NCFM

NSE's CERTIFICATION IN FINANCIAL MARKETS

Banking Sector Module

NATIONAL STOCK EXCHANGE OF INDIA LIMITED

Test Details:

Sr. No.	Name of Module	Fees (Rs.)	Test Duration (in minutes)	No. of Questions	Maximum Marks	Pass Marks (%)	Certificate Validity
1	Financial Markets: A Beginners' Module *	1500	120	60	100	50	5
2	Mutual Funds : A Beginners' Module	1500	120	60	100	50	5
3	Currency Derivatives: A Beginner's Module	1500	120	60	100	50	5
4	Equity Derivatives: A Beginner's Module	1500	120	60	100	50	5
5	Interest Rate Derivatives: A Beginner's Module	1500	120	60	100	50	5
6	Commercial Banking in India: A Beginner's Module	1500	120	60	100	50	5
7	Securities Market (Basic) Module	1500	105	60	100	60	5
8	Capital Market (Dealers) Module *	1500	105	60	100	50	5
9	Derivatives Market (Dealers) Module *	1500	120	60	100	60	3
10	FIMMDA-NSE Debt Market (Basic) Module	1500	120	60	100	60	5
11	Investment Analysis and Portfolio Management Module	1500	120	60	100	60	5
12	Fundamental Analysis Module	1500	120	60	100	60	5
13	Banking Sector Module	1500	120	60	100	60	5
14	Insurance Module	1500	120	60	100	60	5
15	Macroeconomics for Financial Markets Module	1500	120	60	100	60	5
16	NISM-Series-I: Currency Derivatives Certification Examination	1000	120	60	100	60	3
17	NISM-Series-II-A: Registrars to an Issue and Share Transfer Agents – Corporate Certification Examination	1000	120	100	100	50	3
18	NISM-Series-II-B: Registrars to an Issue and Share Transfer Agents – Mutual Fund Certification Examination	1000	120	100	100	50	3
19	NISM-Series-IV: Interest Rate Derivatives Certification Examination	1000	120	100	100	60	3
20	NISM-Series-V-A: Mutual Fund Distributors Certification Examination *	1000	120	100	100	50	3
21	NISM-Series-VI: Depository Operations Certification Examination	1000	120	100	100	60	3
22	NISM Series VII: Securities Operations and Risk Management Certification Examination	1000	120	100	100	50	3
23	Certified Personal Financial Advisor (CPFA) Examination	4000	120	80	100	60	3
24	NSDL–Depository Operations Module	1500	75	60	100	60 #	5
25	Commodities Market Module	1800	120	60	100	50	3
26	Surveillance in Stock Exchanges Module	1500	120	50	100	60	5
27	Corporate Governance Module	1500	90	100	100	60	5
28	Compliance Officers (Brokers) Module	1500	120	60	100	60	5
29	Compliance Officers (Corporates) Module	1500	120	60	100	60	5
30	Information Security Auditors Module (Part-1)	2250	120	90	100	60	2
	Information Security Auditors Module (Part-2)	2250	120	90	100	60	2
31	Options Trading Strategies Module	1500	120	60	100	60	5
32	FPSB India Exam 1 to 4**	2000 per exam	120	75	140	60	NA
33	Examination 5/Advanced Financial Planning **	5000	240	30	100	50	NA
34	Equity Research Module ##	1500	120	65	100	55	2
35	Issue Management Module ##	1500	120	80	100	55	2
36	Market Risk Module ##	1500	120	50	100	55	2
37	Financial Modeling Module ###	1000	150	50	75	50	NA

* Candidates have the option to take the tests in English, Gujarati or Hindi languages.

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

** Following are the modules of Financial Planning Standards Board India (Certified Financial Planner Certification)

- FPSB India Exam 1 to 4 i.e. (i) Risk Analysis & Insurance Planning (ii) Retirement Planning & Employee Benefits (iii) Investment Planning and (iv) Tax Planning & Estate Planning
- Examination 5/Advanced Financial Planning

\## Modules of Finitiatives Learning India Pvt. Ltd. (FLIP)

\### Module of IMS Proschool

The curriculum for each of the modules (except Modules of Financial Planning Standards Board India, Finitiatives Learning India Pvt. Ltd. and IMS Proschool) is available on our website: www.nseindia.com > Education > Certifications.

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

This book has been deveoped for NSE by Mr. Sundar Sankaran, Director, Finberry Academy Pvt. Ltd.

Chapter 1 : Introduction to Banking

1.1 Fundamental Role and Evolution

1.1.1 India

The banking sector is meant to meet the financial needs of the economy. Too much of money can cause inflation – too little can stifle economic growth and create problems of unemployment and lost opportunity. Accordingly the apex banking institution, the Reserve Bank of India (RBI) has a basic function "...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."[1]

The RBI, which commenced operations on April 1, 1935, is at the centre of India's financial system. Hence it is called the *Central Bank*. It has a fundamental commitment to maintaining the nation's monetary and financial stability. It started as a private share-holders' bank – but was nationalized in 1949, under the Reserve Bank (Transfer of Public Ownership) Act, 1948.

RBI is banker to the Central Government, State Governments and Banks. Key functions of RBI Include:

- Monetary policy
- Supervision of Banking companies, Non-banking Finance companies and Financial Sector, Primary Dealers and Credit Information Bureaus
- Regulation of money market, government securities market, foreign exchange market and derivatives linked to these markets.
- Management of foreign currency reserves of the country and its current and capital account.
- Issue and management of currency
- Oversight of payment and settlement systems
- Development of banking sector
- Research and statistics.

While RBI performs these functions, the actual banking needs of individuals, companies and other establishments are met by banking institutions (called *commercial banks)* and non-banking finance companies that are regulated by RBI.

RBI exercises its supervisory powers over banks under the Banking Companies Act, 1949, which later became Banking Regulation Act, 1949.

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1 Preamble to the Reserve Bank of India Act, 1934

The largest commercial bank in the country is State Bank of India (SBI). Its origins can be traced back to 1806, when Bank of Calcutta was constituted. It was re-named Bank of Bengal in 1809. Bank of Bombay (created in 1840), Bank of Madras (created in 1843) and Bank of Bengal were amalgamated in 1921 to form Imperial Bank of India. Until 1935 (when RBI commenced operations), the Imperial Bank of India performed the functions of Central Bank as well as Commercial Bank.

In 1955, State Bank of India was constituted to take over the Imperial Bank of India. Later, 8 state associated banks (State Bank of Jaipur, State Bank of Bikaner, State Bank of Patiala, State Bank of Hyderabad, State Bank of Indore, State Bank of Mysore, State Bank of Travancore and State Bank of Saurashtra) were brought under SBI. Subsequently, State Bank of Jaipur and State Bank of Bikaner merged to form State Bank of Bikaner and Jaipur. In course of time, State Bank of Saurashtra and State Bank of Indore were merged into SBI. In order to benefit from economies of scale and technology, SBI has a grand vision to merge the other associate banks too, into itself.

RBI earlier owned the entire share capital of SBI. Later, when SBI went public, other investors too became shareholders. A few years ago, the shares of SBI that were owned by RBI were transferred to the Government of India.

The reach of the banking network is a key determinant of banking services available for the economy. In order to ensure that banks focus on building that reach irrespective of profitability considerations, the Government of India went through two rounds of nationalization of banks:

- In 1969, 14 major Indian commercial banks (like Central Bank of India and Punjab National Bank) were nationalized (SBI, as seen earlier, was already under the control of RBI).
- 6 more banks (like Vijaya Bank and Corporation Bank) were nationalized in 1980.

SBI, its subsidiaries, and the 20 nationalised banks are generally referred to as *public sector banks.*

Other private sector banks (essentially the smaller ones of Indian origin) were allowed to continue as private entities under RBI supervision. These are commonly referred to as *old private banks.* Foreign banks that were operating in the country were similarly allowed to continue as private entities.

In order to enhance banking services for the rural sector, a framework of Regional Rural Banks came up in 1975. Ownership of these banks is split between three stake-holders viz. Central Government (50%), concerned State Government (15%) and the bank which sponsors the RRB (35%). The sponsoring bank is expected to assist the RRB in its operations. The smaller

RRBs are in the process of being merged with each other so that they have the critical mass for meaningful banking operations.

Another vehicle for local reach is the Co-operative Banks, which have been in existence for over a century. They are registered under the Co-operative Societies Act, 1960 and regulated under the Banking Regulations Act, 1949 and Banking Laws (Co-operative Societies) Act, 1956. Several states have their own regulations. Urban co-operative banks finance small-scale units and self-employment businesses, besides home finance, consumer finance and personal finance. Rural co-operative banks are active in areas like farming, cattle, hatcheries and milk.

In some cases, the co-operative banks have become tools for politics, thus endangering the money of depositers. RBI has been working towards a mechanism for better regulation and control over the co-operative banks.

In line with the liberalization in the 1990s, private sector was permitted to promote new banks, subject to obtaining banking license from RBI. These are commonly referred to as *new private banks.*

The RBI recently announced a draft policy framework for issue of new banking licenses to the private sector.

At a socio-economic level, the test of a country's banking system is how well it meets the needs of the weaker and disadvantaged sections of society. Accordingly, RBI is giving a thrust to *financial inclusion* and *financial literacy.*

1.1.2 United States

After the stock market crash of 1929 and the banking crisis in the 1930s, the US brought in the Glass-Stegall Act, 1933. The intention was to prohibit commercial banks from investment banking activities and taking equity positions in borrowing firms.

Many of the restrictions of the Glass-Stegall Act were reversed through the Gramm-Leach-Bliley Act, 1999 (GLB Act, also called Financial Services Modernisation Act, 1999). The act permitted commercial banks, investment banks, securities firms and insurance companies to consolidate. This paved the way for *Universal Banking*, where all kinds of banking services would be offered under a single umbrella institution.

Leading economists like Paul Krugman and Joseph Stigilitz believe that the GLB Act was responsible for the sub-prime mortgage crisis which hit the world in 2007. It also created huge institutions that were risky to the financial system and *too big to fail.*

President Obama's administration is moving to correct some of the anomalies. Former Federal Reserve Governor, Paul Volcker has made proposals which have come to be called the Volcker

Rule. It specifically prohibits a bank, or an institution that owns a bank, from engaging in proprietary trading that isn't at the behest of its clients, and from owning or investing in a hedge fund or private equity fund. It also limits the liabilities that the largest banks could hold.

An important recent development is the Dodd–Frank Wall Street Reform and Consumer Protection Act, 2010. The Act, which was passed as a response to the late-2000s recession, is the most sweeping change to financial regulation in the United States since the Great Depression. It changes significantly, the American financial regulatory environment affecting all Federal financial regulatory agencies and affecting almost every aspect of the financial services industry in the United States. The highlights of the Act are as follows:

- *Consumer Protection with Authority and Independence*

  The Ac creates a new independent watchdog, The Consumer Financial Protection Bureau, housed at the Federal Reserve. Its role is to ensure American consumers get the clear, accurate information they need to shop for mortgages, credit cards, and other financial products, and protect them from hidden fees, abusive terms, and deceptive practices.

- *Ends Too Big to Fail Bailouts*

  The Act seeks to end the possibility that taxpayers will be asked to write a cheque to bail out financial firms that threaten the economy. It does this by:

  - Creating a safe way to liquidate failed financial firms;
  - Imposing tough new capital and leverage requirements that make it undesirable to get too big;
  - Updating the Fed's authority to allow system-wide support but no longer prop up individual firms; and
  - Establishing rigorous standards and supervision to protect the economy and American consumers, investors and businesses.

- *Advance Warning System*

  Creates a council, The Financial Stability Oversight Council, to identify and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the economy.

- *Transparency and Accountability for Exotic Instruments*

  - Eliminates loopholes that allow risky and abusive practices to go on unnoticed and unregulated - including loopholes for over-the-counter derivatives, asset-backed securities, hedge funds, mortgage brokers and pay day lenders.

    - Requires companies that sell products like mortgage-backed securities to retain at least 5% of the credit risk, unless the underlying loans meet standards that reduce riskiness.

- *Executive Compensation and Corporate Governance*

  Provides shareholders with a say on pay and corporate affairs with a non-binding vote on executive compensation and golden parachutes.

- *Protects Investors*

    - Provides tough new rules for transparency and accountability for credit rating agencies to protect investors and businesses.
    - Creates an Office of Credit Ratings at the Securities Exchange Commission (SEC) with expertise and its own compliance staff and the authority to fine agencies.
    - Creates the first ever office in the Federal government focused on insurance. The Office, as established in the Treasury, will gather information about the insurance industry, including access to affordable insurance products by minorities, low- and moderate- income persons and underserved communities. The Office will also monitor the insurance industry for systemic risk purposes.
    - Gives SEC the authority to impose a fiduciary duty on brokers who give investment advice - the advice must be in the best interest of their customers.

- *Enforces Regulations on the Books*

  Strengthens oversight and empowers regulators to aggressively pursue financial fraud, conflicts of interest and manipulation of the system that benefits special interests at the expense of American families and businesses.

- *Card Transactions*

  Requires Federal Reserve to issue rules to ensure that fees charged to merchants by credit card companies / debit card transactions are reasonable and proportional to the cost of processing those transactions.

  Since many of the large global banks are incorporated in the US, developments on this front will influence the global banking architecture in the next few years.

1.2 Banking Structure in India

Problems in the banking sector can seriously affect the real economy, as has been experienced globally in the last few years. Therefore, a well-regulated banking system is a key comfort for local and foreign stake-holders in any country. Prudent banking regulation is recognized as one of the reasons why India was less affected by the global financial crisis.

The Banking Regulation Act, 1949 defines a *banking company* as a company which transacts the business of banking in India. *Banking* is defined as accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.

Section 49A of the Act prohibits any institution other than a banking company to accept deposits from the public withdrawable by cheque.

RBI is the apex regulater for banks.

Banks can be broadly categorized as Commercial Banks or Co-operative Banks.

Commercial Banks include:

- Public Sector Banks (SBI, SBI Associates and Nationalised Banks)
- Private Sector Banks (Old, New and Foreign)
- Regional Rural Banks

Co-operative Banks include:

- Urban co-operative banks
- Rural / Agricultural co-operative banks.

Banks which meet specific criteria are included in the second schedule of the RBI Act, 1934. These are called *scheduled banks.* They may be commercial banks or co-operative banks. Scheduled banks are considered to be safer, and are entitled to special facilities like re-finance from RBI. Inclusion in the schedule also comes with its responsibilities of reporting to RBI and maintaining a percentage of its demand and time liabilities as Cash Reserve Ratio (CRR) with RBI.

Non-banking finance companies (NBFC) become a source of incremental finance. At times, they finance businesses which do not meet strict banking norms. NBFCs do not have access to cheap bank deposits from the public (in the form of savings account, current account etc., which are discussed in the next Chapter), although they can accept fixed deposits. Their cost of funds being higher than banks, their lending too tends to be at a higher rate. Yet borrowers access these funds, either because they are unable to mobilise funds from banks, or to fund their requirements beyond what they can mobilise from banks. NBFCs are particularly active in consumer finance and personal finance.

1.3 Licensing of Banks in India

Before anyone can carry on the business of banking in India, a license from RBI is required. RBI has the discretion to decide on the conditions to be complied with, before grating a license. Some of the points considered by RBI are as follows:

- Whether the company is or will be in a position to pay its present and future depositors in full as their claims accrue;
- Whether the affairs of the company are being conducted or likely to be conducted in a manner detrimental to the interests of its present or future depositors;
- Whether the general character of proposed management of the company will not be prejudicial to public interest or the interest of depositers;
- Whether the company has an adequate capital structure and earning prospects;
- Whether public interest will be served by grant of license to the company;
- Whether considering the banking facilities available in the proposed area of operation, the potential scope for expansion of business by banks already in existence in that area and other relevant factors, the grant of license would be prejudicial to the operation and consolidation of the banking system, consistent with monetary stability and economic growth;
- The fulfillment of any other condition which the Reserve Bank considers relevant in public interest or in the interest of depositors.

When it comes to foreign banks, RBI also considers the following:

- Whether the government or the law of the country, in which the company is incorporated, discriminates in any way against banking companies registered in India.
- Whether the company complies with the provisions of the Banking Regulation Act, as applicable to foreign companies.

  RBI also has the right to cancel the bank license if the company stops its banking business in India or does not follow any directions issued by RBI.

1.4 Branch Licensing

Besides the banking license, banks have to obtain prior permission of RBI for opening a new place of business or changing the location of the existing place of business. 'Place of business' includes any place at which deposits are received, cheques are cashed or moneys lent.

The requirement of permission is however not applicable in the following cases:

- Changing the location of an existing place of business within the same city, town or village.
- Opening a temporary place of business upto one month for the purpose of affordable banking facilities for any exhibition, mela, conference or like occasion. The temporary place should however be within the limits of the city, town or village where there is an existing branch.

Banks earlier had to obtain permission separately for each ATM location. Now, they can obtain permission once a year for opening new branches, administrative offices of ATM locations.

RRBs need to route their request for permission through NABARD, alongwith comments of the sponsor bank.

