Banking Law and Practice
Board of Studies

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<td>Annual Branch Expansion Plan</td>
</tr>
<tr>
<td>ALCO</td>
<td>Asset-Liability Management Committee</td>
</tr>
<tr>
<td>ALM</td>
<td>Asset Liability Management</td>
</tr>
<tr>
<td>ATM</td>
<td>Automated Teller Machine</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
<tr>
<td>BRBNMPL</td>
<td>Bharatiya Reserve Bank Note Mudran Pvt. Ltd</td>
</tr>
<tr>
<td>BSCSBI</td>
<td>Banking Codes and Standards Board of India</td>
</tr>
<tr>
<td>CBS</td>
<td>Core Banking Solution</td>
</tr>
<tr>
<td>CDD</td>
<td>Customer Due Diligence</td>
</tr>
<tr>
<td>CGTMSE</td>
<td>Credit Guarantee for Micro and Small Enterprises</td>
</tr>
<tr>
<td>CPC</td>
<td>Central Processing Centres</td>
</tr>
<tr>
<td>CR</td>
<td>Current Ratio</td>
</tr>
<tr>
<td>CRMS</td>
<td>Country Risk Management System</td>
</tr>
<tr>
<td>DCCB</td>
<td>District Central Cooperative Bank</td>
</tr>
<tr>
<td>DER</td>
<td>Debt Equity Ratio</td>
</tr>
<tr>
<td>DRT</td>
<td>Debt Recovery Tribunals</td>
</tr>
<tr>
<td>DSCR</td>
<td>Debt Service Coverage Ratio</td>
</tr>
<tr>
<td>EBIT</td>
<td>Earnings Before Interest And Tax</td>
</tr>
<tr>
<td>EMS</td>
<td>Export Marketing Services</td>
</tr>
<tr>
<td>EXIM Bank</td>
<td>Export-Import Bank</td>
</tr>
<tr>
<td>FIP</td>
<td>Financial Inclusion Plan</td>
</tr>
<tr>
<td>FIU</td>
<td>Financial Intelligence Unit</td>
</tr>
<tr>
<td>HFC</td>
<td>Housing Finance Companies</td>
</tr>
<tr>
<td>HUF</td>
<td>Hindu Undivided Family</td>
</tr>
<tr>
<td>ICC</td>
<td>International Chamber of Commerce</td>
</tr>
<tr>
<td>ICR</td>
<td>Interest Coverage Ratio</td>
</tr>
<tr>
<td>IFC</td>
<td>International Financial Corporation</td>
</tr>
<tr>
<td>IRB</td>
<td>Internal Rating Based</td>
</tr>
<tr>
<td>KYC</td>
<td>Know Your Customer</td>
</tr>
<tr>
<td>LAB</td>
<td>Local Area Bank</td>
</tr>
<tr>
<td>LCR</td>
<td>Liquidity Coverage Ratio</td>
</tr>
<tr>
<td>LOC</td>
<td>Lines of Credit</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Mergers &amp; Acquisitions</td>
</tr>
<tr>
<td>MCA</td>
<td>Ministry of Corporate Affairs</td>
</tr>
<tr>
<td>MSME</td>
<td>Micro, Small and Medium Enterprise</td>
</tr>
<tr>
<td>NABARD</td>
<td>National Bank for Agriculture and Rural Development</td>
</tr>
<tr>
<td>NHB</td>
<td>National Housing Bank</td>
</tr>
<tr>
<td>NPA</td>
<td>Non Performing Asset</td>
</tr>
<tr>
<td>NPM</td>
<td>Net Profit Margin</td>
</tr>
<tr>
<td>NSFR</td>
<td>Net Stable Funding Ratio</td>
</tr>
<tr>
<td>OPM</td>
<td>Operating Profit Margin</td>
</tr>
<tr>
<td>PACS</td>
<td>Primary Agricultural Cooperative Societies</td>
</tr>
<tr>
<td>PCARDB</td>
<td>Primary Cooperative Agriculture &amp; Rural Development Banks</td>
</tr>
<tr>
<td>PEP</td>
<td>Politically Exposed Person</td>
</tr>
<tr>
<td>RBI</td>
<td>Reserved Bank of India</td>
</tr>
<tr>
<td>ROCE</td>
<td>Return On Capital Employed</td>
</tr>
<tr>
<td>RRB</td>
<td>Regional Rural Bank</td>
</tr>
<tr>
<td>SA</td>
<td>Standardised Approach</td>
</tr>
<tr>
<td>SARFAESI</td>
<td>Securitisation and Reconstruction of Financial Assets and the Enforcement of Security Interest</td>
</tr>
<tr>
<td>SCARDB</td>
<td>State Cooperative Agriculture &amp; Rural Development Banks</td>
</tr>
<tr>
<td>SIDBI</td>
<td>Small Industries Development Bank of India</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Form</td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
</tr>
<tr>
<td>SPMCIL</td>
<td>Security Printing and Minting Corporation of India Limited</td>
</tr>
<tr>
<td>UCB</td>
<td>Urban Cooperative Bank</td>
</tr>
<tr>
<td>UCO</td>
<td>United Commercial Bank</td>
</tr>
<tr>
<td>UNO</td>
<td>United Nations Organisation</td>
</tr>
</tbody>
</table>
Chapter I

An Introduction to Banking System

Aim

The aim of this chapter is to:

- introduce the banking system
- explain the functions of Reserve Bank of India
- explicate the State Bank of India and its associates

Objectives

The objectives of this chapter are to:

- explain the process of nationalisation of banks
- elucidate the purpose of nationalisation
- enlist the different types of banks in India

Learning outcome

At the end of this chapter, you will be able to:

- identify the constituents of the Indian banking system
- understand the concept of commercial banks
- describe the developments in banks
1.1 Introduction

Indian Banking System for the last two centuries has witnessed numerous developments. The businessmen of the ancient times, such as Sharoffs, Seths, Sahuksars, Mahajans, Chettis, etc., ran the indigenous banking systems. The standard functions of lending money to traders and craftsmen and sometimes financing the wars by placing funds at the disposal of kings were performed by these indigenous bankers. The native bankers could not develop the system of obtaining deposits from the public, which is an important function of modern banks.

It was in the last decades of the 18th century that modern banking in India originated. The General Bank of India started in 1786, and the Bank of Hindustan was the first bank. After that, three presidency banks, the Bank of Bengal (originally started in the year 1806 as Bank of Calcutta and then became the Bank of Bengal in the year 1809), the Bank of Bombay and the Bank of Madras were set up. The Presidency banks for many years, acted as quasi-central banks. The Imperial Bank of India was formed by the merger of these three banks in 1925. The Union Bank in 1839 was established by the Indian merchants in Calcutta. It failed in 1848 as a consequence of the economic crisis of 1848-49. Bank of Upper India was established in 1863, but that too failed in 1913.

The oldest survived Joint Stock bank in India is The Allahabad Bank established in 1865. Oudh Commercial Bank was established in 1881 in Faizabad and failed in 1958. The next was the Punjab National Bank, established in Lahore in 1895, which is now one of the largest banks in India. The Swadeshi movement encouraged local businessmen and political figures to establish banks of and for the Indian community during 1906 to 1911. Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India have survived to the present. The main landmark in Indian banking history took place in 1934 when a resolution was taken to establish ‘Reserve Bank of India’ which started functioning in 1935. RBI, since then has been the regulating banking system of the country as the central bank.

1.1.1 Reserve Bank of India as a Central Bank of the Country

As the central bank of the country, the Reserve Bank started their operations as a private shareholder’s bank. The Imperial Bank of India was replaced by RBI which started issuing the currency notes and acting as the government’s banker. Imperial Bank of India was allowed to act as the agent of the RBI. The whole of undivided India was covered by RBI. In order to integrate the policies of the Reserve Bank and the Government, it was decided to nationalise the Reserve Bank immediately after the independence of the country. From 1st January 1949, the Reserve Bank began its operations as a state-owned and state-controlled Central Bank. To reorganise the functioning of commercial banks, the Government of India enacted the Banking Companies Act, 1949 which was later changed as the Banking Regulation Act 1949. RBI operates as a regulator of banks, banker to the Government and banker’s bank. It controls financial system in the country through a range of ways.

1.1.2 State Bank of India and its Associate (Subsidiaries) Banks-A New Channel of Rural Credit

The All India Rural Credit Survey Committee suggested the formation of a state-partnered and state-sponsored bank by taking over the Imperial Bank of India, and integrating the former state-owned or state-associate banks with it in order to serve the economy in general and the rural sector in particular. An Act was accordingly passed in Parliament in May 1955 and the State Bank of India was constituted on 1 July 1955. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959, enabling the State Bank of India to take over eight former state-associated banks as its subsidiaries (later named Associates). The State Bank of India was thus born with a new sense of social purpose. Associate Banks of State Bank of India, viz., State Bank of Hyderabad, State Bank of Mysore, State Bank of Bikaner and Jaipur, State Bank of Travancore, State Bank of Patiala, State Bank of Indore, State Bank of Saurashtra has been functioning as per the direction of State Bank of India.

Two banks, viz., State Bank of Patiala and State Bank of Hyderabad are fully-owned by State Bank of India and in other Associate Banks; the majority of shareholdings are with the SBI. Out of these associate banks, two banks, viz., State Bank of Indore and State Bank of Saurashtra have been combined with the State Bank of India and fusion of the remaining five banks is under process. State Bank of India and its Associate Banks were given favoured treatment by RBI over the other commercial banks through their appointment as an agent of RBI for the performance of Central and State Government business as well as the establishment of currency chests for the smooth cash management in the country.
1.1.3 Nationalisation of Banks for Implementing Government Policies

When 14 major commercial banks in the private sector were nationalised on 19th July, 1969, Indian Banking System saw a key revolution. Most of these banks that have deposits of above 50 crores were promoted by the industrialists. These banks were the following:

- Allahabad Bank
- Bank of Baroda
- Bank of India
- Bank of Maharashtra
- Canara Bank
- Central Bank of India
- Dena Bank
- Indian Bank
- Indian Overseas Bank
- Punjab National Bank
- Syndicate Bank
- Union Bank of India
- United Bank of India
- United Commercial Bank (now known as UCO bank)

The rationale of nationalisation was:

- To enlarge the presence of banks across the nation.
- To provide banking services to different sections of the Society.
- To alter the perception of class banking into mass banking.
- To support priority-sector lending and growth.

In 1980, six more commercial banks with deposits of above 200 crores were nationalised:

- Andhra Bank
- Corporation Bank
- New Bank of India
- Punjab and Sind Bank
- Oriental Bank of Commerce
- Vijaya Bank

The New Bank of India later merged with Punjab Nationalised Bank. The nationalisation of banks resulted in the fast branch development and the number of commercial bank branches have increased many folds in Metro, Urban, Semi-urban and Rural Areas. The branch network helped the banks to mobilise deposits and many economic activities have been initiated on account of priority sector lending.

1.1.4 Regional Rural Banks

In 1975, based on the recommendations of a working group headed by Shri Narasimham, a new set of banks called the Regional Rural Banks, were setup to help out the rural population in addition to the banking services offered by the co-operative banks and commercial banks in rural areas. The beginning of regional rural banks (RRBs) is seen as a distinctive experiment as well as experience in bettering the effectiveness of rural credit delivery mechanism in India.
With joint shareholding by Central Government, the concerned State Government and the sponsoring bank, an attempt was made to assimilate commercial banking within the broad policy thrust towards social banking considering the peculiarities of that particular area. RRBs were supposed to play an essential role in mobilising the savings of the small and marginal farmers, artisans, agricultural labourers and small entrepreneurs and encourage banking habit among the rural people. These institutions were also expected to minimise the gap created in extending the credit to rural areas by largely urban-oriented commercial banks and the rural cooperatives despite having close contact with rural areas, but falling short in terms of funds.

1.1.5 Local Area Banks
Local Area Banks with operations in two or three adjacent districts were conceived in the 1996 Union budget to mobilise rural savings and make them accessible for investments in local areas. They are supposed to bridge the gaps in credit availability and augment the institutional credit outline in rural and semi-urban areas. Although the geographical area of operation of such banks is restricted, they are allowed to perform all functions of a scheduled commercial bank.

The Raghuram Rajan Committee had foreseen these local area banks as private, well governed, deposit-taking small-finance banks. They were to have high capital adequacy norms, a strict prohibition on related party transactions, and lower concentration norms to counterbalance chances of higher risk from being geographically constrained. Six entities were given licences to operate LABs by RBI, but only four are operational. Of these four banks, Capital Local Area Bank accounted for more than 70 per cent of total assets of all four LABs taken together as on 31st March, 2012.

1.1.6 New Private Sector Banks
In 1991, the Narasimham committee suggested that banks should increase operational effectiveness, toughen the supervisory control over banks and the new players should be allowed to create a competitive environment. Based on the recommendations, new private banks were authorised to start the operations.

1.2 Structure of Banks in India
Banks can be categorised into scheduled and non-scheduled banks based on some distinct aspects.

**Scheduled banks**
Scheduled Banks in India are the banks which are listed in the Second Schedule of the Reserve Bank of India Act1934. As compared to non-scheduled banks, the scheduled banks enjoy several privileges. Scheduled banks are entitled to receive refinance facilities from the Reserve Bank of India. They are also permitted to have currency chest facilities. They are entitled to become members of the Clearing House. Cooperative banks like commercial banks may also become scheduled banks, if they satisfy the norms predetermined by RBI.

<table>
<thead>
<tr>
<th>Bank Group</th>
<th>Rural</th>
<th>Semi-urban</th>
<th>Urban</th>
<th>Metropolitan</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Sector Banks</td>
<td>23286</td>
<td>18854</td>
<td>14649</td>
<td>13632</td>
<td>70421</td>
</tr>
<tr>
<td>Private Sector Banks</td>
<td>1937</td>
<td>5128</td>
<td>3722</td>
<td>3797</td>
<td>14584</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>8</td>
<td>9</td>
<td>65</td>
<td>249</td>
<td>331</td>
</tr>
<tr>
<td>Regional Rural Banks</td>
<td>12722</td>
<td>3228</td>
<td>891</td>
<td>166</td>
<td>17007</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>37953</td>
<td>27219</td>
<td>19327</td>
<td>17844</td>
<td>102343</td>
</tr>
</tbody>
</table>

Table 1.1 No. of branches of Scheduled Commercial Banks as on 31st March, 2013
Non-scheduled banks
These are banks which are excluded in the Second Schedule of the Reserve Bank of India. These, classified as non-scheduled banks do not function as per the norms of the Reserve Bank of India within the meaning of the RBI Act or according to specific functions, etc., or according to the judgement of the Reserve Bank. Non-scheduled banks are not capable of helping and defending the depositors’ interests.

1.3 Different Types of Banks in India
All banks included in the Second Schedule to the Reserve Bank of India Act, 1934 are Scheduled Banks. These banks include Scheduled Commercial Banks and Scheduled Co-operative Banks. Scheduled Commercial Banks in India are classified into five diverse groups as per their ownership and/or nature of operations.

Fig. 1.1 Different banks
(Source: http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

1.4 Constituents of the Indian Banking System
The constituents of the Indian Banking System can be broadly listed as under:

<table>
<thead>
<tr>
<th>Commercial Banks</th>
<th>Cooperative Banks</th>
<th>Development Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Sector Banks</td>
<td>Short-term agricultural institutions</td>
<td>National Bank for Agriculture and Rural Development (NABARD)</td>
</tr>
<tr>
<td>Private Sector Banks</td>
<td>Long-term agricultural credit institutions</td>
<td>Small Industries Development Bank of India (SIDBI)</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>Non-agricultural credit institutions</td>
<td>EXIM Bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td>National Housing Bank</td>
</tr>
</tbody>
</table>

Table 1.2 Constituents of the Indian banking system
1.4.1 Commercial Banks
A commercial bank provides services, such as accepting deposits, making business loans, and offering basic investment products. Commercial bank can also refer to a bank or a division of a bank that is mostly concerned with deposits and loans from corporations or large businesses as opposed to individual members of the public.

1.4.1.1 Public Sector Banks
The term, ‘public sector banks’ by itself refers to a situation, where the major/full stake in the banks is held by the Government. There were only 8 Public Sector Banks (SBI and its 7 associate banks) till July 1969. When 14 commercial banks (total 20 banks) were nationalised in 1969, 100% ownership of these banks was held by the Government of India. Consequently, six more private banks were nationalised in 1980. With changes in time and environment, these banks were allowed to raise capital through IPOs and thereby the share holding pattern has changed.

By default the minimum 51% shares would be kept by the Government of India, and the management control of these nationalised banks is only with Central Government. As all these banks have the ownership of Central Government, they can be classified as public sector banks. Apart from the nationalised banks, State Bank of India, and its associate banks, IDBI Bank and Regional Rural Banks are also included in the category of Public Sector banks. The total numbers of public sector banks as on March 2013 were 82 as per the following categorisation:

- State Bank of India and its Associate Banks 6
- Nationalised Banks 19
- Regional Rural Banks 56
- IDBI Bank 1

1.4.1.2 Private Sector Banks
The major stakeholders in the private sector banks are individuals and corporate. When banks were nationalised under two tranches (in 1969 and in 1980), some banks were excluded. Those non-nationalised banks which carry on the operations even now are classified as Old Generation Private Sector Banks like The Jammu & Kashmir Bank Ltd., The Federal Bank, The Laxmi Vilas Bank, etc.

In July 1993 on the basis of banking sector reforms, the Reserve Bank of India allowed many new banks to start off banking operations. Some of the leading banks that were given licences were UTI bank (presently called Axis Bank) ICICI Bank, HDFC Bank, Kotak Mahindra Bank, Yes Bank, etc.; these banks are recognised as New Generation Private Sector Banks. Ten banks were licensed on the basis of guidelines issued in January 1993. The guidelines were revised in January 2001 based on the experience gained from the functioning of these banks, and fresh applications were invited. Of the 10 licences issued in 1993, four banks merged with other lenders over a period of time. Times Bank merged with HDFC Bank, while Global Trust Bank was amalgamated with the state-owned Oriental Bank of Commerce. Centurion Bank took over Bank of Punjab to become Centurion Bank of Punjab, which merged with HDFC Bank in 2008.

On account of these new generation private sector banks, a new competitive environment was created in the Indian Banking System. These banks were having competitive advantages over their counterparts (of the existing old private banks, public sector banks) in their IT support system, inventive products, and their product-pricing. Private sector banks have been swiftly increasing their presence in the modern times and tendering a variety of newer services to the customers and posing a firm competition to the group of public sector banks. Total private sector banks as on 31st March 2013 were 22. Besides these, four Local Area Banks are also categorised as private banks.

1.4.1.3 Foreign Banks
The other significant division of the commercial banking is that of foreign banks. Foreign banks have their registered offices outside India, and through their branches they operate in India. Foreign banks are allowed on mutual-basis. They are allowed to function through branches or wholly-owned subsidiaries. These foreign banks are very dynamic in Treasury (forex) and Trade Finance and Corporate Banking activities. These banks lend a hand to their clients in raising External Commercial Borrowings through their branches outside India or foreign correspondents. They are active in loan syndication as well.
Foreign banks have to hold on to all local laws as well as guidelines and directions of Indian Regulators, such as Reserve Bank of India, Insurance and Regulatory Development Authority, Securities Exchange Board of India. The foreign banks have to fulfil the requirements of the Reserve Bank of India in respect to Priority Sector lending, and Capital Adequacy ratio and other norms. Total foreign banks as on 31st March, 2013 were 43 having 331 branches. Besides these, 46 foreign banks have their representative offices in India as on 31st March, 2013.

1.4.2 Co-operative Banking System

Cooperative banks play a significant role in the Indian Financial System, especially at the village level. The growth of Cooperative Movement commenced with the passing of the Act of 1904. A cooperative bank is a cooperative society registered or deemed to have been registered under any State or Central Act. If a cooperative bank is functioning in more than one State, the Central Cooperative Societies Act is applicable. In other cases, the State laws are applicable. Apart from a variety of other laws like the Banking Laws (Application to Co operative Societies) Act, 1965 and Banking Regulation (Amendment) and Miscellaneous Provisions Act, 2004, the provisions of the RBI Act, 1934 and the BR Act, 1949 would also be applicable for governing the banking activities.

These cooperative banks cater to the needs of agriculture, retail-trade, small and medium industries and self-employed businessmen usually in urban, semi urban and rural areas. In case of co-operative banks, the shareholders should be members of the co-operative banks. The share-linkage to borrowing is a unique feature of a co-operative bank. Rural cooperative sector in India plays a crucial role in fulfilling the credit requirements of rural agricultural sector of India. In recent times, the rural credit flow through rural cooperative sector has risen significantly in order to keep up with the increasing demand for credit in the rural parts of India. The cooperative rural credit structure in our country is discussed below.

1.4.2.1 Short-term Agricultural Credit institutions

The short-term credit structure consists of the Primary Agricultural Credit Societies at the base-level, which are affiliated at the district-level into the District Central Cooperative bank and further into the State Cooperative Bank at the state-level. Being federal structures, the membership of the DCCB includes all the affiliated PACS and other functional societies and for the SCB, the members are the affiliated DCCBs.

The DCCB being the middle-tier of the Cooperative Credit Structure is functionally positioned to tackle the concerns of both the upper and lower tiers. This very often puts the DCCB in a position of balancing competing concerns. While the SCB may supervise District Central Cooperative wish the DCCB to prioritise its task in a particular way, the PACs may have their own demands on the DCCB. Balancing these conflicting concerns could often be a predicament for the DCCBs. There are 30 State Cooperative Banks. These banks support and guide 372 District Central Cooperative Banks (DCCBs) in India which have 13,478 branches as on March, 2013. These DCCBs provide finance to more than 35 lakhs farmers through 1.15 lakhs Primary Agricultural Cooperative Societies (PACS).

1.4.2.2 Long-term Agricultural Credit Institutions

The long-term cooperative credit structure consists of the State Cooperative Agriculture & Rural Development Banks (SCARDBs) and Primary Cooperative Agriculture & Rural Development Banks (PCARDBs) affiliated to the SCARDBs. The total no. of SCARDBs are 19; of which 10 have Federal Structure, 7 have Unitary Structure and 2 have Mixed Structure (i.e., operating through PCARDBs as well as its own branches).Loans are granted to members on the mortgages of their land normally up to 50% of their worth in some states or up to 30 times the land revenue to be paid in other states, duly taking into account their need and repayment ability. The performance of these banks as on 31st March 2012 has been as under:

| No. of SCARDBs | 19 |
| No. of PCARDBs | 714 |
| No. of Branches of PCARDBs | 1,056 |
| No. of Branches of Unitary SCARDBs | 761 |
| Annual Lending | 17,603.42 Cr |
| Total Membership | 13.65 Million |
1.4.2.3 Urban Cooperative Banks

The term Urban Cooperative Banks (UCBs), though not formally defined, refers to the primary cooperative banks located in urban and semi-urban areas. Until 1996, these banks were allowed to lend money only to non-agricultural purposes. This distinction remains even today. Traditionally, these banks have been around communities and localities working out loans to small borrowers and businesses. Today, their scope of operation has expanded considerably. The urban co-operative banks can extend operations to other States and such banks are described as multi-state cooperative banks. They are governed by the Banking Regulations Act 1949 and Banking Laws (Cooperative Societies) Act, 1965. The total number of UCBs stood at 1,618 as on 31st March 2012. Scheduled UCBs are banks included in the Second Schedule of the RBI Act, 1934 and include banks that have paid-up capital and reserves of not less than 5 lakhs and carry out their business in the interest of depositors to the satisfaction of the Reserve Bank.

1.4.3 Development Banks

The history of development banking in India can be traced to the establishment of the Industrial Finance Corporation of India in 1948. Consequently, when State Financial Corporation Act, 1951 was passed, several SFCs came into being. With the introduction of financial sector reforms, many changes have been witnessed in the domain of development banking. There are more than 60 Development Banking Institutions at both Central and State level. The major four development banks which assist in extending long-term lending and re-finance facilities to the diverse areas of economy for the economic development connected to small-scale and medium industries, agricultural sector and housing sector have been discussed below. These financial institutions play a decisive role in supporting different segments along with the rural economic development.

1.4.3.1 National Bank for Agriculture and Rural Development (NABARD)

National Bank for Agriculture and Rural Development (NABARD) was instituted in July 1982 by an Act of Parliament based on the recommendations of CAFICARD. It is the apex institution connected with the policy, planning and operations in the agricultural field and other rural economic activities. NABARD has developed several refinance and promotional schemes over the years and has been making steady efforts to liberalise, broad-base and refine/rationalise the schemes in response to the field-level needs. The refinance provided by NABARD has the following two basic objectives:

• Supplemening the resources of the cooperative banks and RRBs for meeting the credit needs of its clients.
• Ensuring the build-up of a sound, proficient, effectual and feasible cooperative credit structure and RRBs for supplying credit.

NABARD undertakes a number of inter-related activities/services which fall under the following three broad categories:

• Credit dispensation: NABARD creates a potential linked credit plan which forms the basis for district credit plans for each district annually. It participates in finalisation of Annual Action Plan at block, district and state levels and monitors implementation of credit plans at above levels. It also provides guidance in evolving the credit discipline to be followed by the credit institutions in financing production, marketing and investment activities of rural farm and non-farm sectors.

• Developmental and promotional: The developmental role of NABARD can be broadly classified as follows:
  • Nurturing and strengthening of the Rural Financial Institutions (RFIs) like SCBs/SCARDBs, CCBs, RRBs, etc., by various institutional strengthening initiatives.
  • Fostering the growth of the SHG Bank linkage programme and extending essential support to SHPIs NGOs/VAs/Development Agencies and client banks.
  • Development and promotional ventures in farm and non-farm sectors.
  • Extending support for research and development.
  • Acting as a catalyst for Agriculture and rural growth in rural areas.

• Supervisory activities: As the Apex Development Bank, NABARD shares with the Central Bank of the country (Reserve Bank of India) some of the supervisory functions in respect of Cooperative Banks and RRBs.
1.4.3.2 Small Industries Development Bank of India (SIDBI)

Small Industries Development Bank of India (SIDBI) was founded in October 1989 and initiated its operations from April 1990 with its Head Office at Lucknow as a development bank. It is the chief and special financial institution for the promotion, financing and development of the Micro, Small and Medium Enterprise (MSME) sector and for co-ordination of the functions of the institutions involved in similar activities. It is a central government undertaking. The main aspiration of SIDBI is to sustain MSMEs by providing them the valuable factor of production finance. Many institutions and commercial banks supply finance, both long-term and short-term, to small entrepreneurs. SIDBI coordinates the work of all of them.

SIDBI has developed a strategy to investigate the problems faced by MSMEs and come out with tailor-made solutions. It has covered around 600 MSME clusters, through a pan-India network of 85 branches, 50 Credit Advisory Centres, and partnerships with cluster-level industry associations as on January 31, 2013. A special scheme of the credit guarantee for Micro and Small Enterprises called CGTMSE has provided coverage to about 1 million with guarantee covers for an aggregate loan amount of over Rs. 48,000 crore.

Functions of small industries development bank of India (SIDBI)

Over the years, the scope of promotional and developmental activities of SIDBI has been enlarged to include several new activities. It performs a string of functions in partnership with voluntary organisations, non-governmental organisations, consultancy firms and multinational agencies to augment the overall performance of the small-scale sector. The important functions of SIDBI are discussed as follows:

- Initiates steps for technology-adoption, technology-exchange, transfer and up-gradation and modernisation of existing units.
- SIDBI participates in the equity type of loans on soft terms, term loan, working capital both in rupee and foreign currencies, venture capital support and different forms of resource support to banks and other institutions.
- SIDBI facilitates timely flow of credit for both term loans and working capital to MSMEs in collaboration with commercial banks.
- SIDBI enlarges marketing capabilities of the products of MSMEs in both domestic and international markets.
- SIDBI directly discounts and rediscounts bills with a view to promotes bills culture and helping the SSI units to realise their sale proceeds of capital goods/equipments and components, etc.
- SIDBI promotes employment-oriented industries especially in semi-urban areas to create more employment opportunities, so that rural-urban migration of people can be checked.

1.4.3.3 National Housing Bank (NHB)

National Housing Bank was established in July, 1988 as the top financing institution for the housing sector with the directive to encourage competent, feasible and sound Housing Finance Companies (HFCs). Its functions aim at augmenting the institutional credit flow for the housing sector and regulating HFCs. NHB mobilises resources and channelises them to various schemes of housing infrastructure development. It provides refinance for direct housing loans given by commercial banks and non-banking financial institutions.

The NHB also provides refinance to Housing Finance Institutions for direct lending for construction/purchase of new housing/dwelling units, public agencies for land development and shelter projects, primary cooperative housing societies and property developers. At present, it is a wholly-owned subsidiary of Reserve Bank of India which contributed the entire paid-up capital. RBI has suggested transferring its entire shareholding to the Government of India to evade clash of ownership and regulatory roles. For this transfer, the central bank will pay RBI in cash, an amount equal to the face value of the subscribed capital issued by the RBI. The exceptional portfolio of NHB at Rs. 33,083 crores as on 31st December 2012 is almost equally divided between the commercial banks and the HFCs.
1.4.3.4 Export Import Bank of India (EXIM Bank)

Export-Import Bank of India was set up in 1982 by an Act of Parliament for the purpose of financing, facilitating and promoting India’s foreign trade. It is the major financial institution in the country for synchronising the working of institutions engaged in financing exports and imports. Exim Bank is fully owned by the Government of India and the Bank’s authorised and paid up capital are Rs. 10,000 crore and Rs. 2,300 crore respectively.

Exim Bank lays special stress on extension of Lines of Credit (LOCs) to overseas entities, national governments, regional financial institutions and commercial banks. Exim Bank also extends Buyer’s credit and Supplier’s credit to finance and promote country’s exports. The Bank also provides financial assistance to export-oriented Indian companies by way of term loans in Indian rupees or foreign currencies for establishing a new production facility, expansion/modernisation or up-gradation of existing facilities and for acquisition of production equipment or technology. Exim Bank helps Indian companies in their globalisation pains through a wide array of products and services presented at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.

The Bank has initiated a new lending programme to finance research and development activities of export oriented companies. R&D finance by Exim Bank is in the form of term loan to the extent of 80 per cent of the R&D cost. In order to support in the creation and enhancement of export capabilities and international competitiveness of Indian companies, the Bank has put in place an Export Marketing Services (EMS) Programme. Through EMS, the Bank proactively assists companies in identification of prospective business partners to facilitating placement of final orders. Under EMS, the Bank also assists in detection of opportunities to establish plants or projects or for acquisition of companies overseas. The service is provided on a success fee basis.

Exim Bank supplements its financing programmes with a wide assortment of value-added information, advisory and support services, which facilitate exporters to estimate international risks, exploit export opportunities and improve competitiveness, thereby assisting them in their globalisation efforts.

1.5 Functions of Commercial Banks

Sections 5 & 6 of Banking Regulation Act, 1949 contain the functions which commercial banks can transact. These functions can be divided into two parts as follows:

- **Major functions**
  - Accepting deposits
  - Granting advances

- **Other functions/ancillary services**
  - Discounting of bills and cheques
  - Collection of bills and cheques
  - Remittances
  - Safe custody of articles
  - Safe deposit lockers
  - Issue of letter of credit
  - Issue of guarantees
Besides the above functions, Banks now-a-days connect themselves in the following activities also either by opening separate departments or through individually floated independent subsidiaries:

- Investment counselling
- Investment banking
- Mutual fund
- Project appraisal
- Merchant banking services
- Taxation advisory services
- Executor trustee services
- Credit card services
- Forex consultancy
- Transactions of government business
- Securities trading
- Factoring
- Gold/silver/platinum trading
- Venture capital financing
- Bank assurance: Selling of life and general insurance policies as corporate agent
Summary

- Indian Banking System for the last two centuries has witnessed numerous developments. It was in the last decades of the 18th century that the modern banking in India originated.
- The General Bank of India started in 1786, and the Bank of Hindustan were the first banks.
- Scheduled Banks in India are the banks which are listed in the Second Schedule of the Reserve Bank of India Act 1934.
- The term ‘public sector banks’ by itself refers to a situation, where the major/full stake in the banks is held by the Government.
- The major stakeholders in the private sector banks are individuals and corporate.
- Foreign banks have their registered offices outside India, and through their branches they operate in India. Foreign banks are allowed on reciprocal basis.
- Cooperative banks play a significant role in the Indian Financial System, especially at the village level.
- The term Urban Cooperative Banks (UCBs), although not formally defined, refers to the primary cooperative banks located in urban and semi-urban areas.
- National Bank for Agriculture and Rural Development (NABARD) was instituted in July 1982 by an Act of Parliament based on the recommendations of CRAFICARD.
- National Housing Bank was established in July, 1988 as the top financing institution for the housing sector with the directive to encourage competent, feasible and sound Housing Finance Companies (HFCs).
- Export-Import Bank of India was set up in 1982 by an Act of Parliament for the purpose of financing, facilitating and promoting India’s foreign trade.

References


Recommended Reading

Self Assessment

1. Banking in India originated in the last decades of the 18th century.
   a. Modern
   b. Technical
   c. Cultural
   d. International

2. Which of the following controls financial system in the country?
   a. Central Bank
   b. RBI
   c. International Bank
   d. State Bank

3. Which banks are not included in the Second Schedule of the Reserve Bank of India?
   a. Commercial Banks
   b. Schedule Banks
   c. Non-schedule Banks
   d. Co-operative Banks

4. The major shares in the private sector banks are individuals and corporate.
   a. shareholders
   b. investors
   c. stakeholders
   d. account holders

5. Which of the following statement is true?
   a. Commercial banks play an important role in the Indian Financial System.
   b. The term Urban Cooperative Banks (UCBs), refers to the primary cooperative banks located in rural and semi-urban areas.
   c. Urban co-operative banks, until 1996, were allowed to lend money only to agricultural purposes.
   d. National Bank for Agriculture and Rural Development (NABARD) was established in July 1982.

6. Total ________ banks as on 31st March 2013 were 22.
   a. public sector
   b. private sector
   c. commercial sector
   d. international sector

7. Which of the following banks have their registered offices outside India?
   a. International
   b. Commercial
   c. Foreign
   d. Scheduled
8. The urban co-operative banks can spread operations to other States and such banks are called as ____________ banks.
   a. multi-state cooperative  
   b. cooperative  
   c. scheduled  
   d. non-scheduled  

9. Which of the following statement is false?
   a. Foreign banks are very active in Treasury (forex) and Trade Finance and Corporate Banking activities.  
   b. The short term credit structure consists of the Primary Agricultural Credit Societies.  
   c. Development Banks are governed by the Banking Regulations Act 1949.  
   d. NABARD has evolved several refinance and promotional schemes over the years and has been making constant efforts to liberalise.  

