods. In order for the payment to occur, the seller has to present the bank with the necessary documents.
leverage: Is the amount of long term debt relative to equity with a higher ratio meaning a greater amount of leverage. A business entity's funding pattern generally is a judicious mix of equity and debt. Loosely speaking, it represents the influence one financial variable has over some other related financial variable.
liability: It is a claim on the assets of a business. It is the amount owed by the business to the shareholders, both preferential and equity, creditors both long term (banks and institutions) and short term.
LIBOR: It is the London Interbank offering rate. It is the standard for international transactions by Indian entities.
lien: A legal claim against an asset which is used to secure a loan and which must be paid when the asset is sold. Liens can be structured in many different ways. In some cases, the creditor will have legal claim against an asset, while not actually holding it in possession and in other cases, the creditor will actually hold on to the asset until the debt is paid of.
lien, banker's: Banker's lien gives it a right of sale on possession of goods in the event of failure of the debtor to meet the obligation. Banker's lien is an implied pledge.
lien, negative: In which borrowers undertake that the assets are free from any charge and that no charge will be created without bankers prior consent. The first right of charge lies with bank.
liquidate: To convert an asset to cash. Or
to sell off an entity to meet legal obligation.
liquidity ratio: Total value of cash and marketable assets (receivables and easily realisable) divided by current liabilities. For a bank, this is the cash held by the bank as a proportion of deposits in the bank. The liquidity ratio measures the extent to which a corporation or other

entity can quickly liquidate assets and cover short-term liabilities and therefore is of interest/concern to short-term creditors.
long-term debt: Loans and obligations with a maturity of longer than one year; accompanied by interest payments.
mandate: Power given to a person or group of persons for carrying out certain jobs/activities/obligations.

margin: Margin refers to an amount required to be brought in by a borrower, as specified by the lender, as his own contribution (equity) to the business.
market value: A security's last reported sale price on an exchange.
OR
The market price of an entire company calculated by multiplying the number of shares outstanding, by
the price per share. This is also called market cap or market capitalisation.
marketable security: Security that probably could be converted into cash quickly and easily.
material alteration: Any alteration that changes the tenor of an instrument. To validate a material alteration, the drawer must authenticate.
maturity date: The date on which a debt becomes due for payment.
memorandum of association: Document which governs the association of a company with the outside world; gives details of the type of company, objects of the company (activities the company may carry out), capital structure, etc.
moratorium: A period of time during which a certain activity is not allowed or required. For instance, when repayment on a loan starts only after a lapse of a certain period after its disbursement, then that period is called the moratorium on the loan.
mortgage: A loan to finance the purchase of real estate or plant and machinery, usually with specified payment periods and interest rates. The borrower (mortgagor) gives the lender (mortgagee) a lien on the property as collateral for the loan.
NAV: Net Asset Value. The value in rupees of a single mutual fund share based on the value of the underlying assets of the fund minus its liabilities/expenses, divided by the number of shares outstanding. Calculated at the end of each business day.
negligence: Failure to act during the normal course of business in an usually accepted manner.
negotiable instrument: A transferable, signed document that promises to pay the bearer a sum of money at a future date or on demand. Examples include cheques, bills of exchange and promissory notes.
net present value; NPV: A method of evaluating investment proposals. It is the present value of future cash flows less the sunk costs (initial investment). When evaluating two proposals, the assumption is that the one with higher NPV is the better of the two. Sometimes a comparative ratio of the NPVs to the initial investment is also used for the purpose.
net worth: For a company, it is total assets minus total outside liabilities. Net worth is an important determinant of the value of a company, considering it is composed primarily of all the money that has been invested since its inception, as well as the retained earnings for the duration of its operation. Net worth can be used to determine creditworthiness because it gives a snapshot of the company's investment history. Also called owner's equity, shareholders' equity, or net assets.
Non performing asset: A loan that is not meeting its stated principal and interest payments. More generally an asset that is not producing Income.
non-recourse debt: Debt for which the borrower is not personally liable.
nostro account: A banking term to describe an account one bank holds with a bank in a foreign country, usually in the currency of that foreign country.
notary public: A person authorized by the state to notarize certain documents,
online banking: A svstem allowing individuals to perform banking activities at home, via the internet.