1.5 Foreign Banks

Foreign banks in India mostly operate as branches of the international entity. Recently, RBI has come out with a discussion paper on the subject, which incorporates the learning from the recent global financial crisis. Key points mentioned in the report are as follows:

- There are currently 34 foreign banks operating in India as branches.
  - o Their balance sheet assets, accounted for about 7.65 percent of the total assets of the scheduled commercial banks as on March 31, 2010 as against 9.03 per cent as on March 31, 2009.
  - o In case, the credit equivalent of off balance sheet assets are included, the share of foreign banks was 10.52 per cent of the total assets of the scheduled commercial banks as on March 31, 2010, out of this, the share of top five foreign banks alone was 7.12 per cent.
- The policy on presence of foreign banks in India has followed two cardinal
- principles of (i) Reciprocity and (ii) Single Mode of Presence. These principles are independent of the form of presence of foreign banks. Therefore, these principles should continue to guide the framework of the future policy on presence of foreign banks in India.
- Prima facie the branch mode of presence of foreign banks in India provides a ring-fenced structure as there is a requirement of locally assigned capital and capital adequacy requirement as per Basel Standards.
- It may not be possible to mandate conversion of existing branches into subsidiaries. However, the regulatory expectation would be that those foreign banks which meet the conditions and thresholds mandated for subsidiary presence for new entrants or which become systemically important by virtue of their balance sheet size would voluntarily opt for converting their branches into Wholly Owned Subsidiaries (WOS) in view of the incentives proposed to be made available to WOS.
- The following category of banks may be mandated entry in India only by way of setting up a WOS:
  - o Banks incorporated in a jurisdiction that has legislation which gives deposits made/ credit conferred, in that jurisdiction a preferential claim in a winding up.

  - Banks which do not provide adequate disclosure in the home jurisdiction.
  - Banks with complex structures,
  - Banks which are not widely held, and
  - Banks other than those listed above may also be required to incorporate locally, if the Reserve Bank of India is not satisfied that supervisory arrangements (including disclosure arrangements) and market discipline in the country of their incorporation are adequate or for any other reason that the Reserve Bank of India considers that subsidiary form of presence of the bank would be desirable on financial stability considerations.

- The minimum capital requirements for WOS may generally be in line with those prescribed for the new private sector banks. The WOS shall be required to maintain a minimum capital adequacy ratio of 10 per cent of the risk weighted assets or as may be prescribed from time to time on a continuous basis from the commencement of operations.
- In order to ensure that the board of directors of the WOS of foreign bank set up in India acts in the best interest of the local institution, RBI may, in line with the best practices in other countries, mandate that
  - Not less than 50 percent of the directors should be Indian nationals resident in India,
  - Not less than 50 percent of the directors should be non-executive directors,
  - A minimum of one-third of the directors should be totally independent of the management of the subsidiary in India, its parent or associates and
  - The directors shall conform to the 'Fit and Proper' criteria.
- With a view to incentivise setting up of WOS/conversion of foreign bank branches into WOS, it is proposed that the branch expansion policy as applicable to domestic banks as on January 1, 2010, may be extended to WOS of foreign banks also.
- The expansion of the branch network of foreign banks in India – both existing and new entrants – who are present in branch mode would be strictly under the WTO commitments of 12 branches or as may be modified from time to time.
- At present under the WTO commitments, there is a limit that when the assets (on balance sheet as well as off-balance sheet) of the foreign bank branches in India exceed 15% of the assets of the banking system, licences may be denied to new foreign banks.

Building on this to address the issue of market dominance, it is proposed that when the capital and reserves of the foreign banks in India including WOS and branches exceed 25% of the capital of the banking system, restrictions would be placed on

- o further entry of new foreign banks,
- o branch expansion in Tier I and Tier II centres of WOS and
- o capital infusion into the WOS

This will require RBI's prior approval.

1.6 Private Banks – Capital and Voting Rights

The minimum capital requirement for a new private bank is Rs300crore.

No shareholder can exercise voting rights in respect of the shares held by him in excess of 10% of the total voting rights of all shareholders in the bank. Banks have to take RBI's acknowledgement before transferring shares in favour of a party beyond this threshold limit.

1.7 Dividend

RBI has also laid down conditions regarding declaration of dividends.

- Capitalized expenses will have to be written off, before dividend is declared.
- It can be paid only out of current year's profits only.
- The dividend payout can be a maximum of 40%. The ceiling is linked to net NPA level.
- Minimum capital adequacy ratio of 9% has to be maintained.
- Net NPAs should not exceed 7%.

1.8 Corporate Governance

At least 51% of the total number of directors have to be persons with special knowledge or practical experience of accounting, agriculture and rural economy, banking, co-operatives, economics, finance, law, small scale industry or any other aspect, the special knowledge or practical experience of which is useful to the banking company.

At least two directors should have special knowledge or practical experience in agriculture and rural economy or co-operative or small scale industry.

Directors other than the Chairman and whole-time directors shall hold office for not more than a period of 8 years, continuously.

Chapter 2 : Banking and the Economy

Banks, as seen earlier, are a key constituent of the economy. They are a key vehicle through which RBI implements its monetary policy and exchange rate policy. The following are key concepts to understand in this regard:

2.1 Cash Reserve Ratio (CRR)

Scheduled Commercial Banks are required to maintain with RBI, an average cash balance, the amount of which shall not be less than 6% of the total of the Net Demand and Time Liabilities (NDTL) in India.

Demand Liabilities include all liabilities which are payable on demand and they include current deposits, demand liabilities portion of savings bank deposits, margins held against letters of credit/ guarantees, balances in overdue fixed deposits, cash certificates and cumulative/ recurring deposits, outstanding Telegraphic Transfers (TTs), Mail Transfer (MTs), Demand Drafts (DDs), unclaimed deposits, credit balances in the Cash Credit account and deposits held as security for advances which are payable on demand.

Time Liabilities are those which are payable otherwise than on demand and they include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margin held against letters of credit if not payable on demand, deposits held as securities for advances which are not payable on demand, India Millennium Deposits and Gold Deposits.

The CRR is calculated on the basis of average of the daily balance maintained with RBI during the reporting fortnight. Scheduled Commercial Banks are required to maintain minimum CRR balances up to 70 per cent of the total CRR requirement on all days of the fortnight.

If RBI wants to tighten the monetary policy, it will raise the CRR. Lowering the CRR releases more liquidity into the market. Changes in CRR tend to have an immediate impact on the market.

2.2 Statutory Liquidity Ratio (SLR)

All Scheduled Commercial Banks, in addition to CRR, are required to maintain in India,

a) in cash, or

b) in gold valued at a price not exceeding the current market price, or

c) in unencumbered approved securities valued at a price as specified by the RBI from time to time, an amount which shall not, at the close of the business on any day, be less than 24 per cent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight.

If RBI wants to tighten the monetary policy, it will raise the SLR. Such a measure would not be effective, if banks' holding of SLR is higher than the statutory SLR rate.

Lowering the SLR means that banks can sell some of their SLR securities to raise funds. It therefore tends to soften interest rates.

2.3 Repo and Reverse Repo

Banks facing a shortage of funds can borrow from RBI through a *repo* transaction. The transaction, backed by approved securities, has two legs:

- In the first leg, the bank sells the required value of approved securities to RBI. RBI will release funds to the bank against this transaction.
- In the second leg, the bank buys back the same securities. The price for buying them back (higher than the price for the first leg) is pre-decided, when the repo transaction is agreed upon.

The difference between the prices for the two legs thus, is the borrowing cost for the borrowing bank.

A repo transaction is meant to meet only the short term (single day to a few days) requirements of banks.

A *reverse repo* is the opposite of a repo.

RBI announces the repo rate and reverse repo rate. They tend to remain steady for several weeks, until RBI chooses to change it. The current repo rate is 6.5% p.a.; reverse repo rate is 5.5%. The reverse repo rate will always be lower than the repo rate. (Why? Point for reflection).

If RBI wants to signal tight monetary policy, it will increase the repo rate. If the overall liquidity position is tight, banks will increase their deposit rates or lending rates, since the borrowing cost from RBI is up.

A reduction in reverse repo rate makes it less interesting for banks to park their funds with RBI. This measure is adopted when there is too much liquidity in the market, as reflected in the inter-bank call money market or short term funds.

In general, the call money rate (which is determined by the market, not RBI) is expected to be between the repo rate and reverse repo rate (Why? Point for reflection).

2.4 Open Market Operations

Changes in CRR and SLR are mandatory. They affect all the scheduled commercial banks. These are very important tools of central banks in countries where the debt market is not so developed.

In countries where debt markets are well developed, the central banks can influence liquidity through open market operations.

- If they want to suck liquidity from the market, they will securities (or gold, foreign exchange etc.) to the market. When the market buys these assets, liquidity is transferred from the market to the coffers of the central bank.
- If a central bank wants to increase liquidity in the market, it will buy back securities (or gold, foreign exchange etc.) from the market. When it pays for the assets acquired, liquidity is released in the market.

For instance, in the United States, in the last few years, the Federal Reserve has been seeking to release liquidity in the market (Why? Point for reflection). For this, it set target amounts. The exercise was called *quantitative easing (QE).* The first phase of the exercise was called QE1. A few months ago, the Federal Reserve announced its QE2 program.

2.5 Security Valuation

The entire investment portfolio of the banks (including SLR Securities) have to be classified under three categories viz. Held to Maturity (HTM), Available for sale (AFS) and Held for Trading (HFT).

- Investment classified under *Held to Maturity* category need not be marked to market and will be carried at acquisition cost unless it is more than the face value. In such a case, the premium should be amortised over a period remaining to maturity.

  Banks' Boards should fix internal limits for holdings in HTM category, which shall be followed on a consistent basis at least for a period of 3 to 5 financial years, without any change.
- Individual scrips in the *Available for Sale* category will be marked to market at consistent monthly or more frequent intervals. The net depreciation under each classification should be recognized and fully provided for and any appreciation should be ignored. The book value of the individual securities would not undergo any change after the revaluation.

  Available for sale securities are those securities that are designated as available for sale or are not classified under HTM or HFT categories. Banks have to include their investments in the equity shares of their subsidiaries/ associates/ joint ventures in AFS category.

- The individual scrips in the *Held for Trading* category will be revalued daily, and net appreciation/depreciation under each classification will be recognized in income account. The book value of the individual scrip will be changed with revaluation.

  Trading generally reflects active and frequent buying and selling. These securities are to be sold within 90 days.

Banks should decide the category of investment at the time of acquisition and the decision should be recorded on the investment proposals.

- If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as Held to Maturity, it shall be reclassified as Available for Sale and re-measured at market value, and the difference between its book value and market value shall be accounted for in 'Unrealised gain/loss on AFS portfolio'. The book value of individual securities would undergo change. A bank should not classify any security as HTM, if the bank has, during the current financial year, sold or reclassified before maturity, more than 5 per cent of HTM investments at the end of the previous financial year.
- Banks should not reclassify securities into or out of the Held for Trading category while it is held. However, shifting of investments from HFT category to AFS category will be permitted under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

  Transfer of scrips from HFT to AFS category should be done at the acquisition cost/ book value/ market value on the date of transfer, whichever is the least. The book value of the individual securities would undergo change with a corresponding debit to the Profit and Loss account.
- Banks should not reclassify securities out of the AFS category, while it is held.

2.6 Capital Account Convertibility

Every country decides on the restrictions it would like to impose on transactions between its locals and non-residents. Since these have an implication on conversion of local currency into foreign currency and vice versa, it is called *convertibility.* There can be shades of differences between countries on their convertibility. Broadly, countries fall into any of three categories:

- *Largely non-convertible*

  In such countries (e.g. many countries in Africa) almost every transaction with the outside world requires permission of the government or the central bank. This was India's position, before the liberalization commenced in the 1990s.

- *Convertible on Current Account*

  Most transactions that are in the nature of consumption, do not call for permissions. Investment kind of transactions are either limited, or require permissions. This is India's current position. Indians no longer need permission for import of most goods and services (except a negative list of select items). Similarly, banks can issue international credit card for resident Indians, who can use it for paying their expenses abroad, buying international magazines, software etc.

  However, there are limits to resident Indians' investments abroad in securities, real estate etc. Similarly, there are limits to investments by foreigners in Indian securities, real estate etc.

  India's recognition as a country with current account convertibility was established when we accepted the obligations under Article VIII of the IMF's Articles of Agreement in August 1994.

- *Convertible on Capital Account*

  Here, even investment transactions are considerably liberalized. The United States and many of the developed countries of Europe are examples.

Foreign investors and lenders like free convertibility, because they can easily transfer moneys into the country and back, without much of transaction cost or time in taking approvals.

In India, the RBI constituted the Tarapore Committee, which, in 1997, laid down a road map for India to move towards convertibility. It prescribed certain pre-conditions before India can consider full convertibility viz.

- Gross Fiscal Deficit of the center at less than 3.5% of Gross Domestic Product (GDP)
- Inflation rate of 3 – 5% (average for 3 years)
- Gross Non-Performing Assets (NPAs) of financial sector less than 5% of total advances
- Average effective CRR of the banking system at 3%.

During the 1990s, several Latin American countries, Turkey and Russia suffered international currency crises. The South East Asia crisis in 1997 highlighted the risks entailed in full capital account convertibility. Countries like Indonesia, Thailand and Malaysia faced major problems on account of the activities of investors, lenders and speculaters. India's pragmatic approach to convertibility ensured that the country was largely isolated from the South East Asian crisis.

In 2006, RBI constituted another committee under Mr. Tarapore, to re-examine the matter. It came out with a report on *Fuller Capital Account Convertibility.* Various measures have been proposed in a 5 year time frame (2006-07 to 2010-11). Some of these have been implemented, as India continues its gradualist approach to fuller capital account convertibility.

Chapter 3 : Bank Deposits, Nomination and Deposit Insurance

Deposits are a key source of low cost funds for banks. The bank is profitable, when it is able to lend or invest these funds and earn a higher return.

The deposit accounts serve various purposes of the account holders:

- A safe avenue to park surplus funds
- Earn a return on surplus funds
- Receive payments from others, and make payments to others.

3.1 Kinds of Deposits

3.1.1 Demand Deposits

These are deposits which the customer can get back on demand or which are placed for very short time periods. For example:

- *Savings account deposits*

  This is the normal bank account that individuals and Hindu Undivided Families (HUFs) maintain. The account can be opened by individuals who are majors (above 18 years of age), parents / guardians on behalf of minors and Karta of HUFs. Clubs, associations and trusts too can open savings accounts as provided for in their charter.

  Banks insist on a minimum balance, which may be higher if the account holder wants cheque book facility. The minimum balance requirement tends to be lowest in the case of co-operative banks, followed by public sector banks, private sector Indian banks and foreign banks, in that order.

  Banks do impose limits on the number of withdrawals every month / quarter. Further, overdraft facility is not offered on savings account.

  Traditionally, banks paid an interest on the lowest balance in the bank account between the 10th and the end of the month. Suppose the balance in the depositer's account in a particular month was as follows:

1st to 10th	Rs. 50,000
11th	Rs. 10,000
12th to 31st	Rs. 50,000

  Although Rs. 50,000 was maintained for all but one day in the month, the depositer would receive interest as if only Rs. 10,000 (the lowest balance between 10th and the end of the month) was maintained in the account during the month. The bank thus got "free money" of Rs. 50,000 less Rs. 10,000 i.e. Rs. 40,000 for all but one day in the month.

Since April 1, 2010, scheduled commercial banks have been directed to pay interest on the daily balances. Thus, banks have lost on the free money, and their cost of funds has gone up.

Interest is paid on a half-yearly basis, every September and March.

- *Current account deposits*

  This is maintained by businesses for their banking needs. It can be opened by anyone, including sole-proprietorships, partnership firms, private limited companies and public limited companies.

  The current account comes with a cheque book facility. Normally, there are no restrictions on the number of withdrawals. Subject to credit-worthiness, the bank may provide an overdraft facility i.e. the account holder can withdraw more than the amount available in the current account.

  Current accounts do not earn an interest. Therefore, it is prudent to leave enough funds in current account to meet the day-to-day business needs, and transfer the rest to a term deposit.

  CASA is a term that is often used to denote Current Account and Savings Account. Thus, a bank or a branch may have a CASA promotion week. This means that during the week, the bank would take extra efforts to open new Current Accounts and Savings Accounts.

3.1.2 Term Deposits

These are deposits that are maintained for a fixed term. The time period can be anything from 7 days to 10 years. This is not like a normal operating bank account. Therefore, cheque book facility is not offered.

Benefit of term deposits is that the interest rate would be higher. Weakness is that if the investor needs the money earlier, he bears a penalty. He will earn 1% less than what the deposit would otherwise have earned, if it had been placed for the time period for which the money was left with the bank.

Suppose the bank offers 6% for deposits of 1 year, and 7% for deposits of 2 years. The depositer placed money in a 2-year deposit (at 7%), but did a premature withdrawal after 1 year. The interest earning would be limited to 6% (the rate applicable for the time period for which the money was placed with the bank) less 1% i.e. 5%.

Banks may also offer the facility of loan against fixed deposit. Under this arrangement, a certain percentage of the fixed deposit amount may be made available as a loan, at an interest rate, which would be higher than the term deposit rate. This is an alternative to premature withdrawal.

Unlike interest rate on savings account, the interest in term deposits is de-regulated. Therefore, every bank decides its own interest rate structure. Further, it is normal to offer 0.50% extra interest to senior citizens.

For large deposits of above Rs. 1 crore, the bank may be prepared to work out special terms.

The term deposits may also be structured as *recurring* i.e. the depositer would invest a constant amount every month / quarter, for anything from 12 months to 10 years. Benefit of such an account is that the interest rate on the future deposits is frozen at the time the recurring account is opened. Thus, even if interest rates on fixed deposits, in general, were to go down, the recurring deposits would continue to earn the committed rate of interest. Interest rate in a recurring deposit may be marginally lower than the rate in a non-recurring term deposit for the same time period.

