**2B) BANKING**

Role of commercial banks; Credit and its importance in Industrial Functioning

**What is a 'Bank' :** A bank is a financial institution licensed as a receiver of deposits. There are two types of banks **:** (i) Commercial / Retail Banks and (ii) Investment Banks.
In most countries, banks are regulated by the national government or central bank.
Commercial banks are mainly concerned with managing withdrawals and deposits as well as supplying short-term loans to individuals and small businesses. Consumers primarily use these banks for basic checking of savings accounts, certificates of deposit and sometimes for home mortgages. Investment banks focus on providing services such as underwriting and corporate reorganization to institutional clients.

In banking, underwriting is the detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower; such underwriting falls into several areas: (a) Consumer loan underwriting includes the verification of such items as employment history, salary and financial statements; publicly available information, such as the borrower's credit history, which is detailed in a credit report; and the lender's evaluation of the borrower's credit needs and ability to pay. Examples include mortgage underwriting. (b) Commercial (or business) underwriting consists of the evaluation of financial information provided by small businesses including analysis of the business balance sheet including tangible net worth, the ratio of debt to worth (leverage) and available liquidity (current ratio). Analysis of the income statement typically includes revenue trends, gross margin, profitability, and debt service coverage.

Underwriting can also refer to the purchase of corporate bonds, commercial paper, government securities, municipal general-obligation bonds by a commercial bank or dealer bank for its own account or for resale to investors. Bank underwriting of corporate securities is carried out through separate holding-company affiliates, called securities affiliates or Section 20 affiliates.

While many banks have both a brick-and-mortar and online presence, some banks have only an online presence. Online-only banks often offer consumers higher interest rates and lower fees. Convenience, interest rates and fees are the driving factors in consumers' decisions of which bank to do business with. As an alternative to banks, consumers can opt to use a credit union.

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What is banking and what is the role of banking in an economy?
In simple words, Banking can be defined as the business activity of accepting and safeguarding money owned by other individuals and entities, and then lending out this money in order to earn a profit. However, with the passage of time, the activities covered by banking business have widened and now various other services are also offered by banks. The banking services these days include issuance of debit and credit cards, providing safe custody of valuable items, lockers, ATM services and online transfer of funds across the country / world.

It is well said that banking plays a silent, yet crucial part in our day-to-day lives. The banks perform financial intermediation by pooling savings and channelizing them into investments through maturity and risk transformations, thereby keeping the economy's growth engine revving (to accelerate / to increase the speed).

Banking business has done wonders for the world economy. The simple looking method of accepting money deposits from savers and then lending the same money to borrowers, banking activity encourages the flow of money to productive use and investments. This in turn allows the economy to grow. In the absence of banking business, savings would sit idle in our homes, the entrepreneurs would not be in a position to raise the money, ordinary people dreaming for a new car or house would not be able to purchase cars or houses.
In simple words, we can say that Bank is a financial institution that undertakes the banking activity ie.it accepts deposits and then lends the same to earn certain profit.

Banking Company transacts the business of banking defined above.

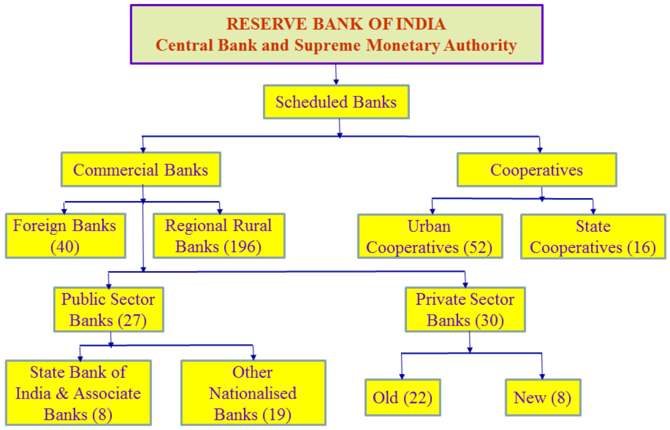
Banking systems can be defined as a mechanism through which the money supply of the country is created and controlled.