466

operating cycle: The average time between purchasing or acquiring inventory and receiving cash proceeds from its sale in finished goods form. Also called working capital cycle in which the period covers the time from purchase of raw materials, its conversion to final goods, subsequent sale and realisation of the proceeds.

opportunity cost: It is the rate of return that can be earned on the best alternative investment.

order nisi: To freeze all transactions in a debtors' account and use the amount to payoff the judgement debt.

overdraft: The amount by which withdrawals exceed deposits or the extension of credit by a lending institution to allow for such a situation.

passbook: Book issued by a bank to record deposits, withdrawals and interest earned in a deposit account.

payee: One who receives a payment, such as through cash, cheque, money order: bill of exchange, etc. paying banker: Bank on whom the negotiable instrument is drawn and which is sent for collection.

personal guarantee: Promise made by an entrepreneur which obligates him/her to personally repay debts his/her corporation defaults on.

personal identification number (PIN): Code used by an individual so that he/she can access his/her bank account at an ATM machine.

pledging: Offering assets to a lender as collateral for a loan. Though the asset will be pledged and may be in the custody of the lender, it is still owned by the borrower unless he/she defaults on the loan.

post-date: To put a future date on a document or cheque, postponing the effective or negotiable date.

power of attorney: A legal document that enables an individual to designate another person called the attorney, in fact, to act on his/her behalf as long as the individual does not become disabled or incapacitated.

preamble: It is an introductory statement, a preliminary explanation. It tells about the rules governing a body, which form the basis for their existence and future action.

preferential shares: Shares on which a specific dividend is paid before any dividends are paid to equity shareholders, and which takes precedence over equity in the event of a liquidation. Preferential shareholders do not enjoy any of the voting rights of equity shareholders.

prime rate: The interest rate that commercial banks charge their most creditworthy borrowers, such as large corporations. The prime rate is a lagging indicator. Also, called prime.

probate: The review or testing of a will before a court of law to ensure that the will is authentic.

profit and loss statement: An official quarterly or annual financial document published by a public company, showing earnings, expenses and net profit. Net income is determined from this financial report by subtracting total expenses from total revenue. The profit and loss statement and the balance sheet are the two major financial reports that every company publishes. The difference between this statement and the balance sheet deals with the periods of time that each one represents. The profit and loss statement shows transactions over a given period (usually quarterly or annually), whereas the balance sheet gives holdings on a specific date.

promissory note: a promise by the drawer of the note to pay a certain sum of money on certain date to the drawee.

prospectus: Description of a company, raising funds from the capital market, to the prospective investors.

467

prudential limits: Limits of sector wise credit exposure set by RBI on commercial banks. These limits helps control, among other things too much exposure to a particular sector vis-a-

vis others as also the effects of artificial prices, demand-supply mismatches, default situations and so on.
reconciliation: Adjusting one's cheque/cash book balance to match a bank statement.
redemption: The return of an investor's principal amount in a security, such as a bond, debenture or mutual fund shares, at or prior to maturity.
remit: To make a payment by transfer. Examples of remittance include cash, cheque/draft and electronic transfer.
reserve ratio: Amount of money and liquid assets that the member banks must hold in gilt securities or cash with the RBI, usually a specified percentage of their demand deposits and time deposits. Also called reserve requirement.
resolution: An official document representing an action on the part of the board of directors of a corporation. For instance, a board may resolve to borrow funds from or place deposits in a bank and may appoint certain directors or officials to operate the bank account.
retail banking: Banking services for individual customers.
retained earnings: Earnings not paid out as dividends but instead reinvested in the core business or used to payoff debt.
revaluation reserves: Reserves that are created after revaluation of assets that are under valued in the books of accounts. An example is of an asset, which commands a market price well above the book value (after depreciation) such as land and therefore the company decides to increase its value in the books and create a reserve (notional).
revolving line of credit: An agreement by a bank to lend a specific amount to a borrower and to allow that amount to be borrowed again once it has been repaid. Also called revolving credit.
right of recourse: The right to recover a bad debt.
Sans recourse: without liability to the endorser. The liability is solely that of the drawee/acceptor.
savings deposits: Accounts that pay interest and can be withdrawn on demand, offered by banks.
secondary market: A market in which an investor purchases a security from another investor rather than the issuer, subsequent to the original issuance in the primary market. It is a place where buyers and sellers of a security meet to deal/operate.
secured debt: Backed by a pledge of collateral/assets. Opposite of unsecured.
secured loan: A loan which is backed by assets belonging to the borrower in order to decrease the risk assumed by the lender. The assets may be forfeited to the lender if the borrower fails to make the necessary payments.
securitisation: The process of aggregating similar instruments, such as loans or mortgages into a negotiable/tradable security.
set-off: Adjusting debit in one account of a borrower with credit in another.
simple interest: The interest calculated on a principal sum, not compounded on earned interest.
sinking fund: A fund into which a company sets aside money over time, in order to retire its preferential shares, bonds or debentures.
statutory: Something which is enacted by legislation. As a law perhaps.