10. Match the following

| 1. Small Industries Development Bank of India | A. Was set up in July, 1988 |
| 2. National Housing Bank (NHB) | B. Was set up in 1982 |
| 3. Export-Import Bank of India | C. Was setup in 1975 |

   a. 1-D, 2-A, 3-B, 4-C  
   b. 1-C, 2-B, 3-A, 4-D  
   c. 1-A, 2-C, 3-D, 4-B  
   d. 1-B, 2-D, 3-C, 4-A
Chapter II
Regulation and Control on Banking in India

Aim

The aim of this chapter is to:

- introduce reserve bank of India act, 1934
- explain the process of opening of new banks and licensing
- explicate cash currency management

Objectives

The objectives of this chapter are to:

- explain setting of a new bank
- elucidate the classification of fraud
- enlist the banking codes and standards board of India

Learning outcome

At the end of this chapter, you will be able to:

- identify new bank licensing policy, 2013
- understand the concept of RBI act
- describe the banking ombudsman scheme
2.1 Introduction

The Reserve Bank of India (RBI) is India’s central banking institution, which manages the fiscal policy of the Indian rupee. RBI was established on 1st April 1935 during the British Raj in agreement with the provisions of the Reserve Bank of India Act, 1934.

2.1.1 Reserve Bank of India Act, 1934

The Reserve Bank of India Act, 1934 was enacted to comprise the Reserve Bank of India with an objective to perform the following functions:

• Regulate the issue of bank notes.
• For keeping reserves to ensure that the monetary system is stable.
• To function efficiently the nation’s currency and credit system.

The RBI Act covers the following:

• The constitution
• Powers
• Functions of the Reserve Bank of India

The Act does not directly deal with the regulation of the banking system excluding few sections like Sec 42 which relates to the maintenance of CRR by banks and Sec 18 which deals with direct discount of bills of exchange and promissory notes as part of rediscounting facilities to control the credit to the banking system.

The RBI Act deals with the following:

• Incorporation, capital, management and business of the RBI.
• The functions of the RBI, such as issue of bank notes, monetary control, banker to the Central and State.
• Governments and banks, lender of last resort and other functions.
• General provisions in respect of reserve fund, credit funds, audit and accounts.
• Issuing directives and imposing penalties for violation of the provisions of the Act.

2.2 Banking Regulation Act, 1949

The Banking Regulation Act, 1949 is one of the important legal frame works. Initially, the Act was passed as Banking Companies Act, 1949 and it was changed to Banking Regulation Act 1949. Along with the Reserve Bank of India Act 1935, Banking Regulation Act 1949 provides many guidelines to banks covering wide assortment of areas.

Some of the important provisions of the Banking Regulation Act 1949 are listed below:

• The term banking is defined as per Sec 5(i) (b), as acceptance of deposits of money from the public for the purpose of lending and/or investment. Such deposits can be repayable on demand or otherwise and withdrawn by means of cheque, drafts, and order or otherwise.
• Sec 5(i)(c) defines a banking company as any company which handles the business of banking.
• Sec 5(i)(f) distinguishes between the demand and time liabilities, as the liabilities which are repayable on demand and time liabilities means which are not demand liabilities.
• Sec 5(i)(h) deals with the meaning of secured loans or advances. Secured loan or advance granted on the security of an asset, the market value of such an asset in not at any time less than the amount of such loan or advances. Whereas, unsecured loans are recognised as a loan or advance this is not secured.
• Sec 6(1) deals with the definition of banking business.
• Sec 7 specifies that banking companies doing banking business in India should use at least on work bank, banking, and banking company in its name.
• Banking Regulation Act through a number of sections restricts or prohibits the following activities for a bank:
  • Trading activities of goods are restricted as per Section 8.
  • Prohibitions: Banks are prohibited to hold any immovable property subject to certain terms and conditions as per Section 9. Further, a banking company cannot create a charge upon any unpaid capital of the company as per Section 14. Sec 14(A) stipulates that a banking company also cannot create a floating charge on the undertaking or any property of the company without the prior permission of Reserve Bank of India.
  • A bank cannot declare dividend unless all its capitalised expenses are fully written off as per Section 15.

2.2.1 Other Important Sections of Banking Regulation Act, 1949
Sections 11 and 12 deal with the Paid-up Capital, Reserves and their terms and conditions, Sec 18 specifies the Cash Reserve Ratio to be maintained by Non-scheduled banks and Sec 19 (2) clarifies about the share holding of a banking company. No banking company shall hold shares in any company, (either as pledge, or mortgagee or absolute owners of any amount exceeding 30% of its own paid up share capital plus reserves (or) 30% of the paid up share capital of that company whichever is less

Section 24 specifies the requirement of maintenance of Statutory Liquidity Ratio (SLR) as a percentage (as advised by Reserve Bank of India from time-to-time) of the bank’s demand and time liabilities in the form of cash, gold and unencumbered securities.

2.2.2 Other Compliance Requirements
• Section 29: Every bank needs to publish its balance sheet as of March 31st.
• Section 30(i): Audit of Balance sheet by qualified auditors.
• Section 35: Gives powers to RBI to undertake inspection of banks.

The important returns to be submitted by the banks to Reserve Bank of India are as follows:
• Return of bank’s liquid assets and liabilities (Monthly)
• Return of bank’s assets and liabilities in India (Quarterly)
• Return of unclaimed deposits of 10 years and above (Yearly)

With changing time and requirements from time-to-time, a variety of other compliance issues which need to be handled by banks, have been amended/incorporated relating to the following:
• Nomination facilities
• Time period for preservation of bank books/records

2.3 Opening of New Banks and Branch Licensing
In India, there are various types of banks and they were established under different Acts passed by the Central and State Governments as under:

<table>
<thead>
<tr>
<th>Banks-Category</th>
<th>Legal Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Bank of India</td>
<td>State Bank of India Act, 1955</td>
</tr>
<tr>
<td>SBI Associate Banks</td>
<td>State Bank (Subsidiary Banks) Act, 1959</td>
</tr>
<tr>
<td>Nationalised Banks-1969</td>
<td>Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970</td>
</tr>
<tr>
<td>Nationalised Banks-1980</td>
<td>Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980</td>
</tr>
<tr>
<td>Type of Bank</td>
<td>Applicable Acts</td>
</tr>
<tr>
<td>---------------------------</td>
<td>------------------------------------------------------------------</td>
</tr>
<tr>
<td>Regional Rural Banks</td>
<td>Regional Rural Banks Act, 1986</td>
</tr>
<tr>
<td>Private Sector Banks</td>
<td>Indian Companies Act, 1986</td>
</tr>
<tr>
<td>Co-operative Banks</td>
<td>Co-operative Societies Acts (State/Central) and Banking Laws (Applicable to Cooperative Societies) Act, 1965</td>
</tr>
</tbody>
</table>

**Table 2.1 Acts passed by the central and state governments**

All the above types of banks are required to follow the relevant laws of RBI Act and Banking Regulation Act besides the provisions of the specific Act under which the said bank has been incorporated.

### 2.3.1 Setting up of a New Bank

The Reserve Bank of India has the powers as per the provisions of the BR Act and the RBI Act to issue licences to new banks to function as banks and also to open new branches from time-to-time. The Banking Regulation Act, 1949 requires a company or entity to obtain a licence from the Reserve Bank of India to start the business of banking in India. Further to the licensing, the required permission is also to be obtained for opening and shifting of branches as per the Branch Authorisation Policy declared by RBI from time-to-time.

Reserve Bank of India would grant the licence and the permission subject to certain terms and conditions in each case. It is open to the Reserve Bank of India to consider the findings of the inspection report under Sec 35 of the Banking Regulation Act while disposing of an application for licence. Before granting a licence under Sec 22, Reserve Bank may have to be satisfied by an inspection of the books of the banking company in respect of the following aspects:

- Whether the company is or will be able to pay its present and future depositors in full as and when 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 and future depositors.
- Whether the company has an adequate capital structure and earning prospects.
- Whether public interest will be served by grant of licence to the company.
- Other issues relating to branch expansion, unbanked area and other aspects.

In respect of foreign banks, (which are incorporated outside India), application for a licence to the Reserve Bank of India to open banks/branches in India, would be considered by RBI on satisfying the following conditions apart from the conditions applicable to domestic banks:

- Whether carrying on of banking business by the company in India will be in public interest.
- Whether the government or the law of the country in which the company is incorporated discriminates against banking companies registered in India.
- Whether the company complies with provisions of the BR Act as applicable to foreign companies.

Section 11 of the Banking Regulation Act stipulates the minimum capital and reserve requirements of Banking Company. The Reserve Bank of India can stipulate a higher requirement of capital for licensing a company. As per the provisions of the Banking Regulation Act, 1949 Reserve Bank of India can cancel the licences granted to any banking company on account of any one or more of the following reasons:

- The company ceases to carry on banking business in India.
- The company fails to comply with any of the conditions imposed under the specific provisions of the Banking Regulation Act.
Before cancellation of a licence for non-compliance with any of the conditions, the company has to be given an opportunity for taking necessary steps for complying with or fulfilling the conditions. However, in cases, where the Reserve Bank is of the opinion that delays will be prejudiced to the interests of the depositors or the public, then Reserve Bank can take appropriate action. A banking company whose licence is cancelled can appeal to the Central Government within 30 days from the date of the order of cancellation.

2.3.2 Branch Licensing

The opening of branches by banks is governed by the provisions of Section 23 of the Banking Regulation Act, 1949. In terms of these provisions, without the prior approval of the Reserve Bank of India (RBI), banks cannot do the following:

- Open a new place of business in India or abroad.
- Cannot shift or change, except within the same city, town or village the location of the existing place of business.

As regards branch licensing, banks have to refer to the guidelines of the Reserve Bank from time-to-time, including change of premises, shifting of branches to other locations, etc. As regards Regional Rural Banks, the application for permission have to be routed through the National Bank for Agriculture and Rural Development and based on the comments of NABARD, RBI would act accordingly.

The Branch Authorisation Policy for commercial banks as on 1st July, 2013 is as under:

- For the purpose of branch authorisation policy, a ‘branch’ means a full-fledged branch, including a specialised branch, a satellite or mobile office, an Extension Counter, an off-site ATM (Automated Teller Machine), administrative office, controlling office, service branch (back office or processing centre) and credit card centre. A call centre will not be treated as a branch.

- Domestic scheduled commercial banks (other than RRBs) are permitted to open branches, Administrative offices, Central Processing Centres (CPCs) and Service branches in Tier 2 to Tier 6 centres (with population up to 99,999 as per Census 2001 and in rural, semi-urban and urban centres in North Eastern States and Sikkim, and to open mobile branches in Tier 3 to Tier 6 centres (with population up to 49,999 as per Census 2001) and in rural, semi-urban and urban centres in North Eastern States and Sikkim without permission from Reserve Bank of India in each case, subject to reporting. As the concept of mobile branches was mooted for rural areas, the general permission granted for operationalising mobile branches in Tier 3 to Tier 6 centres has not been extended to the operationalisation of mobile branches in Tier 2 centres.

- With a view to further increasing operational flexibility of banks, domestic scheduled commercial banks (other than RRBs) are permitted to open offices exclusively performing administrative and controlling functions (Regional Offices/Zonal Offices) in Tier 1 Centres without the need to obtain prior permission in each case, subject to reporting.

- Opening of branches/Central Processing Centres (CPCs)/Service branches by domestic scheduled commercial banks (other than RRBs) in Tier 1 centres (centres with population of 1,00,000 and above as per 2001 Census) will continue to require prior permission of the Reserve Bank of India, except in the case of North Eastern States and Sikkim, where the general permission would cover Tier-1 centres also.

- Domestic Scheduled Commercial Banks, while preparing their Annual Branch Expansion Plan (ABEP) should allocate at least 25 percent of the total number of branches proposed to be opened during a year in unbanked rural (Tier 5 and Tier 6) centres. An unbanked rural centre would mean a rural (Tier 5 and Tier 6) centre that does not have a brick and mortar structure of any scheduled commercial bank for customer-based banking transactions.

- In view of the requirement for opening at least 25 per cent of the branches under ABEP in unbanked rural centres, it would now not be mandatory to open at least one third of the total number of branches proposed to be opened in Tier 2 to Tier 6 centres in under-banked districts of under-banked States. However, as there is a continuing need for opening more branches in under-banked districts of under-banked States for ensuring more uniform spatial distribution, banks would be provided incentive for opening such branches. Accordingly, for each branch proposed to be opened in Tier 2 to Tier 6 centres of under-banked districts of under-banked States,
excluding such of the rural branches proposed to be opened in unbanked rural centres that may be located in the under-banked districts of under-banked States in compliance with the requirement as indicated in the paragraph above, authorisation will be given for opening of a branch in a Tier 1 centre. This will be in addition to the authorisation given for branches in Tier 1 centres based on the considerations stated above.

- Banks may consider front-loading (prioritising) the opening of branches in unbanked rural centres over a 3 year cycle co-terminus with their Financial Inclusion Plan (2013-16). Credit will be given for the branches opened in unbanked rural centres in excess of the required 25 percent of the ABEP for the year which will be carried forward for achieving the criteria in the subsequent ABEP/year of the Financial Inclusion Plan (FIP).

2.4 New Bank Licensing Policy, 2013

Over the last two decades, the Reserve Bank of India (RBI) gave licence to twelve banks in the private sector. This happened in two phases. Ten banks were licensed on the basis of guidelines issued in January 1993. The guidelines were revised in January 2001 based on the experience gained from the functioning of these banks, and fresh applications were invited. The applications received in response to this invitation were vetted by a high-level Advisory Committee constituted by the RBI, and two more licences were issued, to two entities, viz., Kotak Mahindra Bank and Yes Bank. While preparing these guidelines, the Reserve Bank recognised the need for an explicit policy on banking structure in India keeping in view the recommendations of the Narasimham Committee, Raghuram Rajan Committee and other viewpoints.

2.5 Cash-Currency Management

The currency (bank notes) of our country is issued by the Reserve Bank of India. The Reserve Bank has the exclusive right to issue and manage the currency in India under Section 22 of the RBI Act. RBI may issue notes of different denominations as decided by the Central Government based on the recommendations made by the Central Board of the bank from time-to-time. Such notes should be legal tender at any place in India.

The Reserve Bank handles the currency management function through its Department of Currency Management in Mumbai. The combined value of gold coins, bullion and foreign securities held by RBI should not be below the prescribed limit at any time. The Reserve Bank currency management is handled through two departments’, viz., the Issue Department and the Banking Department. The issue department should ensure that the aggregate value of the currency notes and bank notes in circulation from time-to-time should be equivalent to the eligible assets (gold coins, bullion and foreign securities) held by RBI.

2.5.1 Currency Chests

Adequate arrangements have been made by the Reserve Bank of India for the issue of currency notes and distribution of coins and currency notes across India. One of the distribution channels used by the Reserve Bank is Currency Chests. Selected branches of banks have been authorised by the Reserve Bank to establish currency chests. On behalf of the Reserve Bank, bank notes and coins are stocked/stored in these currency chests. Currency chests are managed by banks and they store soiled and re-issuable notes and also fresh currency notes. The banks review the currency notes (which are in their view not fit for circulation and forward them to RBI for further action. After their re-examination, RBI if necessary, re-circulates them or arranges to destroy them as per their procedures. The issue department co-ordinates with the printing-presses and mints the regular supply of notes and coins. It also ensures that notes/coins are distributed through different channels, such as Reserve Bank counters, banks, post offices and co-operative banks.

2.5.2 Currency Printing and Coin Minting

The Government of India on the guidance of the Reserve Bank of India decides on the various denominations for printing the notes. The Reserve Bank coordinates with the Government in the design of the bank notes. Printing of currency notes is handled by the Security Printing and Minting Corporation of India Limited (SPMCIL) and The Bharatiya Reserve Bank Note Mudran Pvt Ltd. (BRBNMPL) in their different printing presses setup at Nashik, Devas, and Mysore. SPMCIL has mints for coin production at Mumbai, Noida, and Hyderabad. The Reserve Bank acts as agent for the Central Government for issue, circulation and withdrawal of the coins.
Reserve Bank of India’s concern is on the level of forged notes infiltrated into the circulation. The Reserve Bank has been on a regular basis educating the public, banks and others through press releases and exhibition of ‘Know Your Bank Note’. Reserve Bank from time-to-time circulates information on the security features of the currency notes. Banks are advised to install the required ultra violet machines and counterfeit note detecting machines. Reserve Bank provides training to banks and government treasury offices and issues detailed guidelines on how to detect and take further necessary steps including impounding of such notes.

2.6 Audit

The balance sheet and the profit and loss account of a banking company have to be audited as stipulated under Section 30 of the Banking Regulation Act. Every banking company’s account needs to be verified and certified by the Statutory Auditors as per the provisions of legal frame-work. The powers, functions and duties of the auditors and other terms and conditions as applicable to auditors under the provisions of the Companies Act are applicable to auditors of the banking companies as well. The audit of banking companies books of accounts calls for additional details and certificates to be provided by the auditors.

They include whether or not:

- Information and explanation, required by the auditor were found to be satisfactory.
- The transactions of the company as observed by the auditor were within the powers of the company.
- Profit and loss account shows a true picture of the profit or loss for the period for which the books have been audited and any other observations to be brought to the notice of the shareholders.

Special responsibility is cast on the bank auditor in certifying the bank’s balance sheet and profit and loss account, since that reflects the sound financial position of the banking company.

Apart from the balance sheet audit, Reserve Bank of India is empowered by the provisions of the Banking Regulation Act to conduct/order a special audit of the accounts of any banking company. The special audit may be conducted or ordered to be conducted in the opinion of the Reserve Bank of India that the special audit is necessary:

- In the public interest and/or
- In the interest of the banking company and/or in the interest of the depositors.

The Reserve Bank of India’s directions can order the bank to appoint the same auditor or another auditor to conduct the special audit. The special audit report should be submitted to the Reserve Bank of India with a copy to the banking company. The cost of the audit is to be borne by the banking company.

2.7 Inspection

As per Sec 35 of the Banking Regulation Act, the Reserve Bank of India is empowered to conduct an inspection of any banking company. After conducting the inspection of the books, accounts and records of the banking company a copy of the inspection report to be furnished to the banking company. The banking company, its directors and officials are required to produce the books, accounts and records as required by the RBI inspectors, also the required statements and/or information within the stipulated time as specified by the inspectors.

Government’s role:

The Central Government may direct the Reserve Bank to conduct inspection of any banking company. In such cases, a copy of the report of inspection needs to be forwarded to the Central Government. On review of the inspection report, the Central Government can take appropriate action. In the opinion of the Central Government, if the affairs of the banking company is not being carried out in the interests of the banking company, public and or depositors, the Central Government may prohibit the banking company to accept fresh deposits and direct the Reserve Bank to apply for winding up of the banking company under the provisions of the Banking Regulation Act. Before taking action, the Government has to give an opportunity to the banking company to explain their stand. Based on the response, the Government can initiate appropriate action as required.
Scrutiny
Apart from inspecting the books and accounts of the company, the Reserve Bank can conduct scrutiny of the affairs and the books of accounts of any banking company. Like in the case of inspection, the Reserve Bank can handle the scrutiny as required.

2.8 Fraud
Fraud is a deception deliberately practised in order to secure unfair or unlawful gain (adjectival form fraudulent; to defraud is the verb). As a legal construct, fraud is both a civil wrong (i.e., a fraud victim may sue the fraud perpetrator to avoid the fraud and/or recover monetary compensation) and a criminal wrong (i.e., a fraud perpetrator may be prosecuted and imprisoned by governmental authorities). Defrauding people or organisations of money or valuables is the usual purpose of fraud, but it sometimes instead involves obtaining benefits without actually depriving anyone of money or valuables, such as obtaining a driver’s licence by way of false statements made in an application for the same.

2.8.1 Classification of Frauds
Frauds are classified, mainly on the basis of the provisions of Indian Penal Code (IPC), as under:

- Misappropriation and criminal breach of trust.
- Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- Unauthorised credit facilities extended for reward or for illegal gratification.
- Negligence and cash shortages.
- Cheating and forgery.
- Irregularities in foreign exchange transactions.
- Any other type of fraud not coming under the specific heads as above.
- Cases of ‘negligence and cash shortages’ and ‘irregularities in foreign exchange transactions’ are to be reported as fraud, if the intention to cheat/defraud is suspected/proved.
- Cases of cash shortage more than Rs. 10,000/-.
- Cases of cash shortage more than Rs. 5,000/- if detected by management/auditor/inspecting officer and not reported on the day of occurrence by the persons handling cash. Where fraudulent intention is not suspected/proved at the time of detection will be treated as fraud.
- Frauds involving forged instruments have be reported only by the paying banker, whereas collection of a genuine instrument fraudulently by a person who is not the true owner, the collecting bank, which is defrauded, will have to file fraud report with the RBI.
- Collection of an instrument where the amount has been credited before realisation and subsequently the instrument is found to be fake/forged and returned by the paying bank, the collecting bank is required to report the transaction as fraud with the RBI as they are at loss by parting the amount.
- Collection of an altered/fake cheque involving two or more branches of the same bank, the branch where the altered/fake cheque has been encashed is required to report the fraud to its H.O. for further reporting to RBI by the H.O.
- An altered/fake cheque having been paid/encashed involving two or more branches of a bank under Core Banking Solution (CBS), the branch which released the payment is required to report the fraud to its H.O. for further reporting to RBI.
- Cases of theft, burglary, dacoit and robbery are not treated as fraud.
- Banks (other than foreign banks) having overseas branches/offices are required to report all frauds perpetrated at such branches/offices to RBI.
2.9 Corporate Governance

Corporate governance is an integral part of the management control system which reflects the corporate strategy in maintaining the image and reputation of the company. In today’s global competition, banks have to be careful in ensuring their integrity in dealing with the financial aspects of their clients. In this respect, a dynamic corporate governance practices are needed.

Corporate Governance means to ensure that the transparency, accountability in the interests of the stakeholders such as the shareholders, employees, clients and others. Over the years ever since the Cadbury Committee in 1992 came out with set of guidelines on the topic of Corporate Governance, many more committees have highlighted the need for a changing corporate governance practices with the changing time and business environment.

2.9.1 Effective Corporate Governance Practices

The objectives of effective corporate governance practices are:

- To promote transparent and efficient markets which are consistent with the rule of Law.
- To protect and facilitate the exercise of shareholders’ rights.
- Timely and accurate disclosures to be made on all important issues relating to the corporation covering the financial situation, performance, ownership and governance of the company.

2.9.2 Corporate Governance in Banks

Over the years, the Reserve Bank of India as Supervisor of Banking companies in India has been playing an important role in ensuring the sound corporate governance practices which are followed by the banking companies. RBI’s various guidelines in mergers and acquisitions, pattern of shareholding, restrictions on various issues are some of the examples of RBI’s role in the corporate governance practices of banks in India.

Prevention of Money Laundering Act, 2002 (PMLA)

Laundering means acquiring, owning, possessing or transferring any proceeds (of money) of crime or knowingly entering into any transaction related to proceeds of the crime either directly or indirectly or concealing or aiding in the concealment of the proceeds or gains of crime, within or outside India. It is a process for conversion of money obtained illegally to appear to have originated from legitimate sources. Invariably, there are three stages through which money laundering takes place.

![Fig. 2.1 Three stages of money laundering](http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)
The three stages of money laundering are as follows:

- The first step is called the placement, when the cash is deposited in the domestic banks or is used to buy goods such as precious metals, work of art, etc.
- The second step is called the layering. Once the funds are entered into the financial system (banks), the funds are converted by transfers to different destinations. This stage is called as layering. At different locations, bank accounts are opened and the funds are transferred as quickly as possible (at times breaking into series of small transactions to escape from the limits set up by banks for cash transactions).
- The last stage is called the integration. In this stage, the launderer attempts to justify that the money obtained through illegal activities is legitimate. Through different methods attempts are made at this stage, like using front offices of the companies, using the tax haven and off shore units, using these funds as security for loans raised, etc.

The Prevention of Money laundering Act, 2002 (PMLA) aimed at combating money laundering in India with three main objectives to prevent and control money laundering to confiscate and seize the property obtained from laundered money, and to deal with any other issue connected with money laundering in India. The Act provides that 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 projective it as untainted property should be guilty offences of money laundering. For the purpose of money laundering, the PMLA identifies certain offences under the Indian Penal Code, the Narcotic Drugs and Psychotropic Substances Act, the Arms Act, the Wild Life (Protection) Act, the Immoral Traffic (Prevention) Act and the Prevention of Corruption Act, the proceeds of which would be covered under this Act.

To combat the menace of aforesaid offences of money laundering the Government is entrusting the work relating to investigation, attachment of property/proceeds of crime relating to the scheduled offences under the Act and filling of complaints, etc., to the Directorate of Enforcement, which currently deals with offences under the Foreign Exchange Management Act.

2.9.3 Role of Banks

All banks (including RRBs and Co-operative banks) are covered under the above Act. The money launderers may open deposit accounts with banks in fake names and banks will be required to be vigilant for not becoming a party to such transactions. With a view to preventing banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing, it is clarified that whenever there is suspicion of money laundering or terrorist financing or when other factors give rise to a belief that the customer does not, in fact, pose a low risk, banks should carry out full-scale customer due diligence (CDD) before opening an account.

Similarly, they have to observe the norms regarding record keeping, reporting, account opening and monitoring transactions. The Act has made various provisions regarding money laundering transactions which include maintenance of record of all transactions relating to money laundering. Records relating to such transactions should be preserved for 10 years from date of cessation of transactions between the client and the banking company. Government has set up Financial Intelligence Unit (FIU-IND) to track and curb money laundering offences. Banks, financial institutions, stock brokers, etc., are to report non-cash transactions (cheques/drafts) totalling to over Rs. 1 crore a month and cash transactions of Rs. 10 lakhs a month, to Financial Intelligence Unit.

Non-adherence of the provision of the Act will be an offence and these offences are cognisable/non-bailable. Punishment would be rigorous imprisonment for not less than 3 years but up to 7 years and fine as per the gravity of the offence. Enforcement Directorate has been made the designated authority to track cases of money laundering.

As per the Act, banking companies, financial institutions and intermediaries should maintain record of transactions, identity of clients, etc. A director appointed by the Central Government has the right to call for records and impose penalties in case of failure on the part of the banking companies and other financial intermediaries. Central Government in consultation with the Reserve Bank has framed rules regarding the maintenance of records, retention period of records, verification of the identity of client (KYC norms) and submitting the details and information to the director when called upon to do so.
To ensure compliance under the PMLA, banking companies should strictly comply with the KYC norms without any deviation. KYC norms are applicable for both the new and existing client accounts. One of the objectives of KYC norms is the clear identity of the customer. The identity does not end with obtaining the required identity proof like, verification and retaining copies of PAN card, Passport, AADHAR card, and other relevant documents as specified. Further to obtaining the required application forms, the photo identity and address proof documents, banks are required to ensure that all the relevant details like status of the customer, and relevant documentary verification to confirm the status, declaration about the multiple bank account details, source of income, source of funds, and expected income and activities in the accounts, etc., are obtained and bank records are updated with these details.

Banks should also accordingly set up internal control checking systems, whereby the system can identify and caution the bank officials about unusual transactions, at the time of input stage to enable the officials to take appropriate action. Banks should be very careful to avoid incidents of Money Laundering at the entry-level itself. This precautionary action on the part of bank officials and the inbuilt warning system in the computers of banking companies would go a long way to control the menace of Money Laundering. Banking companies should also ensure that as part of effective control system, that all the employees at all levels should be informed and trained to practice anti money laundering to safe-guard not only the customers' funds, but also to be proactive to avoid incidents of money laundering.

The internal auditors, external auditors including the Statutory Auditors and the Reserve Bank of India inspectors should include the verification of the Anti-money Laundering procedures as part of their audit and inspection of banking companies. They should ensure that all the required guidelines and directives in respect of Anti Money Laundering including the adherence to the KYC norms, monitoring of accounts, maintenance of records, reporting of high-volume transactions, suspicious transactions, filing of required returns to the authorities and proper control mechanism are adhered to. The executives should ensure monitoring and controlling of such incidents. Further, the computer systems should be upgraded with the required checking and cautioning of suspicious and unauthorised transactions at the input stage.

2.10 Banking Codes and Standards Board of India (BSCSBI)

The Banking Codes and Standards Board of India have been registered as a separate society under the Societies Registration Act, 1860. It functions as an independent and autonomous body, to monitor and assess the compliance with codes and minimum standards of service to individual customers to which the banks agree to. The Code is a voluntary initiative by a bank and is also a unilateral commitment by the bank to its individual customers to deal with them in a transparent and fair manner in its day-to-day operations. RBI derives supervisory comfort in case of banks which are members of the Board.

The main function of the Board is to ensure adherence to the “Code of Bank’s Commitment to Customers”. The Code is voluntary and sets minimum standards of banking practices for banks to follow when they are dealing with individual customers in their day-to-day operations. The Code is not only meant to provide protection to the individual customers, but is also expected to generate awareness in the common man about his rights as a consumer of banking services.

Banks are required to register themselves with BCSBI as members and have the Code adopted by their respective boards. Thereafter, the banks will have to enter into a covenant with BCSBI, binding them to monitoring by BSCBI as far as implementation of the code is concerned. Any Scheduled Commercial Bank is eligible to become a member of BCSBI. The Code represents each member bank’s commitment to minimum standards of service to individual customers in relation to the following products and services offered by the bank:

- Deposit accounts
- Safe deposit lockers
- Settlement of accounts of deceased account holders
- Foreign exchange services
- Remittances within India
- Loans and advances and guarantees
Banking Law and Practice

• Credit cards
• Internet banking
• Interest rates
• Tariff schedule
• Terms and conditions governing relationship between the bank and the customer
• Compensation for loss, if any, to the customer due the acts of omission or commission on the part of the bank
• Privacy and confidentiality of the information relating to the customer
• Norms governing advertisements, marketing and sales by banks
• Have a Help desk/ Helpline at the branch
• Have a Code Compliance officer at each Controlling office above the level of the branch
• Display at each branch name and contact number of Code Compliance Officer
• Display name and address of the Banking Ombudsman

In case a customer is not provided services as promised in the Code, he can first approach the help desk of the branch/bank. In case the issue is not resolved, the Code Compliance Officer of the bank may be approached by the complainant. In case the issue is still not resolved to the satisfaction of the customer, he should take it up with the Banking Ombudsman.

2.11 The Banking Ombudsman Scheme

The Banking Ombudsman Scheme enables an expeditious and inexpensive forum to bank customers for resolution of complaints relating to certain services rendered by banks. The Banking Ombudsman Scheme is introduced under Section 35 A of the Banking Regulation Act, 1949 by RBI with effect from 1995. The Banking Ombudsman is a senior official appointed by the Reserve Bank of India to redress customer complaints against deficiency in certain banking services. As on date, fifteen Banking Ombudsmen have been appointed with their offices located mostly in state capitals. The addresses and contact details of the Banking Ombudsman offices have been provided in the annex. All Scheduled Commercial Banks, Regional Rural Banks and Scheduled Primary Co-operative Banks are covered under the Scheme.

2.11.1 Grounds of Complaints

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.
• Any other matter relating to the violation of the directives issued by the Reserve Bank in relation to banking or other services.

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.
• 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.

There is no cost involved in filing complaints with Banking Ombudsman. The Banking Ombudsman does not charge any fee for filing and resolving customers’ complaints.

2.11.2 Miscellaneous Provisions
The amount, if any, to be paid by the bank to the complainant by way of compensation for any loss suffered by the complainant is limited to the amount arising directly out of the act or omission of the bank or Rs 10 lakhs, whichever is lower. The Banking Ombudsman may award compensation not exceeding Rs 1 lakh to the complainant only in the case of complaints relating to credit card operations for mental agony and harassment. The Banking Ombudsman will take into account the loss of the complainant's time, expenses incurred by the complainant, harassment and mental anguish suffered by the complainant while passing such award.
Summary

- The Reserve Bank of India Act, 1934 was enacted to constitute the Reserve Bank of India with an objective to regulate the issue of bank notes, for keeping reserves to ensure stability in the monetary system and to operate effectively the nation’s currency and credit system.

- The term banking is defined as per Sec 5(i) (b), as acceptance of deposits of money from the public for the purpose of lending and/or investment. Banking Regulation Act through a number of sections restricts or prohibits certain activities for a bank.

- Banks are prohibited to hold The Banking Regulation Act,1949 requires a company or entity to obtain a licence from the Reserve Bank of India to start the business of banking in India.

- Section 11 of the Banking Regulation Act stipulates the minimum capital and reserve requirements of Banking Company.

- The opening of branches by banks is governed by the provisions of Section 23 of the Banking Regulation Act, 1949.

- Promoters/ Promoter Groups should be ‘fit and proper’ in order to be eligible to promote banks through a wholly owned NOFHC.

- The NOFHC will be registered as a non-banking financial company (NBFC) with the RBI and will be governed by a separate set of directions issued by RBI.

- As per the relevant provisions of the Banking Regulation Act, at least fifty one percent of the total number of directors should be persons, who have special knowledge or practical experience, with respect of accountancy, agriculture and rural economy, banking, economics, finance, law, etc.

- Cash Reserve Ratio (CRR) is the mandatory reserves to be maintained with Reserve Bank of India.

- Open market operations are a flexible instrument of credit control by means of which the Reserve Bank on its own initiative alters the liquidity position of the bank by dealing directly in the market instead of using its influence indirectly by varying the cost of credit.

- A banking company may be amalgamated with another banking company as per BR Act.

- There are various types of users of the financial statements of banks like shareholders, investors, creditors, credit rating agencies, management students and others who need information about the financial position and performance of the banks.

- The Banking Ombudsman Scheme enables an expeditious and inexpensive forum to bank customers for resolution of complaints relating to certain services rendered by banks.

References


- SEBI as Regulatory Body in Indian Financial System Lecture by Mr. B.K. Jain. [Video online] Available at: <http://www.youtube.com/watch?v=nHcOpEn_zAA> [Accessed 1 April 2014].

Recommended Reading


Self Assessment

1. Which of the following act was enacted to constitute the Reserve Bank of India?
   a. The Banking Regulation Act, 1949
   b. The Reserve Bank of India Act, 1934
   c. The State Bank of India Act, 1955
   d. The Regional Rural Banks Act, 1986

2. The opening of branches by banks is governed by the provisions of Section 23 of the __________.
   a. Banking Regulation Act, 1949
   b. Reserve Bank of India Act, 1934
   c. State Bank of India Act, 1955
   d. Regional Rural Banks Act, 1986

3. Which of the following term is defined as per Sec 5(i) (b), as acceptance of deposits of money from the public for the purpose of lending and/or investment?
   a. Regulation
   b. Act
   c. Banking
   d. Company

4. Match the following

   | 1. Sec 5(i)(c) | A. It deals with the meaning of secured loans or advances. |
   | 2. Sec 5(i)(f) | B. It defines a banking company as any company which handles the business of banking. |
   | 3. Sec 5(i)(h) | C. It deals with the definition of banking business. |
   | 4. Sec 6(1)   | D. It distinguishes between the demand and time liabilities, as the liabilities which are repayable on demand and time liabilities means which are not demand liabilities. |

   a. 1- A, 2- B, 3-C, 4- D
   b. 1- B, 2- D, 3-A, 4- C
   c. 1- C, 2-A, 3-D, 4- B
   d. 1- D, 2- C, 3-B, 4- A

5. Which of the following section specifies banking companies doing banking business in India should use at least on work bank, banking, and banking company in its name?
   a. Sec 7
   b. Sec 6(1)
   c. Sec 5(i)(h)
   d. Sec 5(i)(f)

6. The currency (bank notes) of our country is issued by the __________ Bank of India.
   a. State
   b. Reserve
   c. Central
   d. Rural
7. The Reserve Bank has the sole right to issue and management of currency in India under __________ of the RBI Act.
   a. Section 22
   b. Section 20
   c. Section 2
   d. Section 7

8. Which of the following statement is true?
   a. The cost of the audit is not to be borne by the banking company.
   b. The cost of the audit is never to be borne by the banking company.
   c. The cost of the audit is to be denied by the banking company.
   d. The cost of the audit is to be borne by the banking company.