Banking in India in the modern sense originated in the last decades of the 18$^{th}$ century. Among the first banks were the Bank of Hindustan, which was established in 1770 and liquidated in 1829-32; and the General Bank of India, established in 1786 but failed in 1791.

The largest bank, and the oldest still in existence, is the State Bank of India (S.B.I). It originated as the Bank of Calcutta in June 1806. In 1809, it was renamed as the Bank of Bengal. This was one of the three banks funded by a presidency government, the other two were the Bank of Bombay and the Bank of Madras. The three banks were merged in 1921 to form the Imperial Bank of India, which upon India's independence, became the State Bank of India in 1955. For many years the presidency banks had acted as quasi-central banks, as did their successors, until the Reserve Bank of India was established in 1935, under the Reserve Bank of India Act, 1934.

In 1960, the State Banks of India was given control of eight state-associated banks under the State Bank of India (Subsidiary Banks) Act, 1959. These are now called its associate banks. In 1969 the Indian government nationalised 14 major private banks. In 1980, 6 more private banks were nationalized. These nationalised banks are the majority of lenders in the Indian economy. They dominate the banking sector because of their large size and widespread networks.

Structure of organized Banking sector in India




Note : Number of banks are given in brackets

The Indian banking sector is broadly classified into scheduled banks and non-scheduled banks. The scheduled banks are those which are included under the 2nd Schedule of the Reserve Bank of India Act, 1934. The scheduled banks are further classified into: nationalised banks; State Bank of India and its associates; Regional Rural Banks (RRBs); foreign banks; and other Indian private sector banks. The term commercial banks refers to both scheduled and non-scheduled commercial banks which are regulated under the

Banking Regulation Act, 1949.
Generally banking in India is fairly mature in terms of supply, product range and reach-even though reach in rural India and to the poor still remains a challenge. The government has developed initiatives to address this through the State Bank of India expanding its branch network and through the National Bank for Agriculture and Rural Development with facilities like microfinance.

Post-Independence **:** The partition of India in 1947 adversely impacted the economies of Punjab and West Bengal, paralysing banking activities for months. India's independence marked the end of a regime of the Laissez-faire for the Indian banking. The Government of India initiated measures to play an active role in the economic life of the nation, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted in greater involvement of the state in different segments of the economy including banking and finance. The major steps to regulate banking included:

(i) The Reserve Bank of India, India's central banking authority, was established in April 1935, but was nationalised on 1 January 1949 under the terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948.

(ii) In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the banks in India".

(iii) The Banking Regulation Act also provided that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

List of Banks in India **:** The Indian banking sector is broadly classified into scheduled banks and non-scheduled banks.All banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are Scheduled Banks. These banks comprise Scheduled Commercial Banks and Scheduled Co-operative Banks. Scheduled Co-operative Banks consist of Scheduled State Co-operative Banks and Scheduled Urban Cooperative Banks. Scheduled Commercial Banks in India are categorised into five different groups according to their ownership and/or nature of operation:
- State Bank of India and its Associates
- Nationalised Banks
- Private Sector Banks
- Foreign Banks
- Regional Rural Banks.

In the bank group-wise classification, IDBI Bank Ltd. is included in Nationalised Banks.

By 2010, banking in India was generally fairly mature in terms of supply, product range and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government.

With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong.

Pradhan Mantri Jan Dhan Yojana (Hindi: प्रधानमंत्री जन धन योजना, English: Prime Minister's People Money Scheme) is a scheme for comprehensive financial inclusion launched by the Prime Minister of India, Narendra Modi, in 2014. Run by Department of Financial Services, Ministry of Finance, on the inauguration day, 1.5 Crore (15 million) bank accounts were opened under this scheme. By 15 July 2015, 16.92 crore accounts were opened, with around ₹20288.37 crore (US$3.0 billion) were deposited under the scheme, which also has an option for opening new bank accounts with zero balance.