stop payment: An order to a bank not to honour the payment of a cheque after it has been delivered but before it has been cashed.
subordinated debt: Debt that is either unsecured or has a lower priority than that of another debt claim on the same asset or property. Also called a junior debt.
surety: A pledge, guarantee or bond, usually to back the performance of an individual or company.
swap: An exchange of streams of payments over time according to specified terms. Also an exchange of loan portfolio by banks.

tangible asset: Assets having a physical existence, such as cash, equipment and real estate; accounts receivable are also usually considered tangible assets for accounting purposes. Opposite of intangible asset.
tenor: instructions appearing on the face of a negotiable instrument such as date, amount, name of payee and so on.
terminal value: It is the value of an asset at some point in time in future. It is a notional value assigned, while estimating the future cash flows of a business but is essential nevertheless.
third party: Someone other than the principals directly involved in a transaction or agreement.
time deposit: money kept as deposit in a financial institution, usually a bank, for a fixed term or with the understanding that the customer can withdraw only by giving advanced notice.
transfer: A movement of funds from one account to another.
traveller's cheque: Cheque issued by a financial institution which functions as cash but is protected against loss or theft. Traveller's checks are useful when travelling, especially in case of overseas travel when not all credit and debit cards carried by a person will be accepted. A charge or a commission, is usually incurred when a person exchanges cash for traveller's checks, though some issuers provide them free of charge.
treasury Bill: A negotiable debt obligation issued by the government and backed by its full faith and credit, having a short maturity. Also called the "T-Bill". These instruments, liquid in nature, are a source for meeting the central bank's (RBI) reserve ratios.
trust: A legal arrangement in which an individual gives fiduciary control of property to a person or institution (the trustee) for the benefit of beneficiaries.
underwrite: To assume risk, as when offering a policy or bringing a corporation's new securities issue to the public; in the latter case, the term originally applied only to firm commitment offerings, but is now used for all offerings. To put it simply if the IPO is undersubscribed the underwriter subscribes to the extent of his commitment for a fee/commission which is payable in all situations.
usance: The length of time allowed for the payment of a bill of exchange.
variable rate: Any interest rate or dividend that changes on a periodic basis. Variable rates, are often used for convertibles, mortgages, and certain other kinds of loans. The change, is usually tied to movement of an outside indicator, such as the prime interest rate. Movement above or below certain levels is often prevented by a predetermined floor and ceiling for a given rate. Also called the adjustable rate.
vicarious liability: Liability that arises out of the responsibility of a superior for the acts of his subordinate. As in case of a bank which is liable to the acts of its employees in the natural discharge of duties.
waiver: The act of voluntarily giving up a right or covenant. Covenants are certain clauses in an agreement.

warrant: A certificate, usually issued by a corporation along with a bond or debenture, entitling the holder to buy a specific amount of securities of that corporation at a specific price, usually above the prevailing market price at the time of issuance. In case the price of the security rises to above that of the warrant's exercise (entitled) price, then the investor can buy the security at the warrant's exercise price and resell it for a profit. Otherwise, the warrant may simply expire or remain unused.