9. What means acquiring, owning, possessing or transferring any proceeds (of money) of crime or knowingly entering into any transaction related to proceeds of the crime either directly or indirectly or concealing or aiding in the concealment of the proceeds or gains of crime, within or outside India?
   a. Corporate governance
   b. Laundering
   c. Layering
   d. Integration

10. Which of the following statement is false?
    a. A bank cannot declare dividend unless all its capitalised expenses are fully written off as per Section 15.
    b. Sections 11 and 12 deals with the Paid up Capital, Reserves and their terms and conditions.
    c. Sec 18 specifies the Cash Reserve Ratio to be maintained by non-scheduled banks.
    d. Sec 12 clarifies about the share holding of a banking company.
Chapter III
Banker-Customer Relation

Aim
The aim of this chapter is to:

• introduce the relation between a banker and his customer
• describe a customer
• explicate a banking company

Objectives
The objectives of this chapter are to:

• enlist the rights of a banker
• elucidate closing of a bank account
• explain various types of customers

Learning outcome
At the end of this chapter, you will be able to:

• identify the insurance of bank deposits
• understand the concept of KYC
• describe the concept of nomination
3.1 Introduction

The nature of service provided by a banker decides the relationship between a banker and his customer. Accepting deposits and lending and/or investing is the core banking business of a bank. In addition to its primary functions, it deals with various customers by providing other services like safe custody services, safe deposit lockers, and helping the clients by collecting their cheques and other instruments as an agent and trustees for them.

So, based on the above, a banker-customer relationship can be classified as under:

![Banker customer relationship classification](Source: http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

From the above diagram, it can be seen that different types of relationships exist between a banker and customer.

3.2 Meaning of a Banking Company

A banking company is defined as a company which transacts the business of banking in India. Section 5 (b) of The Banking Regulation Act, 1949 defines the term banking as “accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and with draw by cheque, draft, order or otherwise.”

Section 7 of this Act makes it essential for every company carrying on the business of banking in India to use as part of its name at least one of the words, bank, banker, banking or banking company. Section 49A of the Act prohibits any institution other than a banking company to accept deposit money from public withdrawal by cheque. The essence of banking business is the task of accepting deposits from public with the facility of withdrawal of money by cheque. In other words, the combination of the functions of acceptance of public deposits and withdrawal of the money by cheques by any institution cannot be performed without the approval of Reserve Bank.

3.2.1 Features of Banking

The following are the basic characteristics to capture the essential features of Banking:

- Dealing in money: The banks accept deposits from the public and advance the same as loans to the needy people. The deposits may be of different types, such as current, fixed, savings, etc., accounts. The deposits are accepted on various terms and conditions.
- Deposits must be withdrawal: The deposits (other than fixed deposits) made by the public can be withdrawal by cheques, draft or otherwise, i.e., the bank issue and pay cheques. The deposits are usually withdrawal on demand.
- Dealing with credit: The banks are the institutions that can create credit, i.e., creation of additional money for lending. Thus, ‘creation of credit’ is the unique feature of banking.
Commercial in nature: As all the banking functions are carried on with the aim of making profit, it is regarded as a commercial institution.

Nature of agent: Besides the basic function of accepting deposits and lending money as loans, bank possesses the character of an agent because of its various agency services.

### 3.3 Customer

The term ‘customer’ of a bank is not defined by law. Ordinarily, a person who has an account in a bank is considered as customer. Banking experts and the legal judgements in the past, however, used to meet the requirements of this statement by laying emphasis on the period for which such account had actually been maintained with the bank. In Sir John Paget’s view “to constitute a customer there must be some recognisable course or habit of dealing in the nature of regular banking business.” This definition of a customer of a bank lays emphasis on the duration of the dealings between the banker and the customer and is, therefore, called the ‘duration theory’. According to this viewpoint a person does not become a customer of the banker on the opening of an account; he must have been accustomed to deal with the banker before he is chosen as a customer. The above-mentioned emphasis on the duration of the bank account is now discarded.

According to Dr. Hart, “a customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such.” Supporting this viewpoint, the Kerala High Court observed in the case of Central Bank of India Ltd. Bombay vs. V. Gopinathan Nair and others (A.I.R., 1979, Kerala 74), “Broadly speaking, a customer is a person who has the habit of resorting to the same place or person to do business.” So far as banking transactions are concerned, he is a person whose money has been accepted on the footing that banker will honour up to the amount standing to his credit, irrespective of his connection being of short or long-standing.”

For the purpose of KYC policy, a ‘Customer’ is defined as:

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

Thus, a person who has a bank account in his name and for whom the banker undertakes to provide the facilities as a banker is considered to be a customer. It is not essential that the account must have been operated upon for some time. Even a single deposit in the account will be sufficient to designate a person as customer of the banker. Though emphasis is not being laid on the habit of dealing with the banker in the past, but such habit may be expected to be developed and continued in figure. In other words, a customer is expected to have regular dealings with his banker in future.

An important consideration which determines a person’s status as a customer is the nature of his dealings with a banker. It is evident from the above that his dealings with the banker must be relating to the business of banking. A banker performs a number of agency functions and tenders various public utility services besides performing essential functions as a banker. A person who does not deal with the banker in regard to the essential functions of the banker, i.e., accepting of deposits and lending of money, but avails of any of the services rendered by the banker, is not called a customer of the banker.

For example, any person without a bank account in his name may remit money through a bank draft, encash a cheque received by him from others or deposit his valuables in the Safe Deposit Vaults in the bank or deposit cash in the bank to be credited to the account of the Life Insurance Corporation or any joint stock company issuing new shares. However, he will not be called a customer of the banker as his dealing with the banker is not in regard to the essential functions of the banker. Such dealings are considered as casual dealings and are not in the nature of banking business. Thus, to constitute a customer the following essential requisites must be fulfilled:
• A bank account, savings, current or fixed deposit must be opened in his name by making necessary deposit of money.
• The dealing between the banker and the customer must be of the nature of banking business.

A customer of a banker need not necessarily be a person. A firm, joint stock company, a society or any separate legal entity may be a customer. Explanation to Section 45-Z of the Banking Regulation Act, 1949, clarifies that section ‘customer’ includes a government department and a corporation incorporated by or under any law.

As the banker-customer relationship is contractual, a bank follows that any person who is competent to contract can open a deposit account with a bank branch of his/her choice and convenience. For entering into a valid contract, a person needs to fulfil the basic requirements of being a major (18 years of age or above) and possessing sound mental health (i.e., not being a lunatic). A person who fulfils these basic requirements, as also other requirements of the banks as mentioned below, can open a bank account. However, minors (below 18 years of age) can also open savings account with certain restrictions. Though any person may apply for opening an account in his name, the banker may reserve the right to do so on being satisfied about the identity of the customer.

By opening an account with the banker, a customer enters into relationship with a banker. The special features of this relationship impose several obligations on the banker. He should, therefore, be careful in opening an account in his name, but the banker reserves the right to do so on being satisfied about the identity of the customer. Prior to the introduction of ‘Know Your Customer (KYC)’ guidelines by the RBI, it was the practice amongst banks to get a new customer introduced by a person who has already one satisfactory bank account with the Bank or by a staff member who knows him properly. Most of the banks preferred introduction to be given by a current account holder. Different practices of various banks were causing confusion and sometimes loss to the bank on not opening ‘properly’ introduced account, when any fraud took place in the account. A new customer was also facing difficulty in opening an account, if he was a new resident of that area. To overcome all these problems and streamline the system of knowing a customer, RBI has directed all banks to adopt KYC guidelines.

3.4 Banker and his Rights
A banker is a person who is doing the banking business. There is no clear definition for banking as it performs multifarious functions. A customer is a person who maintains an account with the banks. He must have some sort of account. Even a single transaction may constitute him as a customer. Frequency of transactions is anticipated, but not insisted upon.

3.4.1 Right of Appropriation of a Banker
In case of his usual business, a banker receives payments from his customer. If the latter has more than one account or has taken more than one loan from the banker, the question of the appropriation of the money subsequently deposited by him naturally arises. Sections 59 to 61 of the Indian Contract Act, 1872 contain provisions regarding the right of appropriation of payments in such cases. According to Section 59, such right of appropriation is vested in the debtor, who makes a payment to his creditor to whom he owes several debts. He can appropriate the payment as follows:
• An express intimation.
• Under circumstances implying that the payment is to be applied to the discharge of some particular debt.

If the creditor accepts such payment, it must be applied accordingly. For example, A owes B several debts, including Rs. 1,000/- upon a promissory note which falls due on 1st December, 1986. He owes B no other debt of that amount. On 1-12-1986, A pays B Rs.1,000/-. The payment is to be applied to the discharge of the promissory note. If the debtor does not intimate or there is no other circumstance indicating to which debt the payment is to be applied, the right of appropriation is vested in the creditor. He may apply it as his discretion to any lawful debt actually due and payable to him from the debtor (Section 60). Further, where neither party makes any appropriation, the payment shall be applied in discharge of each proportionately (Section 61).
In M/s. Kharavela Industries Pvt. Ltd. v. Orissa State Financial Corporation and Others [AIR 1985 Orissa 153 (A)], the question arose whether the payment made by the debtor was to be adjusted first towards the principal or interest in the absence of any stipulation regarding appropriation of payments in the loan agreement. The Court held that in case of a debt due with interest, any payment made by the debtor is in the first instance to be applied towards satisfaction of interest and thereafter toward the principal, unless there is an agreement to the contrary.

In case a customer has a single account and he deposits and withdraws money from it frequently, the order in which the credit entry will set off the debit entry is the chronological order, as decided in the famous Clayton’s Case. Thus, the first item on the debit side will be the item to be discharged or reduced by a consequent item on the credit side. The credit entries in the account adjust or set-off the debit entries in the chronological order. The rule derived from the Clayton’s case is of great practical importance to the bankers. In a case of death, retirement or insolvency of a partner of a firm, the then existing debt due from the firm is adjusted or set-off by the ensuing credit made in the account.

The banker thus loses his right to claim such debt from the assets of the deceased, retired or insolvent partner and may ultimately suffer the loss if the debt cannot be recovered from the remaining partners. Therefore, to avoid the operation of the rule given in the Clayton’s case the banker closes the old account of the firm and opens a new one in the name of the reconstituted firm. Thus the liability of the deceased, retired or insolvent partner, as the case may be, at the time of his death, retirement or insolvency is determined and he may be held liable for the same. Consequent deposits made by surviving/solvent partners will not be applicable to discharge the same.

3.4.2 Right of General Lien of a Banker

One of the important rights enjoyed by a banker is the right of general lien. Lien means the right of the creditor to retain the goods and securities owned by the debtor until the debt due from him is repaid. It bestows upon the creditor the right to retain the security of the debtor and not the right to sell it. Such right can be exercised by the creditor in respect of goods and securities entrusted to him by the debtor with the intention to be retained by him as security for a debt due by him (debtor). Lien may be either of the following:

- A general lien
- A particular lien

A particular lien can be exercised by a craftsman or a person who has spent his time, labour and money on the goods retained. In such cases, goods are retained for a particular debt only. For example, a tailor has the right to keep the clothes made by him for his customer, until his tailoring charges area paid by the customer. So is the case with public carriers and the repair shops. A general lien, on the other hand, is applicable in respect of all amounts due from the debtor to the creditor. Section 171 of the Indian Contract Act, 1872, confers the right of general lien on the bankers as follows, “Bankers… may, in the absence of a contract to the contrary, retain as a security for a general balance of account, any goods bailed to them.”

3.5 Special Features of a Banker’s Right of General Lien

The special features of a banker’s right of general lien can be enumerated as follows:

- The banker possesses the right of general lien on all goods and securities entrusted to him in his capacity as a banker and in the absence of a contract inconsistent with the right of lien. Thus, he cannot exercise his right of general lien, if the following are not satisfied:
  - The goods and securities have been entrusted to the banker as a trustee or an agent of the customer.
  - A contract, express or implied exists between the customer and the banker which is inconsistent with the banker’s right of general lien.

In other words, if the goods or securities are entrusted for some specific purpose, the banker cannot have a lien over them. These exceptional cases are discussed later on.

- A banker’s lien is tantamount to an implied pledge: As noted above the right of lien does not confer on the creditor the right of sale, but only the right to retain the goods till the loan is repaid. In case of pledge, the creditor enjoys the right of sale. A banker’s right of lien is more than a general lien. It confers upon him the power to sell the goods and securities in case of default by the customer. Such right of lien thus resembles a pledge and is usually called an ‘implied pledge’. The banker thus enjoys the privileges of a pledge and can dispose of the securities after giving proper notice to the customer.
The right of lien is conferred upon the banker by the Indian Contract Act: No separate agreement or contract is, therefore, necessary for this purpose. However, to be on the safe side, the banker takes a letter of lien from the customer mentioning that the goods are entrusted to the banker as security for a loan, existing or future taken from the banker and that the latter can exercise his right of lien over them. The banker is also authorised to sell the goods in case of default on the part of the customer. The latter thus spells out the object of entrusting the goods to the banker, so that the same may not be denied by the customer later on.

The right of lien can be exercised on goods or other securities standing in the name of the borrower and not jointly with others. For example, in case the securities are held in the joint names of two or more persons, the banker cannot exercise his right of general lien in respect of a debt due from a single person. The banker can exercise his right of lien on the securities remaining in his possession after the loan, for which they are lodged, is repaid by the customer, if no contract to contrary exists. In such cases, it is an implied presumption that the customer has re-offered the same securities as a cover for any other advance outstanding on that date or taken subsequently. The banker is also entitled to exercise the right of general lien in respect of a customer’s obligation as a surety and to retain the security offered by him for a loan obtained by him for his personal use and which has been repaid.

In Stephen Manager North Malabar Gramin Bank vs. Chandra Mohan and State of Kerala, the loan agreement authorised the bank to treat the ornaments not only as a security for that loan transaction, but also for any other transaction or liability existing or to be incurred in future. As the liability of the surety is joint and several with that of the principal debtor, such liability also came within the ambit of the above provision of the agreement.

Section 171 of the Contract Act entitles a banker to retain the goods bailed to him for any other debt due to him, i.e., any debt taken prior to the debt for which the goods were entrusted as security. However in a lien, there should be a right of possession because, lien is a right of one man to retain that which is in his possession belonging to another. Possession of the goods by the person claiming right of lien, is anterior to the exercise of that right and for which possession whether actual or conductive is a must. (Syndicate Bank vs. Davander Karkare (A.I.R. 1994 Karnataka 1)

### 3.6 Various Types of Customers

The types of customers can be broadly divided into eight types. They are discussed in the following paragraphs.

#### 3.6.1 Individuals

Accounts of individuals form a major chunk of the deposit accounts in the personal segment of most banks. Individuals who are major and of sound mind can open a bank account. The following are the various types of individuals:

- **Minors:** In case of minor, a banker would open a joint account with the natural guardian. However to encourage the habit of savings, banks open minor accounts in the name of a minor and allows single operations by the minor himself/herself. Such accounts are opened subject to certain conditions as follows:
  - The minor should be of some minimum age say 12 or 13 years or above.
  - Should be literate.
  - No overdraft is allowed in such accounts.
  - Two minors cannot open a joint account.
  - The father is the natural guardian for opening a minor account, but RBI has authorised mother also to sign as a guardian (except in case of Muslim minors).

- **Joint Account Holders:** A joint account is an account by two or more persons. At the time of opening the account all the persons should sign the account opening documents. Operating instructions may vary, depending upon the total number of account holders. In case of two persons it may be as follows:
  - Jointly by both account holders either or survivor former or survivor In case no specific instructions is given, then the operations will be by all the account holders jointly
  - The instructions for operations in the account would come to an end in cases of insanity, insolvency, death of any of the joint holders and operations in the account will be stopped.
• Illiterate Persons: Illiterate persons who cannot sign are allowed to open only a savings account (without cheque facility) or fixed deposit account. They are generally not permitted to open a current account. The following additional requirements need to be met while opening accounts for such persons:
  • The depositor’s thumb impression (in lieu of signature) is obtained on the account opening form in the presence of preferably two persons, who are known to the bank and who have to certify that they know the depositor.
  • The depositor’s photograph is affixed to the ledger account and also to the savings passbook for identification.

Withdrawals can be made from the account when the passbook is furnished, the thumb impression is verified and a proper identification of the account holder is obtained.

3.6.2 Hindu Undivided Family (HUF)

HUF is a unique entity recognised under the Hindu customary law as comprising of a ‘Karta’ (senior-most male member of the joint family), his sons and grandsons or even great grandsons in a lineal descending order, who are ‘coparceners’ (who have an undivided share in the estate of the HUF). The right to manage the HUF and its business vests only in the Karta and he acts on behalf of all the coparceners such that his actions are binding on each of them to the extent of their shares in the HUF property. The Karta and other coparceners may possess self-acquired properties other than the HUF property, but these cannot be clubbed together for the HUF dues.

HUF business is quite distinct from partnership business which is governed by Indian Partnership Act, 1932. In partnership, all partners are individually and collectively liable to outsiders for the dues of the partnership and all their individual assets, apart from the assets of the partnership, would be liable for attachment for partnership dues. Contrarily, in HUF business, the individual properties of the coparceners are spared from attachment for HUF dues.

The following special requirements are to be fulfilled by the banks for opening and conducting HUF accounts:
• The account is opened in the name of the Karta or in the name of the HUF business.
• A declaration signed by Karta and all coparceners, affirms the composition of the HUF, its Karta and names and relationship of all the coparceners, including minor sons and their date of birth.
• The account is operated only by the Karta or the authorised coparceners.
• In determining the security of the family property for purposes of borrowing, the self-acquired properties of the coparceners are excluded.
• On the death of a coparcener, his share may be handed over to his wife, daughters and other female relatives as per the Hindu Succession Act, 1956.

The Hindu Succession Act, 1956 has been amended in 2005. The Amendment Act confers equal rights to daughters in the Mitakshara Coparcenary property. With this amendment the female coparcener can also act as Karta of the HUF. When any HUF property is to be mortgaged to the Bank as a security of loan, all the major coparceners (including female coparceners) will have to execute the documents.

3.6.3 Firms

The concept of ‘Firm’ indicates either a sole proprietary firm or a partner-ship firm. A sole proprietary firm is wholly owned by a single person, whereas a partnership firm has two or more partners. The sole-proprietary firm’s account can be opened in the owner’s name or in the firm’s name. A partnership is defined under section 4 of the Indian Partnership Act, 1932, as the relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all. It can be created by an oral as well as written agreement among the partners. The Partnership Act does not provide for the compulsory registration of a firm. While an unregistered firm cannot sue others for any cause relating to the firm’s business, it can be sued by the outsiders irrespective of its registration. In view of the features of a partnership firm, bankers have to ensure that the following requirements are complied with while opening its account:
• The account is opened in the name of the firm and the account opening form is signed by all the partners of the firm.

• Partnership deed executed by all the partners (whether registered or not) is recorded in the bank’s books, with suitable notes on ledger heading, along with relevant clauses that affect the operation of the account.

• Partnership letter signed by all the partners is obtained to ensure their several and joint liabilities. The letter governs the operation of the account and is to be adhered to accordingly.

The following precautions should be taken in the conduct of a partnership account:

• The account has to be signed ‘for and on behalf of the firm’ by all the authorised partners and not in an individual name.

• A cheque payable to the firm cannot be endorsed by a partner in his name and credited to his personal account.

• In case the firm is to furnish a guarantee to the bank, all the partners have to sign the document.

• If a partner (who has furnished his individual property as a security for the loan granted to the firm) dies, no further borrowings would be permitted in the account until an alternative for the deceased partner is arranged for, as the rule in Clayton’s case operates.

3.6.4 Companies

A company is a legal entity, distinct from its shareholders or managers, as it can sue and be sued in its own name. It is a perpetual entity until dissolved. Its operations are governed by the provisions of the Companies Act, 1956. A company can be of three types:

• Private Limited company: Having 2 to 51 shareholders.

• Public company: Having 7 or more shareholders.

• Government company: Having at least 51 per cent shareholdings of Government (Central or State).

The following requirements are to be met, while opening an account in the name of a company:

• The account opening form meant for company accounts should be filled and specimen signatures of the authorised directors of the company should be obtained.

• Certified up-to-date copies of the Memorandum and Articles of Association should be obtained. The powers of the directors need to be perused and recorded to guard against ‘ultra vires’ acts of the company and of the directors in future.

• Certificate of Incorporation (in original) should be perused and its copy retained on record.

• In the case of Public company, certificate of commencement of business should be obtained and a copy of the same should be recorded. A list of directors duly signed by the Chairman should also be obtained.

• Certified copy of the resolution of the Board of Directors of the company regarding the opening, execution of the documents and conduct of the account should be obtained and recorded.

3.6.5 Trusts

A trust is a relationship where a person (trustee) holds property for the benefit of another person (beneficiary) or some object in such a way that the real benefit of the property accrues to the beneficiary or serves the object of the trust. A trust is generally created by a trust deed and all concerned matters are governed by the Indian Trusts Act, 1882. The trust deed is carefully examined and its relevant provisions, noted. A banker should exercise extreme care by functioning in the following manner while conducting the trust accounts:

• A trustee cannot delegate his powers to other trustees, nor can all trustees by common consent delegate their powers to outsiders.

• The funds in the name of the trust cannot be used for crediting in the trustee’s account, or for liquidating the debts standing in the name of the trustee.

• The trustee cannot raise loan without the permission of the court, unless permitted by the trust deed.
3.6.6 Clubs
Account of a proprietary club can be opened like an individual account. However, clubs that are collectively owned by several members and are not registered under Societies Registration Act, 1860, or under any other Act, are treated like an unregistered firm. While opening and conducting the account of such clubs, the following requirements are to be met:
- Certified copy of the rules of the club is to be submitted.
- Resolution of the managing committee or general body, appointing the bank as their banker and specifying the mode of operation of the account has to be submitted.
- The person operating the club account should not credit the cheques drawn favouring the club, to his personal account.

3.6.7 Local Authorities
Municipal Corporation, Panchayat Boards are local authorities created by specific Acts of the state legislature. Their constitution, functions, powers, etc., are governed by those Acts. Bankers should ensure that accounts of such bodies are opened and conducted strictly as per the provisions of the relevant Act and regulations framed there under. The precautions applicable for company or trust accounts are also applicable in the case of these accounts, in order to guard against ultra vires acts by the officers of the local authority operating the account.

3.6.8 Co-operative Societies
Co-operative societies are required to open accounts only with these banks which are recognised for this purpose (under the Co-operative Society Act). The following documents should be obtained while opening their account:
- Certificate of registration of the society under the Co-operative Society Act.
- Certified copy of the bylaws of the society.
- Resolution of the managing committee of the society prescribing the conditions for the conduct of the account.
- List of the members of the managing committee with the copy of the resolution electing them as the committee members.

3.7 Closing of a Bank Account
Banker-customer relationship is a contractual relationship between two parties and it may be terminated by either party on voluntary basis or involuntarily by the process of law. These two modes of termination are described below.

3.7.1 Voluntary Termination
The customer has a right to close his demand deposit account because of change of residence or dissatisfaction with the service of the banker or for any other reason, and the banker is bound to comply with this request. The banker also may decide to close an account, due to an unsatisfactory conduct of the account or because it finds the customer undesirable for certain reasons. However, a banker can close an account only after giving a reasonable notice to the customer. Such cases of closure of an account at the instance of the banker are quite rare, since the cost of securing and opening a new account is much higher than the cost of closing an account. If a customer directs the banker in writing to close his account, the banker is bound to comply with such direction. The latter need not ask the reasons for the former’s direction. The account must be closed with immediate effect and the customer be required to return the unused cheques.

3.7.2 If the Bank Desires to Close the Account
If an account remains un-operated for a very long period, the banker may request the customer to withdraw the money. Such step is taken on the presumptions that the customer no longer needs the account. If the customer could not be traced after reasonable effort, the banker usually transfers the balance to an ‘Unclaimed Deposit Account’, and the account is closed. The balance is paid to the customers as and when he is traced.
The banker is also competent to terminate his relationship with the customer, if he finds that the latter is no more a desirable customer. The banker takes this extreme step in circumstances when the customer is guilty of conducting his account in an unsatisfactory manner, i.e., if the customer is convicted for forging cheques or bills or if he issues cheques without sufficient funds or does not fulfil his commitment to pay back the loans or overdrafts, etc. The banker should take the following steps for closing such an account:

- The banker should give to the customer due notice of his intention to close the account and request him to withdraw the balance standing to his credit. This notice should give sufficient time to the customer to make alternative arrangements. The banker should not, on his own, close the account without such notice or transfers the same to any other branch.

- If the customer does not close the account on receipt of the aforesaid notice, the banker should give another notice intimating the exact date by which the account be closed otherwise the banker himself will close the account. During this notice period the banker can safely refuse to accept further credits from the customer and can also refuse to issue fresh cheque book to him. Such steps will not make him liable to the customer and will be in consonance with the intention of the notice to close account by a specified date.

The banker should, however, not refuse to honour the cheques issued by the customer, so long as his account has a credit balance that will suffice to pay the cheque. If the banker dishonours any cheque without sufficient reasons, he will be held liable to pay damages to his customer under Section 31 of the Negotiable Instruments Act, 1881. In case of default by the customer to close the account, the banker should close the account and send the money by draft to the customer. He will not be liable for dishonouring cheques presented for payment subsequently.

### 3.7.3 Termination by Law

The relationship of a banker-customer can also be terminated by the process of law and by the occurrence of the following events:

- **Death of customer:** On receiving notice or information of the death of a customer, the bank stops all debit transactions in the account. However, credits to the account can be permitted. The balance in the account is given to the legal representative of the deceased after obtaining the letters of administration, or succession certificate, or indemnity bond as per the prescribed procedure, and only then, the account is closed.

- **Bankruptcy of customer:** An individual customer may be declared bankrupt, or a company may be wound up under the provisions of law. In such an event, no drawings would be permitted in the account of the individual/company. The balance is given to the Receiver or Liquidator or the Official Assignee and the account is closed thereafter.

- **Garnishee order:** After receiving a garnishee order from a court or attachment order from income tax authority, the account can be closed as one of the options after taking the required steps.

- **Insanity of the customer:** A lunatic/person of unsound mind is not competent to contract under Section 11 of the Indian Contract Act, 1872. As banker-customer relationship is contractual, the bank will not honour cheques and can close the account after receiving notice about the insanity of the customer and receiving a confirmation about it through medical reports.

### 3.8 ‘Know Your Customer’ (KYC) Guidelines of the RBI

KYC establishes the identity and residential address of the customers by specified documentary evidences. One of the main objectives of KYC procedure is to prevent misuse of the banking system for money laundering and financing of terrorist activities. The ‘KYC’ guidelines also reinforce the existing practices of some banks and make them compulsory, to be adhered to by all the banks with regard to all their customers who maintain domestic or non-resident rupee or foreign currency accounts with them. All religious trust accounts and non-religious trust accounts are also subjected to KYC procedure. RBI had advised banks the following:

- No account is opened in anonymous or fictitious/benami name (s).
- Bank will not open an account or close an existing account if the bank is unable to verify the identity or obtain documents required by it due to non-cooperation of the customer.
3.8.1 Customer Identification Procedure

Customer identification means identifying the customer and verifying his/her identity by using reliable, independent source documents, data or information. Banks need to obtain sufficient information necessary to establish to their satisfaction, the identity of each new customer, whether regular or occasional, and the purpose of the intended nature of banking relationship. Being satisfied means that the bank must be able to satisfy the competent authorities that due diligence was observed based on the risk profile of the customer in compliance with the extant guidelines in place.

The risk-based approach is considered necessary to avoid disproportionate cost to banks and a burdensome regime for the customers. Besides risk perception, the nature of information/documents required would also depend on the type of customer (individual, corporate, etc.). For customers that are natural persons, the banks should obtain sufficient identification data to verify the identity of the customer, his address/ location, and also his recent photograph. For customers that are legal persons or entities, the bank should:

- Verify the legal status of the legal person/entity through proper and relevant documents.
- Verify that any person purporting to act on behalf of the legal person/entity is so authorised and identify and verify the identity of that person.
- Understand the ownership and control structure of the customer and determine the natural persons who ultimately control the legal person.

3.8.2 Customer Identification Requirements

The following are the customer identification requirements:

- Trust/Nominee or Fiduciary Accounts: There exists the possibility that trust/nominee or fiduciary accounts can be used to circumvent the customer identification procedures. Banks should determine whether the customer is acting on behalf of another person as trustee/nominee or any other intermediary. If so, banks should insist on receipt of satisfactory evidence of the identity of the intermediaries and of the persons on whose behalf they are acting, as also obtain details of the nature of the trust or other arrangements in place. While opening an account for a trust, banks should take reasonable precautions to verify the identity of the trustees and the settlers of trust (including any person settling assets into the trust), grantors, protectors, beneficiaries and signatories. Beneficiaries should be identified, when they are defined. In the case of a ‘foundation’, steps should be taken to verify the founder managers/directors and the beneficiaries, if defined.
- Accounts of companies and firms: Banks need to be vigilant against business entities being used by individuals as a ‘front’ for maintaining accounts with banks. Banks should examine the control structure of the entity, determine the source of funds and identify the natural persons who have a controlling interest and who comprise the management. These requirements may be moderated according to the risk perception, e.g., in the case of a public company it will not be necessary to identify all the shareholders.
- Client accounts opened by professional intermediaries: When the bank has knowledge or reason to believe that the client account opened by a professional intermediary is on behalf of a single client, that client must be identified. Banks may hold ‘pooled’ accounts managed by professional intermediaries on behalf of entities like mutual funds, pension funds or other types of funds. Banks also maintain ‘pooled’ accounts managed by lawyers,chartered accountants or stockbrokers for funds held ‘on deposit’ or ‘in escrow’ for a range of clients. Where funds held by the intermediaries are not co-mingled at the bank and there are ‘sub-accounts’, each of them attributable to a beneficial owner, all the beneficial owners must be identified. Where such funds are co-mingled at the bank, the bank should still look through to the beneficial owners. Where the banks rely on the ‘Customer Due Diligence’ (CDD) done by an intermediary, they should satisfy themselves that the intermediary is regulated and supervised and has adequate systems in place to comply with the KYC requirements. It should be understood that the ultimate responsibility for knowing the customer lies with the bank.
- Accounts of Politically Exposed Persons (PEPs) resident outside India: Politically exposed persons are individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior government/judicial/military officers, senior executives of state-owned corporations, important political party officials, etc. Banks should gather sufficient information on any person/customer of this category intending to establish a relationship and check all the information available
on the person in the public domain. Banks should verify the identity of the person and seek information about the sources of funds before accepting the PEP as a customer. The decision to open an account for PEP should be taken at a senior level which should be clearly spelt out in Customer Acceptance Policy. Banks should also subject such accounts to enhanced monitoring on an ongoing basis. The above norms may also be applied to the accounts of the family members or close relatives of PEPs.

- Accounts of non-face-to-face customers: With the introduction of telephone and electronic banking, increasingly accounts are being opened by banks for customers without the need for the customer to visit the bank branch. In the case of non-face-to-face customers, apart from applying the usual customer identification procedures, there must be specific and adequate procedures to mitigate the higher risk involved. Certification of all the documents presented should be insisted upon and, if necessary, additional documents may be called for. In such cases, banks may also require the first payment to be effected through the customer’s account with another bank which, in turn, adheres to similar KYC standards. In the case of cross-border customers, there is the additional difficulty of matching the customer with the documentation and the bank may have to rely on third party certification/introduction. In such cases, it must be ensured that the third party is a regulated and supervised entity and has adequate KYC systems in place.

- Basic Savings Bank Deposit Accounts (No-Frills Savings Bank accounts). The features of Basic Savings Bank Deposit Accounts are as follows:
  - Persons belonging to low income group both in urban and rural areas are not able to produce such documents to satisfy the bank about their identity and address. This may lead to their inability to access the banking services and result in their financial exclusion. Accordingly, the KYC procedure also provides for opening accounts for those persons who intend to keep balances not exceeding Rupees Fifty Thousand (50,000/-) in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed Rupees One Lakh (1,00,000/-) in a year. In such cases, if a person who wants to open an account and is not able to produce documents mentioned as mentioned in the chart below, banks should open an account for him, subject to introduction from another account holder who has been subjected to full KYC procedure. The introducer’s account with the bank should be at least six months old and should show satisfactory transactions. Photograph of the customer who proposes to open the account and also his address needs to be certified by the introducer.
  - While opening accounts as described above, the customer should be made aware that if at any point of time, the balances in all his/her accounts with the bank (taken together) exceeds Rupees Fifty Thousand (Rs. 50,000/-) or total credit in the account exceeds Rupees One Lakh (Rs. 1,00,000/-) in a year, no further transactions will be permitted until the full KYC procedure is completed. In order not to inconvenience the customer, the bank must notify the customer when the balance reaches Rupees Forty Thousand (Rs. 40,000/-) or the total credit in a year reaches Rupees Eighty thousand (Rs. 80,000/-) that appropriate documents for conducting the KYC must be submitted, otherwise operations in the account will be stopped.

3.8 3 Specimen Signature
Specimen signature of the customer is obtained on the account opening form in the presence of the bank staff and it is attested by an authorised bank officer on the form itself. A customer is recognised mainly by his/her signature on the cheques/vouchers and these are compared with the specimen signature on record to verify the genuineness of the customer’s signature.

3.8.4 Power of Attorney
A power of Attorney is a document duly stamped as per Stamp Act and given by a customer to his banker, authorising his attorney or agent named therein to operate the account. The banker should ensure the following regarding the document:
  - Gives specific authority to the named person to operate the named account on behalf of the customer.
  - Is properly stamped and notarised.
  - Is valid and not time-barred.
  - Does not contain conditions or limitations on the authority of the attorney.
  - Binds the principal for all the transactions done by the attorney.
The Power of Attorney is then registered in the branch’s documents and the attorney’s signature is recorded in the account for its operation. A ‘mandate’, which is a simpler and a general purpose version of the power of attorney, is a simple authority given in writing to the banker by a customer, authorising a named person to operate the account temporarily for a specified period.