The Banking Codes and standards Board of India is an independent and autonomous banking industry which monitor all available banks in India while delivering services to customers. To improve the quality of banking services in India S S Tarapore (former deputy governor of RBI) came up with the idea to form a committee

Adoption of banking technology

The IT revolution has had a great impact on the Indian banking system. The use of computers has led to the introduction of online banking in India. The use of computers in the banking sector in India has increased many fold after the economic liberalisation of 1991 as the country's banking sector has been exposed to the world's market. Indian banks were finding it difficult to compete with the international banks in terms of customer service, without the use of information technology.

The RBI set up a number of committees to define and co-ordinate banking technology. These have included:

• In 1984 was formed the Committee on

Mechanisation in the Banking Industry (1984) whose chairman was Dr. C. Rangarajan, Deputy Governor, Reserve Bank of India. The major recommendations of this committee were introducing MICR technology in all the banks in the metropolises in India. This provided for the use of standardized cheque forms and encoders.

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• In 1988, the RBI set up the Committee on Computerisation in Banks (1988) headed by Dr. C. Rangarajan. It emphasised that settlement operation must be computerised in the clearing houses of RBI in Bhubaneshwar, Guwahati, Jaipur, Patna and Thiruvananthapuram. It further stated that there should be National Clearing of inter-city cheques at Kolkata, Mumbai, Delhi, Chennai and MICR should be made operational. It also focused on computerisation of branches and increasing connectivity among branches through computers. It also suggested modalities for implementing on-line banking. The committee submitted its reports in 1989 and computerisation began from 1993 with the settlement between IBA and bank employees' associations.

• In 1994, the Committee on Technology Issues relating to Payment systems, Cheque Clearing and Securities Settlement in the Banking Industry (1994) was set up under Chairman W. S. Saraf. It emphasised Electronic Funds Transfer (EFT) system, with the BANKNET communications network as its carrier. It also said that MICR clearing should be set up in all branches of all those banks with more than 100 branches.

• In 1995, the Committee for proposing Legislation on Electronic Funds Transfer and other Electronic Payments (1995) again emphasised EFT system.

Automated teller machine growth

The total number of automated teller machines (ATMs) installed in India by various banks as of end June 2012 was 99,218. The new private sector banks in India have the most ATMs, followed by off-site ATMs belonging to SBI and its subsidiaries and then by nationalised banks and foreign banks, while on-site is highest for the nationalised banks of India.

Expansion of banking infrastructure **:** Physical as well as virtual expansion of banking through mobile banking, internet banking, tele banking, bio-metric and mobile ATMs is taking place since last decade and has gained momentum in last few years.

Some of the major important role of commercial banks in a developing country are as follows **:**

Besides performing the usual commercial banking functions, banks in developing countries play an effective role in their economic development. The majority of people in such countries are poor, unemployed and engaged in traditional agriculture.

There is acute shortage of capital. People lack initiative and enterprise. Means of transport are undeveloped. Industry is depressed. The commercial banks help in overcoming these obstacles and promoting economic development. The role of a commercial bank in a developing country is discussed as under.

<u>The role of a commercial bank in developing country</u>

**1.** *Mobilising Saving for Capital Formation*
**2.** *Financing Industry*
**3.** *Financing Trade*
**4.** *Financing Agriculture*
**5.** *Financing Consumer Activities*
**6.** *Financing Employment Generating Activities*
**7.** *Help in Monetary Policy*

**1.** *Mobilising Saving for Capital Formation* **:** The commercial banks help in mobilising savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilise idle savings of the few rich. By mobilising savings, the banks channelise them into productive investments. Thus they help in the capital formation of a developing country.

**2.** *Financing Industry* **:** The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-term loans. Income of the Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry.
In India, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire-purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

**3.** *Financing Trade* **:** The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

**4.** *Financing Agriculture* **:** The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernisation and mechanisation of their farms, for providing irrigation facilities, for developing land, etc.

They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, pisciculture (breeding, hatching, and rearing of fish under controlled conditions ) and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

**5.** *Financing Consumer Activities* **:** People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

**6.** *Financing Employment Generating Activities* **:** The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young person’s studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help inhuman capital formation but also in increasing entrepreneurial activities in developing countries.