wholesale banking: Banking services for institutions.
wire transfer: An electronic transfer of funds.
withdrawal: A removal of funds from an account.
working capital: Is current assets minus current liabilities. Working capital measures how much liquid assets a company has to build its business. The number can be positive or negative, depending on how much debt the company is carrying. In general, companies that have a lot of working capital will be more successful since they can expand and improve their

operations. Companies with negative working capital may lack the funds necessary for growth.
working capital loan: A short-term loan which provides money to buy earning assets.
write-off: To charge an asset amount to expense or loss, in order to reduce the value of that asset and one's earnings. An example is of receivables not being recoverable charged to the profit and loss account in order to offset the income that has already accrued to the account.
written down value method: It is a method of calculation by which depreciation is charged as a percentage of the net asset value (written down value) in the books year after year.

GLOSSARY Marketing Terms
advertising: The placement and purchase of announcements and persuasive messages in time or space in any of the mass media by business firms. It can also be defined as any paid form of non-personal presentation and promotion, of ideas, goods or services, by an identified sponsor.
analysis: In marketing and other social science disciplines, a variety of statistical and non-statistical methods are used to analyse data, instead of sheer intuition or simple descriptive statistics.
attitude: The degree of enthusiasm for a product which can be classified into enthusiastic, positive, indifferent, negative and hostile.
audience: The number and/or characteristics of the persons or households who are exposed to a particular type of advertising media or media vehicle.
brand: A name, term, design, symbol or any other feature that identifies one seller's goods or service as distinct from those of other sellers. The legal term for brand is trademark. A brand may identify one item, a family of items or all items of that seller. If used for the firm as a whole, the preferred term is trade name.
brand equity: The positive differential value given to product with a strong brand, by the consumer. For instance, "thanda means Coca Cola".
census: A complete canvas of a population.
channel of distribution: An organised network of agencies and institutions which, in combination, perform all the functions required to link producers with end customers to accomplish the marketing task.
circulation: The number of copies of a print advertising medium that are distributed.
competition: The rivalry among sellers trying to achieve such goals as increasing profits, market share and sales volume by varying the elements of the marketing mix: price, product, distribution and promotion.
consumer: The ultimate user of goods, ideas or services. Also, the buyer or decision-maker, for example, the parent selecting children's books is the consumer.
consumer behaviour: The behaviour of the consumer or decision-maker in the market place of products and services.
consumer characteristics: The demographic, lifestyle and personality characteristics of the consumer.
consumer satisfaction: The degree to which a consumer's expectations are fulfilled or surpassed by a product.
customer: The actual or prospective purchaser of products or services.
demand: The number of units of a product sold in a market over a period of time.
demographic analysis: A detailed analysis of the prospective market for the product after segmentation based on various characteristics of the population essential for the product in question.
direct marketing: Marketing efforts, in total, directed toward a specific targeted group - direct selling,