3.9 Closing of a Bank Account

Banker-customer relationship is a contractual relationship between two parties and it may be terminated by either party on voluntary basis or involuntarily by the process of law. These two modes of termination are described below:

- **Voluntary termination:** The customer has a right to close his demand deposit account because of change of residence or dissatisfaction with the service of the banker or for any other reason, and the banker is bound to comply with this request. The banker also may decide to close an account, due to an unsatisfactory conduct of the account or because it finds the customer undesirable for certain reasons. However, a banker can close an account only after giving a reasonable notice to the customer. However, such cases of closure of an account at the instance of the banker are quite rare, since the cost of securing and opening a new account is much higher than the cost of closing an account. If a customer directs the banker in writing to close his account, the banker is bound to comply with such direction. The latter need not ask the reasons for the former’s direction. The account must be closed with immediate effect and the customer be required to return the unused cheques.

- **If the bank desires to close the account:** If an account remains un-operated for a very long period, the banker may request the customer to withdraw the money. Such step is taken on the presumption that the customer no longer needs the account. If the customer could not be traced after reasonable effort, the banker usually transfers the balance to an ‘Unclaimed Deposit Account’, and the account is closed. The balance is paid to the customers as and when he is traced.

The banker is also competent to terminate his relationship with the customer, if he finds that the latter is no more a desirable customer. The banker takes this extreme step in circumstances when the customer is guilty of conducting his account in an unsatisfactory manner, i.e., if the customer is convicted for forging cheques or bills or if he issues cheques without sufficient funds or does not fulfil his commitment to pay back the loans or overdrafts, etc.

The banker should take the following steps for closing such an account:

- **The banker should give to the customer due notice of his intention to close the account and request him to withdraw the balance standing to his credit.** This notice should give sufficient time to the customer to make alternative arrangements. The banker should not, on his own, close the account without such notice or transfers the same to any other branch.

- **If the customer does not close the account on receipt of the aforesaid notice,** the banker should give another notice intimating the exact date by which the account be closed otherwise the banker himself will close the account. During this notice period, the banker can safely refuse to accept further credits from the customer and can also refuse to issue fresh cheque book to him. Such steps will not make him liable to the customer and will be in consonance with the intention of the notice to close account by a specified date.

The banker should, however, not refuse to honour the cheques issued by the customer, so long as his account has a credit balance that will suffice to pay the cheque. If the banker dishonours any cheque without sufficient reasons, he will be held liable to pay damages to his customer under Section 31 of the Negotiable Instruments Act, 1881. In case of default by the customer to close the account, the banker should close the account and send the money by draft to the customer. He will not be liable for dishonouring cheques presented for payment subsequently.

- **Termination by Law:** The relationship of a banker-customer can also be terminated by the process of law and by the occurrence of the following events:
  - **Death of customer:** On receiving notice or information of the death of a customer, the bank stops all debit transactions in the account. However, credits to the account can be permitted. The balance in the account is given to the legal representative of the deceased after obtaining the letters of administration, or succession certificate, or indemnity bond as per the prescribed procedure, and only then, the account is closed.
Bankruptcy of customer: An individual customer may be declared bankrupt, or a company may be wound up under the provisions of law. In such an event, no drawings would be permitted in the account of the individual/company. The balance is given to the Receiver or Liquidator or the Official Assignee and the account is closed thereafter.

Garnishee order: After receiving a garnishee order from a court or attachment order from income tax authority, the account can be closed as one of the options after taking the required steps.

Insanity of the customer: A lunatic/person of unsound mind is not competent to contract under Section 11 of the Indian Contract Act, 1872. As banker-customer relationship is contractual, the bank will not honour cheques and can close the account after receiving notice about the insanity of the customer and receiving a confirmation about it through medical reports.

3.10 Insurance of Bank Deposits

An important feature of Indian banking is that deposits of the public with the banks are insured up to the limit of Rs.1 lakh in each account. After the failure of the Palai Central Bank, a scheduled bank of South India in 1960, the Government and the Reserve Bank felt the necessity of insuring the deposits in the banks so that public confidence in the banking institutions was not shaken whenever any bank failed to operate or was merged with another bank. The Deposit Insurance Corporation of India was established by an Act of Parliament to insure the deposits in the banks and the scheme of deposit insurance was introduced with effect from January 1, 1962. The Corporation was renamed as Deposit Insurance and Credit Guarantee Corporation with effect from July 15, 1978.

3.10.1 Salient Features of Deposit Insurance

- The scheme of deposit insurance applies since its inception to all commercial banks in India, scheduled and non-scheduled. The deposits insurance cover has been extended to co-operative banks also in 21 States and 3 Union Territories. The Regional Rural Banks have also been included in this scheme. All these banks are called insured banks.

- The insurance cover is extended to all deposits with the insured banks except the deposits of the Central and State Governments, Foreign Governments and the commercial banks.

- The deposits with the insured banks are insured up to a special limit only. The insurance cover is available in respect of all unpaid balances due to a depositor held in a bank in the same capacity and in the same right up to Rs. 1 lakh. This means that every account of a depositor in every insured bank is insured to the extent of Rs. 1 lakh. The accounts with credit balance up to Rs. 1 lakh each are called fully protected accounts.

- The corporation reimburses the depositors in case the insured bank fails or is amalgamated with another bank and defaults in paying fully the balances due to the depositors in cash or by crediting the same to the full extent in the books of the transferee banks. The difference between the amount so paid or credited and the limit of insurance cover per account is paid by the corporation. For example, if bank X, on its merger with bank Y, gives a credit equal to 75% of the deposit, a depositor having a credit balance of Rs. 10,000/- will get credit of Rs. 7,500/-. The balance of Rs. 2,500/- will be reimbursed to him by the corporation.

- The rate of insurance premium is 5 paise per annum for every hundred rupees of assessable deposits. It is payable by the insured banks and not by the depositors at half-yearly intervals. Assessable deposits are those deposits to which the cover of insurance is extended under.

- The Corporation maintains the following two funds:
  - Deposit Insurance Fund: The income from insurance premia is credited to the Deposit Insurance Fund and is invested in the Central Government securities. Income from such investments is credited to and the insurance losses are debited to the Revenue Account of the Fund.
  - General Fund: The General Fund meets all other expenses of the Corporation.
### 3.11 Nomination

While opening accounts and accepting deposits, bankers need to ensure certain procedures and precautions. For example, KYC norms. Similarly, at the time of repayment of deposits banks should be careful and repay the amount as per banks’ policies and the guidelines of the RBI.

As per the Banking Regulation Act, 1949, a depositor of a bank (including cooperative banks) may nominate one person as nominee of the depositor/s. The nomination is to be made in a prescribed manner. In the event of the death of the depositor, the deposit may be returned to the nominee. The nominee is entitled to receive the deposit in case of the death of the depositor. A minor can also be nominated as nominee. However in case a minor is appointed as nominee, banks should request that a person be appointed to receive the deposit on behalf of the minor. Commercial banks are governed by the provisions of Banking Companies (Nomination) Rules 1985, and for Co-operative banks provisions of Co-operative Banks (Nomination) Rules 1985 are applicable. Banks get valid discharge, if they make payment to the nominee. Depositors should avail the facility of nomination and nominate a person.

Nomination facility is also available in case of articles kept in safe deposit lockers and also in safe custody with banks. As per the provisions of the Banking Regulation Act, 1949, any person who keeps any article in safe deposit locker and/or in safe custody, may nominate one person as his nominee to receive the article in the event of the death of that person. The nomination is to be made in a prescribed manner. In the event of the death of the bank’s customer, the nominee is entitled to receive the articles kept in safe custody or remove the contents of locker and the bank gets a valid discharge.

#### 3.11.1 Settlement of Claims

A banker should be careful while making payment of deposit amount, when he receives a claim. When a depositor dies, a claim would be received by the banker either from the nominee or legal heirs of the depositor.

#### 3.11.2 Settlement of Claims from a Nominee

Banks obtain nominations from the depositors in a prescribed manner and should register the nomination in their records. A proper acknowledgment is to be given to the depositor. Once the banker gets a claim from the nominee of the depositor, the banker should verify and satisfy himself the following:

- Whether the claim is received from the person whose name is recorded as nominee in bank’s records.
- The deposit amount may be paid to the nominee after proper verification of the necessary documents like claim form, the death certificate of the depositor and the proper identity of the nominee.
- The banker should get an acknowledgement from the nominee.

The nominee should acknowledge the receipt of the amount of the deposit, including interest if any, duly signed by the nominee on a revenue stamp. The acknowledgement should clearly state that the nominee has received the deposit amount, as nominee of the depositor. Obtaining the acknowledgement and stamped receipt (as mentioned above) serves as a valid discharge of the bank.

As regards safe deposit lockers and custody accounts, the claims can be settled by the bank after proper verification of bank’s records and other relevant documents like claim forms, death certificate of the bank’s customer and identity of the nominee. In case no nomination is available, then banks should follow their legal department’s advice and bank’s policy and procedures, to settle the claims. Important documents to be obtained are claim forms, death certificate of the depositor, succession certificate if applicable, proper identification of legal heirs, proper acknowledgment of repayment of deposits from the legal heirs.

#### 3.11.3 Payment of Balance without Succession Certificate

Banks open and deal with various accounts of different types of customers like individuals, minors, non-resident Indians, partnership firms, companies, co-operative societies, associations, institutions, government departments, etc. While opening and maintaining the accounts of these categories of customers, the banks should follow the regulator’s guidelines and the applicable legal framework.
Summary

• The relationship between a banker and his customer depends upon the nature of service provided by a banker.
• On the opening of an account the banker assumes the position of a debtor.
• A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. For example, he buys or sells securities on behalf of his customer, collects cheques on his behalf and makes payment of various dues of his customers, e.g., insurance premium, etc.
• A banker has the statutory obligation to honour his customer’s cheques unless there is valid reason for refusing payment of the same.
• Though the Pass Book contains true and authenticated record of the customer’s account with the banker, no unanimous view prevails regarding the validity of the entries in the Pass Book.
• Banks obtain nominations from the depositors in a prescribed manner and should register the nomination in their records. A proper acknowledgment is to be given to the depositor.
• An important feature of Indian banking is that deposits of the public with the banks are insured up to the limit of 1 lakh in each account.
• The banker is also competent to terminate his relationship with the customer, if he finds that the latter is no more a desirable customer.
• Specimen signature of the customer is obtained on the account opening form in the presence of the bank staff and it is attested by an authorised bank officer on the form itself.
• One of the main objectives of KYC procedure is to prevent misuse of the banking system for money laundering and financing of terrorist activities.
• Banker-customer relationship is a contractual relationship between two parties and it may be terminated by either party on voluntary basis or involuntarily by the process of law.
• The Karta and other coparceners may possess self-acquired properties other than the HUF property, but these cannot be clubbed together for the HUF dues.

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Recommended Reading

1. The relationship between a banker and his customer depends upon the _______ of service provided by a banker.
   a. number
   b. nature
   c. amount
   d. total

2. The term ‘_______’ of a bank is not defined by law.
   a. customer
   b. agent
   c. bank
   d. banking

3. Match the following

<table>
<thead>
<tr>
<th>1. A company</th>
<th>A. It can be opened like an individual account.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Local Authorities</td>
<td>B. It is a legal entity, distinct from its shareholders or managers, as it can sue and be sued in its own name.</td>
</tr>
<tr>
<td>4. Account of a proprietary club</td>
<td>D. It is quite distinct from partnership business which is governed by Indian Partnership Act, 1932.</td>
</tr>
</tbody>
</table>

   a. 1-B, 2- C, 3- D, 4-A
   b. 1- A, 2- B, 3- C, 4-D
   c. 1- C, 2- D, 3- A, 4-B
   d. 1- D, 2- A, 3- B, 4-C

4. Which of the following section of the Banking Regulation Act, 1949, clarifies that section “customer” includes a Government department and a corporation incorporated by or under any law?
   a. Section 7-A
   b. Section 4
   c. Section 45-Z
   d. Section 2-C

5. Which of the means the right of the creditor to retain the goods and securities owned by the debtor until the debt due from him is repaid?
   a. KYC
   b. Lien
   c. Pledge
   d. Contract
6. In case of minor, a banker would open a joint account with the ________ guardian.
   a. natural
   b. unnatural
   c. two
   d. one

7. Which of the following statement is true?
   a. A joint account is an account by only two persons.
   b. A joint account is an account by two or more persons.
   c. A joint account is an account by only one person.
   d. A joint account is an account by only husband and wife.

8. HUF business is quite distinct from partnership business, it is governed by which of the following?
   a. Indian Individual Act, 1947
   b. Indian Partnership Act, 1947
   c. Indian Individual Act, 1937
   d. Indian Partnership Act, 1932

   a. Section 11
   b. Section 15
   c. Section 72
   d. Section 37

10. Which of the following statement is false?
    a. The nomination is to be made in a prescribed manner.
    b. The nominee is entitled to receive the deposit in case of the death of the depositor.
    c. A minor cannot be nominated as nominee.
    d. Banks get valid discharge if they make payment to the nominee.
Chapter IV
Legal Aspects of Banking Operations

Aim

The aim of this chapter is to:

• describe cheques
• explain the crossing of cheques
• explicate endorsement

Objectives

The objectives of this chapter are to:

• elucidate the collection of cheques
• enlist the duties of the collecting banks
• explain indemnities and guarantees

Learning outcome

At the end of this chapter, you will be able to:

• identify banking hours/working hours/operation
• understand the concept of banker as a holder for value
• describe remittance
4.1 Introduction

A cheque is defined in Sec 6 of NI Act as under:

- A cheque is a bill of exchange drawn on a specified banker
- Payable on demand
- Drawn on a specified banker
- Electronic image of a truncated cheque is recognised under law

The Information Technology Act, 2002 recognises the following:

- Digital signatures
- Electronic transfers

A cheque is nothing, but a bill of exchange with special features. It is always payable on demand (A bill of exchange can be payable on demand/at sight and/or after a specific term called as usance bill) always drawn on a specified banker, i.e., the drawee of a cheque is the banker on whom the cheque is drawn. The banker with whom the customer holds his/her account. This drawee bank is called the paying bank.

![Cheque Diagram]

Fig. 4.1 Parties to a cheque
(Source: http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

Apart from the above three parties, others involved in payment and collection of cheques are as follows:

- Endorser: The person who transfers his right to another person.
- Endorsee: The person to whom the right is transferred.

4.1.2 Different Types of Cheques

Cheques can be classified as follows:

- Open cheque: A cheque is classified as ‘Open’ when cash payment is allowed across the counter of the bank.
- Bearer cheque: A cheque which is payable to any person who holds and presents it for payment at the bank counter is called a ‘bearer cheque’. A bearer cheque can be transferred by mere delivery without any endorsement.
- Order cheque: An order cheque is a cheque which is payable to a particular person. In case of order cheque, the word ‘bearer’ might have been cancelled and the word ‘order’ is written. The payee can transfer an order cheque by endorsement to another person by signing his name on the back of the cheque.
4.2 Crossing of a Cheque

Crossing is an ‘instruction’ given to the paying banker to pay the amount of the cheque through a banker only and not directly to the person presenting it at the counter. A cheque bearing such an instruction is called a ‘crossed cheque’; others without such crossing are ‘open cheques’ which may be encashed at the counter of the paying banker as well. The crossing on a cheque is intended to ensure that its payment is made to the right payee. Sections 123 to 131 of the Negotiable Instruments Act contain provisions relating to crossing. According to Section 131-A, these Sections are also applicable in case of drafts. Thus, not only cheques but bank drafts also may be crossed.

4.2.1 Cheque Crossed Generally

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.

4.2.2 Cheque Crossed Specially

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

4.2.3 Payment of Cheque Crossed Generally or Specially

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

4.2.4 Cheque Bearing ‘Not Negotiable’

A person taking a cheque crossed generally or specially, bearing in either case the words ‘not negotiable’, shall not have, and shall not be capable of giving, a better title to the cheque than that which the person from whom he took it had (Section 130). Thus, mere writing words ‘Not negotiable’ does not mean that the cheque is not transferable. It is still transferable, but the transferee cannot get title better than what transferor had. N.I. Act does not recognise ‘Account Payee’ crossing, but this is prevalent as per practice of banks in India. In view of this, RBI has directed banks the following:

- Crediting the proceeds of account payee cheques to parties other than that clearly delineated in the instructions of the issuers of the cheques is unauthorised and should not be done in any circumstances.
- If any bank credits the account of a constituent who is not the payee named in the cheque without proper mandate of the drawer, it would do so at its own risk and would be responsible for the unauthorised payment. Reserve Bank has also warned that banks which indulge in any deviation from the above instructions would invite severe penal action.
- In case of an ‘account payee’ cheque where a bank is a payee, the payee bank should always ensure that there are clear instructions for disposal of proceeds of the cheques from the drawer of the cheque. If there are no such instructions, the cheque should be returned to the drawer.
- However, with a view to mitigating the difficulties faced by the members of co-operative credit societies in collection of account payee cheques, relaxation has been extended in respect of co-operative credit societies. Banks may consider collecting account payee cheques drawn for an amount not exceeding Rs. 50,000/- to the account of their customers who are co-operative credit societies, if the payees of such cheques are the constituents of such co-operative credit societies.

4.2.5 Double Crossing

A cheque bearing a special crossing is to be collected through the banker specified therein. It cannot, therefore, be crossed specially again to another banker, i.e., cheque cannot have two special crossings, as the very purpose of the first special crossing is frustrated by the second one. However, there is one exception to this rule for a specific purpose. If a banker, to whom the cheque is originally specially crossed submits it to another banker for collection as its agent, in such a case the latter crossing must specify that it is acting as agent for the first banker to whom the cheque is specially crossed.
4.3 Endorsement

“When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called endorser.”

Thus, an endorsement consists of the signature of the maker (or drawer) of a negotiable instrument or any holder thereof, but it is essential that the intention of signing the instrument must be negotiation; otherwise it will not constitute an endorsement. The person who signs the instrument for the purpose of negotiation is called the ‘endorser’ and the person in whose favour instrument is transferred is called the ‘endorsee’. The endorser may sign either on the face or on the back of the negotiable instrument but according to the common usage; endorsements are usually made on the back of the instrument. If the space on the back is insufficient for this purpose, a piece of paper, known as ‘allonge’ may be attached thereto for the purpose of recording the endorsements.

4.3.1 Legal Provisions Regarding Endorsements

The following provisions are contained in the Act as regards endorsements:

- **Effect of endorsements.** The endorsement of a negotiable instrument followed by delivery transfers the endorsed property therein with the right of further negotiation (Section 50). Thus the endorsee acquires property or interest in the instrument as its holder. He can also negotiate it further. (His right can, of course, be restricted by the endorser in case of a restrictive endorsement.) Section 50 also permits that an instrument may also be endorsed in the following manners so as to constitute the endorsee an agent of the endorser:
  - To endorse the instrument further.
  - To receive its amount for the endorser or for some other specified person.

The examples of such endorsements are as follows:

- Pay C for my use.
- Pay C or order for the account

Where a negotiable instrument is endorsed for any of the above purposes, the endorser becomes its holder and property therein is passed on the endorsee. In Kunju Pillai and Others vs. Periasami (1969 II. M.I.J. 148), the High Court held that a holder of a negotiable instrument, who secures the same by endorsement, does not lose the right of his action by reason of the death of the original payee. In Mothireddy vs. Pothireddy (A.I.R. 1963, A.P. 313) the Andhra Pradesh High Court also held that “the right based on the endorsement having made for a specific purpose, namely, collection of the amount, will be valid till that purpose is served.” The ordinary law regarding agency does not, therefore, apply in such cases.

- **Endorser:** “Every sole maker, drawer, payee or endorsee or all of several joint makers, payees or endorsers of a negotiable instrument may endorse and negotiate the same.” This is subject to the condition that the right to negotiate has not been restricted or excluded (Section 51). Thus in case the instrument is held jointly by a number of persons, endorsements by all of them is essential. One cannot represent the other. The absence of the words ‘or order’ in the instrument or endorsement thereon does not restrict further negotiation. For example, a bill is drawn payable to A or order. A endorses it to B, but the endorsement does not contain the words ‘or order’ or any equivalent words. B may further negotiate the instrument.

It is, however, essential that the maker or drawer or drawer of an instrument must have lawful possession over it, i.e., he must be its holder in order to enable him to endorse o negotiate it. A payee or an endorsee of the instrument must be its holder for the same purpose.

- **Time:** A negotiable instrument may be negotiated until its payment has been made by the banker, drawee or acceptor at or after maturity, but not thereafter (Section 60).

- **Endorsement for a part of the amount:** The instrument must be endorsed for its entire amount. Section 56 provides that “no writing on a negotiable instrument is valid for the purpose of negotiable if such writing purports to transfer only a part of the amount appearing to be due on the instrument.” Thus an endorsement for a part of the amount of the instrument is invalid. However, in case an instrument has been partly paid, it may...
be negotiated for the balance of the amount provided a note to that effect is given on the instrument (Section 56). If the endorser intends to transfer the document to two or more endorsees separately, it will not constitute a valid endorsement.

- The legal representative of a deceased person cannot negotiate by delivery only, a promissory note, bill of exchange or cheque payable to order and endorsed by the deceased but not delivered (Section 57). If the endorser dies after endorsing the instrument payable to order but without delivering the same to the endorsee, such endorsement shall not be valid and his legal representative cannot complete its negotiation by mere delivery thereof.

- Unless contrary is proved, it is presumed under Section 118 that “the endorsements appearing upon a negotiation instrument were made in the order in which they appear thereon.” It means that the endorsement which appears on an instrument first is presumed to have been made earlier to the second one.

### 4.3.2 General Rules Regarding the Form of Endorsements

An endorsement must be regular and valid in order to be effective. The appropriateness or otherwise of a particular form of endorsement depends upon the practice amongst the bankers. The following rules are usually followed in this regard:

- **Signature of the endorser:** The signature on the document for the purpose of endorsement must be that of the endorser or any other person who is duly authorised to endorse on his behalf. If a cheque is payable to two persons, both of them should sign their names in their own handwriting. If the endorser signs in block letters, it will not be considered a regular endorsement.

- **Spelling:** The endorser should spell his name in the same way as his name appears on the cheque or bill as its payee or endorsee. If his name is miss-spelt or his designation has been given incorrectly, he should sign the instrument in the same manner as given in the instrument. Thereafter, he may also put his proper signature in the same handwriting, if he likes to do so.

- **No addition or omission of initial of the name:** An initial name should neither be added nor omitted from the name of the payee or endorsee as given in the cheque. For example, a cheque is payable to S.C. Gupta should not be endorsed as S. Gupta or vice versa. Similarly, a cheque payable to Harish Saxena should not be endorsed as H. Saxena because it will be doubtful for the paying banker to ascertain that H. Saxena is Harish Saxena and nobody else. It is possible that some Hari Saxena has signed on the cheque as H. Saxena.

- **Prefixes and suffixes to be excluded:** The prefixes and suffixes to the names of the payee or endorsee need not be included in the endorsement. For example, the words ‘Mr., Messrs, Mrs., Miss, Shri, Shrimati, Lala, Babu, General, Dr., Major, etc.,’ need not be given by the endorser otherwise the endorsement will not be regular. However, an endorser may indicate has title or rank, etc., after his signature. For example, a cheque payable to Major Raja Ram or Dr. Laxmi Chandra may be endorsed as ‘Raja Ram, Major’ or Laxmi Chandra, M.D.’ A cheque payable to Padmashri Vishnu Kant may be endorsed as Vishnu Kant, Padmashri.

### 4.4 Legal Aspects of Collection of a Cheque

Collection of cheques, bills of exchange and other instruments on behalf of a customer is an indispensable service rendered by a banker to his customer. When a customer of a banker receives a cheque drawn on any other banker he has two options before him either to receive its payment personally or through his agent at the drawee bank, or to send it to his banker for the purpose of collection from the drawee bank. In the latter case, the banker, deputed to collect the amount of the cheque from another banker, is called the ‘collecting banker’. He presents the cheque for encashment to the drawee banker and on its realisation credits the account of the customer with the amount so realised.

A banker is under no legal obligation to collect his customer’s cheques, but collection of cheques has now become an important function of a banker with the growth of banking habit and with wider use of crossed cheques, which are invariably to be collected through a banker only. While collecting his customer’s cheques, a banker may act as either of the following:

- **As a holder for value**
- **As an agent of the customer**
The legal position of the collecting banker, therefore, depends upon the capacity in which he collects the cheques. If the collecting banker pays to the customer the amount of the cheque or credits such amount to his account and allows him to draw on it, before the amount of the cheque is actually realised from the drawee banker, the collecting banker is deemed to be its ‘holder for value’. He takes an undertaking from the customer to the effect that the latter will reimburse the former in case of dishonour of the cheque.

4.4.1 Banker as a Holder for Value
A banker becomes its holder for value by giving its value to the customer in any of the following ways:
- By lending further on the strength of the cheque.
- By paying over the amount of the cheque or part of it in cash or in account before it is cleared.
- By agreeing either then or earlier, or as a course of business, that customer may draw before the cheque is cleared.
- By accepting the cheque in avowed reduction of an existing overdraft.
- By giving cash over the counter for the cheque at the time it is paid in for collection.

In any of these circumstances, the banker becomes the holder for value and also the holder in due course. He bears the liability and possesses the rights enjoyed by the holder for value. If the last but one endorsement is proved to be forged, he will be liable to the true owner of the cheque. However, he shall have the right to recover the money from the last endorser, i.e., his own customer, if the customer is unable to pay, the banker himself will bear the loss. If the cheque sent for collections returned dishonoured, the collecting banker can sue all the previous parties after giving them the notice of dishonour. It is, however, essential that the amount of the cheque is paid to the customer in good faith.

4.4.2 Collecting Banker as an Agent
A collecting banker acts as an agent of the customer, if he credits the latter’s account with the amount of the cheque after the amount is actually realised from the drawee banker. Thereafter, the customer is entitled to draw the amount of the cheque. The banker thus acts as an agent of the customer and charges from him a commission for collecting the amount from outstation banks. As an agent of his customer, the collecting banker does not possess the title to the cheque better than that of the customer. If the customer has no title thereto, or his title is defective, the collecting banker cannot have good title to the cheque. In case the cheque collected by him did not belong to his customer, he will be held liable for conversion of money, i.e., illegally interfering with the rights of true owner of the cheque.

4.4.3 Conversion by the Collecting Banker
Sometimes a banker is charged for having wrongfully converted cheques to which his customer had no title or had defective title. Conversion means wrongful or unlawful interference (i.e., using, selling, occupying or holding) with another person’s property which is not consistent with the owner’s right of possession. Negotiable instruments are included in the term ‘property’ and hence a banker may be charged for conversion if he collects cheques for a customer who has no title or defective title to the instrument.

The basic principle is that the rightful owner of the goods can recover the same from anyone who takes it without his authority and in whose hands it can be traced. When the banker acts as an agent of his customer for the collection of his cheques, he cannot escape this liability. However, the right of the true owner is a restricted one and cannot be exercised in case the goods reach the hands of one of the following people:
- Receives it in good faith
- For value
- Without the knowledge that the other party had no authority thereon

Except in these circumstances, the true owner of the goods (including the negotiable instrument) can file a suit for conversion.
4.4.4 Statutory Protection to Collecting Bank

Section 131 of the Negotiable Instruments Act grants protection to a collecting banker and reads as follows:

- Non-liability of a banker receiving payment of cheque: A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment.

- Explanation: A banker receives payment of a crossed cheque for a customer within the meaning of this section notwithstanding that he credits his customer’s account with the amount of the cheque before receiving payment thereof.

- The provisions of the above section have been applied to drafts as per Section 131 A of the Negotiable Instruments Act.

- Conditions for protection: Though Section 131 grants protection to a collecting banker, the protection is not unconditional. For the collecting banker to claim the protection under Section 131, he has to comply with certain conditions and they are:
  - The collecting banker should have acted in good faith.
  - He should have acted without negligence.
  - He should receive payment for a customer.
  - The cheque should be crossed generally or specially to himself.

4.5 Duties of the Collecting Bank

Section 131 of the Negotiable Instruments Act which affords protection to the collecting bank requires amongst other conditions, that the bank should not have been negligent. To show that the bank has not been negligent, the bank will have to prove that it has taken all precautions that would be required of a prudent banker in collecting a cheque. Over the years based on practice and judicial pronouncements, these precautions have been laid down as duties imposed on bankers, the non-compliance of which can make the bank liable on the grounds of negligence. We shall now individually examine these duties.

4.5.1 Duty to Open the Account with References and Sufficient Documentary Proof

The duty to open an account only after the new account holder has been properly introduced to be too well grained into today’s banker’s mind that it would be impossible to find an account without introduction. The necessity to obtain introduction of a good customer is to keep off crooks and fraudsters who may open accounts to collect forged cheques or other instruments. As an added precaution, RBI has insisted that while opening accounts photograph of the customer and sufficient documentary proofs for constitution and address be obtained.

In this regard the English Decision Ladbroke vs. Todd (1914) 30 TLR 433 can be referred to. In this case, a thief stole a cheque in transit and collected the same through a banker where he had opened an account without reference and by posing himself as the payee whose signature the thief forged. After the cheque was collected the thief withdrew the amount. The bank was held liable to make good the amount, since it acted negligently while opening the account in as much as it had not obtained any reference.

In Syndicate Bank vs. Jaishree Industries and Others AIR 1994 Karnataka 315, the Appellant opened an account in the name of “M/s Axle Conductor Industries Ltd. by the Proprietor, R.K. Vyas”. The introduction was given by one Nanjunde Gowda, who was having a small shop at the address given by the account holder. The address of the account holder, given by the account holder, was just opposite the Appellant Bank. In the account opening form, the name of the account holder was given as “M/ Axle Conductor Industries by the Proprietor R.K. Vyas”. No information was sought or inquiry neither held as to the incorporation of the account holder nor was the Memorandum of Association, Resolution, etc., scrutinised. On 3 January 1979, partners of Firm ‘A’ purchased a draft for Rs. 2, 51,125/- from State Bank of India, Ahmednagar, in favour of M/s Axle Conductor Industries Ltd. The draft was deposited in the account with the Appellant on 5 October 1979 and the amount was collected by the Appellant and credited to the account on 9 October 1979. On 10 October 1979, the monies were withdrawn from the account. The partners of ‘A’ filed a suit against the Appellant and State Bank of India for recovery of Rs. 2,51,125/- wrongly collected by Appellant and paid by State Bank of India.
The High Court held that there was failure to follow the proper procedure for opening account in the name of a limited company, that the account was opened as if it was a proprietary concern, the staff of the Appellant Bank did not bestow sufficient care even to notice the word “Ltd.” on several occasions, such as, at the time of opening of the account or withdrawal of amounts from the account. The High Court felt that having accepted the application as if it was an application by a proprietary concern, strangely the Appellant Bank allowed the account to operate in the name of the limited concern. There was, therefore, lack of care on the part of the Appellant Bank in the entire transaction.

The conditions to be satisfied for claiming protection under Section 131 of the Negotiable Instruments Act are:

- That the banker should act in good faith and without negligence in receiving payment, i.e., in the process of collection.
- That the banker should receive payment for a customer, i.e., act as mere agent in the collection of the cheque, and not on his account as holder.
- That the person for whom the banker acts must be his customer.
- That the cheque should be one crossed generally or specially to himself.

The High Court stated that if the draft was drawn in favour of a fictitious person, it could not be said that the ownership stood transferred to a non-existent person for the purpose of examining the question, whether the bank as a collecting banker acted negligently or not. The ownership would pass to the true owner. The High Court did not consider it necessary to decide as to what extent a person obtaining a draft in favour of a fictitious person would lose the ownership in favour of a bona fide ‘holder in due course’.

In view of the aforesaid, the Appellant Bank was held to have acted without taking any care, and was found negligent throughout and was not entitled to the protection under Section 131 of the Negotiable Instruments Act. In Indian Bank vs. Catholic Syrian Bank AIR 1981 Mad 129, the Madras High Court had occasion to consider negligence of collecting banker.

Briefly the facts were that one D had opened an account with Salem branch of bank A. A customer of that branch had taken D to the said branch and had informed the manager that D was a man from Indore and that he wanted to open a bank account to enable him to purchase carpets from Salem. Although bank A had claimed that the customer, who had introduced D, was a well-known customer of bank A and was a leading merchant of Salem and had a large volume of business, it was found in the evidence recorded by the Court, that these claims were not true. The introducer had an account and also had some fixed deposits with bank A. The transactions were for paltry amount and the amount standing to the credit of the introducer at the relevant time was only Rs. 192.57/-.

On 12 June 1969, M obtained a demand draft for Rs. 20/- from the branch at Singanallur of the bank B. The draft was drawn on the branch office of bank B in favour of D and company. By means of clever forgery, the draft was altered for Rs. 29,000/- drawn in favour of D. The draft was presented by D on 13 June 1969 for credit to his account opened with Salem branch of bank A and the amount was collected by bank A from bank B and credited to the account of D.

On 14 June 1969, the Salem branch of bank B came to know from its Singanallur branch that the draft was issued for Rs.20/- and was drawn in favour of D and company, payable at Cochin and that no draft for a sum of Rs.29,000/- had been issued. At once the Salem branch of bank A was contacted and was informed of the fraud, but unfortunately by then, bank A had already paid a large part of the draft amount to D under a self cheque. Bank B (Paying banker) filed the suit against bank A (collecting banker) for recovery of Rs. 29,000/- on the ground that the collecting banker had been negligent while opening an account in the name of D and by reasons of its negligence and want of good faith, the forged draft got to be wrongly converted.

The High Court observed that the collecting banker had opened the account, in the name of D on a mere introduction of one of its account holders, knowing that the said account holder was not a well-known leading merchant and had no large business with it at the relevant time. Further, the collecting banker had not independently questioned D about his business and his creditworthiness before allowing him to open an account. When D stated that he had come
from Indore, the Manager of the collecting banker did not even care to find out his permanent address, more so when in the application for opening account filed by D, the address given was of that of the introducer. Moreover, when D told the Manager of collecting banker that he had not till then opened any account although he had come from Indore to Salem to do business, the collecting banker, before opening the account, should have been more alert.

**4.5.2 Duty to Confirm the Reference where the Referee is not known or has given Reference in Absentia**

Though as a matter of practice, bankers in India require introduction by an existing customer of the bank, this may not always be possible especially when the branch is newly opened. In such cases, the customers are required to get references from known persons in the locality or from the existing bankers. In such cases, the banker is required to make enquiries with the referee to confirm that the person whose account is newly opened is a genuine person.

In Harding vs. London Joint Stock Bank [1914] 3 Legal Decision Affecting Bankers 81, an account was opened for a new customer after complying with the necessary formalities. The account was not opened by deposit of cash as is the usual practice, but was by paying in a third party cheque. The bankers in the case made enquiries with the customer who thereupon produced a forged letter issued by his employer giving him power to deal with the cheque. It was thereafter found that the cheque was stolen by the customer and credited to his account. The bank was held negligent for failure to make necessary enquiries from the employer as to whether the customer who was an employee had in fact the necessary power to deal with the cheque.