**7.** *Help in Monetary Policy* **:** The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.

Thus the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

The Importance of Building Business Credit **:** An asset can be defined as a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Many startups rely on the use of personal assets to secure funding for the business. Although money is often tight during the early stages, the goal of a small business owner should be to not only increase sales revenues but to build the company's creditworthiness.

In particular, business credit is an asset and considered an economic resource that make up the financial foundation of a company.
Here are two important questions that you should be able to answer:
What is a tangible business asset?
What is an intangible business asset?

A tangible business asset is when you purchase vehicles, real estate, computers, office furniture and other fixtures exclusively for business use.

Intangible business asset are nonphysical resources and rights that have value to a business. Some examples are copyrights, trademarks, patents, accounts receivables and you guessed it - business credit.

In this particular article we will be discussing the importance of building business credit. Business credit has value to a company's financing ability and credit capacity.

By building business credit with all the National business credit bureaus a company increases its finance capacity. This creates an asset that can be used to acquire financing for the business based on its own creditworthiness rather than that of its owners.

Here are three major benefits of building business credit:
**1. *L***_arge Credit Capacity_ – Businesses have 10 to 100 times greater credit capacity compared to personal credit. As a creditworthy business your company will be in a position to qualify for financing based on factors strictly related to the business. Without building business credit you will have to continue to rely on your personal credit.

**2. *I***_ncrease Company Value_ – A creditworthy business has a powerful advantage in financing ability. Because this asset is fully transferable with the business it makes it very attractive for a potential buyer or investor.

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**3. *P***_rotect Personal Credit_ – A business owner will be able to limit if not eliminate the use of personal credit checks since the company has its own credit ratings. This prevents a business owner from having to co-mingle personal credit, personal debts, and personal assets with his company.

Building business credit truly provides remarkable benefits for a business and gives unique financial advantages in the market place. With this asset a business can secure lines of credit, lease equipment, finance a company vehicle, and obtain business loans and credit cards without putting personal credit at risk.

Finally, it's important to remember, the greater the business credit, the greater the worth and potential return you will receive if you choose to sell the business in the future.

When starting a new business from scratch, there are several factors you need to consider from marketing materials and hiring employees to selling products and saving money, that your business' credit could easily take a backseat on the priority list. However, maintaining your business' good credit is extremely important when it comes to building a successful company.

Much like your personal credit, your business' credit score determines whether your company can be trusted when it comes to handling money. Think of your business' credit score as a gauge for the reputation of your company. Among other factors, it reveals any sign of your business' delinquent payments or bankruptcy, which could affect your chances of landing future business relationships. If your business has poor credit history, potential lenders or investors may not want to partner with your company because it would be considered a high risk endeavour.
While you may have excellent personal credit, you won't want to put a loan for your business in your name for liability reasons, as you could become responsible for your business' debt. There is always a chance that your business could hit hard times, and if your business cannot repay the loan, you don't want that debt reflected on your own personal credit report. Not to mention in some extreme cases, the creditors could go after your personal assets if you filed the loan in your own name. Therefore it's best to build business credit, and then apply for business loans with your company's credit report instead.

The better your business credit the more financial opportunities your business will receive. For one, if your business has good credit history, lenders will be more likely to loan your business money. Not only will lenders trust you to repay them, but they will generally offer you lower interest rates than if your business had bad or no credit history. With access to loans, your business can borrow money to invest in a new product or electronic equipment, which it might not otherwise be able to afford out of its own pocket.

In the same way that lenders won't mind engaging in business with your company, investors and partners may be more inclined to invest in your business as well. Your business' credit score will prove that your company is reliable.

Additionally, good credit creates a safety net for your business. You may not need extra money now, but what if sales drop next month? Can you still pay your company's rent? Will you have enough money to cover your employees' payroll? If your business has already built good credit, then your business should have no trouble borrowing money during a financial bind.
Now that you understand the importance of good business credit, the following are just a few simple steps, which can help your business build credit.
**1.** ***F****orm a Business Entity* **:** To begin, your business must have a legal business entity, such as a corporation or LLC, which will allow to you to build your business' credit separate from your own credit.