distribution: The marketing and carrying of products to customers.
diversification: Moving into attractive opportunities outside the existing business.
environmental analysis: Gathering data regarding political, cultural, social, demographic, economic, legal, international and ecological forces, identifying trends affecting businesses.
focus group: A method of gathering quantitative data on the preferences and beliefs of consumers through group interaction and discussion usually focused on a specific topic or product.
goals: A concrete point of measurement that the business unit intends to meet to achieve objectives.
goods: A product that has tangible form in contrast to services that are intangible.
hybrid: Mix of products or services making for an unusual whole.
heterogenous: A mix of different types of products or services.
inventory management: Management of goods on hand in terms of holding, selling, and so on.
knowledge: Consumers' meanings or beliefs about products, brands, stores that are stored in memory.
label: An important element of a product which identifies and describes it.
market: The set of actual or potential users/customers.
market area: A geographical area containing the customers/users of a particular company for specific goods or services.
market demand: The total volume of a product or service bought/used by a specific groups of customers/ users in a specified market area during a specified period.
market development: Expanding the total market served, by - (1) entering new segments, (2) converting non-users, (3) increasing use by present users.
market positioning: Positioning refers to the user's perceptions of the place a product or brand occupies in' a market segment or how the company offering is differentiated from the competitors.
market profile: A breakdown of a facility's market area according to income, demography and lifestyle.
market research: The systematic gathering, recording and analysing of data with respect to a particular market, where market refers to a specific user group in a specific geographic area.
market segmentation: The process of subdividing a market into distinct subsets of users that behave in the same way or have similar needs for the product/service.
market share: A proportion of the total sales/use in a market obtained by a given facility or chain of the product/service in question.
marketing: The process of planning and executing the conception, pricing, promotion, and distribution of ideas, goods and services to create exchanges that satisfy individual and organisational goals. In short, it is much more than mere selling.
marketing channel: A set of institutions necessary to transfer the title to goods and to move goods to the point of consumption.
marketing mix: The mix of controllable variables that the company uses to reach desired use/sales level in target market, including price, product, place and promotion-4 Ps.
marketing opportunity: An attractive arena of relevant marketing action in which a particular organisation is likely to enjoy a superior and competitive advantage.
marketing plan: A document composed of an analysis of the current marketing situation, opportunities and threats, analysis, marketing objectives, marketing strategy, action programs and projected income statement.

motivation: The positive or negative needs, goals, desires and forces that impel an individual toward or away from certain actions, activities, objects or conditions. The inner needs and wants of an individual is what affects behaviour.
objectives: The desired or needed result to be achieved by a specific time. An objective is broader than a goal and one objective can be broken down into a number of specific goals.
observation: A method of data collection in which the situation of interest is watched and the relevant facts, actions and behaviours are recorded.
packaging: A convenient container for a product which is suitable and provides information relating to the product.
penetrated market: Set of users actually consuming the product/service.
perception: Perception is the cognitive impression that is formed of "reality" which in turn influences the individual's actions and behaviour toward that object. Simply speaking, it is the market's understanding of the product.
perishable: Low shelf life.
personal selling: Oral presentation in a conversation with one or more prospective purchasers for the purpose of making sales.
place: In the channels of distribution, the physical facilities, point of location.
potential market: Set of users who profess some level of interest in a designed market offer.
price: The formal ratio that indicates the quantities of money, goods or services needed to acquire a given quantity of goods or services. All goods and services have a value and this reflects in their price generally fixed by market forces.
pricing:
- mark-up: Price determined by adding a mark-up to the costs.
- target return: Pricing based on required return on investment.
- perceived value: Price based on buyer's perception.
- going rate pricing: Price based on the competitors' prices.
- market penetration: Price is lower initially to generate volume sales.
- discriminatory: Different prices for different buyers.

product: A bundle of attributes or features, functions, benefits and uses capable of exchange, usually in tangible (money) or intangible forms.
product life cycle: The four stages products go through from birth to death: introductory, growth, maturity and decline.
- introduction stage of product life cycle: Period of low sales and growth.
- growth state of product life cycle: Second stage during which sales/use are increasing.
- maturity stage of product life cycle: Initial rapid growth is over and use and/or sales level peaks off.
- decline stage of product life cycle: The last stage in the life cycle when the product loses its marketability.

product mix: The full set of products offered by an organisation.
product positioning: it is the act of designing the company's offer and image so that the target market understands and appreciates what the company stands for in relation to its competitors. This can be manipulated by the organisation.

promotion: The various communication techniques such as advertising, personal selling, sales promotion and public relations/product publicity available to the marketer to achieve specific goals.