**4.5.3 Duty to Ensure Crossing and Special Crossing**

It is the duty of the banker to ensure that the cheque is crossed specifically to himself and if the cheque is crossed to some other banker they should refuse to collect it. Similarly, where the cheque is crossed to a specific account then crediting the same to another account without necessary enquiries would make him liable on the grounds of negligence. In case of ‘non-negotiable’ crossing a banker cannot be held negligent merely because of collection of such instruments. In the case of Crumpling vs. London Joint Stock Bank Ltd. [1911–13] All England Rep 647, it was held that a non-negotiable crossing is only one of the factors amongst others to be considered to decide about the banker’s negligence and that the mere taking of a non-negotiable cheque cannot be held to be evidence of negligence on the part of the bankers.

**4.5.4 Duty to Verify the Instruments or Any Apparent Defect in the Instruments**

Sometimes the instrument which is presented for collection would convey to the banker a warning that a customer who has presented the instrument for collection is either committing a breach of trust or is misappropriating the money belonging to some other. In case the banker does not heed the warning which is required of a prudent banker then he could be held liable on the grounds of negligence as can be seen from the following cases:

- In Underwood Ltd. vs. Bank of Liverpool Martin Ltd. [1924] 1 KB 775, the Managing Director of a company paid into his private account large number of cheques which were to be paid into the company’s account and the bank was held negligent since it did not make enquiries as to whether the Managing Director was in fact entitled to the amounts represented by these cheques.

- In Savory Company vs. Llyods Bank [1932] 2 KB 122, the cheques which were payable to the employer was collected by the employee in a private account opened by him and the bank was held liable for negligence. In this case, two dishonest clerks of a Stock Broker stole bearer cheques belonging to their employer which were collected in an account maintained by one of the clerks and in another account in his wife’s name. It was held that the bank had been negligent in opening the clerks account inasmuch as they had not obtained his employer’s name while opening the account and that in the case of his wife’s account the bank was negligent in as much as it had not obtained the husband’s occupation and his employer’s name while opening the account.

- In the case of Australia and New Zealand Bank vs. Ateliers de Constructions Electriques de Cherleroi [1967] 1 AC 86 PC, an agent paid his principal’s cheque into his personal account and the bank was charged with conversion. However, the bank defended the same on the grounds that there was implied authority from the principal to his agent to use his private account for such purpose. Though the banker was negligent in dealing with the cheques without specific authority, the bank escaped the liability since it was found that the principal had in fact authorised his agent to use his private account.
In Morrison vs. London County and Westminster Bank Ltd. [1914-5] All ER Rep 853, the Manager of the plaintiff was permitted to draw cheques per pro his employer and he drew some cheques payable to himself which he collected into his private account. The bank was held negligent for collecting such cheques without making necessary enquiries, even though there was a clear indication that the Manager was signing as an agent of the firm.

4.5.5 Duty to Take into Account the State of Customer’s Account

The collecting banker is required to take into account the status of the customer and also the various transactions that have taken place in the customer’s account, so as to know the circumstances and the standard of living of the customer. If for example, a person is an employee and the nature of his employment is that of a clerk, his salary would be known to the bank and any substantial credits by way of collection of cheques would be suspected and it would be the duty of the banker to take necessary precautions while collecting such cheques.

In Nu-Stilo Footwear Ltd. vs. Lloyds Bank Ltd. [1956] 7 Legal Decisions Affecting Bankers P. 121, the plaintiffs who were manufacturer of ladies footwear were defrauded by their Secretary and Works Accountant who converted 9 cheques payable to the plaintiffs into his account. The Secretary opened the accounts in the defendant bank in a false name and as reference gave his real name. The bank thereupon called the reference and got a satisfactory reply which included the fact that the account holder had recently come down from Oxford and intended setting up a business of his own. The Secretary thereupon presented 9 cheques totally aggregating to £4855. Since these cheques were drawn on the plaintiffs, they sued the defendant bank who had collected the cheques. The Court held that the collecting bank was negligent in as much as the collecting bank did not take necessary precautions because the amounts collected were inconsistent with the business of the account holder and therefore necessary enquires should have been made by the bank.

4.5.6 Negligence of Collecting Bank in Collecting Cheques Payable to Third Parties

The collecting bank has to make necessary enquiries before any third party cheques are collected on behalf of its customer. In Ross vs. London County Westminster and Parrs Bank Ltd. [1919] 1 KB 678, cheques payable to ‘the Officer in charge, Estate Office, Canadian Overseas Military Force’ were used by an individual to pay off his debts. There was an instruction in all the cheques that it was negotiable by the concerned officer. However, it was held that the fact that the cheques were drawn in favour of the officer in charge should have put the banker on enquiry and since no such enquiry was made by the banker the bank is liable on the grounds of negligence.

4.6 Indemnities

In day-to-day banking operations, a banker comes across instances, where he has to protect his interest in case of certain transactions. A customer may request a banker to issue a duplicate draft or fixed deposit receipt. In such cases, to protect against any possible loss, the banker should issue the duplicate draft and/or fixed deposit receipt against an indemnity.

Section 124 of the Indian Contract Act, 1872 defines indemnity as, “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’.” Indemnity is applicable where there is a loss. The contract of insurance is based on the principles of indemnity. The life insurance companies agree to cover the loss of life, whereas the general insurance companies wish to cover the loss to the property or asset, covered under respective insurance policies. The two parties involved in the contract of indemnity are:

- ‘Indemnifier’, the person who gives the undertaking or promise.
- The ‘indemnified’ to which such a promise is given.

While issuing a duplicate fixed deposit receipt, the bank obtains an indemnity (usually in their standard form) and the indemnifier (customer) need to give all details regarding the original receipt. The indemnity will have clauses to protect the bank’s interest. The indemnifier will undertake not to use the original and surrender the same to the bank, in case he is able to locate the original. He further undertakes to cover the loss, if any that will be incurred by the bank on account of issuing such duplicate fixed deposit receipt.
4.7 Guarantees

Banks grant loans and advances (fund based) and provide other credit facilities (non-fund based) such as, bank guarantee and letters of credit. Non-fund based limits are granted by banks to facilitate the customers to carry on with the trading and business activities more comfortably. Bankers can earn front end fees and these non-fund based items become contingent liabilities for banks.

A contract of guarantee is covered under the Indian Contract Act, 1872. Sec 126 defines a guarantee as contract to perform the promise or discharge a liability of a third person in case of his default. The contract of guarantee may be oral or in writing. Banks, however insist on written guarantees. There are 3 parties to the contract of guarantee. They are called Surety, Principal Debtor and the Creditor. These parties are also called as the guarantor, borrower and the beneficiary. Banks deal with the following two types of guarantees:

- Guarantees accepted by the bank: At the time of lending money, banks accept securities. In addition to the tangible assets a borrower arranges to furnish a personal security given by surety (guarantor). This is called third party guarantee, who undertakes to pay the money to the bank inclusive of interest and other charges, if any, in case the principal borrower fails to repay or if the borrower commits default. Banks also obtain corporate guarantees issued by companies who execute corporate guarantee as authorised by the Board of Directors’ resolution. As per Sec 128 of the Contract Act, 1872, the surety’s liability is co-extensive with that of the principal debtor.

  For example, Bank MNC has sanctioned a term loan of Rs 10 lakhs to P on the personal guarantees of Q and S. In this case Bank MNC is the creditor. P is the borrower or the principal debtor. Both Q&S are the sureties or guarantors. In case P commits a default, in repaying the debt to the Bank MNC (as per the terms and conditions of bank’s sanction letter) then both Q&S (as sureties/guarantors) are liable to pay the dues to the bank.

- Guarantees issued by the bank: A Bank Guarantee is a commitment given by a banker to a third party, assuring her/him to honour the claim against the guarantee in the event of the non-performance by the bank’s customer. A Bank Guarantee is a legal contract which can be imposed by law. The banker as guarantor assures the third party (beneficiary) to pay him a certain sum of money on behalf of his customer, in case the customer fails to fulfil his commitment to the beneficiary.

4.8 Banking Hours/Working Hours/Operation

The following are the rules to be adhered to by banks regarding the banking hours/working hours/operation:

- Banks are required to function for public transactions at least for 4 hours on week days and 2 hours on Saturdays in the larger interest of public and trading community. Extension counters, satellite offices, one man offices or other special class of branches may remain open for such shorter hours as may be considered necessary.

- Banks may fix, after due notice to customers, whatever business hours are convenient, i.e., double shift, weekly holiday other than Sunday, or functioning Sundays also (7 days working), etc.

- The banks’ branches in rural areas can fix the business hours (i.e., number of hours, as well as timings) and the weekly holidays to suit local requirements subject to the guidelines.

- Commencement of employees’ working hours 15 minutes before commencement of business hours could be made operative by banks at branches in metropolitan and urban centres.

- Banks are required to extend business hours for banking transactions other than cash till one hour before close of working hours. Banks can have evening counters at the premises of existing branches in metropolitan/urban centres for providing facilities to the public beyond normal business hours to bring about improvement in customer service and the transactions should be merged with the main accounts of the branch where it is set up.

- All branches except very small branches should have ‘Enquiry’ or ‘May I help you’ counters either exclusively or combined with other duties located near the entry point of the banking hall. Time norms should also be displayed prominently in the banking hall.

- All branches are required to display the various products and services they provide along with various key aspects such as service charges, interest rates, time norms for various banking transactions and grievance redressed mechanism, etc., grouped in 4 heads, viz., ‘Customer Service Information’, ‘Service Charges’, ‘Grievance redressed’ and ‘Others’ as indicators in the Notice Boards as per the format provided by RBI. This would enhance the quality of customer service in banks and level of customer satisfaction.
Further, in addition to the above Board, the banks should also display details such as ‘Name of the bank / branch, Working Days, Working Hours and Weekly Off-days’ outside the branch premises.

Banks are further required to make available the detailed information in their website in such a manner that customers are able to easily access the same from the Home Page of the site, besides in booklet form in the touch screen by placing them in the information kiosks or Scroll Bars, or Tag Boards. Website should contain the minimum information such as Policy/Guidelines, Complaints, Opening of accounts/ forms, Loans and Advances, Branches, etc.

4.8.1 Sick/Old/Incapacitated Account Holders-Operational Procedure

The sick/old/incapacitated account holders-operational procedure is as follows:

- In case the old/sick/incapacitated account holder can put his thumb or toe impression, the same may be accepted for withdrawal of money. It should be identified by two independent witnesses known to the bank, one of whom should be a responsible bank official:

- Where the customer cannot put even his/her thumb impression and also not able to present in the bank, a mark can be obtained on the cheque/withdrawal form which should be identified by two independent witnesses, one of whom should be a responsible bank official.

- Person to whom the payment is to be made may be indicated by the customer in both the above cases and he should be identified by two independent witnesses. The person should be asked to furnish his signature to the bank.

- As per the opinion obtained by IBA, a toe impression or any mark by a customer who lost both the hands can be taken for acceptance.

- Banks are required to take necessary steps to provide all existing ATMs/future ATMs with ramps, so that wheelchair users/persons with disabilities can easily access them and also make arrangements in such a way that the height of the ATM does not create an impediment in its use by a wheelchair user.

- Banks are required to ensure that all the banking facilities such as cheque book facility including third party cheques, ATM facility, Net banking facility, locker facility, retail loans, credit cards, etc., are invariably offered to the visually challenged without any discrimination.

- Banks are required to make at least one third of new ATMs installed as talking ATMs with Braille keypads and place them strategically in consultation with other banks to ensure that at least one talking ATM with Braille keypad is generally available in each locality for catering to needs of visually impaired persons.

- In respect of disabled persons with autism, cerebral palsy, mental retardation and multiple disabilities Banks can rely upon the Guardianship Certificate issued either by the District Court under Mental Health Act or by the Local-level Committees under the above Act for the purposes of opening/operating bank accounts.

4.8.2 Remittance

The banks are required to adhere to the following rules during remittances:

- Remittance (DD/MT/TT, etc.) of Rs. 50000/- and above should be by debit to customer’s account or against cheques only. DDs of Rs. 20,000/- and above are to be issued with ‘Account Payee’ crossing only.

- A DD is uniformly valid for a period of three months and procedure for revalidation after three months should be simplified.

- Duplicate Draft in lieu of lost for amount up to and including Rs 5000/- can be issued against suitable indemnity without waiting drawing advice within a fortnight from the date of receipt of the request. Delay beyond the period, penal provision to be invoked.

- Banks may ensure that both drop box facility and the facility for acknowledgement of cheques are made available at collection centres (branches) and no branch should refuse to give acknowledgement of cheques, if tendered at the counters. Banks should display on the drop box itself that “Customers can also tender the cheques at the counter and obtain acknowledgement on the pay-in-slips.”

- Banks may place per transaction limits, based on their risk perception in respect of Mobile transactions with the approval of their respective Boards.
• Banks need not make payment of cheques/drafts/pay orders/banker’s cheques bearing that date or any subsequent date, if they are presented beyond the period of three months from the date of such instrument (w.e.f. 01.04.12)
• For loss of cheque in transit or in clearing process or at the paying bank’s branch, the banks are required to reimburse the account holder related expenses for obtaining duplicate instruments and also interest for reasonable delays occurred in obtaining the same. The onus rests with the collecting banker and not the account holder.

4.9 Complaints

The following rules have to be followed while making complaints:
• Banks are required to provide Complaints/suggestion box at each office besides maintaining Complaint Book/Register with perforated copies in each set. A copy of the complaint is also to be forwarded to Controlling Office along with remark of the Branch Manager within a time frame.
• Complaint form along with name of the nodal officer for complaint redressed is provided in the Homepage of Website to facilitate submission by customers. Complaints received are to be reviewed by Board for taking corrective steps wherever required. The details are to be disclosed in the financial results giving the number of complaints received, redressed, awards by Ombudsman, etc.
• Banks are also required to put in place a proper Grievance Redressed Mechanism and examine on an ongoing basis whether it is found effective in achieving improvement in customer service in different areas.

4.10 Erroneous Debits arising on Fraudulent or Other Transactions

The erroneous debits arising on fraudulent or other transactions should be treated as follows:
• While opening and allowing operation in deposit accounts, banks should remain vigilant to avoid lapses to safeguard against unscrupulous persons opening accounts mainly to use them as conduit for fraudulently encashing payment instruments, etc.
• In such cases, banks should compensate the customer upon completion of departmental action or police interrogation as part of their approved Customer Relation Policy.

4.11 Safe Deposit Locker/Safe Custody Article Facility

The following rules have to be followed while allotting safe deposit lockers and safe custody:
• Banks have to refrain from restrictive practices, such as linking the lockers facility with placement of fixed or any other deposit beyond what is specifically permitted. Banks may obtain Fixed Deposits to cover 3 years rent and charges of breaking open the locker to take care of an eventuality that the locker-hirer neither operates the locker nor pays rent.
• Bank branches are required to maintain a wait list for the purpose of allotment of lockers and ensure transparency in allotment of the lockers. A copy of the Agreement may be passed on to the locker-hirer at the time of allotment of the locker.
• Banks may carry out customer due diligence for both new and existing customers at least to the levels prescribed for customers classified as medium risk. If the customer is classified in a higher risk category, customer due diligence as per KYC norms applicable to such higher risk category should be carried out.
• Where the lockers have remained non-operated for more than three years for medium-risk category or one year for a higher risk category, banks should immediately contact the locker-hirer and advise him to either operate the locker or surrender it. This exercise should be carried out even if the locker hirer is paying the rent regularly.
• Nomination facility is available to locker hirer which would provide for nomination and release of contents of safety lockers/safe custody article to the nominee and protection against notice of claim of other persons (Sec. 45ZC to 45 ZF of B.R. Act 1949).
• Nomination facility can be made available in respect of deposits held in the name of individuals (single/joint accounts) including sole proprietorship concerns and Safe Deposit Locker/Safe Custody. Nomination should be made only in favour of individuals and a nominee cannot be an Association, Trust, Society or any other Organisation or any office-bearer thereof in his official capacity.
• There cannot be more than one nominee in respect of a joint deposit account. In the case of a joint deposit account, the nominee’s right arises only after the death of all the depositors.

• Banks may allow variation/cancellation of a subsisting nomination by all the surviving depositor(s) acting together. This is also applicable to deposits having operating instructions ‘either or survivor’.

• Banks are required to acknowledge in writing to the depositor(s)/locker hirer(s) the filing of the relevant duly completed Form of nomination, cancellation and/or variation of the nomination.

• Banks may introduce the practice of recording on the face of the passbook the position regarding availment of nomination facility with the legend ‘Nomination Registered’. This may be done in the case of term deposit receipts also.
Summary

- A cheque is nothing, but a bill of exchange with special features. It is always payable on demand.
- Crossing is an ‘instruction’ given to the paying banker to pay the amount of the cheque through a banker only and not directly to the person presenting it at the counter.
- A cheque bearing a special crossing is to be collected through the banker specified therein. It cannot, therefore, be crossed specially again to another banker, i.e., cheque cannot have two special crossings, as the very purpose of the first special crossing is frustrated by the second one.
- Collection of cheques, bills of exchange and other instruments on behalf of a customer is an indispensable service rendered by a banker to his customer.
- A collecting banker acts as an agent of the customer if he credits the latter’s account with the amount of the cheque after the amount is actually realised from the drawee banker.
- The duty to open an account only after the new account holder has been properly introduced to be too well grained into today’s banker’s mind that it would be impossible to find an account without introduction.
- A DD is uniformly valid for a period of three months and procedure for revalidation after three months should be simplified.
- Bank branches are required to maintain a wait list for the purpose of allotment of lockers and ensure transparency in allotment of the lockers.
- Banks may introduce the practice of recording on the face of the passbook the position regarding availment of nomination facility with the legend ‘Nomination Registered’.
- Banks may place per transaction limits based on their risk perception in respect of Mobile transactions with the approval of their respective Boards.
- A customer may request a banker to issue a duplicate draft or fixed deposit receipt.
- The endorsement of a negotiable instrument followed by delivery transfers the endorsed property therein with the right of further negotiation.

References

- *JAIIB-Legal Aspects of Banking - Companies*. [Video online] Available at: <http://www.youtube.com/watch?v=MTNAaKBD0Rk> [Accessed 08 April 2014].
- *JAIIB-Legal Aspects of Banking - Regulation of Banks*. [Video online] Available at: <http://www.youtube.com/watch?v=_tdilAS0nME> [Accessed 08 April 2014].

Recommended Reading

Self Assessment

1. What is the cash payment allowed across the counter of the bank called?
   a. Bearer cheque
   b. Open cheque
   c. Order cheque
   d. Crossing of cheque

2. A ______ is nothing but a bill of exchange with special features.
   a. cheque
   b. Reserve Bank of India Act, 1934
   c. State Bank of India Act, 1955
   d. Regional Rural Banks Act, 1986

3. Which of the following term denotes a bill of exchange with special features?
   a. Loan
   b. Cash
   c. Cheque
   d. Invoice

4. Match the following

<table>
<thead>
<tr>
<th>1. Open Cheque</th>
<th>A. Is a cheque which is payable to a particular person.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. A bearer cheque</td>
<td>B. When cash payment is allowed across the counter of the bank.</td>
</tr>
<tr>
<td>3. An order cheque</td>
<td>C. Must be regular and valid in order to be effective.</td>
</tr>
<tr>
<td>4. An endorsement</td>
<td>D. Can be transferred by mere delivery without any endorsement.</td>
</tr>
</tbody>
</table>

   a. 1- A, 2- B, 3-C, 4- D
   b. 1- B, 2- D, 3-A, 4- C
   c. 1- C, 2- A, 3-D, 4- B
   d. 1- D, 2- C, 3-B, 4- A

5. What is the term called when a cheque bears across its face an addition of the name of a banker, either with or without the words “not negotiable”?
   a. Cheque crossed specially
   b. Cheque crossed generally
   c. Open cheque
   d. Cheque bounce

6. A ______ banker acts as an agent of the customer if he credits the latter’s account with the amount of the cheque after the amount is actually realised from the drawee banker.
   a. donating
   b. collecting
   c. reserving
   d. exchange
7. Indemnity is applicable where there is a ____________.
   a. loss
   b. profit
   c. loan
   d. interest

8. Which of the following statement is true?
   a. As per Sec 128 of the Contract Act, 1874, the surety’s liability is co-extensive with that of the principal debtor.
   b. As per Sec 128 of the Contract Act, 1873, the surety’s liability is co-extensive with that of the principal debtor.
   c. As per Sec 128 of the Contract Act, 1871, the surety’s liability is co-extensive with that of the principal debtor.
   d. As per Sec 128 of the Contract Act, 1872, the surety’s liability is co-extensive with that of the principal debtor.

9. Which of the following is not a type of a cheque?
   a. Bearer cheque
   b. Closed cheque
   c. Open cheque
   d. Order cheque

10. Which of the following statement is false?
    a. A contract of guarantee is covered under the Indian Contract Act, 1872.
    b. Bank branches are required to maintain a wait list for the purpose of allotment of lockers and ensure transparency in allotment of the lockers.
    c. A DD is uniformly valid for a period of eight months and procedure for revalidation after eight months should be simplified.
    d. A Bank Guarantee is a commitment given by a banker to a third party.
Chapter V
Banking Related Laws

Aim
The aim of this chapter is to:

• introduce the limitation act, 1963
• explain bankers book evidence act, 1891
• explicate the tax laws applicable in banking operations

Objectives
The objectives of this chapter are to:

• enlist the recovery of debts to banks and financial institutions act, 1993
• elucidate lok adalats
• explain SARFAESI act 2002

Learning outcome
At the end of this chapter, you will be able to:

• identify the lenders liability act
• understand banking ombudsman
• describe the consumer protection act, 1986
5.1 Introduction

The Limitation Act, 1963 specifies certain period prescribed within which any suit appeal or application can be made.

5.1.1 Important Aspects

The ‘prescribed period’ means the period of limitation computed in accordance with the provisions of the Limitation Act. A banker is authorised to take legal action by filing a suit, prefer an appeal and apply for recovery only when the documents are within the period of limitation. On the other hand, if the documents expired or are time-barred, the banker cannot take any legal course of action to recover the dues. Therefore, banks should be careful to ensure that all legal loan documents held are valid and not time-barred. In other words, it is the responsibility of lenders to certify that all loan documents are correctly executed and they are all within the mandatory limitation period as per the limitation act. This is one of the critical aspects in credit management of banks.

5.1.2 Period of Limitation for Certain Documents

The limitation periods for various kinds of documents are given in the table below.

<table>
<thead>
<tr>
<th>Nature of Documents</th>
<th>Limitation Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Demand Promissory Note</td>
<td>Three years from the date of DP Note.</td>
</tr>
<tr>
<td>A Bill of Exchange payable at sight or upon presentation</td>
<td>Three years when the bill is presented.</td>
</tr>
<tr>
<td>Usance Bill of exchange</td>
<td>Three years from the due date.</td>
</tr>
<tr>
<td>Money payable for money lent</td>
<td>Three years from the loan was made.</td>
</tr>
<tr>
<td>A guarantee</td>
<td>Three years from the date of invocation of the guarantee.</td>
</tr>
<tr>
<td>A mortgage-enforcement of payment of money</td>
<td>Twelve years from the date the money sued becomes due.</td>
</tr>
<tr>
<td>A mortgage-foreclosure</td>
<td>Twelve years from the money secured by the mortgage becomes due.</td>
</tr>
<tr>
<td>A mortgage possession of immovable property</td>
<td>Thirty years when the mortgagee becomes entitled to possession.</td>
</tr>
</tbody>
</table>

Table 5.1 Period of limitation and the time from which the period begins to run

5.1.3 Revival of Documents

Banks are expected to hold valid legal documents as per the provisions of the limitation act. If the limitation period expires, then the bank should coordinate to get hold of fresh set of documents. Such situations are to be discouraged. In certain situations, the limitation period can be exceeded.

A limitation period can be extended in the following manners:

- Acknowledgement of debt: As per Section 18 of Limitation Act, obtaining acknowledgement of debt in writing across the requisite revenue stamp from the borrower before expiration of the prescribed period of limitation can extend limitation period.
- Part-payment: When part repayment of the loan is made by the borrower himself or his duly authorised agent, before expiry of the documents (Sec 19 of Limitation Act). Evidence of such payments should be in the handwriting or under the signature of the borrower or his authorised agent.
- Fresh set of documents: When the bank obtains the fresh set of documents before the expiry of the original document, fresh period of limitation will start from the date of execution of the fresh documents. A time-barred debt can be revived under Sec 25(3) of the Indian Contract Act only by a fresh promise in writing and signed by
the borrower or his authorised agent, generally or specially authorised in that behalf. A promissory note/fresh
documents executed for the old or a barred debt will give rise to a fresh cause of action and a fresh limitation
period will be available from the date of execution of such documents.

5.1.4 Court Holiday
In case, if the court is closed on the prescribed period of any suit, appeal or application falls on a date, then the suit
appeal or application may be instituted, preferred or made, on the day when the court reopens.

5.1.5 Limitation Period-Precautions to be taken by Bank
The following are the precautions to be taken by the bank in respect of the limitation period:
• Banks should preserve all the relevant loan documents in a secured place.
• The documents should be under dual control of authorised persons.
• Banks should not allow any document to become time-barred as per the provisions of Law of Limitation.
• Bank's internal control and monitoring system should be very effective in the sense that the renewal of documents
should be done well in advance.

5.2 Banker’s Book Evidence Act, 1891
The main points of the Banker’s Book Evidence Act, 1891 is as follows:
• The Act extends to the whole of India except the State of Jammu & Kashmir.
• ‘Bank’ and ‘banker’ means:
  • Any company or corporation carrying on business of banking.
  • Any partnership or individual to whose books, provision of this Act are made applicable.
  • Any post office saving bank or money order office.
• ‘Bankers’ books include all books like ledgers, day book, cash book and all other records used in the ordinary
business of a bank. The records can be maintained in any form, such as manual records and printed computer
printouts. It can be in written form or stored in a micro-film, magnetic tape or any other form of mechanical or
electronic data. Such records can be either onsite or any offsite location including a back-up or disaster recovery
site.
• Court means the person or persons before whom a legal proceeding is held and the ‘judge’ refers to a judge of
a High Court.
• Legal proceeding refers to different types of inquiries proceedings and investigation. Legal proceedings
means:
  • Any proceeding or inquiry in which evidence is or may be given.
  • An arbitration
  • Any investigation or inquiry under Code of Criminal Procedure, 1973 or under any other law as applicable
for collection of evidence, conducted by a police officer as well.
• A certified true copy of the bank records.

5.2.1 Important Aspects of Bankers’ Book Evidence Act, 1891
• If the records are maintained in written form, a copy of any entry along with a certificate certifying at the foot
of such copy clearly indicating that:
  • It is a true copy of such entry/entries.
  • The extract is taken from one of the ordinary books of the bank.
  • Such entry was made in the ordinary course of business.
  • Such record is still in the custody of the bank.
  • If the copy was obtained by a mechanical or other process a certificate is required for the authenticity of
the information/data.
Please note that each certificate mentioned above should bear date and should be signed by the principal accountant or manager of the bank with his name and official designation/title.

- If the records are maintained in the electronic form (computer printouts, floppy, disc, tapes, etc.), a copy of print out and a certificate as mentioned for the manual records.

- If the records are maintained in mechanical form (a printout of any entry in the books of a bank stored in a mechanical or electronic form), it should contain a certificate covering all the characteristics discussed for manual records.

Further in case the books of the bank are not written in the handwritten form, then the copies in the form computer printout, such copy must accompany:

- A certificate by the principal accountant or the manager stating that it is a printout of such entry or a copy of such printout.

- In addition to the above another certificate by a person who is in charge of computer furnishing a brief description of the computer system and other particulars like:
  - The safety features adopted by the bank to guard the date integrity.
  - Prevention of unauthorised access into the system.
  - Checks and balancing system of verification of legitimacy of input and output.
  - If the data is retrieved and transformed, details of control system.
  - In case of micro film and similar manner in which the data are stored, then the details of the agreement for the storage and safekeeping of such storage systems and practices.

In short, the certificate should be certified by the person in charge of the computer system certifying about the integrity, correctness and security of the computer system and the data/records. A certificate of any entry in a banker’s book should in all legal proceedings be received as prima facie proof of the existence of such entry, and should be permissible as if original is produced. On production of certified copy, no additional evidence is required. Court can order the scrutiny of books of accounts.

### 5.3 Tax Laws Applicable in Banking Operations

Like any other business units, companies, banks and financial institutions are required to ensure that all the applicable provisions of the various tax laws (Income Tax Act, Finance Act, etc.) to deduct and pay income tax, professional tax, service tax, etc. As an employer as well as the beneficiary of different services, banks are required to adhere to the applicable tax provisions.

Apart from the role of employer and beneficiary of services, banks are expected to pay tax on the interest payable to the customers as per the directives of authorities like TDS on interest payable on fixed deposits, NRO deposits, etc. Apart from the above, income on investments made by the bank and dealing in securities by banks also attracts provisions of TDS.

In view of the above banks should guarantee that:

- Calculation of taxes and recovery of such taxes are correctly handled.
- Deducted taxes are paid within the prescribed due date to the concerned authorities without fail. This is one of the critical compliance requirements and for noncompliance or wrong calculation information; banks may face action as well as penalty.
- Further, banks are required to keep accurate records of tax collection and remittance.
- In addition to the above, banks are required to report the details to the authorities within a specific time frame. The reporting requirement would also include quarterly reporting as well as submission of half-yearly and/or annual statements.
At the time of payment of salary to employees, banks should deduct applicable tax at source and arrange to issue the necessary certificates for TDS on form 16 to employees. For other deductions like payment to contractors, etc., TDS on form 16A should be issued to the service providers. These TDS (16 and 16A forms) would serve as follows:

- As evidence of tax deducted at source.
- As a record.
- Enable the employees and service providers/professionals to claim refund of tax.

### 5.4 Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT ACT)

Recovery of the dues of loans from the borrowers through courts was a chief issue for the banks and financial institutions due to huge back log of cases and the time involved. The Act came into operation from 24th June 1993.

Important highlights of DRT Act 1993 are as follows:

- This Act constituted the special ‘Debt Recovery Tribunals’ for speedy recovery.
- This Act is applicable for the debt due to any bank or financial institution or a consortium of them, for the recovery of debt above Rs. 10 lakhs.
- This Act is applicable to the whole of India except the State of Jammu & Kashmir.
- The term ‘debt’ covers the following types of debts of the banks and financial institutions:
  - Any liability inclusive of interest, whether secured or unsecured.
  - Any liability payable under a decree or order of any Civil Court or any arbitration award or Otherwise.
  - Any liability payable under a mortgage and subsisting on and legally recoverable on the date of application.

Some examples of interpretation of the term ‘debt’ by different courts are as follows:

- In the case of United Bank of India vs. DRT (1999) 4 SCC 69, the Supreme Court held that if the bank had alleged in the suit that the amounts due to it from respondents as the liability of the respondents had arisen during the course of their business activity and the same was still subsisting, it is sufficient to bring such amount within the scope of definition of debt under the DRT Act and is recoverable under that Act.
- In G.V. films vs. UTI (2000) 100 Compo Cases 257 (Mad) (HC), it was held that payment made by the bank by mistake is a debt.
- In the case of Bank of India vs. Vijay Ramniklal AIR 1997 Guj.75., it was held that, if an Employee commits fraud and embezzlement of money, the amount recoverable from him is not a debt within the meaning of DRT Act.

### 5.4.1 Debt Recovery Tribunals

Debt recovery tribunals (DRTs) have been established by the Central Government. The Central Government decides the jurisdiction and also appoints one member as presiding officer, who should be at least a district Judge.

**DRT: Other important aspects**

The following are some important aspects of DRT:

- When DRT has jurisdiction in such matters, the Civil Courts are debarred from handling any case.
- The Tribunal and Appellate Tribunal function from the appointed day, which is declared in notification. Their duties, powers and jurisdiction are well defined. From the date of establishing the Tribunal, i.e., the appointed day, no court or other authority should have any jurisdiction, powers or authority to deal with in any way in recovery cases above Rupees ten lakh. High Courts and Supreme Courts, however, have jurisdiction under Constitution Articles 226 and 227.
Recovery procedure: Bank has to file an application for recovery of loan taking into consideration the jurisdiction and cause of action. Other bank or financial institution can also jointly apply. Application can be filed with fees, documents and evidence. The Limitation Act is also applicable on the DRT cases; therefore, the application must be filed by the bank or the financial institution within limitation period from cause of action. In case when the defendant against whom the DRT has passed recovery order, wants to prefer appeal to the Appellate Tribunal, he is required to deposit 75% or the prescribed percent of the amount as decided by the Tribunal. Without such payment an appeal cannot be filed.

The tribunal issues Recovery Certificate to the applicant. Recovery officers attached to the tribunal, have adequate powers for recovery under the Act. On receiving the recovery certificate, the recovery officer has to proceed for the recovery by attachment and sale of movable and immovable property. Defendant is debarred from disputing the correctness of the amount given in recovery certificate. Orders of recovery officer are applicable within thirty days to the Tribunal.

Special features of DRT: The provisions of this Act have overriding effect when there is inconsistency with any other law or in any instrument by virtue of any other law for the time being in force.

Case laws: DRT is a special Act for recovery of debt due to banks and financial institutions. DRT has overriding effect over the provisions of Companies Act, 1956, hence leave of the company court is not required even if the company is under winding up proceedings (Allahabad Bank vs. Canara Bank AIR 2000 SC 1535).

Money realised under DRT Act and distribution between bank and other secured creditors, in cases where winding up proceedings are pending in company court, priority of secured creditors is subject to provisions of 529 A of Companies Act (as per the said section, priority of secured creditors and workmen over other dues and distribution inter se between secured creditors and workmen should be pari-pasu).

5.5 Lok Adalats

Lok Adalats are organised under the Legal Services Authorities Act, 1987. They are intended to bring about a compromise or settlement in respect of any dispute or potential dispute. Lok Adalats derive jurisdiction by consent or when the court is satisfied that the clash between the parties could be settled at Lok Adalats. It should be directed by the principles of justice, equity, fair play and other legal principles. In case of settlement, the Award should be binding on the parties to the dispute. No appeal should lie in any court against the Award. Currently, Lok Adalats organised by civil courts to effect a compromise between disputing parties in matters pending before any court can handle cases up to a ceiling of Rs. 20 lakh.

5.6 SARFAESI ACT, 2002

The objective of enactment of the SARFAESI ACT was to regulate securitisation and reconstruction of financial assets and the enforcement of security interest and for the matters connected therewith or incidental thereto.

5.6.1 SARFAESI Act-Important Aspects

The following are the important aspects of the SARFAESI Act:

- This Act is popularly called as Securitisation Act.
- This Act empowers the banks and financial institutions to recover their dues in Non-Performing Asset (NPA) accounts, without the intervention of a court.
- This Act also authorises the banks and financial institutions to issue notice for recovery from the defaulting borrowers and guarantors, calling upon them to discharge the dues in full within 60 days.
- In case the borrower and/or guarantor fails to fulfil the 60 days’ notice issued by the bank or financial institution in repayment of full dues, then the bank and/or financial institution can:
  - Take the possession or the management of secured assets of the borrower, and also can transfer the same by way of lease, assignment or sale for realising the secured assets without the intervention of a court/DRT.
Appoint any person to administer the secured assets which have been taken over by the secured creditor (bank).