3.1.3 Hybrid Deposits / Flexi Deposits

These are value added facilities offered by some banks. For instance, a *sweep facility* may be offered in their CASA accounts. Under the facility, at the end of every day, surplus funds beyond the minimum balance required, is automatically swept into an interest earning term deposit account. When more money is required for the regular operations, it is automatically swept from the interest earning term deposit account. Benefit for depositers are:

- Superior interest earnings, as compared to normal CASA
- Less paperwork – no need to sign papers etc. for each sweep in or sweep out.
- Sweep out of money from the interest earning term deposit account does not attract premature withdrawal charges.

However, unlike in a normal term deposit, interest rate is liable to be changed by the bank at any time.

3.1.4 Non-Resident Accounts

These can be opened by Non-Resident Indians and Overseas Corporate Bodies with any bank in India that has an Authorised Dealer license.

- *Foreign Currency Non-Resident Account (FCNR)*

  These are maintained in the form of fixed deposits for 1 year to 3 years. Since the account is designated in foreign currency (Pounds, Sterling, US Dollars, Japanese Yen and Euro), the account holder does not incur exchange losses in first converting foreign currency into rupees (while depositing the money) – and then re-converting the rupees into foreign currency (when he wants to take the money back).

The depositer will have to bring in money into the account through a remittance from abroad or through a transfer from another FCNR / NRE account. If the money is not in the designated foreign currency, then he will have to bear the cost of conversion into the designated currency. On maturity, he can freely repatriate the principal and interest (which he will receive in the designated currency that he can convert into any other currency, at his cost).

Interest earned on these deposits is exempt from tax in India.

- *Non-Resident External Rupee Account (NRE)*

  As in the case of FCNR,

  - o The money has to come through a remittance from abroad, or a transfer from another FCNR / NRE account.
  - o The principal and interest are freely repatriable.
  - o Interest earned is exempt from tax in India.

  The differences are:

  - o It can be operated with a cheque, as in the case of any savings bank account.
  - o It is maintained in rupees. Therefore, a depositer bringing money in another currency will have to first convert them into rupees; and then re-convert them to the currency in which he wants to take the money out.

    If during the deposit period, the rupee becomes weaker, then that loss is to the account of the depositer.

- *Non-Resident Ordinary Account (NRO)*

  As with a NRE account,

  - o It can be operated with a cheque, as in the case of any savings bank account.
  - o It is maintained in rupees with the resulting implications in terms of currency conversion losses for the depositer.

  The differences from NRE are:

  - o The money can come from local sources – not necessarily a foreign remittance or FCNR / NRE account.
  - o The principal amount is not repatriable, though the interest can be repatriated.

- o The bank will deduct tax at source, on the interest earned in the deposit.
- o A non-resident can open an NRO account jointly with a resident.

3.2 Joint Accounts

Two or more individuals may open a joint account. Various options exist for operating the account:

- Jointly by A and B – Both A and B will have to sign for withdrawals and other operations. For example, high value transactions in a partnership firm may require the joint signature of two or more partners.
- Either or Survivor – Either of them can operate the account individually. After the demise of one, the other can operate it as survivor. This is the normal option selected by families.
- Former or Survivor – The first person mentioned as account-holder will operate it during his / her lifetime. Thereafter, the other can operate. This option is often selected by a parent while opening an account with the son / daughter.
- Latter or Survivor - The second person mentioned as account-holder will operate it during his / her lifetime. Thereafter, the other can operate.

While opening the account, the operating option needs to be clearly specified.

3.3 Nomination

The bank account opening form provides for the account holder to select a nominee. In the event of demise of the account holder, the bank will pay the deposit amount to the nominee, without any legal formalities. The salient provisions regarding nomination facility in bank accounts are as follows:

- Nomination facility is available for all kinds of bank accounts – savings, current and fixed deposit.
- Nomination can be made only in respect of a deposit which is held in the individual capacity of the depositor and not in any representative capacity such as the holder of an office like Director of a Company, Secretary of an Association, partner of a firm and Karta of an HUF.
- In the case of a deposit made in the name of a minor, nomination shall be made by a person lawfully entitled to act on behalf of the minor.
- Nomination can be made in favour of one person only.
- Nomination favouring the minor is permitted on the condition that the account holder, while making the nomination, appoints another individual not being a minor, to receive

the amount of the deposit on behalf of the nominee in the event of the death of the depositor during the minority of the nominee.

- Cancellation of, or variation in, the nomination can be made at any time as long as the account is in force. While making nomination, cancellation or variation, witness is required and the request should be signed by all account holders.
- When the nominee makes a claim to the bank account, two documents are normally asked for:
    - o Proof of death of depositer
    - o Identity proof of nominee
- Payment to nominee only releases the bank from its obligation on the account. The nominee would receive the money, in trust, for the benefit of the heirs. The legal heirs of the deceased person can claim their share of the deposit proceeds from the nominee.

3.4 Closure of Deposit Accounts

This might occur in different ways:

- Account-holder can request closure of the account, and give instructions on how the balance in the deposit should be settled.
- On death of the sole account holder, the account would be closed and balance paid to the nominee. If nominee is not appointed, then bank would pay the legal representative of the account holder.
- On receipt of notice of insanity or insolvency of the sole account holder, the bank will stop operations in the account.
- On receipt of notice of assignment of the bank account, the bank would pay the amount lying in the account to the assignee.
- On receipt of a court order or garnishee order from Income Tax authorities, the bank would stop the transactions in the bank account during the pendency of the order.

3.5 Deposit Insurance

Deposit Insurance and Credit Guarantee Corporation (DICGC) was set up by RBI with the intention of insuring the deposits of individuals. The deposit insurance scheme covers:

- All commercial banks, including branches of foreign banks operating in India, and Regional Rural Banks
- Eligible co-operative banks.

  The insurance scheme covers savings account, current account, term deposits and recurring accounts. However, the following deposits are not covered by the scheme:

- Deposit of Central / State Government
- Deposit of foreign governments
- Inter-bank deposits
- Deposits received outside India

In order for depositers in a bank to benefit from the insurance scheme, the bank should have paid DICGC the specified insurance premium (10 paise per annum per Rs. 100 of deposit).

Under the Scheme, in the event of liquidation, reconstruction or amalgamation of an insured bank, every depositor of that bank is entitled to repayment of the deposits held by him in the same right and same capacity in all branches of that bank upto an aggregate monetary ceiling of Rs. 1,00,000/- (Rupees one lakh). Both principal and interest are covered, upto the prescribed ceiling.

A few points to note:

- Suppose Mr. X has one account in his individual capacity, another account jointly with wife, a third account jointly with wife and son/daughter, and a fourth account as partner of a firm. Each of these would be treated as being in a different right and capacity. Therefore, for each of these accounts, insurance cover of Rs. 1,00,000 is available i.e. the insurance cover could go upto Rs. 4,00,000
- Since the monetary ceiling is applicable for all branches of a bank put together, splitting the deposit between different branches of the same bank does not help.
- If Mr. X maintains an account in his individual capacity in different banks (not different branches of the same bank), then insurance cover of Rs. 1,00,000 will be available in each such bank.

Some other aspects of opening and operating bank accounts including Know Your Customer (KYC) requirements are discussed in Chapter 10.

Chapter 4 : Other Banking Services

Accepting deposits is only one activity of a bank. Banks offer various other services to customers. In the context of universal banking, the services offered by a bank can be extremely wide. Some of these are listed below:

4.1 Fund-based Services

Banks accept deposits and raise other debt and equity funds with the intention of deploying the money for a profit.

The income that a bank earns, as a percentage of its loans and investments, is its *Gross Yield*.

The interest it pays as a percentage of the resources mobilised is its *cost of funding.*

Gross Yield less the Cost of Funding represents its *Gross Spread*.

Gross Spread less Administrative and Other Costs is its *Net Spread.*

Fund-based services are thus a key determinant of the bank's spreads. The lending takes several forms.

4.1.1 For Business

- *Bank Overdraft* – a facility where the account holder is permitted to draw more funds that the amount in his current account.
- *Cash* Credit – an arrangement where the working capital requirements of a business are assessed based on financial projections of the company, and various norms regarding debtors, inventory and creditors. Accordingly, a total limit is sanctioned. At regular intervals, the actual drawing power of the business is assessed based on its holding of debtors and inventory. Accordingly, funds are made available, subject to adherence to specified limits of Current Ratio, Liquid Ratio etc.

  Funding could come from a *consortium* of bankers, where one bank performs the role of lead banker. Alternatively, the company may make *multiple banking* arrangements.
- *Bill Purchase / Discount* – When Party A supplies goods to Party B, the payment terms may provide for a *Bill of Exchange* (traditionally called *hundi)*.

  A bill of exchange is an unconditional written order from one person (the supplier of the goods) to another (the buyer of the goods), signed by the person giving it (supplier), requiring the person to whom it is addressed (buyer) to pay on demand or at some fixed future date, a certain sum of money, to either the person identified as *payee* in the bill of exchange, or to any person presenting the bill of exchange.

- o When payable on demand, it is a *Demand Bill*
- o When payable at some fixed future date, it is a *Usance Bill.*

  The supplier of the goods can receive his money even before the buyer makes the payment, through a Bill Purchase / Discount facility with his banker. It would operate as follows:

- o The supplier will submit the Bill of Exchange, along with Transportation Receipt to his bank.
- o The supplier's bank will *purchase* the bill (if it is a demand bill) or *discount* the bill (if it is a usance bill) and pay the supplier.
- o The supplier's bank will send the Bill of Exchange along with Transportation Receipt to the buyer's bank, who is expected to present it to the buyer:
  - ▪ For payment, if it is a demand bill
  - ▪ For acceptance, if it is a usance bill.
- o The buyer will receive the Transportation Receipt only on payment or acceptance, as the case may be.

- *Term Loan / Project Finance* – Banks largely perform the role of working capital financing. With the onset of universal banking, some banks are also active in funding projects. This would entail assessing the viability of the project, arriving at a viable capital structure, and working out suitable debt financing facilities. At times, the main banker for the business syndicates part of the financing requirement with other banks.

4.1.2 For Individuals

Bank credit for individuals could take several forms, such as:

- *Credit Card* – The customer swipes the credit card to make his purchase. His seller will then submit the details to the card issuing bank to collect the payment. The bank will deduct its margin and pay the seller. The bank will recover the full amount from the customer (buyer). The margin deducted from the seller's payment thus becomes a profit for the card issuer.

  So long as the customer pays the entire amount on the due date, he does not bear any financing cost. He may choose to pay only the minimum amount specified by the bank. In that case, the balance is like a credit availed of by him. The bank will charge him interest on the credit.

  Such a mechanism of availing of credit from the credit card is called *revolving credit*.

It is one of the costliest sources of finance – upwards of 3% p.m. Besides, even for a few days of delay in payment, the bank charges penalties. Similarly, penalties are charged if the credit card outstanding crosses the limit specified by the bank.

Owners of many unorganized businesses (who find it difficult to avail of normal bank credit) end up using the credit card to fund their business in this manner – undesirable, but at times, inevitable.

- *Personal Loan* – This is a form of unsecured finance given by a bank to its customer based on past relationship. The finance is given for 1 to 3 years. Cheaper than credit card, but costly. It is not uncommon to come across interest rates of 1.5% p.m. plus 2-3% upfront for making the facility available plus 3-5% foreclosure charges for amounts pre-paid on the loan.

  At times, banks convert the revolving credit in a credit card account to personal loan. Such a conversion helps the customer reduce his interest cost and repay the money faster. This is however a double edged sword. Once the credit card limit is released, customers tend to spend more on the card and get on to a new revolving credit cycle.

- *Vehicle Finance* – This is finance which is made available for the specific purpose of buying a car or a two-wheeler or other automobile. The finance is secured through hypothecation (discussed in next Chapter) of the vehicle financed. The interest rate for used cards can go close to the personal loan rates. However, often automobile manufacturers work out special arrangements with the financiers to promote the sale of the automobile. This makes it possible for vehicle-buyers to get attractive financing terms for buying new vehicles.

- *Home Finance* – This is finance which is made available against the security of real estate. The purpose may be to buy a new house or to repair an existing house or some other purpose. The finance is secured through a mortgage (discussed in next Chapter) of the property.

  The finance is cheaper than vehicle finance. As with vehicle finance, real estate developers do work out special arrangements with financiers, based on which purchasers of new property can get attractive financing terms.

4.2 Non-Fund-based Services

These are services, where there is no outlay of funds by the bank when the commitment is made. At a later stage however, the bank may have to make funds available.

Since there is no fund outflow initially, it is not reflected in the balance sheet. However, the bank may have to pay. Therefore, it is reflected as a *contingent liability* in the Notes to the Balance Sheet. Therefore, such exposures are called *Off Balance Sheet Exposures.*

When the commitment is made, the bank charges a fee to the customer. Therefore, it is also called *fee-based business*.

4.2.1 For Business

- *Letter of Credit* - When Party A supplies goods to Party B, the payment terms may provide for a *Letter of Credit.*

  In such a case, Party B (buyer, or opener of L/C) will approach his bank (L/C Issuing Bank) to pay the beneficiary (seller) the value of the goods, by a specified date, against presentment of specified documents. The bank will charge the buyer a commission, for opening the L/C.

  The L/C thus allows the Part A to supply goods to Party B, without having to worry about Party B's credit-worthiness. It only needs to trust the bank that has issued the L/C. It is for the L/C issuing bank to assess the credit-worthiness of Party B. Normally, the L/C opener has a finance facility with the L/C issuing bank.

  The L/C may be *inland* (for domestic trade) or *cross border* (for international trade).

- *Guarantee* – In business, parties make commitments. How can the beneficiary of the commitment be sure that the party making the commitment (*obliger)* will live up to the commitment? This comfort is given by a *guarantor*, whom the beneficiary trusts.

  Banks issue various guarantees in this manner, and recover a guarantee commission from the obliger. The guarantees can be of different kinds, such as Financial Guarantee, Deferred Payment Guarantee and Performance Guarantee, depending on how they are structured.

- *Loan Syndication* – This investment banking role is performed by a number of universal banks.

4.2.2 For Individuals

- *Sale of Financial Products* such as mutual funds and insurance is another major service offered by universal banks.
- *Financial Planning* and *Wealth Management*, again, are offered by universal banks.
- *Executors and Trustees* – a department within banks – help customers in managing succession of assets to the survivors or the next generation.
- *Lockers* – a facility that most Indian households seek to store ornaments and other valuables.

4.3 Money Remittance Services

4.3.1 Demand Draft / Banker's Cheque / Pay Order

Suppose A needs to make a payment to B. In the normal course, A would sign a cheque for the requisite amount and give it to B.

- If it is a bearer cheque, B can go to A's bank and withdraw the money.
- If it is a crossed cheque, A will deposit the cheque in his bank account.

B wants to be sure that the money would be received i.e. the cheque would not be bounced for any reason. In such a situation, B will insist on a Demand Draft / Banker's Cheque. If both A and B are in the same city, then the bank would issue a Pay Order.

A will have to buy the instrument from a bank, bearing the prescribed charges. A will then send it to B, who will deposit it in his bank account.

4.3.2 National Electronic Funds Transfer (NEFT)

National Electronic Funds Transfer (NEFT) is a nation-wide system that facilitates individuals, firms and corporates to electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country.

In order to issue the instruction, the transferor should know not only the beneficiary's bank account no. but also the the IFSC (Indian Financial System Code) of the concerned bank. IFSC is an alpha-numeric code that uniquely identifies a bank-branch participating in the NEFT system. This is a 11 digit code with the first 4 alpha characters representing the bank, and the last 6 numeric characters representing the branch. The 5th character is 0 (zero). IFSC is used by the NEFT system to route the messages to the destination banks / branches.

Once the NEFT instruction has been issued, it will be effected between the concerned banks in the next settlement. During weekdays, between 9am and 7 pm, there are 11 settlements i.e. every hour. On Saturdays, there are 5 hourly settlements between 9am and 1 pm.

The beneficiary can expect to get credit on the same day, for the first nine batches on week days (i.e., transactions from 9 am to 5 pm) and the first four batches on Saturdays (i.e., transactions from 9 am to 12 noon). For transactions settled in the last two batches on week days (i.e., transactions settled in the 6 and 7 pm batches) and the last batch on Saturdays (i.e., transactions handled in the 1 pm batch) beneficiaries can expect to get credit either on the same day or on the next working day morning (depending on the type of facility enjoyed by the beneficiary with his bank).

There is no limit to the amount that can be transferred under NEFT. However, for transfers above Rs1lakhs, RTGS (discussion follows) is a superior form of funds transfer.

4.3.3 Real Time Gross Settlement (RTGS)

RTGS transfers are instantaneous – unlike National Electronic Funds Transfer (NEFT) where the transfers are batched together and effected at hourly intervals.

As with NEFT, the transferor needs to know the IFSC Code and the beneficiary's bank account no.

RBI allows the RTGS facility for transfers above Rs1lakhs. The RBI window is open on weekdays from 9 am to 4.30 pm; on Saturdays from 9 am to 12.30 pm.

4.3.4 Society for Worldwide Interbank Financial Telecommunications (SWIFT)

SWIFT is solely a carrier of messages. It does not hold funds nor does it manage accounts on behalf of customers, nor does it store financial information on an on-going basis.

As a data carrier, SWIFT transports messages between two financial institutions. This activity involves the secure exchange of proprietary data while ensuring its confidentiality and integrity.