public opinion: The consensus view of a population on a topic.
public policy: A course of action pursued by the government pertaining to people as a whole on which laws rest.
public relations: The form of communication management that seeks to make use of publicity and other non-paid forms of promotion and information to influence feelings, opinions or beliefs about the company and its offerings.
public sector: Those marketing activities that are carried out by government agencies for public service rather than for profit.
reach: The number of people or households exposed to a particular advertising media or media schedule during a specified time.
response: The set of reactions that the receiver has after being exposed to the message.
sales promotion: Campaign to encourage sales or purchase of goods and services by offering short-term incentives such lower prices or buy 1 take 2.
sample: The selection of a subset of elements from a larger group of objects. For instance, schoolgoing children from a locality would represent a sample for survey relating to education.
sample survey: A cross-sectional study in which the sample is selected to be representative of the target population and in which the emphasis is on the generation of summary statistics such as averages and percentages.
service(s): Products such as a bank loan that are intangible or at least substantially so.
servuction: When production and consumption take place simultaneously. The consumer and service provider interact during the service experience.
strategic thrust: A well thought out foray into the market.
target market: The particular segment of a total population on which the retailer focuses its merchandising expertise to satisfy that sub-market in order to accomplish its profit objectives.
tangible goods: Goods easily identifiable as opposed to service.
target market identification: The process of using income, demographic and life style characteristics of a market and census information for small areas to identify the most favourable locations for placing a product.
warehouse: A unit where goods are stored before sending to distribution centres.
word of mouth (WOM) communication: This occurs when people share information about products or promotions with friends — research indicates WOM is more likely to be negative.

GLOSSARY Information Technology
algorithm: A step-by-step method of accomplishing a task. A series of mathematical commands, that cipher and decipher.
batch: A group of commands that are executed one at a time.
batch File: A file in a DOS/Windows environment with the .bat extension. This file type is executable in DOS or at a Windows command prompt. Batch programs are written in a batch programming language that utilises a superset of standard DOS commands.
buffer: A temporary location to store or group information in hardware or software. Buffers are used whenever data is received in sizes that may be different than the ideal size for the hardware or software that uses the buffer.
buffered memory: Memory modules that have extra chips on them to support Error Checking and Correcting (ECC) functionality.
bug: This is commonly an error in design or programming in a hardware device or piece of software.
bus topology: This network topology has computers connected to a strand of network cabling that is connected to network repeaters at one end and terminated at the other.
cable modem: The device that you attach a coaxial cable from your cable company directly into that can provide you with high speed Internet access.
channel: It consists of controller card, interface cable and power supply.

cheque truncation: It stops the flow of cheques through the banking system and converts it into an electronic processing system.
coaxial cable: It consists of a single copper wire, surrounded by a copper braid or foil that acts as a ground. The entire wire is coated with insulation. The cable carries digital signals at high speeds.
data-information: Any series of bits, characters or objects that has meaning. Data is stored and transmitted by computers.
data compression: Takes something large and makes it smaller.
data encryption standard (DES): An encryption method developed by IBM in 1977. It uses a private 56-bit key that is applied to each 64-bit block of data.
data mining: The act of analysing a database or data warehouse and searching for new facts based on the data.
database: An ordered set of data.
digital signature: A form of electronic signature that works with a public and private key encryption system and a certificate authority.
disk mirroring: Disk mirroring involves two hard drives that are on the same drive controller. The same data is written to both drives over the same channel.
disk duplexing: Disk duplexing is much like disk mirroring, but each drive is on a separate controller. dumb terminal: These are hooked up to mainframes and are little more than a monitor attached to a

keyboard. All they are good for is running programs using the mainframe's hard drive and memory, thus the "dumb" in the name.
dynamic signature verification: It finds out whether a signature is genuine or not.
e-mail: This stands for electronic mail. It is a service provided over the Internet that allows you to send information to another person or list of people.
electronic purse: The space in a card is used to store different types of accounts of a user.
electronic signature: Any form of electronic identifier, including a digital signature.
encryption: The act of altering data to make it unreadable unless you know how to decrypt it.
ethernet: A network topology that is able to send data at 10 Mbits/second. Workstations can exist on the same cable, but only one can communicate at a time. To get by these limitations, switched Ethernet and Fast Ethernet were invented and were also combined. Nowadays, most networking devices are switched fast Ethernet.
FTP (file transfer protocol): A common method of moving files, from system to system, by using TCP/IP. To work properly, it requires an FTP client to contact an FTP server in order to transmit data back and forth.
fault tolerant computer system: The ability of a system to continue operations following failure in one or more components.
full duplex: Originally this referred to a communication between a modem and a remote system, where characters were sent both ways over the phone line so that they could be accurately displayed on a terminal.
gopher: This is often said to be the first incarnation of the World Wide Web. It is an information source based on textual links, now outdated and superseded by the Web.
graphical user interface (GUI): Any system that uses graphics to represent the functions of a program. All Windows operating systems are GUIs.
half duplex: Originally a modem communications term, half duplex now mainly refers to network communications that transmit in one direction at a time. Also, see duplex and full duplex.
host: A generic term used to describe a computer or program that makes a resource available, usually over a network.
internet: Global network of networks. It is system that allows user computers to exchange data, messages, etc.