Instruct at any time by a notice in writing to a person as follows:
- who holds secured assets of the borrower
- from whom any money due or becoming due to the borrower
- to pay such money to the secured creditor (bank)

**Some important terms covered under the SARFAESI Act**

The following are some important terms that are covered under the SARFAESI Act:

- **Bank:** All the banking companies, Nationalised banks, the State Bank of India and its subsidiary banks, Regional Rural Banks, co-operative banks, etc.

- **Borrower:** The borrowers can be as follows:
  - Any person who has availed financial assistance from a bank and/or financial institution.
  - Any person who has given guarantee.
  - Any person who has created any mortgage or pledge as a security for the financial assistance granted by any bank or financial institution.
  - Any person who becomes the borrower of a securitisation company or reconstruction company, because the company has acquired any interest or right of any bank or financial institution, on account of financial assistance granted to a borrower.

- **Central Registry:** The register office set up by the Central Government for the purpose of registration of all the transactions of asset securitisation, reconstruction and transactions of creation of security interests. The registration system will operate on a priority of registration basis, i.e., ‘first come first served basis’ the first person who registers gets priority over the persons who registers at a later date.

- **Financial assistance:** Whenever any bank or financial institution allows a borrower to do the following:
  - To avail of a loan or advance
  - Makes subscription of debenture or bonds
  - Issues a letter of credit
  - Extends any other credit facility, it is called financial assistance

- **The Act covers the following:**
  - Any financial assistance which is due (principle debt or any other amount payable).
  - The right of security enforcement is for a default committed by the borrower, and the creditor is a secured creditor. In other words, any unsecured creditor has no right under this Act.
  - The debt should be classified by the bank as Non-performing Asset.

- **Financial Asset:** Financial asset means debt or receivables and includes the following:
  - Any debt or receivable secured by mortgage of or charge in immovable property.
  - A claim to any debt or receivables or part thereof whether secured or unsecured.
  - Any charges like a mortgage, hypothecation or pledge of moveable property.
  - Any right or interest in the security, whether full or part, securing debt.
  - Any beneficial interest in any movable or immovable property or in debt, receivables whether is existing, future, accruing, conditional or contingent.
  - Any other financial assistance.

- **The Act is applicable only in case of a Non Performing Asset (NPA) of a borrower classified by a bank or financial institution as sub-standard, doubtful or a loss asset as per the RBI’s guidelines.**

- **The term ‘hypothecation’ is defined under this Act as a charge in or upon any movable property (existing or future) created by a borrower in favour of a secured creditor.**

- **The Company formed for the purpose of asset reconstruction and registered under the Companies Act, 1956 is called Reconstruction Company.**
The Act covers the following three important aspects, viz.:

- Securitisation
- Reconstruction of Financial assets
- Enforcement of security interest

### 5.6.2 Securitisation

Securitisation is the process of acquisition of financial asset by the securitisation or reconstruction company from the lender (bank or financial institution). The reconstruction or securitisation company may be raising funds for acquisition of financial asset from the qualified institutional buyers by issue of security receipts representing undivided interest in the financial assets or otherwise.

**Security receipt**

A receipt or another security issued by a securitisation company or reconstruction company to any qualified institutional buyer. The receipt is an evidence of purchase or acquisition by the holder thereof of an undivided right, title or interest in the financial asset involved in securitisation is called the security receipt. The security receipts are transferable in the market. SARFAESI Act made the loans secured by mortgage or other charges transferable.

### 5.6.3 Asset Reconstruction

An asset reconstruction company’s role is to takeover loans or advances from the bank or financial institution for the purpose of recovery. In other words any securitisation company or reconstruction company acquires any right or interest of any bank or financial institution, in any financial assistance for the purpose of realisation of such financial assistance it is called as asset reconstruction.

On acquisition of a financial asset, the securitisation or reconstruction company becomes the owner of the financial asset and steps into the shoes of the lender bank or financial institution. This acquisition can also said to be, as a sale of asset without recourse to the bank or financial institution. The regulatory authority for all securitisation or reconstruction companies is the Reserve Bank of India. It is a company registered under the Companies Act, 1956 for the purpose of securitisation and it also requires a registration from the RBI as per the SARFAESI Act.

### 5.6.4 Enforcement of Security Interest

The ‘enforcement of security interest’ is important for recovery of the bank’s bad loans. The special characteristic of the Act is that the security interest can be enforced without intervention of the courts, subject to certain procedures to be followed, like 60 days notice has to be served by the bank on the borrower with a request to discharge the loan liability. In case, if borrower fails to discharge the liability, secured creditor can take possession of secured asset or other actions as per the provisions of the Act.

**Security interest**

Any right, title and interest of any kind of the property created in favour of any secured creditor are called as security interest. It includes any secured creditor is called as security interest. Whenever any lender takes any security from the borrower the lender gets interest in that security. While taking possession of the asset various precautions are required to be taken and if required the help of the Chief Metropolitan Magistrate or District Magistrate can be taken.

**Special features**

Under certain circumstances properties cannot be attached, such as:

- Any security interest securing repayment of any financial assistance not exceeding 1 lakh
- Security interest not registered under this Act
- Any security interest created in agricultural land
- A pledge of movables as per Sec 172 of the Indian Contract Act
No civil court has any jurisdiction under this Act. The Indian Limitation Act, 1963 is applicable to this Act.

Central registry
The Central registry is set up for registration of securitisation and reconstruction transaction and creation of security interest. Registrations under other Acts are as follows:

- Registration Act, 1908
- Companies Act, 1986
- Patents Act, 1970
- Motor Vehicles Act, 1988

The registration under the SARFAESI Act is in addition to the respective registrations required in the above mentioned acts and/or any other Act.

The following items require registration under the SARFAESI Act:

- Securitisation of financial assets
- Reconstruction of financial assets
- Creation of security interests

The central registry record can be kept fully or partly on electronic form. Filing of details of securitisation, reconstruction, creation of security interests is to be filed with the central registrar. The details in the prescribed form should be filed within thirty days after the date of transaction or the creation of security, by the securitisation company, or the reconstruction company or the secured creditor. The prescribed fees are applicable for registration. The delay if any can be condoned by the central registrar for a period of next thirty days after the first thirty days prescribed subject to payment of fees as required.

In case of modification of details registered with the central registrar, the modification also needs to be filed before the central registrar by the securitisation company, or the reconstruction company or the secured creditor. The time period for modification is also like that of registration, i.e., the modification will have to be filed within thirty days in the prescribed forms with prescribed fees. The delay if any can be condoned by the central registrar for a period of next thirty days after the first thirty days prescribed subject to payment of fees as required.

The security interest registered with the central registrar is required to be satisfied on the payment of full amount by the borrower. Maybe the securitisation company, or the reconstruction company or the secured creditor as the case ought to report the satisfaction, within thirty days of payment in full or satisfaction of the charge.

On receipt of the satisfaction charge, the central registrar is required to cause a notice to be issued to the securitisation company, or the reconstruction company or the secured creditor, calling upon to show cause within a period of fourteen days as to why the payment or satisfaction should not be recorded as intimated. If no cause is shown as required, then the central registrar has to order that the memorandum of satisfaction should be entered in the central register. If any cause is shown, a noting is accordingly recorded in the central register and should inform to the borrower accordingly.

Taking possession of property mortgaged/hypothecated to banks
In a recent case, Supreme Court has observed that we are governed by rule of law in the country and the recovery of loans or seizure of vehicles could be done only through legal means. In this connection, it may be mentioned that the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and the Security Interest (Enforcement) Rules, 2002 framed thereunder have laid down well defined procedures not only for enforcing security interest but also for auctioning the movable and immovable property after enforcing the security interest. It is, therefore, desirable that banks rely only on legal remedies available under the relevant statutes which allow the banks to enforce the security interest without intervention of the Courts.
Where banks have incorporated a re-possession clause in the contract with the borrower and rely on such re-possession clause for enforcing their rights, they should ensure that such re-possession clause is legally valid, is clearly brought to the notice of the borrower at the time of execution of the contract, and the contract contains terms and conditions regarding the following:

- Notice period to be given to the customers before taking possession.
- The procedure which the bank would follow for taking possession of the property.
- The procedure which the bank would follow for sale/auction of property.

This is expected to ensure that there is adequate upfront transparency and the bank is effectively addressing its legal and reputation risks.

### 5.7 Lenders Liability Act

In India, the SARFAESI Act was enacted in 2002. On the basis of the recommendations of the working group on Lenders’ Liability Laws constituted by the Government of India, Reserve Bank of India had finalised a set of codes of conduct called ‘the Fair Practice Code for Lenders’ and advised banks to adopt the guidelines. All the banks have formulated their own set of Fair Practice Codes as per the guidelines and implemented it from 1st November, 2003.

**Some of the important features of Lenders Liability Act**

Banks and financial institutions should give acknowledgment for receipt of all loan applications. The loan applications should scrutinise the loan applications within a reasonable period of time. Loan applications in respect of priority sector and advances up to Rs. 2 lakhs should be comprehensive. Lenders should ensure that the credit proposal is properly appraised after assessing the creditworthiness of the applicants. They should not use margin and security stipulation as a substitute for the due diligence on credit-worthiness and other terms and conditions. The lender should inform to the borrower the sanction of credit limit in writing along with the terms and conditions thereof and keep the borrower’s acceptance of the credit limits and terms and condition on record.

Duly signed acceptance letter should form part of the collateral security. In case of consortium advances, the participating lenders should evolve procedures to complete appraisal of proposals in the time-bound manner to the extent feasible and communicate their decision on financing or otherwise within a reasonable time. Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction.

Post disbursement supervision by lenders, particularly in respect of loans up to Rs. 2 lakhs, should be constructive with a view to taking care of any ‘lender-related; genuine difficulty that the borrower may face, Lenders should release all securities on receiving payment of loan or realisation of loan, subject to any legitimate right of lien for any other claim lenders may have against the borrowers. Lenders should not interfere in the affairs of the borrowers except for what is allowed as per the terms and conditions of the loan sanction documents. In the matter of recovery of loans, lenders should not resort to undue harassment Apart from the Fair Practices Code, banks should also have proper system for grievance redressal system, Apart from the above code; banks have set up codes for Bankers’ Fair Practices Code, Fair Practices Code for Credit Card Operations, Model Code for Collection of Dues and Repossession of Security, etc.

### 5.8 Banking Ombudsman

Banking Ombudsman Service is a grievance redressal system. This service is available for complaints against a bank’s deficiency of service. A bank’s customer can submit complaint against the deficiency in the service of the bank’s branch and bank as applicable, and if he does not receive a satisfactory response from the bank, he can approach Banking Ombudsman for further action. Banking Ombudsman is appointed by RBI under Banking Ombudsman Scheme, 2006. RBI as per Sec 35 A of the Banking Regulation Act, 1949 introduced the Banking Ombudsman Scheme with effect from 1995.
5.8.1 Important Features of Banking Ombudsman
The Banking Ombudsman is a senior official appointed by the Reserve Bank of India to redress customer complaints against deficiency in certain banking services. All Scheduled Commercial Banks, Regional Rural Banks and Scheduled Primary Co-operative Banks are covered under the Scheme.

Some of the deficiencies in banking services including internet banking, covered under the Banking Ombudsman Scheme are as follows:

- Deficiency in customer service like non-acceptance, without sufficient cause, of small denomination notes tendered for any purpose, and for charging of commission in respect thereof.
- Delayed or non-payment of inward remittance, delay in issuance of drafts.
- Non-adherence to prescribed working hours.
- Refusal to open deposit accounts without any valid reason for refusal.
- Levying of charges without adequate prior notice to the customer.
- Forced closure of deposit accounts without due notice or without sufficient reason.
- Refusal to close or delay in closing the accounts, etc.
- Non-adherence to the fair practices code as adopted by the bank or non-adherence to the provisions of the Code of Bank’s 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.

As regards loans and advances, 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 no observance of prescribed time schedule for disposal of loan applications.
- Non-acceptance of application for loans without furnishing valid reasons to the applicant; 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.

One can file a complaint 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.

However a complaint will not be considered by the Ombudsman in the following situations:

- The person has not approached his bank for redressal of his grievance first.
- The subject matter of the complaint is pending for disposal or has already been dealt with at any other forum like court of law, consumer court, etc.
- 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.

A person can file a complaint with the Banking Ombudsman simply by writing on a plain paper. A person can also file it on-line or by sending an email to the Banking Ombudsman. For complaints relating to credit cards and other types of services with centralised operations, complaints may be filed before the Banking Ombudsman within whose territorial jurisdiction the billing address of the customer is located. The complaint can also be filed by one’s authorised representative (other than an advocate).

The amount, if any, to be paid by the bank to the complainant by way of compensation for any loss suffered by the complainant is limited to the amount arising directly out of the act or omission of the bank or Rs. 10 lakhs, whichever is lower. The Banking Ombudsman may award compensation not exceeding Rs. 1 lakh to the complainant only in
the case of complaints relating to credit card operations for mental agony and harassment. The Banking Ombudsman will take into account the loss of the complainant’s time, expenses incurred by the complainant, harassment and mental anguish suffered by the complainant while passing such award.

The Banking Ombudsman may reject a complaint at any stage, if it appears to him that a complaint made to him is as follows:

- Not on the grounds of complaint referred to above compensation sought from the Banking Ombudsman is beyond Rs. 10 lakh
- In the opinion of the Banking Ombudsman there is no loss or damage or inconvenience caused to the complainant

If one is aggrieved by the decision, he/she may, within 30 days of the date of receipt of the award, appeal against the award before the appellate authority. The appellate authority may, if he/ she is satisfied that the applicant had sufficient cause for not making an application for appeal within time, also allow a further period not exceeding 30 days.

5.9 The Consumer Protection Act, 1986

To protect the interests of the consumers, the Consumer Protection Act was enacted. The Act extends to the whole of India except the State of Jammu and Kashmir. The Act covers all goods and services, except goods for resale or for commercial purpose and services rendered free of charge and a contract of personal service. Complaints (i.e., any allegation should be in writing made by a complainant to obtain any relief provided by or under this Act).

The complaint may be made by the complainant which includes a consumer or any voluntary consumer association registered under the Companies Act,1956 or any other law or the Central or State Government or one or more consumers, having the same interest and in case of death of a consumer his/her legal heirs or representative. The Act is for speedy disposal of the redressal of consumer disputes. Consumer councils are established to promote and protect the rights of consumers. The Central Council has the jurisdiction for the entire country, followed by the State Council for each state and District Council for each district. The Councils at the State level is headed by the chairman of the council, i.e., the Minister-in-Charge of the Consumer Affairs in the State Government.

The consumers’ complaints are dealt by District Forum, State and National Commission. District forum and State Commission are established by the State Governments, and the National Commission established by Central Government. District Forum has powers to deal with cases up to Rs. 20 lakhs. The State Commission deals with complaints exceeding value of Rs. 20 lakh and below Rs. 1 crore and appeals against the orders of any District forum within the State. The cases exceeding Rs. 1 crore would be handled by the Central Commission. They also deal with appeals against the order of any State Commission. Complaints should be in a prescribed manner, with full details, evidence and applicable fee. Supporting affidavit is required. Admissibility of complaint is to be decided within twenty one days. Similarly, other procedures and requirements as per the Act which are in force would be applicable.
Summary

- As regards to the Limitation Act, 1963, banks can take legal course of action to recover bank dues if the documents are valid and within limitation period.
- In some cases the limitation period can be extended if certain actions are taken within in a specified time frame (before expiration of documents). Bankers Book Evidence Act, is applicable to throughout India except the State of Jammu & Kashmir.
- The SARFAESI Act covers three important aspects, viz., Securitisation, Reconstruction of Financial assets and Enforcement of security interest.
- The SARFAESI ACT is not a substitute for registration applicable in any other act. The ‘enforcement of security interest’ is of the bank’s bad loans.
- The special feature of the SARFAESI Act is that the security interest can be enforced without intervention of the courts, subject to certain procedures to be followed, like 60 days’ notice has to be served by the bank on the borrower with a request to discharge the loan liability.
- Banking Ombudsman Service is a grievance redressed system.
- The security interest registered with the central registrar is required to be satisfied on the payment of full amount by the borrower.

References

- 8 2 Lecture in Customer Relationship Management mp4. [Video online] Available at: <http://www.youtube.com/watch?v=1m9BUKQMqv0> [Accessed 10 April 2014].
- Understanding the Rights & Duties of the Customer/Banker Relationship. [Video online] Available at: <http://www.youtube.com/watch?v=pqEcGDQFOs0> [Accessed 10 April 2014].

Recommended Reading

Self Assessment

1. An asset __________ company’s role is to takeover loans or advances from the bank or financial institution for the purpose of recovery.
   a. reconstruction
   b. international
   c. engineer
   d. mechanical

2. Which of the following are established to promote and protect the rights of consumers?
   a. Consumer protection
   b. Consumer councils
   c. Consumer act
   d. Consumer Bank

3. Which is a grievance redressal system?
   a. Commercial Bank Service
   b. Schedule Bank Service
   c. Banking Ombudsman Service
   d. Co-operative Bank Service

4. In India, the ________ Act was enacted in 2002.
   a. Labour
   b. Urban
   c. SARFAESI
   d. Banking

5. Which of the following statement is true?
   a. Commercial banks play an important role in the Indian Financial System.
   b. The term Urban Cooperative Banks (UCBs), refers to the primary cooperative banks located in rural and semi-urban areas.
   c. Urban co-operative banks, until 1996, were allowed to lend money only to agricultural purposes.
   d. Reconstruction Company formed for the purpose of asset reconstruction and registered under the Companies Act, 1956 is called Reconstruction Company.

6. Securitisation is the process of acquisition of ________ asset.
   a. public
   b. financial
   c. commercial
   d. international

7. The ‘enforcement of security interest’ is important for recovery of the bank’s ______ loans.
   a. debt
   b. commercial
   c. bad
   d. good
8. The _________ receipts are transferable in the market.
   a. security
   b. financial
   c. business
   d. corporate

9. Which of the following statement is false?
   a. The complaint can also be filed by one’s authorised representative.
   b. Lenders should release all securities on receiving payment of loan or realisation of loan, subject to any
      legitimate right of lien for any other claim lenders may have against the borrowers.
   c. Complaints should not be in a prescribed manner, with full details, evidence and applicable fee.
   d. Banking Ombudsman service is available for complaints against a bank's deficiency of service.

10. Match the following

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<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>1. All Scheduled Commercial Banks, Regional Rural Banks and Scheduled Primary Co-operative Banks</td>
<td>A. Is popularly called as Securitisation Act.</td>
<td></td>
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<tr>
<td>2. SARFAESI Act</td>
<td>B. Means the time of limitation computed in accordance with the provisions of the Limitation Act.</td>
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<td>3. The ‘prescribed period’</td>
<td>C. Is also applicable on the DRT cases.</td>
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<td>4. The Limitation Act</td>
<td>D. Are covered under Banking Ombudsman Scheme.</td>
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</table>

a. 1-D, 2-A, 3-B, 4-C  
b. 1-C, 2-B, 3-A, 4-D  
c. 1-A, 2-C, 3-D, 4-B  
d. 1-B, 2-D, 3-C, 4-A
Chapter VI
Financial Analysis of Banks

Aim
The aim of this chapter is to:

• introduce the principles of lending
• explain the types of analysis
• explicate financial analysis

Objectives
The objectives of this chapter are to:

• explicate the concept of banker as a lender
• elucidate banker as investor
• explain Du Pont model

Learning outcome
At the end of this chapter, you will be able to:

• identify the techniques used in analysis of financial statements
• understand the concept of analysis of profit and loss account
• describe analysis of funds/cash flow statements
6.1 Introduction

An analysis becomes a vital characteristic of decision-making; hence analysis of diverse situations, scenarios and perceptions would aid banks to take appropriate decisions.

![Fig. 6.1 Types of analysis](http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

6.2 Financial Analysis

The performance of a company or business enterprise can be measured by looking into the financial results of the company over a period of time. A comparative study of the financial statements would assist the analyst to assess the results. Two important financial statements commonly used for financial analysis are profit and loss account and balance sheet.

The following financial statements are analysed and interpreted by different classes of persons, such as individual investors, bankers, financial institutions, credit analysts, credit-rating agencies and research and management students:

- The balance sheet shows the financial position of the business as at the end of a particular period (month, quarter or year).
- The profit and loss account shows the financial results of the working of an enterprise over a period of time. For example, 1st of April 2012 to 31st March 2013.
- When comparative analysis of these statements for a number of years is done, it would give a better view about the financial performance of the business unit.
- Financial analysis and interpretation of financial statements have now become important decision-making tools.

The advantages and limitations of analysis of financial statements:

- The financial results in the form of P&L accounts and balance sheets are readily available.
- These financial statements are drawn as per the accounting standards and as per the regulatory and legal framework.
- Depending upon the requirement of the analyst (investors, bankers, credit-rating agencies, etc.) the figures and data available on these statements can be easily grouped and interpreted.
- The financial statements can be used for ratio analysis, trend analysis, etc.
While using the financial statements, the limitations are as follows:

- The balance sheet numbers are available as on a particular date, hence may not reveal the correct position of the financial health for over a period of one year.
- As both profit and loss account and balance sheet are in the form of numerical statements, these statements would not reveal the overall picture about the performance of the concern or business unit.
- The methods of valuation of assets, writing off depreciation, amortisation of costs, large expenses, etc., may vary from business unit to business unit. Therefore, a comparison of these numbers and ratios would not give desired results and calls for further detailed investigations.
- Further, these financial statements depict the performance of the business enterprise. Therefore, any meaningful interpretation of these statements will depend upon the projections of the future trends.

6.2.1 Analysis of Balance Sheet
The balance sheet is the most important financial statement prepared annually. It shows the assets and liabilities of a business concern as on a particular date (For example, as on 31st March). The assets indicate what the company owns and its receivables, and the liabilities indicate what the company owes and its payables.

Assets
The assets are classified into current assets and fixed assets. They are discussed in the paragraphs below.

Current assets
Current assets are those assets which are to be liquidated into cash in the near future. These assets are also known as ‘circulating assets’.

Composition of current assets
Cash and bank balances, marketable securities, inventories, bills receivables and debtors (book debts) are examples of Current Assets. Debts and bills receivable which are outstanding for not more than 12 months are treated as current assets. Inventories and receivables are two important components of current assets. As already indicated while interpreting the financial statements, care should be taken to bifurcate these assets into two categories as current and noncurrent assets. A close review of the inventory and receivables would give better results of the competence of the management in managing these two assets, and clearly specify the liquidity management skills of the business concern.

Fixed assets
The next important classification of assets is fixed assets. The fixed assets usually consist of land and buildings, plant and machinery, fixtures and fittings, etc. These assets are used by the company for carrying on the business and are not meant for sale in the near future. While analysing the fixed assets, care should be taken to verify the book value as well as market value (re-saleable value and necessary precautions to be taken to verify whether such assets are charged to any bank or financial institutions and the impact of the borrowings against such fixed assets). The depreciation and amortisation policies should also be reviewed.

For example, the valuation of the fixed assets varies from type of assets. Land should be valued according to ownership pattern like freehold or leasehold, and the location of the land, etc., The age of the building, location and other factors are to be considered as regards valuation of building.

Intangible assets
With the changing pattern of integration of global business environment, a lot of changes are taking place in the analysis of financial statements as well. Importance is being given to the intangible assets, and their valuation is an important part of financial analysis. Generally, the following items are classified as intangible assets, goodwill, copy right, patents, trade mark, designs, brand value, etc. These are also called as fictitious assets.
Intangible assets do not represent any tangible assets like land and building, raw materials, stocks, etc. These intangible assets in a way represent the reputation earned by the company. Apart from the above, certain other items which can also be classified as intangible assets are preliminary expenses, debit balance in profit and loss account, which are either deferred revenue expenses or are actual losses to be written off over a period of time.

**Liabilities**
The liabilities mainly represent sources of funds and can be broadly classified as follows:

- **Net worth:** Owned funds and share capital and free reserves.
- **Current liabilities:** Those items which are repayable within one year are treated as current liabilities.
- **Borrowings from banks:** Business units avail bank finance in the form of overdraft/cash credit (working capital finance). An analyst should be inclined to know the details of such bank borrowings like amount under different categories, security charged to the banks in the form of hypothecation and pledge of inventories and receivables, etc.
- **Sundry or trade creditors:** The review of trade creditors is critical in determining the company’s liquidity management. The review should be in detail relating to the nature of bills, the credit terms and other conditions. If the bills are drawn by other than trade creditors, then careful review is needed.
- **Term liabilities:** While the term liabilities are long-term in nature, but the instalments of term loans which are repayable or the maturity of debentures and other term liabilities which are due for payment within a period of one year, need to be classified as short-term and treated like other current liabilities.
- **Apart from the above items, provision for taxes, interest on term loans and debentures and other charges, unpaid expenses, etc., are classified as other current liabilities.**
- **Term loans are classified into short-term, medium-term and long-term. While analysing, care should be exercised to check and satisfy to the various terms and conditions of the loans and term finance availed by the company. The details such as the rate of interest, the repayment period, and the security offered etc needs to be carefully reviewed.**
- **Net worth:** The composition of ‘net worth’ is paid-up share capital, the retained profits held in the form of reserves and surpluses and the credit balance in the profit and loss account. One of the important aspects of ‘net worth’ is that the company’s long-term solvency depends on the strong capital base. The financial analyst should review to find out whether the long-term needs of the business concern are financed by the owned funds or long term liabilities.
- **Contingent liabilities or off balance sheet items:** Contingent liabilities are those liabilities which do not exist as on the date of balance sheet, however they may arise in future unlike other items, which are classified as on balance sheet items, the contingent liabilities are classified as off balance sheet items. On balance sheet items are part of the balance sheet as historical items, whereas the contingent liabilities are future items. In case, these items become payable, it would distort the liquidity position of the company, hence a careful review as to the terms and conditions of such contingent liabilities, possible repayment amount and time, etc., need to be given importance.

**Other important features**
The balance sheet and the profit and loss account provide the financial position of a company in numerical numbers. Apart from these, the auditors’ report, explanatory schedules and notes on accounts, if applicable, provide useful information. Funds flow and cash flow statements also offer useful information which show mathematical analysis of changes in the structure of two consecutive balance sheets. These financial statements are prepared as per the applicable Accounting Standards.

The financial statements should be prepared as per the legal framework and the Accounting standards as applicable from time-to-time. In case of banking companies, the formats of both balance sheet and P&L account are prescribed by the Banking Regulation Act. In case of other companies, they have to follow the Companies Act, 1956, as amended from time-to-time. The Ministry of Corporate Affairs (MCA) has issued revised Schedule VI which lays down a new format for preparation and presentation of financial statements by Indian companies for financial years commencing on or after 1 April 2011.
The revised Schedule VI introduces some significant conceptual changes such as current/non-current distinction, primacy to the requirements of the accounting standards, etc. While the revised Schedule does not adopt the international standard on disclosures in financial statements fully, it brings corporate disclosures closer to international practices. Some of the important aspects of the revised Schedule are:

- Format of cash flow statement not prescribed hence companies which are required to present this statement (i.e., other than small and medium-sized companies) to continue to prepare it as per AS 3, Cash Flow Statements.
- Only vertical form of balance sheet is allowed with significant changes vis-à-vis the structure of prerevised Schedule VI.
- Shareholders’ funds to be shown after deduction of debit balance of statement of profit and loss. ‘Reserves and surplus’ and ‘shareholders’ funds’ (i.e., aggregate of Share Capital and Reserves and Surplus) could thus be negative figures.
- Miscellaneous expenditure can no longer be shown as a separate broad heading under ‘Assets’. It would be required to be reclassified depending on the nature of each such item.
- All assets and liabilities to be classified into current and non-current. This provides useful information by distinguishing assets/liabilities continuously circulating as working capital or expected to be settled/realised within 12 months from the balance sheet date from those used in long-term operations.
- Current/non-current distinction will have major impact on classification of accounting information and account heads. Hence, changes would be required in accounting systems and procedures.
- Detailed disclosures required regarding defaults on borrowings.
- All liabilities to be classified into current and non-current on the basis of the same criteria of distinction as in the case of assets.
- Non-current liabilities include long-term borrowings, long-term maturities of finance lease obligations, long-term trade payables and long-term provisions. Current liabilities include current maturities of long-term debt and of finance lease obligations, short-term borrowings, and all borrowings repayable on demand, unpaid matured deposits/debentures, and short-term provisions.
- Intangible fixed assets to be disclosed separately.
- ‘Investments’ no longer to be included under non-current and current assets categories; disclosures rationalised.
- Long-term loans and advances given not to be clubbed with current assets.
- Cash and cash equivalents to be disclosed separately.

### 6.2.2 Analysis of Profit and Loss Account

It is a statement of income and expenditure of an entity for the accounting period. Every Profit and Loss account must indicate the accounting period for which it is prepared. The items of a Profit and Loss account are:

- Gross and net sales: The total price of goods sold and services rendered by an enterprise, including excise duty paid on the goods sold, is called Gross sales. Net sales is gross sales minus excise duties.
- Cost of goods sold: This is the sum of costs incurred for manufacturing the goods sold during the accounting period. It consists of direct material cost, direct labour cost and factory overheads. It is different from the cost of production, which represents the cost of goods produced in the accounting year, not the cost of goods sold during the same period.
- Gross profit: This is the difference between net sales and cost of goods sold. Most companies show this amount as a separate item. Some companies, however, show all expenses at one place without making gross profit a separate item.
- Operating expenses: These consist of general administrative expenses, selling and distribution expenses, and depreciation. Some companies include depreciation under cost of goods sold as a manufacturing overhead rather than under operating expenses.
- Operating profit: This is the difference between gross profit and operating expenses. As a measure of profit, it reflects operating performance and is not affected by non-operating gains/losses, financial leverage, and tax factor.
• Non-operating surplus: This represents gains arising from sources other than normal operations of the business.

Its major components are income from investments and gains from disposal of assets. Likewise, non-operating deficit represents losses from activities unrelated to the normal operations of the firm.

• Profit before interest and taxes: This is the sum of operating profit and non-operating surplus/deficit. Referred to also as Earnings Before Interest and Taxes (EBIT), this represents a measure of profit which is not influenced by financial leverage and the tax factor.

• Interest: This is the expense incurred for borrowed funds, such as term-loans, debentures, public deposits, and working capital advances, etc.

• Profit before tax: This is obtained by deducting interest from profits before interest and taxes.

• Tax: This represents the income tax payable on the taxable profit of the year.

• Profit after tax: This is the difference between the profit before tax and tax for the year.

6.2.3 Analysis of Funds flow/Cash Flow Statements

Each item in the balance sheet represents either source of funds or use of funds. All items on the liabilities side represent the funds provided to the enterprise and all items on the assets side (except cash) represent use of these funds.

When we compare two balance sheets of different dates, change in each item (or introduction of a new item) in the balance sheet of later date, as compared to that item in the balance sheet of earlier date, will represent either addition of funds or additional use of funds in the intervening period. Any increase in any item on the liabilities side means additional funds available. Please note that additional funds are also available if there is decrease in any item on the assets side. Similarly, any increase in any item on the assets side or decrease in any item on the liabilities side means additional use of funds. A statement of these additional sources of funds and additional uses of funds is called Funds flow statement for the intervening period.

If we have to prepare the cash flow statement, we start with the cash in the first balance sheet as opening balance, add all the additional sources, excluding cash (cash is also a source of funds if it is at a reduced level in the subsequent balance sheet), and deduct all additional uses (excluding cash), thus arriving at the closing balance, which will be equal to the cash shown in the second balance sheet. In practice, the statement is prepared perceiving cash as a use or source of funds.

6.3 Techniques used in Analysis of Financial Statements

Financial statement analysis (or financial analysis) is the process of understanding the risk and profitability of a firm (business, sub-business or project) through analysis of reported financial information, by using different accounting tools and techniques.

There are three methods used for analysis of financial statements:

• Funds flow analysis: The total sources of funds are categorised as ‘long-term’ and ‘short-term’. Similarly, the total uses are also categorised as ‘long-term’ and ‘short-term’. If the short-term sources are more than the short uses, it indicates diversion of working capital funds and needs to be probed further. Sometimes, it may be a desirable thing, e.g., in case of companies with very high current ratio, it may be desirable to use the idle funds for creating additional capacity. The guiding principle is that this diversion should not affect the liquidity position of the company to unacceptable level.

• Trend analysis: Under trend analysis, the following methodologies can be used:
  • The items, for which trend is required to be seen, are arranged in horizontal form and percentage increase (decrease) from the previous year’s figure is indicated below it. Generally, this is used to see the trends of sales, operating profit, Profit Before Tax, Profit After Tax, etc., from P&L account. Similarly, the balance sheets arranged in horizontal order give the trends of increase or decrease of various items.
Common size statements are prepared to express the relationship of various items to one item in percentage terms. For example, consumption of raw materials is expressed as a percentage of sales for different years and comparison of these figures gives indication of trend of operating efficiency.

The use of common size statements can make comparisons of business enterprises of different sizes much more meaningful since the numbers are brought to common base, i.e., per cent. Such statement allows an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry.

- Ratio analysis: This is the most commonly used tool for analysis of financial statements.

A ratio is comparison of two figures and can illustratively be expressed as:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>1.33</td>
</tr>
<tr>
<td>Debt Equity Ratio</td>
<td>1:2</td>
</tr>
<tr>
<td>Profitability Ratio</td>
<td>21.4%</td>
</tr>
</tbody>
</table>

Both the figures, used in calculation of a ratio, can be from either P&L account, or balance sheet or one can be from P&L account and the other from balance sheet. Ratios help in comparison of the financial performance and financial position of an entity with other entities, as also for comparison with its own status over the years. While different users of financial statements are interested indifferent ratios, some of the important ratios are as follows:

- Profitability ratios: Operating Profit Margin (OPM) and Net Profit Margin (NPM) are calculated by dividing the figures of operating profit (EBIT which means Earnings Before Interest and Tax) and net profit respectively by the net sales. OPM is an indicator of the operating efficiency of the enterprise while NPM is an indication of ability to withstand the adverse business conditions.

- Liquidity ratios: These are Current Ratio (CR) and quick ratio or acid test ratio. While CR is a ratio of total current assets to total current liabilities, quick ratio is calculated by dividing current assets (excluding inventory) by total current liabilities. These ratios indicate the capacity of an enterprise to meet its short term obligations.

- Capital Structure Ratios: Debt Equity Ratio (DER) is a ratio of total outside long-term liability to the net worth of an enterprise. High debt equity ratios are an indication of high borrowings in relation to the owned funds, but also affects the viability of the operation of the enterprise, as higher borrowings mean higher costs and lower operating margins. In case of those enterprises, which are not capital intensive (i.e., the requirement of fixed assets is low), this ratio may not indicate the correct picture as working capital borrowings, which are not indicated by DER, may be disproportionate to the capital. To get a better result, TOL/TNW ratio, i.e., the ratio of Total Outside Liabilities to Tangible Net Worth can be used.