SWIFT, which has its headquarters in Belgium, has developed an 8-alphabet Bank Identifier Code (BIC). For instance HDFCINBB stands for:

- HDFC = HDFC Bank
- IN = India
- BB = Mumbai

Thus, the BIC helps identify the bank. A typical SWIFT instruction would read as follows:

Please remit [amount in US$] by wire transfer

To HDFC Bank Mumbai Account Number V801-890-0330-937

with Bank of New York, New York [Swift code IRVTUS3N]

for further credit to account number XXXXXXXXXXXXXX of Advantage-India Consulting Pvt. Ltd

with HDFC Bank, Ghatkopar East Branch, Mumbai 400077, India

HDFC Bank's Swift code is HDFCINBBXXX

Internationally, funds are remitted through such SWIFT instructions.

4.4 Banking Channels

Initially, all banking services were offered from the bank branches. Automated Teller Machines (ATMs) made it possible for customers to handle their transactions at multiple ATM locations across the country. Tele-banking, supported by call centers and automated messaging made it convenient for customers to handle many services from their home. E-banking (through the internet) and M-banking (through mobile phones) have added another chapter of banking convenience.

Thus, with the aid of technology, the service offering of banks and convenience of customers is continuously increasing.

Chapter 5 : Bank - Customer Relationship

5.1 Roles of Banks

The relationship with the bank gets defined by the nature of the product / service availed by the customer. Some of these are described below:

5.1.1 Bank as Debtor

This is the normal relationship of a person who has an account with the bank. The moment he deposits money in the account, he becomes a creditor of the bank; the bank will be his debtor for the amount lying in his account. The following are the legal implications:

- The banker is required to return the money only when the customer asks for it.
- The customer will have to ask for the money in the branch where he has an account. These days, of course banks offer the facility of anywhere banking including withdrawing money from the ATM.
- The demand for money should be made in the proper form. Example – cheque / withdrawal slip
- Depending on the nature of the deposit, the bank may impose restrictions, which were discussed in Chapter [3].

  Once the bank has the money, it can use the money the way it chooses. The depositer cannot direct the bank to use it in any specific manner. Similarly, the depositer cannot ask for return of the same currency notes / coins that he deposited.

5.1.2 Bank as Creditor

When a customer takes a loan from the bank, he becomes the borrower. The bank will be his creditor. The terms for the loan will be as incorporated in the loan agreement executed between the parties.

Various forms of creating the security are discussed in Chapter [6].

5.1.3 Bank as Bailee

When the customer deposits valuables or documents with the bank, the bank becomes a bailee of those items. The customer is the bailer. As provided in the Indian Contract Act, 1872, the bailer is responsible to the bailee for any losses that arise on account of the bailer's negligence.

5.1.4 Bank as Agent

When a customer deposits a cheque into his account, the bank will send it for clearing. The bank, in this role, is an agent of the customer. The customer is the principal. Similarly, the bank becomes an agent when the customer leaves various standing instructions for payments with the bank.

It is the duty of the agent to follow the instructions given by the principal. The relationship terminates either when the principal gives notice of such termination, or in the event of death, insolvency or lunacy of the principal.

5.1.5 Bank as Lessor

When a customer opts for a safe deposit locker with a bank, he is effectively leasing the locker. He is a lessee, the bank is the lessor. The relationship lasts so long as the lessee keeps paying the prescribed charges.

The lessor is responsible for ensuring minimum standards of security to ensure the safety of the items deposited in the locker. However, it will be liable for loss only if it is negligent in any manner. It can also insist on the procedures to be followed for using the locker.

5.1.6 Bank as Executor / Trustee

Banks have their Executor and Trustee department, who can be appointed for handling the estate of the customer, after the customer's death. The person, in his Will, would mention the bank as Executor of the Will. So long as the bank has accepted the prescribed charges from the customer, it cannot refuse to act as such. While performing this role, it has to act as a trustee of the customer's affairs, and exercise reasonable diligence and care.

Companies often appoint bankers as Trustees for their debenture-holders. In such situations, the bank has a role to protect the interest of the debenture-holders. This would normally take the form of ensuring that the security is created, payments are made as promised etc. The company may appoint different trustees for different series of debentures.

5.2 Bankers' Obligation of Secrecy

The banker has an obligation to maintain secrecy of the details of the account-holder, not only when he has a relationship with the bank, but also after the account is closed. This right of the customer to expect secrecy is limited in the following situations:

5.2.1 Disclosure under Law

Various legislations impose an obligation on the bank to disclose details of the customer. These legislations prevail over the customer's right to secrecy. The legislations include:

- Income Tax Act, 1961
- Companies Act, 1956
- Reserve Bank of India Act, 1934
- Foreign Exchange Management Act, 1999

The anti-money laundering legislations have increased the responsibility on the banks to disclose information about their customer, even without informing the customer about the information being shared.

5.2.2 Disclosure based on customer's consent

The customer may authorize the bank to share its view on the customer's banking affairs with the customer's customer. He may also authorize the bank to issue a certificate on the balance held in his account on a particular day or during a period. The consent of the customer to disclosure of his information may be express, or implied by the circumstances.

5.2.3 Disclosure with Credit Information Bureaus

Banks routinely share with Credit Information Bureaus, details of defaults by their borrowers. The loan agreement with the borrower typically has a clause that provides for such sharing of information.

5.2.4 Disclosure with Business Correspondent / Business Facilitater (BC/BF)

The role of BC / BF is discussed in Chapter 12. The nature of their role makes it necessary to share customer information. Here again, banks take the precaution of getting a sign off from the customer for the sharing of information, in their standard documentation.

5.2.5 Disclosure in Bankers' Interest

There are situations when the banker has to disclose information in order to protect the bank's own interest. For example, sharing information with a lawyer in order to fight a case; or with a guarantor in order to invoke a guarantee, where the customer has defaulted.

Even when the information is shared on the above grounds, bankers take certain precautions.

- They restrict the sharing information to facts. Opinions are subjective and can expose the bank to huge damages.
- They mention the obligation of secrecy and the grounds on which the information is being made available to the other person – and re-iterate that the receiver of the information needs to respect the customer's right to secrecy.

Chapter 6 : Security Creation

Financing provided by a bank may be backed by some asset as security (also called *collateral*). Loans that are backed by such security are called *secured loans*. The benefit of security is that if the borrower does not re-pay, the bank can sell the asset to recover the dues. If the asset sale does not cover the entire dues, then the bank can still recover the balance from the borrower; any excess recovered on the sale of asset belongs to the borrower. Loans that are not backed by the security of an asset are called *unsecured loans*.

Different kinds of assets are offered as security – land and buildings, plant and machinery, inventory, receivables, shares, debentures, fixed deposit receipts, insurance policies, licenses, brands etc. The banker working on a security structure needs to keep the following in mind:

- The borrower should have clear title to the asset being offered as security. If the asset belongs to someone who is not the borrower (for example, entrepreneur's house being mortgaged for loan to the entrepreneur's business), there has to be clear documentation regarding the same. Even otherwise, documentation is key.
- The security has to be readily encashable. This, for instance, becomes the problem when a telecom license is offered as security. Realising the license to recover moneys gets quite complicated because of the government permissions required.
- Encashment of the asset should not impose significant additional costs on the bank.
- The security has to adequately cover the financing provided. Bankers typically ask for a higher security value than the financing provided. The difference is the *margin* to take care of potential decline in value of the asset or expenses involved in realizing the security. Where the value of the asset is subject to fluctuations (for example, in the case of shares) a higher margin is insisted on. In market parlance, the margin is also called *hair-cut*. Greater the uncertainty, higher the hair-cut.
- With most intangible assets (like brands), the valuation of the asset is highly subjective. Extra precaution has to be taken in such cases.

The rights of the banker also depend on how the security is created. The following are the typical forms of security creation:

6.1 Pledge

As per the Contract Act, 1872, *pledge* means bailment of goods for the purpose of providing security for payment of a debt or performance of a promise.

Bailment is nothing but delivery of goods to the financier. The person offering the goods as security is the *bailer, pawner* or *pledger*. The person to whom the goods are given is the *bailee, pawnee* or *pledgee*.

At times, the delivery of goods may not be actual, but *constructive*. For instance, goods in a warehouse may be pledged by handing over the warehouse receipt. This constructively implies delivery of goods of the pledgee.

There is no legal necessity for a pledge agreement; pledge can be implied. However, it is always preferable for the banker to insist on a pledge agreement.

The pledger is bound to inform the pledgee about any defects in the goods pledged, or any risks that go with possession of the goods. He is also bound to bear any incidental expenses that arise on account of such possession.

Pledge becomes onerous for the pledger, because he has to part with possession. For the same reason, the pledgee is generally comfortable with a pledge arrangement. He does not need to take any extra effort or incur any cost for realizing the security. He is however bound to take reasonable care of the goods.

The pledgee has a *general lien* on the goods i.e. he is not bound to release the goods unless his dues are fully repaid.

A point to note is that the banker's lien is limited to the recovery of the debt for which the pledge is created – not to other amounts that maybe due from the borrower. This is the reason that banks often provide a protective clause in their pledge agreement that the pledge extends to all dues from the borrower.

In the event of default by the borrower, the pledgee can sell the assets to recover his dues. The dues may be towards the original principal lent, or interest thereon or expenses incurred in maintaining the goods during the pledge.

6.2 Hypothecation

Hypothecation is defined under the SARFAESI Act, 2002, (which will be discussed in the next chapter) as follows:

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 moveable property to such creditor, as a security for financial assistance, and includes floating charge and crystallization of such charge into fixed charge on moveable property.

As with pledge, hypothecation is again adopted for movable goods. But, unlike pledge, the possession of the asset is not given to the bank. Thus, the borrower continues to use the asset, in the normal course.

A good example is vehicle financing, where the borrower uses the vehicle, but it is hypothecated to the bank. The bank protects itself by registering the hypothecation in the records of the

Regional Transport Officer (RTO). Therefore, ownership cannot be changed without a NOC from the bank. Further, to prevent any unauthorized transfers, the bank takes possession of the vehicle (*re-possession*) in the event of default by the borrower.

In the business context, it is normal to obtain working capital facilities against hypothecation of stocks and debtors. Since these are inherent to the business, the stocks and debtors keep changing form (some debtors clear their dues; new debtors are created based on credit sales by the borrower) and value. The bank only insists on a minimum asset cover. If the hypothecated assets are worth Rs. 40lakhss and the outstanding to the bank is Rs. 25 lakhss, the asset cover is Rs. 40 lakhss ÷ Rs. 25 lakhss i.e. 1.6 times.

Since the form and value of the assets charged keep changing (the outstanding amount also keeps changing), this kind of a charge is therefore referred to as *floating charge.* In the event of default by the borrower, the bank will seek possession of the assets charged. That is when it becomes a *fixed charge* viz. the assets charged as well as the borrower's dues against those assets get crystallised.

Since possession is with the borrower, there is a risk that non-recoverable debts are included in debtors, or non-moving or obsolete goods are included in inventory. Further, an unethical borrower, despite all provisions in the hypothecation deed, may hypothecate the same stock to multiple lenders. Therefore, banks go for hypothecation in the case of reputed borrowers, with whom they have comfort.

Companies have a requirement of registering the charge with the Registrar of Companies (ROC). Under the Companies Act, if the charge is not registered with ROC within 30 days, (or a further period of 30 days on payment of fine), then such charge cannot be invoked in the event of liquidation of the company. This is a protection against multiple charges created on the same property, in case a company is a borrower. This is also a reason, why banks pursue borrowers until they register the charge with the ROC.

At times, when the asset cover is high, banks may permit other bankers to have a charge on the same property. Such a charge in favour of multiple lenders, all having the same priority of repayment in the event of default, is called *pari passu* charge.

Not all banks are comfortable with pari passu charge. There are situations, where the first lender insists on priority in repayment. Subject to such priority, it may not object to the creation of an additional charge in favour of a second lender. The first lender is said to have a *first charge* on the property; the second lender has *second charge*. Similarly, *third charge, fourth charge* etc are possible, but not common.

Let us consider a situation where in the event of default by a borrower, the following charges get fixed:

Value of assets charged	Rs. 50 lakhs
Dues to first charge-holder	Rs. 40 lakhs
Dues to second charge-holder	Rs. 35 lakhs

In such a situation, the first charge-holder will be fully paid. After that only Rs. 50 lakhs less Rs. 40 lakhs i.e. Rs. 10 lakhs worth of charged asset is left. This will be paid to the second charge-holder.

The second charge holder now has due of Rs. 35 lakhs less Rs. 10 lakhs i.e. Rs. 25 lakhs. He can still recover the money from the borrower, but he will rank with other unsecured creditors for the payment.

If other unsecured creditors are Rs. 5 lakhs, and other assets of the borrower are Rs. 15 lakhs, then the following is the borrower's position:

Assets	Rs. 15 lakhs
Dues to second charge-holder	Rs. 25 lakhs
Other unsecured creditors	Rs. 5 lakhs
Total dues	**Rs. 30 lakhs**

The second charge-holder will receive 50% of Rs. 25 lakhs i.e. Rs. 12.5 lakhs

Other unsecured creditors will receive 50% of Rs. 5 lakhs i.e. Rs. 2.5 lakhs.

Since the company has no further assets left, the lenders will have to write-off their remaining dues as bad debts. The following will be the bad debts position of the two lenders:

Second charge-holder

Total dues of	Rs. 35.0 lakhs
Less Recovered from charged asset	Rs. 10.0 lakhs
Less Recovered from other assets	Rs. 12.5 lakhs
Bad Debts	Rs. 12.5 lakhs

Other unsecured creditors

Total dues of	Rs. 5.0 lakhs
Less Recovered from other assets	Rs. 2.5 lakhs

Bad Debts	Rs. 2.5 lakhs

If however, the first two lenders had pari passu charge, the position would be as follows:

Value of assets charged	Rs. 50 lakhs
Dues to pari passu charge-holders	Rs. 75 lakhs
(Rs. 40 lakhs plus Rs. 35 lakhs)	

Therefore, the first two lenders will receive (Rs. 50 lakhs ÷ Rs. 75 lakhs i.e.) 2/3rd of their dues viz.

Lender 1	2/3 of Rs. 40 lakhs i.e.Rs. 26,66,667
Lender 2	2/3 of Rs. 35 lakhs i.e. Rs. 23,33,333

With this, the asset charged is fully used up. For the balance amount, the 2 lenders will be like unsecured creditors:

Lender 1	1/3 of Rs. 40 lakhs i.e. Rs.13,33,333	
Lender 2	1/3 of Rs.35 lakhs i.e. Rs.11,66,667	
Unsecured creditors		Rs. 5,00,000
Total		**Rs. 30,00,000**

Since assets available is only Rs. 15 lakhs, every lender will receive only 50% of their dues.

Lender 1 will receive Rs. 6,66,667

Lender 2 will receive Rs. 5,83,333

Unsecured creditors will receive Rs. 2,50,000

Thus, all of them will have bad debts as follows:

Lender 1	Rs. 6,66,667
Lender 2	Rs. 5,83,333
Unsecured creditors	Rs. 2,50,000

Lender 1 ends up with bad debts in the pari passu charge situation, which he could have avoided with a first charge. That is the reason banks tend to insist on first charge.

The unsecured creditors' bad debts are the same, irrespective of whether any of the secured creditors have first charge or pari passu charge.

6.3 Mortgage

The term mortgage is defined in the Transfer of Property Act, 1882 as follows:

A mortgage is the transfer of interest in specific immoveable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, on existing or future debt or the performance of an engagement which may give rise to a pecuniary liability.

The person transferring the property is the *mortgager*; the transferee is the *mortgagee.*

The mortgage is generally created through a *mortgage deed*. However, there are exceptions as will clear from the following discussion on different kinds of mortgages. These kinds of mortgages are again defined in the Transfer of Property Act, 1882.

6.3.1 Simple Mortgage

The mortgage is simple because possession of the mortgaged property is not handed over to the mortgagee. However, the mortgager accepts personal liability to pay the mortgage money (principal plus interest).

If the mortgager does not pay the dues, the mortgagee has the right to approach court for a decree to sell the mortgage property. This right of the mortgagee may be expressed in the mortgage deed or implied.

As is logical, the mortgagee does not have the right to receive rent or any other proceeds from the property. These would belong to the mortgager.

Registration is mandatory if the principal amount secured is Rs100 or above.

6.3.2 Mortgage through Conditional Sale

Here, the mortgager "sells" the mortgage property, but subject to conditions:

- The sale becomes absolute only if the mortgager defaults on paying the dues by a specified date; or
- The sale becomes void if the mortgager pays the dues by the specified dates. In that case, the mortgagee will transfer the property back to the mortgager.

A legal technicality is that the mortgagee cannot sue to sell the property, but he can sue to forclose the mortgage deed. Once court grants the foreclosure, the mortgager loses the right to claim the property. Thereafter, the mortgagee can sell the property to recover his dues.

In a standard form of such a mortgage, there is no personal liability on the mortgager to pay the dues [he only (presumably) has an interest in paying it, so that he will get the property back]. If he does not pay, and the asset sale does not fully cover the mortgagee's dues, he cannot claim the balance from the mortgager. Therefore, bankers typically are not comfortable with such a mortgage.

6.3.3 Usufructuary Mortgage

This is a mortgage where the mortgagee has the right to recover rent and other incomes from the mortgaged property, until the dues are cleared. Thus, repayments come from the property rather than from the mortgager.

The transfer of possession from the mortgager to the mortgagee may be express or implied. Thus, legal possession is more important than physical possession. For example, physical possession may be with a tenant who pays the rent.

As with Conditional Sale, there is no personal obligation on the mortgager to pay. The banker has to keep holding the property for an indeterminate period of time, until the dues are cleared. Therefore, bankers are not comfortable with such mortgages.