LAN: A small and an isolated network at one office or physical location. Most office computers are connected to a LAN, but may also be connected to the Internet or a WAN.
management information systems/services (MIS): The department at most companies that provides real-time information to the management.
MODEM (Modulator/Demodulator): A device that serves as a bridge between your digital computer and some form of analogue line used to transmit data, such as a phone line (standard modem) or analogue cable connection (cable modem).
multiplexer (mux): A logic circuit that sends one of several inputs out over a single output channel.
node: One computer/machine or address on a network. If you managed a network with 10 printers, 50 servers and 150 client machines, you could say you managed a network with 210 nodes.
online: This term refers to anything that is on the Internet and electronically transmitted.

optical fibre: Provides high quality transmission at very high speeds.
packet: A collection of information. The term is most often used to refer to the chunks of information sent over computer networks.
peripheral: Any device that is not part of the motherboard, aside from memory and the CPU. For example, video cards, sound cards, modems and hard drives are peripherals.
point-to-point protocol (PPP): The mode of transport used to connect a computer to the Internet via a dial-up adapter (a modem).
protocol: A general behaviour that computers and network devices must follow to understand one another.
real-time: Tasks that are time-critical and must happen in our time (as opposed to the much faster computer). The user interface should always be real-time. If you move the mouse, your pointer should move on screen immediately. Unfortunately, Windows can bog down enough, so that this does not happen.
ring topology: A network that is connected on both ends to one source, with client machines hanging off of the ring. If you break the ring, all computers in the ring lose connectivity.
RTGS: Real time gross settlement system. Instant credit through the RBI clearing system.
safe mode: An operating mode used in Microsoft operating systems. It was introduced in Windows 95 first and was loaded automatically, if Windows 95 crashed during the boot up. You can access Safe Mode if you press the "F8" key when new Windows operating systems are booting—this will bring you to a menu that allows you to boot into safe mode. Safe Mode boots the operating system with minimal driver support. The purpose of it is to help resolve boot problems.
server: A machine whose sole purpose is to supply data so that other machines can use that data.
simplex transmission: It transmits data in one direction only.
smart card: A plastic card with an Integrated chip installed.
standalone: A hardware device or piece of software that works with nothing else required.
star topology: A network topology that has network hubs at the centre, with all connected computers linked back to the hub by a single cable. Thus, if one cable goes down, the rest of the computers can still communicate.
SWIFT: Society for worldwide inter-bank financial telecommunication is an instant transfer of messages internationally.
token ring: A network topology pioneered by IBM and eventually made into the IEEE 802.5 standard. Token ring networks are wired, in a ring topology and nodes on the network pass a token around. Whichever node has the token is allowed to use the network.
usenet newsgroups: Also referred to simply as "newsgroups," Usenet newsgroups are a huge bunch of Internet discussion groups that replicate across the Internet every so often.
vein recognition: Uses unique vein structure of the human body to identify individuals.

visual recognition: Digitising a picture of a person, storing in a smart card then using it for identification.
voice recognition system: It compares voices with original recorded.
VSAT: An outdoor small dish antenna interfacing with a satellite.
WAN (Wide Area Network): Any network that spans more than one location. Typically at least one of the locations is fairly remote.

WAP (Wireless Application Protocol): A proposed standard that allows for transfer of data securely between wireless devices, such as, PDAs, cellphones, pagers or other combinations of those devices. WAP supports many different wireless networks.
world wide web (WWW or Web): This is basically a means of communicating text, graphics and other multimedia objects over the Internet.

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