- Coverage ratios: Interest Coverage Ratio (ICR) and Debt Service Coverage Ratio (DSCR) are the important ratios under this category. ICR is calculated by dividing EBIT (Earnings Before Interest and Tax) by total interest on long term borrowings. DSCR is ratio of total cash flows before interest (net profit + depreciation + interest on long-term borrowings) to total repayment obligation (instalment + interest on long-term borrowings).

- Turnover ratios: Turnover ratios can be classified into the following two types:
  - Inventory turnover ratio: This is one of the important ratios to measure the skills of the management of the firm. This is an indicator of how fast or slow is the movement of inventory. It is calculated by dividing cost of goods sold by average inventory. A higher ratio indicates faster movement of inventory. This is also used for calculating average inventory holding period.
  - Debtors’ turnover ratio: This is another important ratio to measure the efficiency of the receivables management of the firm. It is an indicator of how fast or slow the debtors are realised. It is calculated by dividing the net credit sales by average debtors outstanding during the year. A higher ratio indicates faster collection of debts. This is also used for calculating average collection period.
6.4 Du Pont Model

The Du Pont Company of US introduced a system of financial analysis considered as one of the important tool for financial analysis. The Du Pont identifies that the earning power of a firm is represented by (Return on Capital Employed) ROCE. ROCE shows the combined effect of the profit margin and the capital turn over. A change in any of these ratios would change the company’s earning power. These two ratios are affected by many factors. Any change in these factors would bring a change in these two ratios.

The usefulness of the Du Pont model is that it presents a picture of the overall performance of a company to enable the management to identify the factors relating to the company’s profitability. The two components of this ratio, profit margin and investment turnover ratio individually cannot give the overall view, because the profit margin ratio ignores the profitability of investments and the investment turnover ratio ignores the profitability on sales.

\[
\text{ROCE} = \frac{\text{Profit margin} \times \text{Turnover}}{\text{Capital Employed}}
\]

\[
\text{Turnover} = \frac{\text{Sales}}{\text{Capital Employed}}
\]

\[
\text{Capital Employed} = \text{Working Capital} + \text{Fixed Assets}
\]

\[
\text{Working Capital} = \text{Stock} + \text{Bills Receivable} + \text{Debtors} + \text{Cash}
\]

\[
\text{Net Profit} = \text{Sales} - (\text{Manufacturing costs} + \text{Selling costs} + \text{Administrative costs})
\]

Fig. 6.2 Du Pont chart
(Source: http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

6.4.1 Special Issues in Financial Analysis-Banking Industry

Banks are financial intermediaries playing a crucial role in connecting the depositors (who save money) and the borrowers (who need money). Banks borrow money in the form of acceptance of deposits both from retail and wholesale customers (depositors) as well as banks and financial institutions. The funds are deployed as assets. Bank assets can be broadly classified as follows:

- Loan assets
- Investments
- Other assets (fixed assets)
In both capacities as lending banker and investing banker, a banker needs to be careful. He needs to carry it out as a due diligence exercise for various reasons:

- Safety and security is the concern of a lending and investing banker, since he also acts as trustee for the depositor’s money.
- While lending as well as investing, banks are exposed to many a risks.
- Banks needs to balance their assets and liabilities, and also ensure proper liquidity management.
- Banks should carefully handle their assets portfolio to ensure that their NPA levels remain at minimum possible levels.

In view of the above, a banker’s financial analysis would be different from other category of persons and entities that use the financial statements for various purposes and reasons.

### 6.5 Financial Analysis by Bank as a Lender

While considering a loan proposal, apart from the borrower’s integrity and Know Your Customer (KYC) aspects, the banks are interested in knowing the financial details of the prospective borrower. The extent of these details depends upon the type of loan, type of borrower, purpose of the loan, etc. In case of security-based lending like loans against fixed deposits, etc., these financial details may be few or may not be required at all. However, in other cases of both fund based as well as non-fund based limits, to secure the bank advances and also to manage the risks and recovery of loan amounts, banks would be ensuring collection of all relevant financial data, and other relevant information, to make a proper decision.

Some of the important areas are as follows:

- **Net worth of the borrower**: For an individual, the excess of his assets over his liabilities is his net worth. The same thing applies to any business entity as well but, to consider various types of loans and advances, banks should be careful to evaluate the net worth.
- **Viability**: Banks should assess the viability of the business unit, its operational capacity and its ability to increase its production with the proposed bank loans. This is one of the important considerations for a bank in credit assessment (working capital finance and term finance). A scrutiny of the financial records of the existing activity helps bank in assessing whether the proposed bank loan will result in a significant increase in operations.
- **Repayment capacity**: Depending upon the type of borrower, the repayments of the loans would be determined. In case of an individual, the banks collects information like his income (salary, interest, dividends, etc.) as also his expenditure, including repayments of existing borrowings, if any, to assess the surplus available for repayment of instalment and interest on bank’s loan. However, in case of a business concern, banks obtain most of the required information from its financial statements and for other information banks collect information through their due diligence process.
- **Assessment of performance and financial position**: An analysis of the financial statements reveals the trend of growth of its business and its profitability. The reviews of the financial statements reveal the composition of assets and liabilities of the company. By comparing these to the industry trend, opinion about the management and efficiency of the enterprise is formed.
- **Financial health indicators**: Financial statement analysis is an important tool in identifying direction of business of the company. It also assists the bank to determine the status of the financial health as well. The financial analysis helps the banker to detect any deterioration of its financial health. This signal would enable the bank to take preventive/corrective measures to avoid/minimise losses.
- **Assessment of credit requirements**: Despite all best efforts, one of the difficulties banks face is to accurately assess the financial need of the borrower. Over-financing and under-financing both are risky for the borrower and the bank. Financial statement analysis is used by banks to assess the credit requirement to overcome this issue. Banks are also concerned with repayment of loan interest within a reasonable time. Analysis of the financial statements of the borrower helps in assessing the repayment schedule as also to assess credit risk, and deciding the terms and conditions of loan.
• Cross verification: The statements of stocks and book debts, as on the date of the balance sheet, submitted by the borrower, for calculation of drawing power in the cash credit account, are cross checked with the figures given in the balance sheet.

6.6 Bankers as Investors

As per bank’s investment policy and guidelines of the regulator, banks invest in securities under SLR and Non SLR investment categories. These investments are made by banks for the following reasons:

• To comply with SLR requirements.
• To optimally deploy surplus funds.
• To manage the gap between assets and liabilities (mismatch).
• To diversify risks.

While investing funds in Non-SLR securities, the following need to be taken into account:

• They should adhere to exposure limits and counter-party limits.
• The financial statements of banks and corporate clients, where the funds would be invested, need to be properly analysed.
• Like a lending banker, the investing banker also needs to verify all the important parameters to cover various risks.
• If the investments are in market related instruments, banks also need to do a proper analysis of the market risks and their impact.
• Banks should ensure that all such investments are properly valued by practising the market-to-market concept.
• Apart from trend ratio and other analysis, banks should also carry out PESTEL analysis (Political, Economic, Social, Technological, Environmental and Legal) and impact of the PESTEL factors on their investments.
• To protect the interests of the bank, while investing, careful assessment of the company’s performance and stock markets, also needs to be carried out.
Summary

- The main source of financial analysis is the financial statements, viz., the balance sheet, profit and loss account, cash flow and funds flow statements.
- The balance sheet depicts the position of its assets and liabilities as on a particular date, while Profit and Loss account is prepared for an accounting period and states the position of income, expenses and the profit/loss.
- Different methods of analysis are used on the basis of comparison of two successive balance sheets.
- We can calculate the flow of funds in the intervening period.
- The credit and investment decisions are applicable for future needs of an enterprise, for which usually projected financial statements are also prepared and analysed.
- Analysis of financial statements helps banks in knowing the financial health, performance and viability of an enterprise, and in assessing its credit requirements.
- Some of the important methods used in analysis are trend and ratio analysis.
- The trend analysis shows how the business of an enterprise is growing while the ratio analysis depicts the most critical financial parameters at a glance. Thus, the key ratios like OPM, debt/equity ratio, current ratio, DSCR, debtors’ turnover ratio assist an investor and a lender to get a reasonable understanding about the financial health and the performance of an enterprise. However, for a final decision, a more detailed analysis is necessary.
- While the format for balance sheet and P&L account are prescribed, for meaningful analysis, rearrangement of these statements into various groups can be done according to the requirement of the analyst.
- Du Pont model highlights that the earning power of a firm is represented by Return on Capital Employed (ROCE). ROCE shows the combined effect of the profit margin and the capital turn over. Any change in any of the factors affects the company’s earning power.
- Banks as lender and investor carryout financial analysis. While analysing the company’s performance based on the financial statements, banks should also be careful to give due attention to other factors apart from the financial statements.

References


Recommended Reading

Self Assessment

1. The balance sheet is the most important ___________ statement prepared annually.
   a. financial
   b. commercial
   c. personal
   d. annual

2. Which of the following are deployed as assets?
   a. Salary
   b. Funds
   c. Bonus
   d. Incentives

3. Which of the following statement is true?
   a. An analysis of the annual statements reveals the trend of growth of its business and its profitability.
   b. Different methods of analysis are used on the basis of comparison of three successive balance sheets.
   c. Banks borrow money in the form of acceptance of deposits both from retail and wholesale customers as well as banks and financial institutions.
   d. Debt Equity Ratio (DER) is a ratio of total outside long-term assets to the Net worth of an enterprise.

4. Match the following

   | 1. Interest Coverage Ratio (ICR) and Debt Service Coverage Ratio (DSCR) | A. Is an important tool in identifying direction of business of the company.
   | 2. Inventory Turnover Ratio | B. Are the important ratios under this category.
   | 3. Financial statement analysis | C. Represents gains arising from sources other than normal operations of the business.
   | 4. Non-operating surplus | D. Is one of the important ratios to measure the skills of the management of the firm.

   a. 1- A, 2- B, 3- C, 4- D
   b. 1- B, 2- D, 3- A, 4- C
   c. 1- C, 2- A, 3- D, 4- B
   d. 1- D, 2- C, 3- B, 4- A

5. Which of the following statement is false?
   a. Depending upon the type of borrower, the repayments of the loans would be determined.
   b. Inventory turnover ratio is an indicator of how fast or slow the debtors are realised.
   c. NPM is an indication of ability to withstand the adverse business conditions.
   d. The annual analysis helps the banker to detect any deterioration of its financial health.

6. Financial statement analysis is used by banks to assess the __________ requirement to overcome this issue.
   a. credit
   b. debit
   c. loan
   d. firm
7. __________ assets are those assets which are to be liquidated into cash in the near future.
   a. Fixed
   b. Current
   c. Tangible
   d. Intangible

8. Which of the following is an indicator of the operating efficiency of the enterprise?
   a. NPM
   b. EBDIT
   c. OPM
   d. ROCE

9. __________ is a ratio of total current assets to total current liabilities.
   a. Quick Ratio
   b. Liquid Ratio
   c. Interest Coverage Ratio
   d. Current Ratio

10. __________ is calculated by dividing EBIT.
    a. Interest Coverage Ratio
    b. Liquid Ratio
    c. Turnover Ratio
    d. Quick Ratio
Chapter VII

Risk Management in Banks

Aim

The aim of this chapter is to:

• introduce the concept of risk management
• explain the risk management structure
• explicate credit risk management

Objectives

The objectives of this chapter are to:

• enlist liquidity and market risk management
• elucidate important risks
• explain cross border risks

Learning outcome

At the end of this chapter, you will be able to:

• identify the operational risk
• understand the concept of reporting of banking risk
• describe risk adjusted performance evaluation
7.1 Introduction

A widely used vocabulary for risk management is defined by ISO Guide 73, ‘Risk Management Vocabulary’. In ideal risk management, a prioritisation process is followed whereby the risks with the greatest loss (or impact) and the greatest probability of occurring are handled first, and risks with lower probability of occurrence and lower loss are handled in descending order.

7.1.1 Risks

A risk arises on account of an uncertain event, which might result in a loss or gain to the parties associated with such risk. Even though the risk is an independent event, invariably risks are interlinked in the sense; one risk may lead to other risks as well. Risks can be classified into various types. Few examples of risks are shown in the following diagram:

**Fig. 7.1 Types of risks**
(Source: http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

The first diagram indicates various risks and the second diagram shows three important classifications of the risks.
To illustrate how these risks are interlinked, let us take examples of two market situations.

- **Bank A lends to B Rs.10, 00,000.00/- for a period of six months.** On the due date (maturity of the loan) borrower B needs to repay to Bank A Rs. 10, 00,000.00/- + applicable interest. Assuming on the due date if B fails to repay the amount, then it becomes a credit risk for bank A, on account of default in payment by the borrower. On account of the non-receipt of the funds, Bank A would face another risk called liquidity risk. Not only that, it would lead to a situation of asset liability mismatch (gap risk) for bank A. In view of the shortage of funds, and also to manage the mismatch in its asset liability, bank A should arrange for funds from accepting new deposits and/or approach the market to borrow at the market's interest rate. Hence bank A would be facing the market risk (and needs to pay the market interest rate). In the ordinary course, these transactions would not have arisen, if the borrower B had repaid his loan on the original due date. Further, our assumptions are that after few days, if borrower B repays the loan amount and interest thereof, once again the bank A would face asset liability mismatch on account of funds received. Such funds need to be deployed in the market subject to market interest rate. Assuming on the date of deployment if the market rates come down, the bank A would face a loss. A recap of this illustration would show case how; one risk is extended to series of risks, such as credit risk, liquidity risk, mismatch (gap) risk and market risk (interest rate).

- **Bank X entered into a spot forex deal with Bank Y.** Bank X agreed to sell US$ 1 million to Bank Y at a particular exchange rate. On the date of delivery Bank Y settled the equivalent rupee funds to Bank X. However, Bank X could not deliver the US$ 1 million. So Bank Y is facing a credit risk, also called settlement risk. This would lead to further risks for Bank Y. There would be shortage of funds in the Nostro account of Bank Y. Bank Y needs to fund the account and should either arrange for a fresh deal and/or borrow in US markets at the market’s interest rate. The non-receipt of US funds has created not only credit risk, but also liquidity as well as mismatch risk in the assets and liabilities of the bank Y. Further on account of approaching the forex markets as well as the US market, to enter into a new forex deal and to borrow funds in the US market, bank Y would also face market risks (viz., exchange rate risk and interest rate risk respectively).

**Basel Norms** categorised these risks broadly into three as follows:

- **Credit risk**
- **Market risk**
- **Operational risk**

We have seen examples of credit risk and market risk and how these are interlinked. Let us take another example, i.e., operational risk. Apart from credit and market risks, other risks can be recognised as part of operational risk. Operational risk mainly arises out of non-adherence to the regulatory directives, guidelines, non-compliance of legal framework, on account of human and system errors, natural disasters, and also on account of frauds, misappropriation of funds, weak internal control systems, etc.

Any risk which arises out of one or more factors mentioned above can be recognised as operational risk. Any of the operational risk would create a credit risk for the counter party, and as already explained above, there would be chain effect, like operational risk-credit risk, liquidity risk, mismatch (gap) risk and market risk (interest rate). In view of the above, banks should be very careful in their risk management.

### 7.2 Risk Management-Important Features

The important features of risk management are as follows:

- Risk management policies should be sanctioned by the board. It should cover all the required guidelines and directives of the regulators and applicable legal framework.
- There should be a good support from the Information Technology wing for creating an integrated system, whereby an effective and efficient MIS would be an integral part of the risk management.
- There should be clear demarcation of functions and authority levels to ensure better internal control systems (Eg., front office, mid office and back office of an integrated treasury).
- An effective communication system coupled with the training programmes.
• One of the risk mitigation measures is to setup appropriate limits for various aspects like counter party limit, country limit, currency limit, over night and intraday limits, stop loss limit, individual and group exposure limits, etc.

• Inbuilt checking and balancing systems, such as input and output controls, access control to the computer systems and sensitive areas of the banks.

• Apart from review by the ALCO members, a periodical review and evaluation system should be in place.

Risk management is a methodology that helps managers makes best use of their available resources. The process consists of important steps like:

- Identify
- Analyse
- Evaluate
- Monitor

Fig. 7.3 Risk management steps
(Source: http://www.icsi.in/Study%20Material%20Professional/NewSyllabus/ElectiveSubjects/BL.pdf)

• Identification of risks: Identify the types of risks associated with the banking business and operations. Define the types of risk, with special reference to the goals and objectives of the organisation. Based on the past experience and future forecasts, risks can be identified and classified into different levels like high, medium and low levels.

• Analysing the risks: Risks arise out of many factors like, PESTEL factors, micro and macroeconomic policies, ineffective internal control systems, speculation, etc., Risks can be identified by means of using various analysis like financial, technical, trend and sensitivity analysis based on probability, trend, etc.

• Evaluating the risks: The risk may be evaluated by following the regulators guidelines and directives and also based on past experiences as well. At the time of evaluation, proper weightages need to be assigned for different types of risks as per banks’ risk management policies, such as, risk category, cost associated in managing such risks and also the impact of such risks.

• Monitor and review: Monitoring and review process is an important segment in risk management. An effective monitoring system would assist bank management to identify or forecast risks to enable it to strengthen risk management with more controls to manage the risks which might arise from their business models and their exposure to various markets, across borders. In identifying, prioritising and treating risks, organisations make assumptions and decisions based on situations that are subject to change, (e.g., the business environment, trading patterns or government policies).

• Mitigation of risks: One of the main objectives of the risk management is to ensure that risks are either avoided or minimised. While it is agreed that not all risks can be avoided, good risk management practices should create an effective system of mitigation of risks.
7.3 Risk Management Structure
Banking companies should create an effective risk management structure to handle the risks associated with the bank’s business models and operations. The risk management structure should cover the credit, market, operational and other risks. The structure should be ably supported by the technology in identification and monitoring process of risks. The Risk Management Committee should be formed at the board-level with the overall responsibility to monitor and manage the overall risks of the bank.

Asset-Liability Management Committee (ALCO) is a strategic decision-making body, formulating and overseeing the function of asset liability management (ALM) of a bank. ALCO is headed by the Managing Director or the Chief Executive Officer. The functions of these risk management committees are to recognise, gauge, appraise, scrutinise and measure the risk profile of the bank. The Risk Management Committee also develops the policies and procedures, reviews the pricing models, and also identifies new risks. The Risk Management Committee is assisted by other individual risk management sub-committees.

7.3.1 Risk Management under Basel I
The Basel Committee on Banking Supervision (BCBS) is a committee which was set up by the Central Bank Governors of a group of ten countries, to address international issues relating to the banking supervision. The Basel Committee on Banking Supervision in 1988 came out with a Capital Accord for banks, covering the areas of risks in respect of banks’ assets and liabilities in the balance sheet and off balance sheet exposures. Under the Basel I Accord, only the credit risk factor was considered and the minimum requirement of capital funds was fixed at 8 per cent of the total risk weighted assets. In India, banks are required to maintain a minimum of 9 percent (Capital to Risk Weighted Asset Ratio-CRAR) on an ongoing basis.

7.3.2 Risk Management under Basel II
The second accord brought in significant changes in risk management in banks. The Basel II accord introduced a new approach based on the following three pillars:

- **Pillar I: Minimum capital requirements**
  - The minimum capital requirement should be calculated based on three risks, viz.:
    - Credit risk:
      - Standardised approach
      - Internal ratings based approach
    - Operational risk
    - Market risk

- **Pillar II: Supervisory review process**: This pillar addresses the issues like the key aspects of supervisory review, risk management guidance and transparency and accountability. It also covers the treatment of interest rate risk in the banking book, credit risk (stress testing, credit concentration risk, etc.) operational risk, enhanced cross border risks. The committee identified four key principles of supervisory review:
  - Banks should have in place a process for assessing their overall capital adequacy in respect of their risk profile vs. maintenance of capital level.
  - Supervisors should play a key role in reviewing and evaluating banks’ internal capital adequacy assessments and strategies. Supervisors should also be satisfied with the banks’ abilities in managing the capital adequacy ratios and comply with the regulators’ guidelines. If not satisfied with the performance of banks in their compliance requirements, the supervisors should take appropriate measures.
  - Supervisors should ensure that banks maintain and operate above the minimum regulatory capital ratios.
  - Supervisors should intervene at an early stage, to prevent capital level from falling below the minimum levels required and take quick remedial measures.

- **Pillar III—Market discipline**: As part of an effective risk management, banks are expected to disclose important information. Such market discipline can contribute to a safe and sound banking environment. These disclosures would assist various stakeholders to review and understand the status of the banks’ operations and strategies in a competitive business environment. These disclosures would assist the investors to make their investment decisions.
7.4 Credit Risk Management

Credit risk arises when one of the counter parties fails to fulfill the obligation to settle the payment or repay the borrowed amount. It is also called as default risk and/or settlement risk. Identification of credit risk: Close monitoring of operations in operating loan account like working capital finance cash credit and overdraft accounts would assist the bank to identify the risk based on the signals and warnings from the manner in which the account is being operated. Non-submission of stock statements, wrong information provided in stock statements, regular inspections of stocks, and review of market reports are essential tools to identify the credit risk.

7.4.1 Mitigation of Credit Risk

Credit risks can be mitigated if the banks follow certain norms as given below:

- Adherence to KYC norms: Clear identity of the borrower and the borrowing company, and the nature of business model.
- Credit Appraisal: The loan proposals should be considered as per bank’s loan policy and guidelines of the Reserve Bank of India and other directives. The credit limits (both fund based as well as non-fund based) should be fixed after due assessment of many risks associated with the type of borrower, nature of industry and other factors. Such limits should be subject to sufficient margin and appropriate collateral requirements to safe guard the banks’ interests. Regular monitoring of the loan accounts should be an integral part of effective risk management system. Respecting the credit limits and allowing the clients to operate within the credit limits and ensuring other terms and conditions of the credit sanction, and adherence to the exposure norms as per regulators’ guidelines would assist the banks to manage the credit risks. Risk-based pricing of loans and advances and credit rating can be used as an effective tool as part of credit management.

7.4.2 Credit Risk Measurement-Basel II Norms

The risk which arises on account of default is associated with almost any financial transaction. BASEL-II provides the following two options for measurement of capital charge for credit risk:

- Standardised Approach (SA): Under the SA, the banks use a risk-weighting schedule for measuring the credit risk of its assets and off-balance sheet positions. A risk weight of 100% indicates that an exposure is included in calculation of assets for full value, by assigning risk weights based on the rating assigned by the external credit rating agencies.
- Internal Rating Based Approach (IRB): The IRB approach, on the other hand, allows banks to use their own internal ratings of counterparties and exposures, which permit a finer differentiation of risks for various exposures and hence delivers capital requirements that are better aligned to the degree of risks.

The IRB approaches are of the following two types:

- Foundation: Under this method, banks estimate the risk of default or the probability of default associated with each borrower.
- Advanced: Under this method, banks are allowed to have additional internal capital to assess additional risk factors.

7.5 Liquidity and Market Risk Management

As explained earlier, one of the important risks faced by banks is the liquidity risk. The banks’ treasury handles the liquidity management through money market and forex market operations; hence a careful strategy needs to be in place for market related activities.

Identification of liquidity risks

Review of asset and liability mismatch is one of the eye openers. There should be close control on the utilisation of short-term funds for long-term assets and vice versa, that would lead to maturity mismatches. An effective credit monitoring and operations of the banks can reduce the impact of the liquidity risk. A good internal control review and online monitoring system, identification of weakness in the systems and procedures, etc. would also assist the bank to manage the inflow and outflow of funds effectively. Internal limits for cash management including foreign funds and an effective reconciliation of Nostro accounts are some of the measures to reduce the impact of the liquidity risk.
The role of the treasury in managing the liquidity position is very important. The treasury should closely watch the market movements and accordingly handle the situations. To effectively monitor the risk, banks should set up limits for currency, country and adhere to investment exposure norms as well. A close watch on the macro-level factors in different markets and ensuring necessary control measures of revising exposure limits and other aspects would also assist to manage the liquidity risk. Reviewing and understanding the various features of the monetary policy and quarterly review by the Central Bank (Reserve Bank of India) and appropriately adjusting the strategies would assist the banks in effectively managing the liquidity position.

7.5.1 Market Risks
In a sense, the market risk arises on account of the external factors, i.e., market forces of demand and supply factors. Market risk arises from the adverse movements in market price. Market risk can also be defined as the risk of losses on account of on-balance sheet and off-balance sheet positions due to the movements in market prices.

The market risk can be broadly recognised as follows:

- **Interest rate risk**: One of the important factors that affect the bottom line of any bank is the volatile movement of interest rate. The interest rates of deposits/loans are basically determined by the market forces (i.e., demand and supply for/for funds). These are influenced by various factors like:
  - Government policies
  - Speculation
  - Inflow and outflow of funds
  - Present and future commitments
  - Other factors such as opportunities to invest in other markets, etc.

- **Exchange rate risk**: The price movement in terms of foreign exchange transactions (deals) is called the exchange rate risk. The exchange rate movement is mainly felt in case of the floating exchange rate system (price/exchange rate is decided by the demand and supply factors). As the markets are widespread and the exchange rate movement is so quick and moves either way (up and down), it is difficult to assess the market movements when it is very volatile. The volatility in the exchange rates movement are due to various factors, such as the government and regulators’ policies, speculation, forecasting, markets operating in different time zones almost on 24 x7 basis, etc. The market risk positions necessitate a bank to maintain the capital for calculation of capital adequacy ratio is:
  - The risks associated with the interest related instruments and equities in the trading book of the banks.
  - Foreign exchange risk (including exposures in precious metals) throughout the bank, both in banking and trading book.
    - **Banking book**: The banking book comprises assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity.
    - **Trading book**: Investments held for generating profits on the short-term differences in prices/yields, Held for trading (HFT) and Available for Sale (AFS) category constitute trading book.

Market risks can be assessed/measured by the following analyses, such as scenario analysis, trend and stress analysis:

- **Scenario analysis**: A method in which the earnings or value impact is computed for different interest rate scenarios.
- **Stress analysis (testing)**: This is used to evaluate a bank’s potential vulnerability to certain unlikely events or movements in financial variables. The vulnerability is usually measured with reference to the bank’s profitability and /or capital adequacy duration analysis, measures the price volatility of fixed income securities. It is often used in the comparison of interest rate risk between securities with different coupons and different maturities. It is defined as the weighted average time to cash flows of a bond, where the weights are nothing, but the present value of the cash flows themselves. It is expressed in years. The duration of a fixed income security is always shorter than its term to maturity, except in the case of zero coupon securities where they are the same.
Market risk - Basel II norms: Market risk is defined as the risk of loss arising from movements in market prices or rates away from the rates or prices set out in a transaction or agreement. The capital charge for market risk as per the Basel norms can be estimated by two methods, viz., standardised measurement method and internal risk management model.

The standardised measurement method: This method, currently implemented by the Reserve Bank, adopts a ‘building block’ approach for interest-rate related and equity instruments which differentiate capital requirements for ‘specific risk’ from those of ‘general market risk’. The ‘specific risk charge’ is designed to protect against an adverse movement in the price of an individual security due to factors related to the individual issuer. The ‘general market risk charge’ is designed to protect against the interest rate risk in the portfolio. In the standardised approach, there are two ways to measure market risk, i.e., duration method and maturity method. Under the duration method, banks can calculate the interest rate risk, by calculating the price sensitivity, of each position separately. Further, the measurement of capital charge for market risks should also include all interest rate derivatives and off-balance sheet instruments in the trading book.

Foreign exchange open positions and gold open positions are also to be considered for capital charge as per Basel norms and the Reserve Bank of India guidelines. Banks should strictly follow the Reserve Bank of India’s guidelines in classification of securities as Held for Trading, Available for Sale, etc., and accordingly assign risk weights. Banks should also assess their trading books and assign risk weights as per the Reserve Bank guidelines.

Value at risk: Market risk can be measured through this tool called “Value at Risk” (VaR). VaR is a method for calculating and controlling exposure to market risk. It is a single number (currency amount) which estimates the maximum expected loss of a portfolio over a given time horizon (holding period) and at a given confidence level. It is measured in three variables, the amount of potential loss, the probability of that amount of loss and the timeframe.

7.5.2 Other Important Risks
The other important risks are explained in the paragraphs below.

Mismatch risks (gap risks)
Banks as important players in the financial sector acquire funds in the form of deposits from public (individuals/corporate) and deploy them to (individuals/corporate) as loans and advances. The funds accepted/borrowed are reflected as liabilities and the funds deployed/lent/invested appears as assets in the balance sheets. Depending upon the business model, the liabilities and assets will have a mismatch or gap between them. In case of Foreign Exchange Operations, the Foreign Exchange dealer’s position (exposure) in various currencies arises due to the purchase and sale of foreign currencies in different markets, and for different maturities. The mismatch in maturities between purchases/sales creates a gap. These gaps can be classified based on the time period of maturity (due dates). Therefore, to cover these (exposures) open positions banks need to buy or sell/borrow or lend in the market, depending upon the price of currencies (exchange rates) and interest rates.

Cross border risks
Another risk which is exclusively applicable to foreign exchange transactions is the cross border risk. This type of risk is also known as country risk/sovereign risk. Foreign Exchange markets operate on 24X7 basis almost continuously. Obviously, all centres do not operate simultaneously and hence results in time zone difference and that leads to risks associated with various centres which is popularly called as cross border risk.

Country risks
These are risks in which a foreign entity, private or sovereign may be unwilling or unable to fulfil its foreign obligations for reasons beyond the usual risks, in respect to all lending and investments.
7.5.3 Country Risk Management System (CRMS)

For an effective CRMS, as per the guidelines of the Reserve Bank of India, banks have to adopt the following:

- Strict adherence to the “Know Your Customer” (KYC) principle in international transactions.
- Country risk factor should be given special attention while evaluating the counterparty risk.
- All exposures funded, non-funded from domestic as well as international centres needs to be included while determining the country limits.

The Statutory Auditors have to audit the country risk exposures of the bank as at the end of the year. In addition to the auditing being carried out by the Statutory Auditors, banks have to make necessary provisions for country risk exposures and should disclose them as part of the ‘notes to account’ of the balance sheet and report to the Reserve Bank of India as part of DBS return.

In respect of CRMS, the funded, non-funded and indirect exposures would include the following items:

- Direct exposure-funded
  - Cash balances or foreign currency, if any held by branches.
  - Bank balances and deposit placements: Covers the bank balances and placements with banks incorporated outside India.
  - Loans and advances: Loans against NRI deposits exceeding the deposit amount, travellers’ cheques purchased.
  - Overdrafts in Vostro accounts, etc.

- Direct exposure non funded
  - Letters of Credit: Exposures on account of Letters of credit issued by branches on behalf of constituents’ resident outside India.
  - Guarantees: Exposures on account of guarantees issued by branches on behalf of entities resident outside India
  - Confirmed LCs issued by foreign banks, etc.

Short-term country risk exposures are those exposures which have contractual maturity up to 179 days.

7.6 Operational Risks

In banks, the risks which arise out of the failure in internal systems and procedures, internal control system and/or human and system errors, and other internal/external factors like non-compliance of regulatory and legal framework, frauds, misappropriation, etc., one or more of the above mentioned risks are collectively called as the ‘operational risk’.

7.6.1 Some Examples of Operational Risks

Some examples of operational risks are given in the paragraphs below.

Information technology risks

Banks in India are well supported by the Information Technology to carry out their banking business and operations. This has increased the banks’ operational risks. The risks associated with IT are: Error Risk, Fraud Risk, and Interruption Risk, etc., In case of weak IT controls and non-adherence to the laid down policies and procedures, the computerised systems could be exposed to unauthorised access. Pre-acceptance tests, if not properly carried out can lead to issues which can be termed as operational risk on account of IT. If the computerised control (both around the computer system and through the computer system) is not properly ensured, it can lead to a situation of fraudulent activities. Failure on the part of the management to ensure regular testing of disaster management control, in case of emergency, might increase the risks. Hence, importance should be given and care should also be exercised by having a proper operational risk management with special reference to the Information Technology.
Legal risks
With the changing economic scenario, banks are not only exposed to risks associated with the domestic markets, but also to international markets as well. More and more banking activities across borders, banks have to comply with more than one regulatory authority and also a number of legal frame-work of international importance. The cross border or country specific legal requirements needs to be properly interpreted and understood and applied in the case of international trade and finance. The money laundering has become an important international issue; banks have to be careful in its operations. Banks should appoint international legal firms to handle their legal compliance to avoid legal risks. The Basel Committee defines this risk as “The risk of loss arising out of inadequate or failed internal processes, people and systems, or from external events.” Banks have to make capital allocation for operational risks as well.

The revised BASEL II framework offers the following three approaches for estimating capital charges for operational risks:

- The Basic Indicator Approach (BIA): This approach sets a charge for operational risk as a fixed percentage (alpha factor) of a single indicator, such as the banks’ gross annual revenue.
- The Standardised Approach (SA): This approach requires that the bank separate its operations into eight standard business lines, such as trade finance, corporate banking and others. The capital charge for each business line is calculated by multiplying gross income of that business line by a factor (beta) assigned to that business line.
- Advanced Measurement Approach (AMA): Under this approach, the regulatory capital requirement will equal the risk measure generated by the banks’ internal operational risk measurement system.

As per the guidelines of the Reserve Bank of India, banks are required to integrate to the Basel II framework, with the Standardised Approach for Credit Risk and Basic Indicator Approach for Operational Risk. Banks are also required to upgrade their technology base to support implementation of Risk Assessment and Risk Management structure to meet the requirements of the Advanced Approaches under Basel II.

7.7 Risk Management under Basel III
As per Basel Committee on Banking Supervision (BCBS), Basel III reforms have been introduced to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, thus reducing the risk spill over from the financial sector to the real economy.

Basel III norms address the following:
- At micro-level, through prudential regulation to strengthen the individual banking institution’s ability to handle crisis in the period of stress.
- At macro level, through prudential regulation to address system wide risks across banking sector as well as the pro-cyclical amplification of these risks over a period of time.
- Raising the quality and level of capital to ensure that the banks are better equipped to absorb losses on both, a going concern basis and a gone concern basis.
- Increase the level of risk coverage of the capital framework by introducing leverage ratio to serve as a backdrop to the risk-based capital.
- Raise the standards for supervisory review (Pillar 2) and public disclosures (Pillar 3)
- The capital buffers capital conservation buffer and the countercyclical buffer are expected to protect the banking sector from the periods of excess credit growth.

The BASEL III capital regulations continue to be based on three-mutually reinforcing Pillars, viz. minimum capital requirements, supervisory review of capital adequacy, and market discipline, of BASEL II. In India, guidelines on Basel III capital regulation have been implemented from April 1, 2013 in a phased manner. To ensure smooth transition to BASEL III, appropriate transitional arrangements have been made for meeting the minimum BASEL III capital Ratios, full regulatory adjustments to the components of capital, etc. Consequently, BASEL III capital regulations would be fully implemented as on March 31, 2018.
Guidelines on liquidity coverage ratio and liquidity risk monitoring tools under Basel III
The Basel III Framework on Liquidity Standards includes Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) and liquidity risk monitoring tools. RBI’s guidelines included enhanced guidance on liquidity risk governance, and measurement, monitoring and reporting to the Reserve Bank on liquidity positions. The Basel III liquidity standards were subject to an observation period/revision by the Basel Committee with a view to addressing any unintended consequences that the standards may have for financial markets, credit extension and economic growth.