6.3.4 English Mortgage

In this form of mortgage, the mortgager transfers the property to the mortgagee absolutely. However, the mortgagee will have to re-transfer the mortgaged property to the mortgager, if the dues are paid off.

Since the mortgager assumes personal liability to repay, the mortgagee can sue the mortgager for recovery of dues or seek a court decree to sell the property. This gives comfort to the banker.

6.3.5 Equitable Mortgage / Mortgage by Deposit of Title Deeds

As is clear from the name, the mortgager merely deposits the title deeds to immoveable property with the mortgagee, with the intention of creating a security.

Such mortgages can only be created in Mumbai, Chennai or Kolkatta. The mortgaged property may be located anywhere, but the mortgage creation has to be in any of these three cities.

Benefit of this kind of mortgage is that stamp duty is saved. Further, it is less time consuming to create.

The risk is that a fraudulent mortgager may obtain multiple title deeds, and create multiple mortgages, thus adding to the complexity of the banker when it comes to recovering money.

6.3.6 Anomalous Mortgage

A mortgage which does not fall strictly into any of the above mortgages is an anomalous mortgage. For instance, in a usufructuary mortgage, the mortgager may take personal obligation to pay the dues.

The mortgage creation format is one of the key conditions in the sanction letter of the lender / term sheet that the lender and borrower sign to freeze the terms of their arrangement.

6.4 Assignment

The Banker may provide finance against the security of an *actionable claim*. Under the Transfer of Property Act, an actionable claim is a claim to any debt other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property.

Since security depends on the quality of the debt, bankers are comfortable if the dues to the borrower are from the Government. With such a structure, the bank can earn a return that is higher than what is normal for taking a sovereign risk.

In housing loans, where repayment depends on the earning cycle of the borrower, financiers tend to ask for assignment of life insurance policy that covers the life of the borrower. This can be done by mentioning the same in the reverse of the insurance policy document, along with signature of the assigner. Alternatively, a separate deed of assignment can be signed. Either way, the insurance company needs to be informed about the assignment.

Chapter 7 : NPA and Securitisation

7.1 Non-Performing Assets

In the normal course, borrowers repay their dues to the bank by their respective due dates. Some debts, however, turn sticky. The borrower is unable or unwilling to pay. If such debt is shown as a regular debt, and interest is accrued on such debt as a regular income, then the financial statements would give an incorrect picture of the financial status of the bank. Therefore, RBI has laid down strict requirements regarding recognition of Non-Performing Assets (NPA).

An NPA is a loan or advance where:

- Term Loan – interest and / or instalment of principal remains overdue for more than 90 days.
- Overdraft / Cash credit - account is out of order i.e.
  - o Outstanding balance remains continuously in excess of the sanctioned limit / drawing power; or
  - o Outstanding balance is within the sanctioned limit / drawing power, but there are no credits continuously for 90 days as on the date of balance sheet, or the credits are not enough to cover the interest debited during the same period.
- Bills purchased and discounted – bill remains overdue for more than 90 days.
- Short duration crops (crop season is upto a year) – instalment of principal or the interest thereon remains overdue for two crop seasons.
- Long duration crops - instalment of principal or the interest thereon remains overdue for one crop season.

A few more relevant points –

- Banks are supposed to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.
- If an advance is covered by term deposits, National Savings Certificates eligible for surrender, Indira Vikas Patras, Kisan Vikas Patras and Life policies, then it need not be treated as NPA. This exemption however does not extend to government securities and gold ornaments.
- Drawing power should be determined based on stocks statements that are not older than 3 months. Else, it would be treated as irregular.
- If irregular drawings are permitted in the working capital account for a continuous period

of ninety days, it will become an NPA (even if the financial status of the borrower is stable).

- Regular and ad hoc credit limits are to be reviewed / regularized within 3 months from the due date / date of ad hoc sanction. If this is not done within 180 days of the due date / date of ad hoc sanction, the asset would be treated as NPA.
- Once arrears of interest and principal are paid by the borrower, the NPA becomes a standard asset.
- If even one facility to a borrower or investment in securities issued by a borrower becomes NPA, all the facilities granted by the bank to the borrower and investment in all the securities issued by the borrower will have to be treated as NPA.

7.2 NPA Categories

7.2.1 Sub-Standard Assets

An asset that has remained NPA for upto 12 months.

7.2.2 Doubtful Assets

An asset that has remained sub-standard for upto 12 months.

7.2.3 Loss Assets

An asset that the bank or its auditors or the RBI has identified as a loss, but the amount has not been written off entirely.

In exceptional cases, such as fraud by the borrower, the above mentioned stages of NPA can be skipped. The asset can directly be treated as a doubtful asset or loss asset.

If the realizable value of the security is less than 50% of the value assessed by the bank or accepted by RBI at the time of last inspection, then the asset will be treated as doubtful.

If the realizable value of the security, as assessed by the bank or valuers or RBI is less than 10% of the amount outstanding, then the existence of the security is to be ignored. The NPA asset will be immediately treated as a loss asset.

Where a sub-standard asset is re-structured, then it would be treated as standard asset only 1 year after the first payment (interest or principal) is due. This too is subject to satisfactory performance during the one-year period.

7.3 NPA Provisioning Norms

7.3.1 Loss Assets

Should be entirely written off. If this is not done, provisioning should be made for 100% of the amount shown as outstanding.

7.3.2 Doubtful Assets

Realisable value of the security, if any should be estimated. The excess of the outstanding over the security value should be entirely provided for.

Provisioning requirement for the secured portion is as follows:

- 20%, if the advance has been doubtful for up to 1 year
- 30%, if the advance has been doubtful for 1 to 3 years
- 100%, if the advance has been doubtful for more than 3 years.

7.3.3 Sub-standard Assets

Provision of 10% of the total outstanding should be made, without any allowance for security available or ECGC guarantee available.

Unsecured exposures i.e. where the security value is less than 10% of the outstanding exposure, need to be provided for to the extent of a further 10% (i.e. total 20%).

7.3.4 Standard Assets

Provision is required, even for such assets, as follows:

- Direct advances to agricultural and SME sectors – 0.25%
- Personal loans, loans in the nature of capital market exposures, residential housing loans beyond Rs20lakhs and commercial real estate loans – 1%
- Other advances – 0.40%

7.4 SARFAESI Act

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest, 2002 (SARFAESI Act, 2002) was enacted to provide banks and financial institutions with a more effective framework to enforce the security structure underlying loans and advances given by them, and recover their dues expeditiously. As is evident from the name, it addresses the regulation of three distinct areas:

- Securitisation
- Reconstruction of Financial Assets

- Enforcement of Security Interest

Banks and Financial Institutions can benefit from SARFAESI. The term '*bank*' includes all banking companies, including co-operative banks. However, regional rural banks have been kept out. '*Financial institution*' means:

- A public financial institution within the meaning of the Companies Act, 1956
- Any institution specified by the Central Government under the Recovery of Debts due to Bank and Financial Institutions Act, 1993
- The International Finance Corporation, established under the International Finance Corporation (Status, Immunitis and Privileges) Act, 1958
- Any other institution or non-banking financial company as defined in the Reserve Bank of India Act, 1934, which the Central Government may specify as a financial institution for the purposes of the Act.

The bank or financial institution which has lent money to a borrower is also called *originator* in the context of securitization.

The person who has an obligation to the bank or financial institution is an *obligor*. Under the Act, *obligor* includes a borrower and means a person liable:

- To pay to the originator, whether under a contract or otherwise; or
- To discharge any obligation in respect of a financial asset, whether existing, future, conditional or contingent.

What does 'financial asset' mean? Under the Act, *financial asset* means debt or receivables, and includes:

- A claim to any debt or receivables, or part thereof, whether secured or not; or
- Any debt or receivable secured by mortgage of or charge in immoveable property; or
- A mortgage charge, hypothecation or pledge of moveable property; or
- Any right or interest in the security, whether full or part, securing debt; or
- Any beneficial interest in any moveable or immoveable property or in debt, receivables, whether such an interest is existing, future, accruing, conditional or contingent; or
- Any financial assistance.

'*Property*' means:

- Immoveable property
- Moveable property

- Any debt or any right to receive payment of money, whether secured or unsecured
- Receivables, whether existing or future
- Intangible assets such as know-how, copyrights, trademarks, license, franchise or ay other business or commercial right of a similar nature.

The Act uses the term '*asset re-construction*' for the acquisition of any right or interest, of any bank or financial institution, in any financial assistance, by any securitization company or re-construction company, for the purpose of realization of such financial assistance.

An entity holding more than 10% of the equity capital of a securitization company or re-construction company is its *sponsor.*

RBI is the regulater for securitization companies and re-construction companies, which are companies created for the purpose, under the Companies Act, 1956. Such companies need to be registered with RBI. At the time of registration, they need to have net owned funds of at least Rs2crore. RBI can set a higher requirement, upto 15% of the total financial assets acquired or to be acquired.

The capital adequacy requirement is Rs100crore or 15% of the total assets acquired whichever is less.

A point to note is that a company that is not registered with RBI too can handle the securitization and re-construction business. However, such an unregistered company cannot benefit from the provisions of SARFAESI.

7.4.1 Securitisation

This is a process where financial assets (say, dues from a borrower) are converted into marketable securities (security receipts) that can be sold to investors.

In the first stage of a securitization transaction, an originater sells the financial asset to the securitization company. This can be done as follows:

- The securitization company / asset re-construction company issues a debenture or bond or any other security in the nature of a debenture, for the agreed consideration, and as per the agreed terms and conditions, to the originator; or
- Entering into an agreement for transfer of the financial asset as per the agreed terms and conditions.

On acquisition of the financial asset, the securitization or reconstruction company becomes the owner of the financial asset. In rights, it steps into the shoes of the lending bank or financial institution. It is to be noted that only the assets get transferred – any related liability remains with the bank or financial institution (originator). However, any pending suit, appeal or proceeding against the originator can be continued against the securitization company or asset reconstruction company.

In the second stage, against the security of the financial asset, the securitization company can mobilise money by issuing security receipts to QIB investors.

Thus, securitization makes it possible to transfer loans secured by mortgage or other charges.

The term '*security receipt*' is defined as a receipt or any other security issued by a securitization company or reconstruction company to any qualified institutional buyer (QIB) pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof of an undivided right, title or interest in the financial asset underlying the securitization.

Qualified institutional buyer (QIB) means a financial institution or an insurance company or a bank or a state financial corporation or a state industrial development corporation or trustee or any asset management company making an investment on behalf of a mutual fund or provident fund or gratuity fund or pension fund or SEBI-registered foreign institutional investor (FII) or any other body corporate specified by SEBI. Any other company will have to register itself with SEBI, if it wants to be treated as QIB.

The securitization company can create separate trusts for each scheme, and act as trustee for the schemes.

It is not compulsory to give notice of the transfer to the obliger; or to register the charge with the Registrar of Companies, if the obliger is a company.

- In the absence of notice, payments by the obliger to the bank or financial institution shall be treated as a valid discharge of obligation. The bank or financial institution shall receive the proceeds, in trust, for the benefit of the securitization company / asset re-construction company.
- If notice is given to the obliger, then the obliger will have to make payments to the securitization company / asset re-construction company. Further, if the obliger is a company, then the charge is to be registered with the Registrar of Companies.

7.4.2 Asset Re-construction

Here, the right or interest of any bank or financial institution in any financial asset is acquired by the asset re-construction company for the purpose of realization of dues.

Asset re-construction might entail taking several measures such as:

- Takeover the management of the business of the borrower or bring about any such change.

On realization of the secured debt in full, the management of the business is to be restored back to the borrower.

- To sell or lease a part or whole of the business of the borrower.
- Reschedule debts of the borrower.
- Take possession of secured asset
- Enforce security interest
- Settle dues payable by the borrower

The grounds on which these actions may be taken would be as per the loan agreement between the borrower and the lender. Default is not a necessary pre-condition.

Although the Act does not provide for notice to the borrower before these measures are taken, court rulings in similar cases indicate that it is better that the notice be given.

Within 12 months of acquiring a NPA, the securitization company or the re-construction company has to formulate a plan for its realization. During this period, it can classify the asset as a *standard asset.*

SARFAESI does not cover pledge and enforcement of pledge. Therefore, if the loan is backed by pledge of owner's stake in the company, then the enforcement of power to sell the owner's stake in case of default, would be as per the loan agreement, SEBI requirements (if it is a listed entity) and the Indian Contract Act – not as provided for in SARFAESI.

7.4.3 Enforcement of Security Interest

In the normal course, court intervention is required for sale of property and realization of money due from a defaulter. This is equally applicable to mortgage of immoveable property, as well as charge created on moveable property. Only realization of money from pledged security is outside the requirement of court intervention.

SARFAESI gives another window for banks and financial institutions to enforce their security interest without the intervention of Civil Court or the Debt Recovery Tribunal (DRT).

If the lender also holds security through a pledge of any moveable assets, or the guarantee of any person, then it can sell the pledged goods or proceed against the guarantor without initiating any action against the secured assets.

Under SARFAESI, the bank or financial institution needs to give 60-day notice to the defaulter, giving details of the amount payable and the secured asset intended to be enforced by the secured creditor, in the event of non-payment of the secured debt. The effect of this notice is that the borrower is barred from transferring the property mentioned in the notice.

If the borrower responds to the notice, then the secured creditor needs to consider the representation or objections fairly. If these are not acceptable, then the reasons for non-acceptance need to be conveyed to the borrower within 7 days. Such non-acceptance however does not confer a right on the borrower to approach the DRT or any Civil Court

If the dues are not paid during the notice period, then the secured creditor gets the following rights:

- Take possession of the secured assets, and transfer it by lease, assignment or sale for realization of money.
- Appoint a manager to manage the secured assets that have been re-possessed.
- Takeover management of the secured assets, and transfer it by lease, assignment or sale for realization of money.
- Give notice to any person who has acquired the secured asset from the borrower, and from whom any money is due or may become due to the borrower, to pay the moneys to the secured creditor. Such payment to the secured creditor will be a valid discharge of the person's dues to the borrower.

When the secured creditor transfers the secured asset under SARFAESI, the transferee gets all the rights in, or in relation to the asset, as if the owner of the asset executed the transfer.

In order to take possession or control of the secured asset, or sell or otherwise transfer it, the secured creditor can make a request in writing to the Chief Metropolitan Magistrate or the District Magistrate. On receiving such a request, the judicial authority is bound to take the requisite steps.

Amounts realized from the secured asset are to be applied in the following sequence:

- Costs, charges and expenses incidental towards preservation and protection of securities, insurance premium etc. that are recoverable from the borrower.
- Dues of the secured creditor
- Any surplus will be paid to the person entitled to it in accordance with the rights and interests.

Thus, dues to the secured creditor have precedence over the preferential payments to the government or labour or other creditors.

At any time before the date fixed for sale or transfer, the borrower can pay the entire dues, costs, charges and expenses incurred by the creditor. In that case, the secured creditor will not sell or transfer the asset. Only in the event the borrower company is being wound up, dues to workmen will rank pari passu with secured creditors, as provided in the Companies Act, 1956.

If the financing facility is offered by a consortium of lenders, then no secured creditor can take possession of the secured asset unless agreed upon by the creditors representing not less than three-fourths in value of the outstanding dues (principal, interest and other dues). If at least three-fourths by value agree to the action, then it is binding on the rest of the creditors.

If the sale of secured assets does not fully cover the dues, then for the balance, the bank or financial institution can approach the DRT or Civil Court.

The rights under SARFAESI need to be executed a person of appropriate seniority. The authorized person should be of the level equivalent to a Chief Manager of a public sector bank or equivalent or any other person exercising the powers of superintendence, direction and control of the business or affairs of the creditors.

7.4.4 Central Registry

SARFAESI also provides for a Central Registry to register transactions that are in the nature of securitization and reconstruction of financial assets or creation of security interest under the Act.

The securitization company or reconstruction company or secured creditor is required to file the details with the central registrar within 30 days of the transaction or the creation of security. A further time period of 30 days is available for the registration, provided penalty is paid.

Registration under this Act is in addition to registration requirements under other acts, like the Companies Act, 1956, Registration Act, 1908 and Motor Vehicles Act, 1988.

When payment is made in full, details of the satisfaction of charge are to be filed by the securitization company or the reconstruction company or the secured creditor within 30 days.

If, otherwise, the central registrar receives notice of satisfaction of charge, then it has to issue a notice to the securitization company or the reconstruction company or the secured creditor, to respond within 15 days on why the satisfaction of charge should not be recorded in the central registry. If no response is received, then the satisfaction of charge will be recorded in the registry. If a response is received, the borrower will be informed about it.

7.4.5 Resolution of Disputes

Disputes between the securitization or re-construction company and the bank or financial institution or QIB relating to securitization or re-construction or non-payment of any dues or interest, have to be settled by conciliation or arbitration under the Arbitration and Conciliation Act, 1996. The obliger / borrower is however not covered by this requirement.

7.4.6 Debt Recovery Tribunal (DRT)

Any person, including the borrower, aggrieved by any of the measures taken by the secured creditor or his authorized officer for taking possession of the security may apply to the DRT within 45 days. The DRT has to dispose the application within 60 days. If not done within this time frame, the DRT has to record the reasons for the delay in writing. In any case, the application has to be disposed within 4 months from the date it is filed.

The Recovery of Debts due to Banks and Financial Institutions Act, 1993, has set the jurisdiction of DRT at Rs10lakhs and above. However, since the SARFAESI Act does not provide for a limit, appeals to the DRT are possible even if the amount entailed is lower.