**2.** ***A****pply for a Tax Number* **:** Next, your business needs a tax ID (EIN), which you can receive through the IRS website. This tax number lets your business create a business bank account.

**3.** ***S****et up a Business Bank Account* **:** You'll need a business bank account in order to apply for a business loan, so your next step should be setting up at least one account for your company.

**4.** ***R****egister with Business Credit Bureaus* **:** Your business entity and EIN also allow you to apply for credit file numbers with business credit bureaus. Many businesses register with Dun & Bradstreet, which is the largest business credit bureau in the United States. Because Dun & Bradstreet is one of the top three credit bureaus, a business profile with the company is considered necessary for your business' success.

**5.** ***E****nsure that Vendors Report Your Business' Credit History* **:** If the companies you work with don't report your business' payment history to the credit bureaus, then there's no proof of your financial responsibility. Check with the companies that grant your business credit to make sure that they are sending your good credit for the bureaus to track.

**6.** ***M****anage Payments* **:** Do everything in your power to manage any debt and stay on top of payments. Whether that means creating a budget, cutting back on certain expenses, or setting up payment reminders, you should make paying bills on time a priority. Any delinquency in this area will negatively impact your business' credit score, which will make it difficult for your business to attract lenders, partners, or investors in the future. But if your business does begin to struggle with debt, don't hesitate to contact a financial advisor for professional guidance.

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***I****mportance of Business Credit To The Economy* **:** Without easy access to borrowing, many companies will decide to lay off staff, cease recruitment or reduce pay awards.

The consequent reduction in disposable incomes reduces retail spending and affects economic growth. But Government schemes exist aimed at addressing this.

The availability of credit can be crucial to an organisation, especially in the early years or where the organisation is seeking to expand, recruit or carry out important research. Any reduction in the availability of credit can adversely affect an organisation's cashflow.
Just like a private individual, an organisation seeking finance will have their credit worthiness assessed by a potential lender.

Credit worthiness may be assessed using evidence from many sources, such as:
- Media reports about the organisation
- Data obtained from suppliers and other parties the organisation works with
- The organisation's financial statements
- The organisation's track record in meeting previous loan obligations

Banks can be reluctant to lend to smaller organisations; these are seen as high risk loans as so many smaller organisations fail. The lack of adequate security is a common reason why a business loan application may be unsuccessful. The recent credit crunch has only made banks less willing to lend to organisations, or to increase their overdraft limits, and the credit squeeze has also made it harder for business owners to obtain personal loans and increased credit card limits.

A Bank of England report in October 2011 revealed that the average interest rate being paid by businesses was 4.68%, well in excess of the Bank's base interest rate. The report also stated that lending to businesses with turnover below GBP 25 million had fallen by 5.1% in the previous 12 months.

The economic effects of a business credit crunch

If an organisation is experiencing difficulties with cashflow, it may respond by cutting staff, or at least by ceasing to recruit new staff. Unemployment rates then rise dramatically. An organisation may also choose to address its financial difficulties by freezing pay increases, or granting increases that are well below inflation.

Unfortunately the above scenarios result in reduced levels of disposable income for large numbers of people. This means that people cut back on their retail spending and buy fewer goods and services from businesses, thus increasing organisations' woes further and creating something of a vicious circle.

Government initiatives **:** In response to the adverse effect this is having on economic growth, the United Kingdom government has set targets for the banks to meet regarding the amount lent to small and medium-sized enterprises.

In order to encourage the banks to lend, the government has at various times operated initiatives such as the Small Firms Loan Guarantee Scheme and the Enterprise Finance Guarantee (EFG) Scheme. The latest incentive was the National Loan Guarantee Scheme announced in the 2011 Autumn Statement, where it was confirmed that the government will underwrite GBP 40 billion of low-interest loans to companies with annual turnover of less than GBP 50 million, in what has been described as a credit easing scheme. In the same statement, it was revealed that the EFG Scheme was being extended to cover organisations with turnover up to GBP 44 million.
Other possible solutions **:** Specialist business credit reference agencies may be able to assist businesses in improving their credit rating.

Other solutions may involve more careful cashflow forecasting, and seeking out other forms of business finance such as invoice finance.

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