7.4.7 Appellate Tribunal

Any person aggrieved by an order of the DRT can appeal to the Appellate Tribunal within 30 days of date of receipt of the order. The borrower has to deposit 50% of the amount claimed by the secured creditor, before filing an appeal. The Appellate Tribunal can reduce the deposit requirement to 25% of the amount claimed, after recording the reasons for such a concession.

Chapter 8 : Understanding a Bank's Financials

Banks are a key intermediary in the financial sector. Being companies, they are covered by the Companies Act, 1956. The Act, through Schedule VI has specified a format for financial statements of companies. The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) formulates accounting standards, with a view to harmonise the accounting policies and practices. The Accounting Standards are formulated based on international best practices. When a company does not prepare its accounts in line with accounting standards, the statutory auditor qualifies his auditor's report, highlighting areas of difference.

RBI, on its part, wishes to align Indian banking system with global standards. Further, since banking companies are different from normal manufacturing companies, direct application of the ICAI standards to banking companies created issues. With a view to eliminating gaps in compliance with accounting standards by banks, a Working Group was created. The recommendations of the Working Group were accepted by RBI. Accordingly, RBI has issued guidelines to be followed by banks.

Among other things, RBI has prescribed certain minimum disclosures in the Notes to Accounts. Banks are encouraged to make more disclosures than the minimum prescribed.

On January 2010, the Ministry of Corporate Affairs issued a road map for India to transition to International Financial Reporting Standards (IFRS). India has opted to go for a mechanism of convergence. This means that IFRS is not being directly made applicable in India. Instead, the ICAI will bring out accounting standards which would be in line with the IFRS.

The transition to IFRS in India is scheduled to happen in phases as follows:

- In the first phase, companies included in Nifty 50 or BSE Sensex, and companies whose securities are listed on stock exchanges outside India and all other companies having net worth of Rs. 1,000 crore will prepare and present financial statements using Indian Accounting Standards converged with IFRS, from April 2011.
- Insurance companies will converge their opening balance sheets with IFRS from April 2012.
- Scheduled commercial banks and urban cooperative banks will adopt IFRS from April 1, 2013.
- Listed companies having net worth of Rs. 500 crore or less will convert their opening balance sheet as at April 1, 2014.
- Un-listed companies having net worth of Rs. 500 crore or less will continue to apply

existing accounting standards, which might be modified from time to time.

8.1 Balance Sheet

The following summarised balance sheet of a bank for 1 year gives an idea of the nature of items that feature in a bank's balance sheet. As the reader will appreciate, details of each item are given in separate schedules in the bank's Annual Report. Similarly, the details need to be provided for the previous year as well. The previous year's figures and the schedules have been kept out of this Chapter, for the sake of brevity.

Balance Sheet of ________ as on March 31, 2010 *(000s omitted)*

CAPITAL and LIABILITIES

Capital	634,88,26
Reserves and Surplus	65,314,31,60
Deposits	804,116,22,68
Borrowings	103,011,60,11
Other Liabilities and Provisions	80,336,70,40
Total	**1,053,413,73,05**

ASSETS

Cash and Balances with Reserve Bank of India	61,290,86,52
Balances with banks and Money at call and short notice	34,892,97,64
Investments	285,790,07,06
Advances	631,914,15,20
Fixed Assets	4,412,90,67
Other Assets	35,112,75,96
Total	**1,053,413,73,05**

CONTINGENT LIABILITIES

8.2 Profit and Loss Account

The following summarised profit and loss account of a bank for 1 year gives an idea of the nature of items that feature in a bank's profit and loss account. As the reader will appreciate, details of each item are given in separate schedules in the bank's Annual Report. Similarly, the details need to be provided for the previous year as well. The previous year figures and the schedules have been kept out of this Chapter, for the sake of brevity.

Profit and Loss Account of _______ for the year ended March 31, 2010

(000s omitted)

INCOME

Interest Earned	70,993,91,75
Other Income	14,968,15,27
Total	**85,962,07,02**

EXPENDITURE

Interest Expended	47,322,47,80
Operating Expenses	20,318,68,00
Provisions and Contingencies	91,54,85,92
Total	**76,796,01,72**

PROFIT

Net Profit for the Year	9,166,05,30
Profit brought forward	33,93
Total	**9,166,39,23**

APPROPRIATIONS

Transfer to Statutory Reserves	6,381,08,85
Transfer to Capital Reserve	114,05,47
Transfer to Revenue Reserve and Other Reserves	529,50,65
Dividend: Interim Dividend	634,88,02
Final Dividend proposed	1,269,76,77
Tax on Dividend	236,75,74
Balance carried over to Balance Sheet	33,93
Total	**9,166,39,23**

PRINCIPAL ACCOUNTING POLICIES

NOTES TO ACCOUNTS

8.3 CAMELS Framework

'CAMELS' is a framework for composite evaluation of banks (and financial intermediaries, in general). The acronym stands for:

- **Capital Adequacy**

  This is a measure of financial strength, in particular its ability to cushion operational and abnormal losses. It is calculated based on the asset structure of the bank, and the risk weights that have been assigned by the regulater for each asset class.

- **Asset Quality**

  This depends on factors such as concentration of loans in the portfolio, related party exposure and provisions made for loan loss.

- **Management**

  Management of the bank obviously influences the other parameters. Operating cost per unit of money lent and earnings per employee are parameters used.

- **Earnings**

  This can be measured through ratios like return on assets, return on equity and interest spread.

- **Liquidity**

  In order to meet obligations as they come, the bank needs an effective asset-liability management system that balances gaps in the maturity profile of assets and liabilities. However, if the bank provides too much liquidity, then it will suffer in terms of profitability.

  This can be measured by the Loans to Deposit ratio, separately for short term, medium term and long term.

- **Sensitivity to Market Risk**

  Longer the maturity of debt investments, more prone it is to valuation losses, if interest rates go up. More sensitive the portfolio is to market risk, the more risky the bank is.

  The CAMELS framework was first used by the regulaters in the United States. Based on this, they rated the banks on a scale of 5 – the strongest was rated as 1; the weakest was rated as 5.

Chapter 9 : BASEL Framework

9.1 Bank for International Settlements (BIS)

Established on 17 May 1930, the BIS is the world's oldest international financial organisation. It has its head office in Basel, Switzerland and two representative offices: in the Hong Kong Special Administrative Region of the People's Republic of China and in Mexico City.

BIS fosters co-operation among central banks and other agencies in pursuit of monetary and financial stability. It fulfills this mandate by acting as:

- a forum to promote discussion and policy analysis among central banks and within the international financial community
- a centre for economic and monetary research
- a prime counterparty for central banks in their financial transactions
- agent or trustee in connection with international financial operations

Every two months, the BIS hosts in Basel, meetings of Governors and senior officials of member central banks. The meetings provide an opportunity for participants to discuss the world economy and financial markets, and to exchange views on topical issues of central bank interest or concern. The Basel Committee on Banking Supervision comprises representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

BIS also organises frequent meetings of experts on monetary and financial stability issues, as well as on more technical issues such as legal matters, reserve management, IT systems, internal audit and technical cooperation.

BIS is a hub for sharing statistical information among central banks. It publishes statistics on global banking, securities, foreign exchange and derivatives markets.

Through seminars and workshops organised by its Financial Stability Institute (FSI), the BIS disseminates knowledge among its various stake-holders.

The role of BIS has been changing in line with the times. Initially, it handled the payments that Germany had to make consequent to the First World War. Following the Second World War and until the early 1970s, it focused on implementing and defending the Bretton Woods system.

In the 1970s and 1980s, it had to manage the cross-border capital flows following the oil crises and the international debt crisis. The economic problems highlighted the need for effective supervision of internationally active banks. This culminated in the Basel Capital Accord on international convergence of capital measurement and capital standards, in 1988.

9.2 Basel Accords

The Basel Accord of 1988 (**Basel I**) focused almost entirely on credit risk. It defined capital, and a structure of risk weights for banks. Minimum requirement of capital was fixed at 8% of risk-weighted assets. The G-10 countries agreed to apply the common minimum capital standards to their banking industries by end of 1992. The standards have evolved over time. In 1996, market risk was incorporated in the framework.

In June 2004, a revised international capital framework was introduced through Basel II. The following year, an important extension was made through a paper on the application of Basel II to trading activities and the treatment of double default effects. In July 2006, a comprehensive document was brought out, which integrated all applicable provisions from the 1988 Accord, Basel II and the various applicable amendments.

The **Basel II** framework is based on three pillars:

- *The first Pillar* – Minimum Capital Requirements

  Three tiers of capital have been defined:

  - *Tier 1 Capital* includes only permanent shareholders' equity (issued and fully paid ordinary shares and perpetual non-cumulative preference shares) and disclosed reserves (share premium, retained earnings, general reserves, legal reserves)
  - *Tier 2 Capital* includes undisclosed reserves, revaluation reserves, general provisions and loan-loss reserves, hybrid (debt / equity) capital instruments and subordinated term debt. A limit of 50% of Tier 1 is applicable for subordinated term debt.
  - *Tier 3 Capital* is represented by short-term subordinated debt covering market risk. This is limited to 250% of Tier 1 capital that is required to support market risk.

- *The second Pillar* – Supervisory Review Process

  Four key principles have been enunciated:

  - 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 the bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Appropriate corrective action is to be taken, if required.

- 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.

- *The third Pillar* – Market Discipline

  This is meant to complement the other two pillars. Market discipline is to be encouraged by developing a set of disclosure requirements that will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes and overall capital adequacy of the institution. The bank's disclosures need to be consistent with how senior management and the Board of Directors assess and manage the risks of the bank.

  The capital adequacy requirement was maintained at 8%. However, the whole approach is considered to be more nuanced than Basel I.

  The stresses caused to institutions and the markets during the economic upheaval in the last couple of years, created a need for further strengthening of the framework. At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements. These capital reforms, together with the introduction of a global liquidity standard, deliver on the core of the global financial reform agenda (Basel III).

  Basel III is a comprehensive set of reform measures to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks' transparency and disclosures.

The reforms target:

- bank-level, or micro-prudential regulation, which will help raise the resilience of individual banking institutions to periods of stress.
- macro-prudential, system wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time.

These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system wide shocks.

The Committee's package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. This reinforces the stronger definition of capital agreed by Governors and Heads of Supervision in July and the higher capital requirements for trading, derivative and securitisation activities to be introduced at the end of 2011.

Chapter 10 : Regulatory Framework (Part 1)

10.1 Anti-Money Laundering and Know Your Customer

The G-7 summit in 1989 established the Financial Action Task Force (FATF) in 1989. Membership of the FATF has been expanded subsequently. India has a status of observer in FATF.

In 1990, FATF came out with 40 recommendations to fight money laundering. These covered customer due diligence and record keeping, reporting of suspicious transactions, measures to deter money laundering and handling of countries that do not adopt these practices.

9 recommendations to combat terrorism financing were added in 2001. These were meant to get countries to criminalise terrorism financing, adopt UN resolutions on terrorism and freeze and confiscate terrorism assets. The UN, from time to time, issues lists of people and organisations associated with terrorism. Member countries are expected to freeze their assets.

The Wolfsberg Group consisting of 12 leading international financial institutions formulated AML Principles, specially intended for combating increased money laundering risk in case of private banking and correspondent banking.

In June 2007, the FATF adopted high level principles and procedures in risk-based approach in combating money laundering and terrorist financing.

In India, The Prevention of Money Laundering Act, 2002 (PMLA) came into effect on July 1, 2005. On the same day, the Financial Intelligence Unit-India (FIU-IND) constituted by Government of India on 18th November 2004 as a nodal agency for AML measures got statutory recognition.

Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) and FIU-IND are the bodies mainly responsible for the anti-money laundering efforts for financial institutions in India.

FIU-IND is an independent body reporting directly to the Economic Intelligence Council (EIC) headed by the Finance Minister of India and is responsible for receiving, processing, analyzing and disseminating information relating to suspicious financial transactions. FIU-IND is also responsible for coordinating and strengthening efforts of national and international intelligence, investigation and enforcement agencies in pursuing the global efforts against money laundering and related crimes.

RBI, SEBI and IRDA too have issued guidelines for their regulated entities.

The requirements are being continuously strengthened. For instance, lately, market participants have been asked to be cautious of money flows from Iran. Even earlier, RBI had bought out a watch-list of six countries viz. Sao Tome and Principe, Turkmenistan, Iran, Northern Part of Uzbekistan and Pakistan.

10.1.1 Money Laundering

Money laundering is the approach that criminals take to camouflage their money flows from criminal activities (like drug trafficking, child pornography etc.) and pass it off as regular legal money flows.

According to PMLA, 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.

"Proceeds of crime" means any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence or the value of any such property.

10.1.2 Terrorist Financing

Terrorists adopt the same approach as money launderers, to manage their finances. Since the contributions to terrorist financing may come from normal legal sources – and often the contributions are of small value – terrorist financing is a lot more difficult to track.

10.1.3 Know Your Customer (KYC)

'Customer' has been defined as:

- o a person or entity that maintains an account and/or has a business relationship with the bank;
- o one on whose behalf the account is maintained (i.e. the beneficial owner);
- o beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
- o any person or entity connected with a financial transaction which can pose significant reputation or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

RBI has issued guidelines to banks to prevent money laundering through:

- KYC policies and procedures specifying the objective of KYC framework, i.e. appropriate customer identification. The KYC policies should incorporate the following four key elements:
    - o Customer Acceptance Policy

    - Customer identification procedures
    - Monitoring of transactions
    - Risk Management
- Monitoring transactions of a suspicious nature;
- Risk management and monitoring procedures, i.e. staff awareness, identification and reporting of suspicious transactions, record keeping of transactions;
- Treating the information collected from the customer for the purpose of opening of account as confidential and not divulge any details thereof for cross selling or any other purposes;
- Ensuring that any remittance of funds by way of demand draft, mail/ telegraphic transfer or any other mode and issue of travelers' cheques for value of INR 50,000 and above is effected by debit to the customer's account or against cheques and not against cash payment;
- Ensuring that the provisions of Foreign Contribution and Regulation Act, 1976 wherever applicable, are adhered to strictly.

The RBI regulations are applicable to all the branches of subsidiaries of Indian banks functioning in other countries. For these institutions, where the host country regulations are more rigorous; the host country regulation prevails.

The following transactions need to be reported to FIU-IND:

- All cash transactions of the value of more than INR 1,000,000 or its equivalent in foreign currency;
- All series of cash transactions integrally connected to each other which have been valued below INR 1,000,000 or its equivalent in foreign currency where such series of transactions have taken place within a month, however, aggregating to more than INR 1,000,000;
- All cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine or where any forgery of a valuable security or a document has taken place facilitating the transactions; and
- All suspicious transactions whether or not made in cash.

Staff is expected to ensure that the customers are not informed (i.e. tipped off) that his/ her accounts are under monitoring for suspicious activities and/or that a disclosure has been made to the FIU-IND.

10.1.4 Customer Risk Categorisation (CRC)

RBI has directed banks to categorise customers into low, medium, and high risk categories and have differential due diligence and monitoring standards based on the risk assessment.

The guidelines mention some of the parameters, which may be considered for categorising a customer's risk.

- Customer constitution: Individual, proprietorship, partnership, private limited, etc
- Business segment: Retail, Corporate, etc
- Country of residence/ Nationality: Whether India or any overseas location/ Indian or foreign national.
- Product subscription: Salary account, NRI products, etc.
- Economic profile: High Net Worth Individuals (HNI), public limited company, etc.
- Account status: Active, inoperative, dormant.
- Account vintage: less than six months old, etc.
- Presence in regulatory negative/ Politically Exposed Persons (PEP) /defaulter/fraudster lists.
- Suspicious Transaction Report (STR) filed for the customer.
- AML Alerts

Other parameters like source of funds, occupation, purpose of account opening, nature of business, mode of operation, credit rating, etc. can also be used in addition to the above parameters. Banks may adopt all or some of these parameters based on availability of data.

Examples of some high risk categories are also given, which include Non Resident Indians (NRIs), High Net worth Individuals (HNIs), Trusts, Charities, Non Governmental Organisations (NGOs), companies having closed shareholding structure, firms with sleeping partners, Politically Exposed Persons (PEPs), non-face-to-face customers, persons with dubious reputation, etc.

The guidelines further require the banks to carry out a review of risk categorization of customers at a periodicity of not less than once in six months. It is therefore, now mandatory for banks in India to introduce a system of CRC for their customers.

10.1.5 Customer Identity and Due Diligence

Identity generally means a set of attributes which together uniquely identify a natural or legal person. The attributes, which help establishing the unique identity of a natural or legal person, are called 'identifiers'.

Name (in full), Father' Name, Date of birth, Passport number, Election Card number (EC number), PAN number, Driving License number, etc are unique identifiers available which help establishing the identity of a natural or legal person. These are termed as 'primary identifiers' as they help in uniquely establishing the identity of a natural or legal person.

Addresses / location and nationality and other such identifiers may serve as secondary identifiers' as they help further refine the identity though they may not directly help uniquely identify a natural or legal person.

The following are the typical document requirements for opening an account:

- For individuals
  - Identity – Passport / PAN Card / Voter Identity Card / Driving License / Identity card (subject to bank satisfaction) / Letter from recognized public authority or public servant verifying the identity and residence of the customer (subject to bank satisfaction)
  - Permanent address – Telephone bill / Bank account statement / Letter from recognized public authority / Electricity bill / Ration card / Letter from employer (subject to bank satisfaction).
- For companies
  - Certificate of Incorporation, Memorandum of Association, Articles of Association
  - Resolution of the Board of Directors to open the account and identification of the authorities who will operate the account.
  - Power of Attorney granted to its managers, officers or employees to transact business on behalf of the company
  - PAN allotment letter for company
  - Officially valid document identifying the signing authorities (Passport copy / PAN Card)
- For partnership firms
  - Registration Certificate, if registered
  - Partnership Deed including names and addresses of each partner
  - Power of attorney granted to a partner or employee to transact business on behalf of the firm.
  - Officially valid document identifying the signing authorities (Passport copy / PAN Card)

- For trusts and foundations
    - o Registration Certificate, if registered
    - o Trust Deed including names and addresses of each trustee
    - o Resolution of the board of trustees to open the account
    - o Power of attorney granted to a trustee or employee to transact business on behalf of the trust.
    - o Officially valid document identifying the signing authorities (Passport copy / PAN Card)

Customer Due Diligence (CDD) has been defined as any measure undertaken by a financial institution to collect and verify information and positively establish the identity of a customer. A bank should apply Customer Due Diligence measures when it:

- establishes a business relationship;
- carries out an occasional transaction;
- suspects money laundering or terrorist financing; or
- doubts the veracity of documents, data or information previously obtained for the purpose of identification or verification

When a bank is unable to apply CDD, it

- must not establish a business relationship or carry out an occasional transaction with the customer;
- should not carry out a transaction with or for the customer through a bank account;
- should terminate all existing business relationship with the customer;
- should consider whether it ought to report to FIU-IND/ Regulators, in accordance with extant guidelines.

Depending on the CRC, CDD may be basic (normal), simplified (low income group for financial inclusion) or enhanced (high risk category).

10.1.6 Wire Transfers

Money is transferred between accounts through wire transfers. These may be domestic (within the country) or cross-border (across countries).

For domestic wire transfers, RBI has stipulated the following:

- Information accompanying all domestic wire transfers of Rs.50000/- (Rupees Fifty Thousand) and above must include complete originator information i.e. name, address and account number etc., unless full originator information can be made available to the beneficiary bank by other means.

- If a bank has reason to believe that a customer is intentionally structuring wire transfer to below Rs.50000/- (Rupees Fifty Thousand) to several beneficiaries in order to avoid reporting or monitoring, the bank must insist on complete customer identification before effecting the transfer. In case of no cooperation from the customer, efforts should be made to establish his identity and Suspicious Transaction Report (STR) should be made to FIU-IND.
- When a credit or debit card is used to effect money transfer, necessary information as (a) above should be included in the message.

For cross-border wire transfers, the requirements are:

- All cross-border wire transfers must be accompanied by accurate and meaningful originator information.
- Information accompanying cross-border wire transfers must contain the name and address of the originator and where an account exists, the number of that account. In the absence of an account, a unique reference number, as prevalent in the country concerned, must be included.
- Where several individual transfers from a single originator are bundled in a batch file for transmission to beneficiaries in another country, they may be exempted from including full originator information, provided they include the originator's account number or unique reference number as at (b) above.

10.2 Banking Ombudsman Scheme, 2006

The scheme was introduced with the following objectives:

- To resolve complaints relating to banking services and to facilitate the satisfaction or settlement of such complaints.
- Resolve disputes between a bank and its constituents as well as amongst banks, through the process of conciliation, mediation and arbitration.

All banks are covered by the scheme, including Regional Rural Banks and scheduled primary co-operative banks.

The scheme provides for Reserve Bank to appoint one or more of its officers in the rank of Chief General Manager or General Manager to be known as the banking ombudsmen to carry out the functions entrusted to them within the identified territorial limits. As on date, fifteen Banking Ombudsmen have been appointed, with their offices located mostly in state capitals.

The Banking Ombudsman can receive and consider any complaint relating to the following deficiency in banking services (including internet banking):

- non-payment or inordinate delay in the payment or collection of cheques, drafts, bills etc.;
- non-acceptance, without sufficient cause, of small denomination notes tendered for any purpose, and for charging of commission in respect thereof;
- non-acceptance, without sufficient cause, of coins tendered and for charging of commission in respect thereof;
- non-payment or delay in payment of inward remittances ;
- failure to issue or delay in issue of drafts, pay orders or bankers' cheques;
- non-adherence to prescribed working hours ;
- failure to provide or delay in providing a banking facility (other than loans and advances) promised in writing by a bank or its direct selling agents;
- delays, non-credit of proceeds to parties accounts, non-payment of deposit or non-observance of the Reserve Bank directives, if any, applicable to rate of interest on deposits in any savings, current or other account maintained with a bank ;
- complaints from Non-Resident Indians having accounts in India in relation to their remittances from abroad, deposits and other bank-related matters;
- refusal to open deposit accounts without any valid reason for refusal;
- levying of charges without adequate prior notice to the customer;
- non-adherence by the bank or its subsidiaries to the instructions of Reserve Bank on ATM/Debit card operations or credit card operations;
- non-disbursement or delay in disbursement of pension (to the extent the grievance can be attributed to the action on the part of the bank concerned, but not with regard to its employees);
- refusal to accept or delay in accepting payment towards taxes, as required by Reserve Bank/Government;
- refusal to issue or delay in issuing, or failure to service or delay in servicing or redemption of Government securities;
- forced closure of deposit accounts without due notice or without sufficient reason;
- refusal to close or delay in closing the accounts;

- non-adherence to the fair practices code as adopted by the bank or non-adherence to the provisions of the Code of Banks Commitments to Customers issued by Banking Codes and Standards Board of India and as adopted by the bank ;
- non-observance of Reserve Bank guidelines on engagement of recovery agents by banks; and
- any other matter relating to the violation of the directives issued by the Reserve Bank in relation to banking or other services.

Further, a customer can also lodge a complaint on the following grounds of deficiency in service with respect to loans and advances

- non-observance of Reserve Bank Directives on interest rates;
- delays in sanction, disbursement or non-observance of prescribed time schedule for disposal of loan applications;
- non-acceptance of application for loans without furnishing valid reasons to the applicant; and
- non-adherence to the provisions of the fair practices code for lenders as adopted by the bank or Code of Bank's Commitment to Customers, as the case may be;
- non-observance of any other direction or instruction of the Reserve Bank as may be specified by the Reserve Bank for this purpose from time to time.

The Banking Ombudsman may also deal with such other matter as may be specified by the Reserve Bank from time to time.

Complaint can be filed before the Banking Ombudsman if the reply is not received from the bank within a period of one month after the bank concerned has received one's representation, or the bank rejects the complaint, or if the complainant is not satisfied with the reply given by the bank.

Although RBI, in its website, has made available a form for filing the complaint, it is not mandatory to use the form. Complaint can be filed in plain paper, or even electronically.

The complaint should have the name and address of the complainant, the name and address of the branch or office of the bank against which the complaint is made, facts giving rise to the complaint supported by documents, if any, the nature and extent of the loss caused to the complainant, the relief sought from the Banking Ombudsman and a declaration about the compliance of conditions which are required to be complied with by the complainant.

Complaint is to be filed at the office of the Banking Ombudsman under whose jurisdiction, the bank branch complained against is situated. For complaints relating to credit cards and other types of services with centralized operations, complaints may be filed before the

Banking Ombudsman within whose territorial jurisdiction the billing address of the customer is located.

Complaint can be filed personally, or through an authorized representative (but not an advocate).

There is no filing fee.

Complaint will not be considered if:

- One has not approached his bank for redressal of his grievance first.
- One has not made the complaint within one year from the date one has received the reply of the bank or if no reply is received if it is more than one year and one month from the date of representation to the bank.
- The subject matter of the complaint is pending for disposal / has already been dealt with at any other forum like court of law, consumer court etc.
- Frivolous or vexatious.
- The institution complained against is not covered under the scheme.
- The subject matter of the complaint is not within the ambit of the Banking Ombudsman.
- If the complaint is for the same subject matter that was settled through the office of the Banking Ombudsman in any previous proceedings.

The Banking Ombudsman endeavours to promote, through conciliation or mediation, a settlement of the complaint by agreement between the complaint and the bank named in the complaint.

If the terms of settlement (offered by the bank) are acceptable to the complainant in full and final settlement of his complaint, the Banking Ombudsman will pass an order as per the terms of settlement which becomes binding on the bank and the complainant.

If a complaint is not settled by an agreement within a period of one month, the Banking Ombudsman proceeds further to pass an award. Before passing an award, the Banking Ombudsman provides reasonable opportunity to the complainant and the bank, to present their case.

Compensation for any loss suffered by the complainant is limited to the amount arising directly out of the act or omission of the bank or Rs 10 lakhss, whichever is lower.

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

It is up to the complainant to accept the award in full and final settlement of the complaint or to reject it.

If the complainant is not satisfied with the decision passed by the Banking Ombudsman, he can approach the appellate authority against the Banking Ombudsmen's decision. Appellate Authority is vested with a Deputy Governor of the RBI.

The appellate authority will have to be approached within 30 days of the award. In exceptional cases, the appellate authority may grant a further period of 30 days to file the application.

The complainant can also explore any other recourse and/or remedies available to him/her as per the law.

Chapter 11 : Regulatory Framework (Part 2)

11.1 Indian Contract Act, 1872

Contracts in India are governed by this Act.

11.1.1 Proposal and Promise

When one person signifies to another, his willingness to do or to abstain from doing anything, with a view to obtaining the assent of the other person to such act or abstinence, he is said to make a *proposal*.

When the person to whom the proposal is made signifies his assent to it, the proposal is said to be accepted. A proposal, when accepted, becomes a *promise.*

For a proposal to become a promise, the acceptance must be:

- o Absolute and unqualified;
- o Expressed in some usual and reasonable manner, unless the proposal prescribes the manner in which it is to be accepted.
  - ▪ If the proposal prescribes a manner in which it is to be accepted, and the acceptance is not made in such manner, the proposer may, within a reasonable time after the acceptance is communicated to him, insist that his proposal shall be accepted in the prescribed manner. If he fails to do so, he is deemed to have accepted the acceptance.

The person making the proposal is called the *promisor.* The person accepting the proposal is the *promise.*

When the proposal or its acceptance is made in words, the promise is said to be *express;* else the promise is *implied.*

When, at the desire of the promisor, the promisee or any other person

- o has done or abstained from doing or
- o does or abstains from doing or
- o promises to do or abstain from doing

something, such act or abstinence or promise is called a *consideration* for the promise.

Promises, which form the consideration or part of the consideration for each other, are called *reciprocal promises.*

11.1.2 Agreement and Contract

Every promise and every set of promises, forming the consideration for each other, is an *agreement*.

An agreement enforceable by law is a *contract.*

An agreement not enforceable by law is said to be *void.*

An agreement, which is enforceable by law at the option of one or more parties, but not at the option of the other/s, is a *voidable contract.*

All agreements are contracts if :

- they are made with the free consent
- of parties competent to contract
- for a lawful consideration
- and with a lawful object
- they are not expressly declared to be void.

Two or more parties are said to be in *consent*, when they agree upon the same thing in the same sense.

Consent is said to be *free consent* when it is not caused by:

- coercion
- undue influence
- fraud
- misrepresentation
- mistake

When consent to an agreement is caused by coercion, fraud or misrepresentation, the agreement is a contract voidable at the option of the party whose consent was so obtained.

When both parties to an agreement are under a mistake as to a matter of fact essential to the agreement, the agreement is void.

A person is *competent to contract* if he is

- of the age of majority according to the law to which he is subject; and
- of sound mind; and
- not disqualified from contracting by any law to which he is subject.

The consideration or object of an agreement is *lawful*, unless –

- it is forbidden by law; or
- it is of such a nature that, if permitted, it would defeat the provisions of any law; or
- it is fraudulent; or
- it involves or implies injury to the person or property of another; or
- the Court regards it as immoral, or opposed to public policy.

If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object is unlawful, the agreement is void.

An agreement without a consideration is void, unless:

- it is expressed in writing and registered; or
- it is a promise to compensate, wholly or partly, a person who has already voluntarily done something for the promisor; or
- it relates to payment of a debt which is otherwise time barred by the law of limitation.

Contingent contracts to do or not to do anything, if an uncertain future event happens, cannot be enforced by law unless and until that event has happened. If the event becomes impossible, the contract becomes void.

When a contract consists of reciprocal promises, to be simultaneously performed, no promisor need perform his promise unless the promise is ready and willing to perform his reciprocal promise.

11.1.3 Appropriation of Payments

Where a debtor, owing several distinct debts to one person, makes a payment to him, either with express intimation, or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly.

Where a debtor has omitted to intimate, and there are no other circumstances indicating to which debt the payment is to be applied, the creditor may apply it, at his discretion, to any lawful debt actually due and payable to him from the debtor (even if it is time barred).

Where neither party makes an appropriation, the payment shall be applied in discharge of the debts in order of time (including time barred debts). If the debts are of equal standing, the payment shall be applied in discharge of each proportionately.

11.1.4 Effect of Novation / Rescission

Novation is the substitution of a contract by a new contract. In that case, the original contract need not be performed.

When a person at whose option a contract is voidable, rescinds it, the other party need not perform any promise he has made under the contract. The party rescinding a voidable contract shall, if he has received any benefit under the contract, restore such benefit, so far as may be, to the person from whom it was received.

Similarly, when an agreement is discovered to be void, or when a contract becomes void, any person who has received any benefit or advantage under such agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he received it.

11.1.5 Breach of Contract

When a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from the breach. However, compensation need not be given for any remote or indirect loss or damage sustained by reason of the breach.

Where a contract has been broken, if a su is mentioned in the contract as the amount to be paid in the case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not the actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract, reasonable compensation not exceeding the amount so mentioned or the penalty stipulated.

11.1.6 Indemnity and Guarantee

A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a *contract of indemnity.*

A *contract of guarantee* is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the *surety.* The person in respect of whose default the guarantee is given is called the *principal debtor*. The person to whom the guarantee is given is called the *creditor*. A guarantee may be oral or written.

A guarantee which extends to a series of transactions is called *continuing guarantee.*

11.1.7 Principal and Agent

An *agent* is a person employed to do any act for another or to represent another in dealings with third persons.

The person for whom such act is done, or who is so represented, is called *the principal.*

No consideration is necessary to create an agency. The authority of an agent may be express (given by express words, spoken or written) or implied (inferred from the circumstances).

An agent, having an authority to do an act, has authority to do every lawful thing which is necessary in order to do such act.

An agent, having an authority to carry on a business, has authority to do every lawful thing necessary for the purpose, or usually done in the course of conducting such business.

An agency is terminated though any of the following circmstances:

- Principal revokes the agent's authority
- Agent renounces the business of the agency
- Business of the agency is completed
- Principal or agent dies or becomes of unsound mind or is adjudicated an insolvent.

11.2 Sale of Goods Act, 1930

When banks finance trade, or businesses against the security of inventory, it is important to consider how good that security is. The Sale of Goods Act, 1930, which determines when ownership passes from the seller to the buyer, and the respective rights of the parties, is therefore an important aspect that the banker needs to consider.

11.2.1 Goods

Goods means every kind of movable property other than actionable claims and money, and includes stocks and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.

11.2.2 Documents of title to goods

This includes a bil of lading, dock-warrant, warehouse-keeper's receipt, wharfingers' certificate, railway receipt, multimodal transport document, warrant or order for the delivery of goods and any other document used in the ordinary course of business as proof of possession or control of goods, or authorizing, or purporting to authorize, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented.

11.2.3 Sale and Agreement to Sell

A contract sale of goods is one where the seller transfers, or agrees to transfer the property in goods to the buyer for a price. It may be absolute or conditional.

The contract is made by an offer to sell or buy the goods for a price, and acceptance of that offer. It may provide for immediate delivery of the goods, or immediate payment of the price or both, or for the delivery or payment by instalments, or that the delivery or payment or both shall be postponed.

The contract of sale may be made in writing or by word of mouth or partly in writing and partly by word of mouth or may be implied from the conduct of the parties.

Where, under a contract of sale, the property in the goods is transferred from the seller to the buyer, the contract is called a *sale.*

Where, the transfer of the property in the goods is to take place at a future time, or subject to some condition thereafter to be fulfilled, the contract is called an *agreement to sell.*

An *agreement to sell* becomes a *sale* when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred.

11.2.4 Condition and Warranty

A stipulation in a contract of sale may be a condition or a warranty.

A condition is a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated.

A warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not of a right to reject the goods and treat the contract as repudiated.

11.2.5 Implied Undertakings

In a contract of sale, unless the circumstances of the contract are such as to show a different intention, there is

- An implied condition on the part of the seller that
  - o in the case of a sale, he has a right to sell the goods
  - o in the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass.
- An implied warranty that the buyer shall have and enjoy quiet possession of the goods
- An implied warranty that the goods shall be free from any charge or encumbrance in favour of any third party, not declared, or known to the buyer before or at the time when the contract is made.

112.6 Passing of property

Where there is an unconditional contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer when the contract is made. It is immaterial whether the time of payment of the price or the time of delivery of goods or both is postponed.

Where there is a contract for the sale of specific goods and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done and the buyer has notice thereof.

Unless otherwise agreed, goods remain at the seller's risk until the property is transferred to the buyer. When the property is transferred to the buyer, the goods are at the buyer's risk, whether delivery has been made or not.

Where delivery has been delayed through the fault of either buyer or seller, the goods are at the risk of the party in fault, as regards any loss which might not have occurred but for such fault.

11.2.7 Unpaid Seller

A seller of goods is deemed to be an *unpaid seller-*

- When the whole of the price has not been paid or tendered
- When a bill of exchange or other negotiable instrument has been received as conditional payment, and the condition on which it was received has not been fulfilled by dishonor of the instrument or otherwise.

An unpaid seller has the following rights (even if property has passed to the buyer):

- Lien on the goods for the price, while he is in possession of them
- In case of insolvency of the buyer, a right to stop the goods in transit, after he has parted with possession
- A right of re-sale.

Where the property has not passed, an unpaid seller also has a right of withholding delivery of the goods.

The seller's line comes into play in the following situations:

- Goods have been sold without any stipulation as to credit
- Goods have been sold on credit, but the term of credit has expired
- The buyer becomes insolvent.

The seller can exercise his lien, even if he is holding the goods as agent or bailee of the buyer.

11.3 Negotiable Instruments Act, 1881

The object of this act is to set the legal framework for specified financial instruments to change hands, just as goods can change hands.

11.3.1 Negotiable Instrument

It means a promissory note, bill of exchange or cheque payable either to order or to bearer.

Payable to order means it is payable to a person mentioned in the instrument.

Payable to bearer means it is payable to anyone who has possession of the instrument.

When it is drawn or made in India and made payable in, or drawn upon any person resident in India, it is deemed to be an *inland instrument*. An instrument which is not so drawn, made or made payable, is a *foreign instrument.*

Where an instrument may be construed either as a promissory note or a bill of exchange, the holder may at his election treat it as either, and the instrument shall be thenceforward treated accordingly.

If the amount undertaken or ordered to be paid is stated differently in figures and in words, the amount stated in words shall be the amount undertaken or ordered to be paid.

11.3.2 Promissory Note

It is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.

For example: I promise to pay Mr. Ravi Singh or order Rs. 1,00,000/- (Rupees one lakhs only).

Sd/- Mr. Sunny Singh

If no time for payment is specified, then it is payable on demand.

11.3.3 Bill of Exchange

It is an instrument in writing, containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money, only to, or to the order of, a certain person or to the bearer of the instrument.

For example: I order you, Mr. Sunny Singh to pay Mr. Ravi Singh or his order Rs. 1,00,000/- (Rupees one lakh only).

The person who makes the bill of exchange is the *drawer.* The person who is supposed to make the payment is the *drawee.* The person to whom the payment is to be made is the *payee* or *beneficiary.*

After the drawee of a bill has signed his assent upon the bill, or, if there are more parts thereof than one, upon one of such parts, and delivered the same, or given notice of such signing to the holder of the instrument, or to some person on his behalf, he is called the *accepter.*

The holder must, if so required by the drawee of a bill of exchange presented to him for acceptance, allow the drawee forty-eight hours (exclusive of public holidays) to consider whether he will accept it.

A demand draft that is issued by a bank is an example of a Bill of Exchange. It directs another branch of the bank to pay a specified amount to the beneficiary who is mentioned in the demand draft.

In the case of a demand draft, the drawer and drawee are both bank, albeit different branches of the bank. Bills of exchange can also be made where the drawer and drawee are non-banks.

If no time for payment is specified, then it is payable on demand.

11.3.4 Cheque

It 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.

A *cheque in electronic form* means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

A *truncated cheque* means 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.

As with a demand draft, the drawee of a cheque is a bank. However, unlike a demand draft, the drawer in a cheque does not need to be a bank. Any account holder who has a cheque writing facility from his bank can draw (make) a cheque.

A cheque is payable on demand.

11.3.5 Holder and Holder in due course

The *holder* of a promissory note, bill of exchange or cheque means any person, entitled in his own name, to the possession thereof and to receive or recover the amount due thereon from the parties thereto.

Thus, the finder of a lost instrument may have its possession, but he is not the *holder.*

Holder in due course means any person who, for consideration, became the possessor of a promissory note, bill of exchange or cheque (if payable to bearer) or the payee or indorsee thereof (if payable to order) before the amount mentioned in became payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

11.3.6 Negotiation

When a negotiable instrument is transferred to any person, so as to constitute that person the holder thereof, the instrument is said to be *negotiated.*

An instrument payable to bearer can be negotiated by mere delivery of the instrument to the other person.

An instrument payable to order can be negotiated by indorsement and delivery of the instrument to the other person.

A minor may draw, indorse, deliver and negotiate such instrument so as to bind all parties except himself.

11.3.7 Endorsement / Indorsement

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 the face thereof, or on a slip of paper annexed thereto, or so signs for the same purpose, a stamped paper, intended to be completed as a negotiable instrument, he is said to indorse the same, and is called the *endorser / indorser*.

If the indorser signs his name only, the indorsement is said to be *in blank.*

If, besides his signature, he adds a direction to pay the amount mentioned in the instrument to, or to the order of, a specified person, the indorsement is said to be *in full*. The person so specified is called the *indorsee.*

For example, A draws a bill of exchange on B. Thereafter, A signs it with the intention of negotiating it in favour of someone else. The second signature of A is an *indorsement in blank*. It will convert the instrument into one which is payable to anyone who is in possession of the instrument.

If, besides the second signature, A adds a remark 'Pay C or order', then it is an *indorsement in full.*

In the absence of a contract to the contrary, whoever indorses and delivers a negotiable instrument before maturity, without, in such indorsement, expressly excluding or making conditional his own liability, is bound thereby to every subsequent holder, in case of dishonor by the drawee, acceptor or maker, to compensate such holder for any loss or damage caused to hi by such dishonor, provided due notice of dishonor has been given to, or received by such indorser.

An indorser can escape such liability to subsequent holders by mentioning 'sans recourse' or 'without recorse' against his indorsement.

Suppose A does an indorsement in blank in favour of C, who just adds the words 'Pay D' above A's indorsement. C has effectively converted A's indorsement in blank into an indorsement in full; this is legal; C benefits because he will be able to escape liability if the instrument is subsequently dishonoured.

C can prevent further indorsement of the instrument by putting down th words 'Pay D only'.

11.3.8 General Crossing of Cheque

Where a cheque bears across its face an addition of the words 'and company' or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply, either with or without the words 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be *crossed generally*.

Where a cheque is crossed generally, the banker, on whom it is drawn shall not pay it otherwise than to a banker.

11.3.9 Special Crossing of Cheque

Where a cheque bears across its face an addition of the name of a banker, either with or without th words 'not negotiable', that addition shall be deemed to be *crossed specially,* and to be crossed to that banker.

Where 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.

Where a cheque is uncrossed, the holder may cross it generally or specially.

11.3.10 When payable

If no payment date is mentioned in a bill of exchange or promissory note, then it is payable on demand. A cheque is always payable on demand.

In a promissory note or bill of exchange, 'at sight' or 'on presentment' means on demand.

In a promissory note, 'after sight' means after it has been presented for sight.

In a bill of exchange, 'after sight' means after it has been accepted, or non-acceptance is noted.

The maturity of a promissory note or bill of exchange is the date on which it falls due.

Every promissory note or bill of exchange, which is not expressed to be payable on demand, at sight or o presentment is at maturity, on the third day after the day on which it is expressed to be payable.

When the date on which a promissory note or bill of exchange is at maturity is a public holiday, the instrument shall be deemed to be due on the next preceding business day.

When no rate of interest is specified in the instrument, interest on the amount due thereon is payable at the rate of 18% p.a. from the date at which the same ought to have been paid until the date the amount is realized. An indorser is liable for the interest only from the time that he receives notice of the dishonor.

11.3.11 Payment in due course

It 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.

11.3.12 Dishonour

When a promissory note is not paid at maturity, it is said to be dishonoured. A bill of exchange may be dishonoured either by non-payment or non-acceptance (when it is presented to the drawee for acceptance).

The holder may cause such dishonor to be noted by a notary public upon the instrument, or upon a paper attached thereto, or partly upon each.

The holder may also ask for the dishonor to be noted and certified by the notary public. Such a certificate is called a *protest.*

11.3.13 Dishonour of Cheque for insufficiency of funds (Sec 138)

Suppose 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 in part, of any debt or other liability, is returned by the bank unpaid, either because of the amount of money standing to the credit of that account is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from that account by an agreement made with that bank.

The person shall be deemed to have committed an offence and shall, without prejudice to any other provision, be punishable 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.

The requirements to make the person liable for the punishment are:

- o The cheque has been presented to the bank within a period of six months from the date on which it is drawn, or within the period of its validity, whichever is earlier.
- o The payee or holder in due course of the cheque makes a demand for the payment of the said amount of money by giving a notice in writing, to the drawer of the cheque, within 30 days of the receipt of information by him from the bank regarding the return of the cheque as unpaid; and
- o The drawer of the cheque fails to make the payment of the said amount of money to the payee or the holder in due course, as the case may be, within 15 days of the receipt of the said notice.

If the person committing an offence under section 138 is a company (or body corporate, firm or other association of individuals), every person who, at the time the offence was committed, was in charge of, and was responsible to the company for the conduct of the business of the company, as well as the company shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.

11.4 The Limitation Act, 1963

This Acts sets a time limit beyond which suits cannot be filed and claims cannot be made. Even claims under The Recovery of Debts due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 are possible, only so long as the debts are not time-barred under the Limitation Act. Therefore, an understanding of the relevant time period is important for any banker.

SL. NO.	***DESCRIPTION OF SUIT***	***PERIOD OF LIMITATION***	***TIME FROM WHICH PERIOD BEGINS TO RUN***
1.	For the balance due on a mutual, open and current account where there have been reciprocal demands between the parties.	Three years	The close of the year in which the last item admitted or proved is entered in the account; such year to be computed as in the account.

SL. NO.	***DESCRIPTION OF SUIT***	***PERIOD OF LIMITATION***	***TIME FROM WHICH PERIOD BEGINS TO RUN***
2.	By a principal against his agent for movable property received by the latter and not accounted for.	Three years	When the account is during the continuance of the agency, demanded and refused or, where no such demand is made, when the agency terminates.
3.	Other suits by principals against agents for	Three years	When the neglect or misconduct becomes known to the plaintiff.
4.	For an account and a share of the profits of dissolved partnership	Three years	The date of the dissolution.
5.	For money payable for money lent	Three years	When the loan is made
6.	On a bill of exchange payable at sight, or after sight, but not at a fixed time	Three years	When the bill is presented
7.	On a bill of exchange or promissory note payable at a fixed time after sight or after demand	Three years	When the fixed time expires
8.	On a promissory noe or bod payable by instalments	Three years	The expiration of the first term of payment as to the part then payable; and for the other parts, the expiration of the respective terms of payment
9.	For specific performance of a contract	Twelve years	The date fixed for performance; if no such date is fixed, when the plaintiff has noticed that performance is refused.

Chapter 12 : Financial Inclusion

Financial Inclusion refers to the provision of financial services and facilities to the weaker sections of society. Nobel Prize winner, Dr. Mohammed Yunus is a thought leader in the field. He conceptualized micro-finance, which he defined as the availability of loans to rural people without obtaining collateral for income generating purposes in order to reduce the poverty levels.

Micro-finance through Self Help Groups (SHGs) is widely considered to be a good model of micro finance lending. When a group of individuals who are poor, form an association for their upliftment, the association is called SHG. Members of the SHG contribute regularly to build up the corpus of the SHG. A micro-finance institution (MFI) adds to the corpus through a loan to the SHG. The corpus, which is jointly managed, is used for a joint economic activity. The loan gets repaid through the proceeds from the economic activity. Thus, SHGs create earning opportunities and improve the life of the downtrodden.

Some SHG's use the corpus to fund its members. Since it is a closely knit circle, the SHG is in a position to lend prudently. For instance, it is meaningless to lend to someone who will use the money to finance his drinking. Many SHGs comprise only women members. Moral pressure from other members ensures that defaults are negligible.

For better governance, SHGs have various operating practices such as:

- Upto 20 members in a SHG
- Not more than 1 member of a family in a SHG
- Anyone to be a member of only one SHG
- Proper code of conduct including fixed day, time and place for meetings, maintenance of records of meetings, accounts and activities etc.

The finance ministry and the Reserve Bank of India are keen that the benefits of banking and other financial services should trickle down to all sections of society.

Way back in 2005-06, RBI asked banks to offer a basic banking 'no frills' account, either with nil or very minimum balance as well as charges. Further, it simplified the KYC procedure for persons with balances not exceeding Rs. 50,000/- and credits in the accounts not exceeding Rs100,000/- in a year. It has also suggested that limited overdraft facility be offered in such accounts, without any collateral and without any restriction as to purpose of the financing. Banks also have various SHG financing schemes.

Besides banks, most state governments have schemes to provide micro-finance. All these initiatives have helped reduce the influence of money-lenders, who charge usurious rates of interest.

Several micro-finance institutions (MFIs) have come up in the private sector. Banks as well as cash-surplus companies have been lending to MFIs, for onward lending in hitherto under-banked parts of the country.

With so many MFIs operating all across the country, with various levels of patronage by State Governments, their regulation has been a challenge. RBI, on its part, has been monitoring the exposure of banks to the MFI sector.

Many MFIs have gone beyond SHGs to finance individuals. Operating in a commercial environment, their rates of interest were high, albeit lower than those that money lenders would charge. The industry attributed the high rates of interest to their cost of operations – cost of reaching out to far flung areas, cost of collecting money on daily / weekly basis, instead of the banking norm of monthly / quarterly etc.

In some cases, politicians accustomed to doling out money to win political patronage, viewed MFIs as their competitors. The MFIs too have made their mistakes. Excessive financing to increase their activity level and balance sheet size, often to finance consumption rather than economic activity, stretched the asset quality of the MFIs. Inappropriate modes of recovery compounded the problem and led to suicides by borrowers.

Andhra Pradesh, where a lot of MFI activity was centered, has come out with a legislation, which the MFI industry finds unreasonable. Several borrowers stopped repaying their past dues, thus disrupting the income and cash flow cycle of the MFIs. Credit rating companies reduced the credit rating of MFIs who had large exposure to Andhra Pradesh. This disturbed the avenues for MFIs to obtain alternate means of financing.

In the light of all these developments, RBI set up the Y. H. Malegam Committee to look into all aspects of MFIs. The committee came out with its recommendations in January 2011. Some of the important recommendations are:

- A new category of institutions to be created – NBFC-MFI. They should be exempted from state Money Lending Acts.

  To qualify as a NBFC-MFI, the NBFC should be "a company which provides financial services pre-dominantly to low-income borrowers, with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks".

- Lending to MFIs should be treated as priority sector lending.

- MFIs must hold at least 90% of their assets in qualifying assets (excluding cash and bank balances and money market instruments).
- Not less than 75% of the loans given by the MFI should be for income-generating purposes.
- Annual income of borrower families should not exceed Rs. 50,000.
- Ceiling of Rs. 25,000 on loans to a single borrower.
- Maximum of 2 MFIs to lend to a single borrower.
- A borrower can be a member of only one Self-Help Group (SHG) or a Joint Liability Group (JLG)
- MFIs will be allowed to levy only three charges: Processing fee, interest and insurance charge.
- Interest rate to be capped at 24% for loans. The loans should be without collateral.
- Margin should be capped at 10% for MFIs with a loan portfolio of Rs100crores; 12% for smaller MFIs.
- The Reserve Bank must prepare a draft Customer Protection Code to be adopted by all MFIs
- All MFIs would have to observe a specified code of corporate governance.
- Defaults should be reduced by setting up one or more credit information bureaus.

For monitoring compliance with regulations, a four-pillar approach has been proposed, with the responsibility being shared by (a) MFI (b) industry associations (c) banks and (d) the Reserve Bank.

There are no easy solutions. Credit to the under-privileged is a challenge, especially when India does not even have one bank branch for every 10,000 of population. It is no surprise that money lenders have such a firm grip over people in far flung areas.

In order to build a cost effective reach and distribution capability, RBI has been promoting the concept of Business Facilitaters / Business Correspondents (BFs /BCs). BFs are better informed locals, who can perform critical roles such as advising people on their finances, appraising them as borrowers, helping banks in lending to the borrowers and recovery etc. BCs go beyond this to handle small value cash transactions in areas where there is no bank branch.

The idea originated in Brazil, where retailers and lottery ticket sellers doubled up as bank branches. They were facilitated through Point of Service (POS) terminals with bio-metric reading capability. Who can perform these roles in the Indian context?

Non-government Organisations (NGOs), Community-based Organisations, Village Knowledge Centers, Krishi Vigyan Kendras, Panchayats, Co-operative Societies, Post Offices, insurance agents, IT-enabled outlets of companies, and employees in these organisations can consider performing these roles. Even teachers, retired bank employees and retired government employees, who enjoy a position of trust, are a candidate for the role.

The power of technology and reach of mobile offers various interesting possibilities, as is clear from the following example.

The BC goes to the village with his bio-metric device. He is connected with one or more banks, where he has bank account/s. A villager wants to open a bank account. The BC handles the KYC documentation and also the bio-metric reading of the villager. He accepts a deposit of money from the villager and gives him a printed receipt. Based on the information entered in his system, instantaneously, the receipt of money is confirmed to the villager in his cell phone, while the money is recovered from the BC's bank account with the bank.

Similarly, a villager who wants to withdraw money can do so from the BC. The bio-metric reading of the villager will be matched with the database, which also has information on the balance in the villager's bank account. Accordingly, the BC can give cash. Instantaneously, the money will be transferred by the bank from the villager's bank account to the BC's bank account.

There are obvious risks in the system. Banks, therefore, need to be judicious in their choice of BFs / BCs and train them appropriately. Further, they would need to put in place an effective risk management system.

A single BF / BC handling the activities of multiple banks in his territory is an interesting solution to the issues of cost in reaching out to far flung areas and offering banking services in line with the short term earning cycles of the population.

India needs several such innovative approaches to power the dreams of its people and take the country to the global position it aspires for.

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(Model test paper for the module is available on the

website **www.nseindia.com > 'Education' > 'Prepare for a Testing' link)**