The Basel Committee has issued guidelines on the Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools in January 2013, and is in the process of finalising the NSFR and disclosure requirements. The LCR is to be implemented from January 1, 2015 and the NSFR from January 1, 2018. The Reserve Bank will issue the final guidelines on Basel III liquidity standards and liquidity risk monitoring tools, taking into account the revisions by the Basel Committee.

7.8 Reporting of Banking Risks
Accurate, complete and timely data is a foundation for effective risk management. However, data alone does not guarantee that the board and senior management will receive appropriate information to make effective decisions about risk. To manage risk effectively, the right information needs to be presented to the right people at the right time. Risk reports based on risk data should be accurate, clear and complete. They should contain the correct content and be presented to the appropriate decision-makers in a time that allows for an appropriate response.

To effectively achieve their objectives, risk reports should comply with the following principles:

- **Accuracy:** Risk management reports should accurately and precisely convey aggregated risk data and reflect risk in an exact manner. Reports should be reconciled and validated.
- **Comprehensiveness:** Risk management reports should cover all material risk areas within the organisation. The depth and scope of these reports should be consistent with the size and complexity of the bank’s operations and risk profile, as well as the requirements of the recipients.
- **Clarity and usefulness:** Risk management reports should communicate information in a clear and concise manner. Reports should be easy to understand, yet comprehensive enough to facilitate informed decision-making. Reports should include meaningful information tailored to the needs of the recipients.
- **Frequency:** The board and senior management (or other recipients as appropriate) should set the frequency of risk management report production and distribution. Frequency requirements should reflect the needs of the recipients, the nature of the risk reported, and the speed, at which the risk can change, as well as the importance of reports in contributing to sound risk management and effective and efficient decision-making across the bank. The frequency of reports should be increased during times of stress/crisis.
- **Distribution:** Risk management reports should be distributed to the relevant parties while ensuring that confidentiality is maintained.

7.9 Risk Adjusted Performance Evaluation: Important Aspects
The important aspects of Risk Adjusted Performance Evaluation are summarised below:

- **Breaking down asset returns:** Intuitively, we can consider the total return on an asset to be the sum of the risk free return, which is the reward for the time value of money, the beta return, which is the reward for the additional volatility of the asset, also called the market risk premium, and the alpha return, which is the superior performance attributable to the asset manager’s security selection skill.
The risk free rate carries no volatility. The beta and alpha components of the return bring volatility to the asset’s return stream, and the Sharpe ratio measures the excess return earned by the asset ‘per unit of volatility’. It does so by dividing the excess return, i.e., assets return less risk free rate, by the standard deviation. The following are the various types of ratios:

- The Sharpe ratio: The Sharpe Ratio reflects the ratio of all excess returns over the risk free rate to the total risk (or standard deviation) of the return stream. In other words, we strip out the risk free rate from the earned returns, and divide that by the total standard deviation of the returns.

  \[
  \text{Sharpe ratio} = \frac{\mu - rf}{\sigma}
  \]

  Where \( \mu \) is the expected return, \( s \) is the standard deviation of returns, \( rm \) is the return of the market portfolio and \( rf \) is the risk free rate.

- The Treynor ratio: The Treynor ratio is the ratio of the excess return to the beta of the portfolio. It is similar to the Sharpe ratio, but instead of using volatility in the denominator, it uses the portfolio’s beta. Therefore the Treynor Ratio is calculated as [(Portfolio return - Risk free return)/Portfolio’s beta].

  \[
  \text{Treynor ratio} = \frac{\mu - rf}{\beta}
  \]

  where \( \mu \) is the expected return, \( s \) is the standard deviation of returns, \( \beta \) the beta of the portfolio (or the security in question) measured against the market returns and \( rf \) is the risk free rate.

- Jensen’s alpha: Jensen’s alpha, often just referred to as alpha, and is a measure of the returns that are attributable to the manager’s skill, i.e., the returns remaining after deducting what would have been attributable to beta returns (which do not require skill) and the risk free rate. It is the difference between the return of the portfolio, and what the portfolio should theoretically have earned. Any portfolio can be expected to earn the risk free rate (rf), plus the market risk premium (which is given by [Beta x (Market portfolio’s return - Risk free rate)]. Anything remaining over and above is the result of the manager’s security selection skill, and is alpha. Jensen’s alpha = \( \mu - rf - \beta(rm - rf) \), where \( \mu \) is the expected return, \( \beta \) the beta of the portfolio (or the security in question) measured against the market returns, \( rm \) is the return of the market portfolio and \( rf \) is the risk-free rate.

- Kappa indices: One criticism of other risk adjusted performance measures is that they take both upside and downside risk into account, even though a portfolio manager or investor is only concerned with managing the downside. Kappa indices, which include the Sortino ratio and the Omega statistic, consider semi-variance, i.e., variance calculated only in respect of the downside risk instead of variance based on all returns. One problem with metrics based on semi-variances is that they are not mathematically tractable, i.e., it is difficult to do much more with them once they have been calculated.

- The Information ratio: The Information ratio, often used in the hedge fund world, is the ratio of the alpha component of total returns to the standard deviation of these excess alpha returns. The alpha component is the returns that is attributable to the manager’s skill (or luck), and is the residual after taking out the risk free return and the beta components from the total returns. The information ratio is merely Jensen’s alpha divided by its standard deviation. The higher the information ratio, the greater the chances of the manager making money. The information ratio only looks to compute the return per unit of risk undertaken for the alpha component. This is important because alpha returns are risky, as they represent a zero sum game for the market as a whole. In fact, average alpha for the market as a whole is in practice slightly less than zero because of transaction and other costs. Therefore, it is easy for a manager to take on ‘alpha risk’ and lose money that will bite into the beta returns.
Interpreting the information ratio, or why is the information ratio important?
Identification of Liquidity Risk: Review of asset and liability mismatch is one of the eye openers. If we were to assume that alpha returns will be normally distributed, then the information ratio allows us to model the alpha as being a distribution with mean = IR and standard deviation = 1. This is intuitive because IR = (mean alpha return/standard deviation of alpha returns). A ratio of say, 0.4 can be interpreted to imply a normal distribution with mean equal to 0.4 and a standard deviation of one. From this point, everything is easy because we can now estimate the probability of losing money, or the probability of meeting a benchmark.

<table>
<thead>
<tr>
<th>Expected Alpha=4%</th>
<th>Standard Deviation (Tracking Error) =10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information Ratio=0.4</td>
<td></td>
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</tbody>
</table>

Shaded area represents the probability of expected alpha to be less than zero, i.e., the probability of losing money. Can be calculated as = NORMSDIST(0.4)=0.3446

Fig. 7.5 Interpreting the information ratio

Note that just simply putting the formula = normsdist(-IR) gives us the probability of losing money in one year.

We can extend the analysis to multiple years, for example, consider a manager with an alpha of say, 3%, and standard deviation of say 10% (IR = 0.3). The probability of him losing money over a one year period is 38%. Now think of a three year horizon. The mean returns over a three year period will be 9%, and the standard deviation will be $(3^{1/2})\times10\%$, or 17.3%, and therefore a possibility of losing money over a three year period to be about 30%.
Summary

- Banks, being an important financial intermediary, are associated with many risks.
- It is obvious that despite best efforts banks cannot avoid or completely eliminate the risks.
- As per the Basel norms, banks can integrate the three pillar concepts with an effective management assessment and control, coupled with a very good supervision and market discipline banks can overcome the risks to a greater extent.
- Banks risk management system needs to address various aspects like identification, evaluation, monitoring and measuring the risks.
- Banks should ensure that their Risk Management System should be based on the Basel Norms and the Reserve Bank of India’s guidelines.
- The Information Ratio, often used in the hedge fund world, is the ratio of the alpha component of total returns to the standard deviation of these excess alpha returns.
- Banks in India are well supported by the Information Technology to carry out their banking business and operations.
- Credit risk arises when one of the counter parties fails to fulfil the obligation to settle the payment or repay the borrowed amount. It is also called as default risk and/or settlement risk.

References


Recommended Reading

Self Assessment

1. Which of the following include the Sortino ratio and the Omega statistic; consider semi-variance, i.e. variance calculated only in respect of the downside risk instead of variance based on all returns?
   a. Kappa indices
   b. The Treynor ratio
   c. Jensen’s alpha
   d. The Shape Ratio

2. The ________ is the ratio of the excess return to the beta of the portfolio.
   a. Jensen’s alpha
   b. Treynor ratio
   c. Shape Ratio
   d. Kappa indices

3. Which of the following is used in the hedge fund world?
   a. The Treynor Ratio
   b. The Shape Ratio
   c. The Information Ratio
   d. Turnover Ratio

4. ________ requirements should reflect the needs of the recipients, the nature of the risk reported, and the speed, at which the risk can change.
   a. Frequency
   b. Comprehensive
   c. Accuracy
   d. Clarity

5. Match the following

| 1. Credit risk | A. Approach sets a charge for operational risk as a fixed percentage (“alpha factor”) of a single indicator, such as the banks’ gross annual revenue. |
| 2. Jensen’s alpha | B. Arises when one of the counter parties fails to fulfil the obligation to settle the payment. |
| 3. The Basic Indicator Approach | C. Is defined as the risk of loss arising from movements in market prices or rates away from the rates or prices set out in a transaction or agreement. |
| 4. Market risk | D. Is the difference between the return of the portfolio, and what the portfolio should theoretically have earned. |

   a. 1- A, 2- B, 3-C, 4- D
   b. 1- B, 2- D, 3-A, 4- C
   c. 1- C, 2- A, 3-D, 4- B
   d. 1- D, 2- C, 3-B, 4- A
6. Which of the following statement is false?
   a. Identification of Liquidity Risk: Review of asset and liability mismatch is one of the eye openers.
   b. Credit risk arises when one of the counter parties fails to fulfil the obligation to settle the payment or repay the borrowed amount.
   c. The Information ratio is the ratio of the excess return to the beta of the portfolio.
   d. The information ratio only looks to compute the return per unit of risk undertaken for the alpha component.

7. Which of the following statement is true?
   a. The alpha component is the return that is attributable to the manager’s skill.
   b. Risk management reports should communicate information in a manner which is not good to understand.
   c. Increase the level of risk coverage of the capital framework by introducing leverage ratio to serve as a backdrop to the risk-based capital is the norm of Basel II.
   d. Jensen’s alpha = μ - rf -β(rm - rf).

8. The _______ Ratio reflects the ratio of all excess returns over the risk free rate to the total risk of the return stream.
   a. Liquid
   b. Sharpe
   c. Treynor
   d. Information

9. Which of the following is an important segment in risk management?
   a. Evaluating the risks
   b. Migration of risks
   c. Analysing of risks
   d. Monitoring and review process

10. The _______ accord introduced a new approach based on the three pillars.
    a. Basel I
    b. Basel III
    c. Basel II
    d. Basel I and III
Chapter VIII
Ethics and Corporate Governance in Banks

Aim
The aim of this chapter is to:

- introduce the concept of ethics
- explain corporate social responsibility
- explicate corporate governance in banks

Objectives
The objectives of this chapter are to:

- explain the auditor’s certificate on corporate governance
- elucidate business ethics
- describe clause 49

Learning outcome
At the end of this chapter, you will be able to:

- identify the disclosure of new clause 41
- understand the Basel committee recommendations
- describe the duties of compliance officer
8.1 Introduction
The word ‘ethics’ is derived from the Greek word ‘ethikos’ meaning character or custom. As per Chambers Dictionary, ‘ethics’ is a code of behaviour that is considered right. According to some other views, ethics is the science of moral, moral principles and practices. Ethics also deals with the dissimilarity between different actions like ‘good or bad’; ‘correct or incorrect; ‘moral or immoral’

8.1.1 Understanding Ethics
Religious faiths do influence and guide an individual or group of persons. Religious teachings generate values in the individual or group of persons. Nearly all religious practices are based on similar principles. Some of the important guidelines of religions are as follows:
• Be kind to all others including animals and natural resources.
• Be humble, modest, simple and courteous.
• Be truthful to oneself and others.
• Stay away from greed, lust and anger which are excesses of desire, love and annoyance respectively.
• Be happy in life.
• Be happy with others’ achievements/performance.

8.1.2 Rights of People
People have rights to the following:
• Privacy
• Information
• Freedom of faith and speech
• Practice fair trade/professional practices
• Safety
• Equitable treatment

Any effort by any person to infringe any of these rights is considered unethical. Right to privacy is violated in many ways. For example, the personal data available with researchers have led to many junk/spam mails, tele-marketing calls, etc.

8.1.3 Ethical and Unethical Issues
In practical situations, it is at times difficult to decide whether a particular issue is ethical or unethical. It can be considered as ethical or unethical based on certain perceptions and depending upon the situations. The factor that distinguishes an action as ethical or unethical is one’s value.

Value and ethics
Sincerity, trust, concern for others, keeping up the commitments, respect for others’ rights and selflessness are some examples of values in an individual’s life.

8.2 Business Ethics
The study of moral values based on economic systems prevalent in different countries and across the globe is called as ‘Business Ethics’. In today’s changing environment, this can also be recognised as corporate ethics.

Ethics: Certain important concepts
Ethics involves a discipline that examines good or bad practices within the context of a moral duty. Moral conduct is the behaviour that indicates which is right and wrong. Business ethics include practices and behaviours that are good or bad, in other words ethical or unethical.
There are many concepts of ethics and some of them are discussed below:

- **Utilitarianism:** Action is morally right, if the total net benefit of the action exceeds the total net benefit of any other action. In other words, the result of the action is more favourable than unfavourable to everyone.

- **Egoism:** The theory which treats self-interest as the base of morality. Two forms of ethical egoism can be identified as individual and universal, which include other’s interest only from the point of the assessors’ self-interest. It is mainly self-centred, and importance is given to self pleasure and gain and avoids pressure and pain.

- **Rights:** A Right is considered as a person’s just claim or entitlement.
  - Legal rights: Defined by a system of laws.
  - Moral rights: Based on ethical standards—principles of right or wrong.
  - Justice: Justice is the decision which could arise from the application of rules, policies, or laws that apply to a society or a group.

### 8.2.1 What is a Code of Ethics?

A code is a set of rules, which are accepted as guiding principles. A code is adopted by a corporate, professional body, and/or a nation. A company’s policy statements describe the ethical code. Codes do not create ethical behaviour, unless the ethical practices are understood and practised in both at individual and corporate levels.

### Ethical and unethical practices

There are many reasons for an individual or group of individuals or corporate and others to follow ethical or unethical practices. Some of the reasons are as follows:

- Conflict of interest
- Incentives
- Unreasonable targets
- Decision-making
- Weak control systems
- Unhealthy competition
- Discrimination
- Empathy

While ethical practices would make certain a better and conducive climate in work place, we come across unethical practices in many areas.

### 8.2.2 Ethical Aspects in Human Resource Management

The following are the ethical aspects in Human Resource Management:

- Transparency: Transparency is one of the important ethical aspects in HRM. Lack of openness in interpretation, decision-making and communication, performance appraisal, promotion process, etc., would de-motivate the employees.
- Internal stakeholders: Employees are important internal stakeholders and need to be dealt with highly ethical practices for all-round progress of the institution.

### 8.2.3 Ethical Aspects in Marketing Management

Marketing Mix is an important factor that determines the performance of the marketing team. There are ‘4 Ps’ of Marketing Mix, viz., Place, Product, Price and Promotion. The unethical issues concerning these ‘4Ps’ are as follows:

- Place: ‘Place’ is the link between the customer and producer, through appropriate delivery channels. Convenient location plays a crucial role in increasing the sale of the products. As regards banking, the term ‘place’ represents their delivery channel, i.e., branch network, ebanking channels like ATMs, Internet, Core Banking Solutions, etc. For the convenience of customers, ATMs are also available at offsite locations. The place acts as an important
factor of the marketing mix, and ensures good customer relationship management. Unethical practices on account of ‘Place’ as part of marketing mix arises in the following situations:
- If a branch of a bank is relocated to another area without sufficient notice and time.
- A customer, who uses ATMs, Internet banking facility, is denied access to them on account of bank’s failure to provide the services, and thereby the customer is facing inconvenience, loss of money and time.

- Product: ‘Product’ is one of the important components of marketing mix. Product can be in the form of goods or an article or an instrument (in case of financial services), for which the consumer pays a value (price) and expects to get satisfaction/comfort. If a bank offers a deposit product offering higher interest and suddenly stops offering such type of deposit products without any prior notice, then from the customers’ point of view this could be viewed as unethical practice. Similarly, when new loan products with certain value-added features are launched, such value additions are offered only for the new loan customers, but not for existing loan customers could be viewed as unethical by the existing customers.

- Price: ‘Price’ is another important component of a marketing mix. Price discrimination is labelled as unethical. For example, A bank, when there is change in the floating interest rates, immediately increases the interest rates for loan accounts for the existing borrowers, however, in case of rate cut, the bank does not reduce the interest rate immediately, is considered as unethical. Another example of unethical practice is, any increase in charges, fees are given immediate effect, however any reduction in charges, fees, etc. which would benefit the customers is not passed on to them immediately.

- Promotion: Reaching out to the customers through effective network and attractive communication is the key role of the marketing mix called ‘promotion’. Advertisement is the main component of promoting products. Unethical practices are as follows:
  - Misleading advertisements to draw the clients.
  - Unsolicited telephone calls, e-mails, and thereby causing nuisance to the clients.

8.2.4 Ethical Aspect in Financial Management

A sound financial policy and efficient management control, is very important for good corporate governance. Many unethical practices noticed in the area of financial management are putting pressures on the regulators and governments which affect both internal and external stakeholders. Some of the noteworthy unethical issues in the financial activities and markets are as follows:

- Concealment of facts: In case of Satyam’s scam, for years the (real) financial position was concealed, but unrealistic financial position was reflected in a systematic manner to appear as realistic numbers.
- Money laundering activities: This is not only unethical, but also criminal and illegal. These activities include conversion of illegal money into legal money using the banks as channels to affect such activities.
- Misappropriation and diversion of funds: Many business enterprises including corporate availing of loans and do not use the funds for the purpose the loan was availed of, but divert the funds for other activities. For example: A manufacturing company avails of working capital finance for production purpose. The funds are raised against hypothecation of goods; however the funds are not used for production of the goods, but invested in real estate sector and/or capital markets to earn higher returns. Though the repayment of the loan is on schedule, these activities of the company are unethical on account of misappropriation of funds.
- Lack of internal control: Due to weak internal controls at appropriate levels, sometimes loans become non-performing assets. Unethical practices like corruption, diversion and misappropriation of funds, loans granted against collateral which are of inferior quality, lesser value, etc., not only affect the performance of the banks, but also increases the levels of non-performing assets.
- Non compliance of regulatory and legal framework: Banks face many compliance issues by not following the rules and regulations. These non-compliances have created avenues for conversion of black money to legal money through banking channels, and made banks not only to face embarrassment, but also reputational risks.
8.2.5 Desired Ethical Practices and Corporate Governance

Some important factors of ethical issues as listed below, if not handled properly, would affect the corporate governance practices:

- **Conflict of interest**: In case of mergers and acquisitions (M&As), an audit firm offers consultancy services through their consultancy division. The expertise of auditors’ of the audit division might be used by the consultancy division in valuations and this may be considered as an example of conflict of interest.

- **Transparency**: In financial statements and annual reports, ‘disclosures of actual facts to the stakeholders’ help the investors and others to take decisions. Non-transparent practice is window dressing of data and figures in the financial statements.

- **Insider trading**: The growth of the global economies depends (among other factors) upon the successful participation of financial and other competitive markets. Any changes in prices (interest rates, exchange rates and prices of commodities) significantly affect the profitability of the companies; thereby affect the economic growth of a nation. There are many ways price of a product, and/or interest rate of an investment instrument, and/or exchange rate of a foreign exchange transaction can change or move upwards and/or downwards. Any person, who by virtue of his position in a corporate, can have access to sensitive information relating to the price, if such person makes use of this information to his advantage, which is unethical, it is called as insider trading.

- **Mergers and acquisitions (M&As)**: In the competitive international business environment, mergers and acquisitions play a crucial role in business expansion across borders. Management buyout is one type of takeover. In this case, the management decides to bid for the company. If successful, they can convert the company to a private company and at a later date depending upon the market conditions sell it in the market and make good profits. Unethical aspects relating to such takeover may be that during the buyout, confidential information is leaked by employees/managers for their benefit and there will be a possibility of bringing down the share prices by the vested parties for buying them at a very cheaper rate.

- **Golden parachute**: Special incentives and benefits are offered to top executives to avoid a takeover situation. These benefits would include bonuses, stock options, etc., In view of the golden parachute; the top executives might not support the takeover of the company.

- **Hostile takeovers**: When there is opposition from the board or employees or officers of the target company not to allow mergers and acquisitions, it is called as hostile takeovers. On account of vested interests, and to protect their own interests, managers may oppose the M & A.

- **Green mail**: It is a process through which the management of the target company sends green mails to prevent a shareholder or group of shareholders to take over a company. There is a possibility of the buy back of the shares at a premium by the company at a later stage. Hence green mails are considered unethical. In short, mergers and takeovers are considered unethical, if they ignore the interests of the shareholders.

8.3 Corporate Social Responsibility in the Financial Sector

The institutions representing the financial sector like banks, mutual funds and other institutions. Like other corporate sector players contribute significantly to the community development in many ways. International Financial Corporation (IFC), an affiliate of the World Bank, International Chamber of Commerce (ICC) and United Nations Organisation (UNO) are participating in the various projects across the world. They are motivating banks and financial institutions to play an effective role in promoting environmental protection and social sustainability through these projects. In this respect, the financial institutions and banks are encouraged to follow certain principles in respect of CSR.

- **Commitment to sustainability**: FIs should expand their mission of profit maximisation to a vision of social and environmental sustainability. To achieve these, FIs should integrate the consideration of ecological limits, social equity and economic justice into their corporate strategies and into their core business models.

- **Commitment to ‘Do No Harm’**: FIs should prevent or minimise harm to the environment.

- **Commitment to responsibility**: FIs should take full responsibility for the environmental and social impacts of their transaction.

- **Commitment to transparency**: FIs should have transparency in their policies and business dealings.
• Commitment to Accountability: FIs should be accountable to their stakeholders and the community where they operate. FIs should promote economic development through their CSR activities.
• Commitment to good governance: FIs should frame good corporate governance policies and follow them in letter and spirit.

Quite often we come across much news pertaining to the CSR activities of banks and other players in the financial sector. Some examples of CSR activities are as follows:
• Environment protection: Going Green is an eco-friendly initiative not only to guard the environment, but also to encourage younger generation to make sure that such initiatives would lead to a better life around us. Some of the green initiatives include eco-friendly e-communication, banks and companies forwarding the annual reports by electronic mode (saving reams of papers for printing reports to the shareholders) and saving the globe from different kinds of pollution such as water, air, noise, etc.
• Health care: Many banks and other financial institutions including government organisations are keen in ensuring better health care facilities are provided for the needy persons. They organise regular blood donation drives, free medical checkups, donating ambulances, sponsoring free medical camps in remote villages.
• Education: Educational services occupy an important position in CSR activities of organisations. Many organisations are promoting community schools, colleges. Scholarships are offered to many deserving students.
• Social causes: Many banks offer help and financial assistance through their CSR programmes to assist weaker sections of the society for a better future.

Apart from the above, many employees of the banks and other institutions are very active in their contribution for the community development and these can very well be considered as part of Corporate Social Responsibility in view of the fact that each person is a stakeholder in one respect or another.

**8.4 Corporate Governance in Banking System**

Banks play a significant role in the economic development of a nation. As intermediaries in the Financial Sector, banks also act as trustees of the funds of the depositors. As such for efficient working of banks effectual Corporate Governance practices should be an essential part of bank management. Banks should have good Corporate Governance which should be much more than complying with legal and regulatory requirements. Good governance facilitates effective management and control of business, enables the Banks to maintain a high-level of business ethics and to provide value additions to all their stakeholders.

The objectives of corporate governance would cover the following:
• To protect and enhance shareholder value.
• To protect the interest of all other stakeholders such as customers, employees and society at large.
• To ensure transparency and integrity in communication and to make available full, accurate and clear information to all concerned.
• To ensure accountability for performance and customer service and to achieve excellence at all levels.
• Role of the Board of Directors. Board of Directors should be involved in the following activities:
  • The Bank’s Board of Directors should meet regularly and to provide effective leadership and insights in business and functional areas. They also should monitor Bank’s performance.
  • Setting up of a framework of strategic control and continuously reviewing its efficacy.
  • Implementation, review and monitoring the integrity of its business and control mechanisms.
  • Overseeing the risk profile of the Bank.
  • Ensuring expert management and decision-making, internal control and reporting requirements.
  • Maximising the interests of its stakeholders.
• Role of chairman and/or CEO: The Chairman and/or CEO have the responsibility for all aspects of executive management and are accountable to the Board for the ultimate performance of the Bank and implementation of the policies laid down by the Board.
8.5 Compliance Officer
A senior executive is made responsible in respect of compliance issues with all applicable statutes, regulations and other procedures, policies as laid down by the GOI/RBI and other regulators and the Board, and reports deviations, if any.

8.6 Clause 49
The Bank should ensure compliance with the provisions of Corporate Governance as per Clause 49 of the Listing Agreement with the Stock Exchanges as applicable. Important board-level committees are formed, to assist the Board of Directors to function effectively. These Committees provide effective professional support in the conduct of board-level business in key areas like Audit & Accounts, Risk Management, resolution of Shareholders’/Investors’ grievances, Fraud Review and Control, Review of customer service and redressal of customer grievances, Technology Management and Payment of Incentives to Executive Directors. The Remuneration Committee approves, once in a year, payment of incentives to whole-time Directors, based on Government of India guidelines.

8.6.1 Audit Committee (AC)
The Audit committee functions as per RBI guidelines and complies with the provisions of Clause 49 of the Listing Agreement to the extent that they do not violate the directives/guidelines issued by RBI.

The functions of audit committee are as follows:
• Audit committee provides direction and also oversees the operation of the total audit function in the Bank.
• Audit committee also appoints Statutory Auditors of the Bank and reviews their performance from time-to-time.
• Ensures transparency by reviewing bank’s financials, risk management, IS audit policies and accounting policies, systems and procedures.
• Audit committee also reviews the internal inspection/audit plan and functions in the banking system, its quality and effectiveness in terms of follow-up.
• Audit committee focuses on the follow up of implementation:
  • KYC-AML Guidelines
  • Major areas of housekeeping
  • Compliance of Clause 49 and other guidelines issued by SEBI from time-to-time
• Audit committee follows up on all the issues raised in RBI’s Annual Financial Inspection Reports under Section 35 of Banking Regulation Act, 1949 and Long Form Audit Reports of the Statutory.

8.6.2 Auditors and other Internal Audit Reports
The meetings of Audit Committee are chaired by a Non-Executive Director. The constitution and quorum requirements, as per RBI guidelines, are to be complied with. Apart from Audit Committee, other committees also assist the Board of Directors. As per Clause 49 of the Listing Agreement with the Stock Exchange, Shareholders’/Investors’ Grievance Committee of the Board looks into the redressal of shareholders’ and investors’ complaints regarding transfer of shares, non-receipt of annual report, non-receipt of interest on bonds/declared dividends, etc.

8.6.3 Customer Service Committee
The Customer Service Committee reviews ongoing improvements on a continuous basis in the quality of customer service provided by the Bank.

8.6.4 Special Committee for Monitoring Large Value Frauds
This committee’s functions are as follows:
• To monitor and review all large value frauds with a view to identify systemic issues/risk, if any.
• To find out the reasons for delay in detection and reporting, if any.
• To follow up on the status of progress of CBI/Police investigation, recovery position, etc.
• Action if any on staff involvement and their accountability and action thereof.
• Review the preventive measures to avoid similar frauds.
8.6.5 IT Strategy Committee
This committee assists the Board to track the progress of the Bank’s IT initiatives. Some of the important functions of the committee are as follows:

- Approving IT strategy and policy documents, ensuring that the management has put an effective strategic planning process in place.
- Ensuring that the IT operational structure complements the business model and its direction.
- Ensuring IT investments represent a balance of risks and benefits and those budgets are acceptable.
- Evaluating effectiveness of management’s monitoring of IT risks and overseeing the aggregate funding of IT at the bank level.
- Reviewing IT performance matches with the bank’s policy/plans.

8.6.6 Remuneration Committee
This is one of the important committees in organisation. This committee is set up for evaluating the performance of Whole Time Directors of the Bank in connection with the payment of incentives, as per the scheme advised by Government of India. The remuneration of the whole-time directors and the sitting fees paid to the non-executive directors for attending the meetings of the board/committees of the board are as prescribed by GOI from time-to-time.

8.6.7 Nomination Committee
As per RBI guidelines, a Nomination Committee of independent Directors has been constituted. This committee’s function is to carry out necessary due diligence and arrive at the ‘fit and proper’ status of candidates filing nominations for election as Directors by shareholders. Every financial year the Directors on the Bank’s Board and Senior Management have to sign a declaration for compliance with the Bank’s Code of Conduct for the financial year.

8.7 Disclosure New Clause 41
The bank needs to disclose certain important information as per Clause 49 of the Listing Agreement with the Stock Exchanges, to the extent that the requirements of the Clause do not violate the provisions of the rules and regulations made thereunder and guidelines or directives issued by the Reserve Bank of India.

Mandatory requirements of Clause 49 as to the composition of the Board of Directors, composition and quorum of the Audit Committee, Non-executive Directors’ compensation, the appointment, re-appointment of the Statutory Auditors and fixation of their fees, etc., needs to be disclosed. In terms of Clause 49(V) of the Listing Agreement, a certificate by the Managing Director & Chief Financial Officer on the financial statements and internal controls relating to financial reporting needs to be obtained. The disclosure should cover all other required declarations as applicable.

The bank should also declare that it has complied with applicable rules and regulations prescribed by stock exchanges or SEBI or any other statutory authority relating to the capital markets during the last three years. No penalties or strictures have been imposed by them on the bank. The Whistle Blower Policy, approved by the Board of the Bank, is in place and has been uploaded on the bank’s intranet site for information of all the staff members.

Apart from the above mentioned details in the annual report, the bank should furnish the details of the corporate governance policies and relevant disclosures. As the Annual Report is provided to every shareholder (either by post or by e-mail), it would serve as a means of communication from the bank to reveal not only the financial performance of the bank, but also other important aspects of the bank including the corporate governance practices.
8.8 Basel Committee Recommendations

The Basel Committee guidance provides a foundation for sound corporate governance practices for various banking systems across countries. The guidance is divided into four major sections:

- Overview of corporate governance in banks: The guidance stressed the importance of sound corporate governance practices as vital in gaining and maintaining public trust and confidence in the banking system and economy as a whole. The guidance suggested that the supervisors should take steps to ensure that the ownership structure does not affect the sound corporate governance practices in banks.

- Sound corporate governance principles: The committee proposed the following eight principles which are considered important for an effective corporate governance process.
  - Principle 1: Board members should be qualified for their role in corporate governance and be able to exercise sound judgement in handling the affairs of the bank.
  - Principle 2: The board of directors should approve and oversee the bank’s strategic objective and corporate values that are communicated throughout the organisation.
  - Principle 3: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.
  - Principle 4: The board should ensure that there is appropriate oversight by senior management consistent with board’s policy.
  - Principle 5: The board and senior management should effectively utilise the work conducted by the internal auditors, external auditors and internal control systems.
  - Principle 6: The board should ensure that compensation policies and practices are in consistent with the bank’s corporate culture, long-term objectives and strategy.
  - Principle 7: The bank should be covered in a transparent manner.
  - Principle 8: The board and senior management should understand the bank’s operational structure and the jurisdiction.

- The role of supervisors: Supervisors play a key role to encourage and support strong corporate governance by analysing and assessing a bank’s implementation skills of the sound principles. Supervisors should do as follows:
  - Provide guidance to banks on sound corporate governance.
  - Consider corporate governance as one factor for depositor protection.
  - Assess the quality of banks’ audit and control systems.
  - Evaluate the bank’s performance in respect of effective implementation of corporate governance.

- Promotion of an environment to support sound corporate governance: As per the report the primary responsibility for good governance rests with board of directors and senior management of banks. Banks supervisors also play a key role in developing and assessing bank corporate governance practices. The guidance report also lists out role of others who can promote good corporate governance like shareholders, customers, depositors, auditors, banking industry associations, governments, credit rating agencies, employees, stock exchanges, etc.

According to the Basel guidance banks’ good corporate governance practices would entail banks for better operational efficiency, greater opportunities to get low-cost funds, and a good reputation and increased market value.

8.9 Auditor’s Certificate on Corporate Governance

This certificate issued by Chartered Accountant, is to be furnished along with the Annual Report of the Bank. The certificate indicates the examination by the chartered accountant regarding compliance of conditions of Corporate Governance by the Bank for the financial year ending. This certificate is based on the clause 49 of the listing agreement of the bank with Stock Exchanges in India. The compliance of the conditions of Corporate Governance is the responsibility of the Management. The auditor’s examination is being carried out in accordance with the Guidance Note on Certification of Corporate Governance, issued by the Institute of Chartered Accountants of India. It is regarding the compliance of corporate governance procedures and implementation thereof, adopted by the bank.
Summary

• Business ethics, corporate governance and corporate social responsibility have become not only an integral part of the present globalised business environment, but also have changed the business models of banks.
• More and more banks have started to reshape themselves to offer better customer services and also operate in more ethical manner, through their effective corporate governance practices.
• Every financial year the directors on the bank’s board and senior management have to sign a declaration for compliance with the bank’s code of conduct for the financial year.
• The Customer Service Committee reviews ongoing improvements on a continuous basis in the quality of customer service provided by the Bank.
• A sound financial policy and effective management control, is very important for good corporate governance.
• Ethics involves a discipline that examines good or bad practices within the context of a moral duty.
• An individual or group of persons are influenced and guided by his/their religious faith.
• The study of moral values based on economic systems prevalent in different countries and across the globe is called as ‘Business Ethics’.

References

• ACCA F1 - 8 Ethics and corporate governance. [Video online] Available at: <http://www.youtube.com/watch?v=B7vSsD7LLrM> [Accessed 11 April 2014].
• Challenges to Corporate Governance: Policy and Ethical Considerations in a Time of Change. [Video online] Available at: <http://www.youtube.com/watch?v=HAoSU6jQIZA> [Accessed 11 April 2014].

Recommended Reading

Self Assessment

1. ______ occupy an important position in CSR activities of organisations.
   a. Health care
   b. Educational services
   c. Social services
   d. Financial help

2. The meetings of ______ are chaired by a Non-Executive Director.
   a. Audit Committee
   b. Customer Service Committee
   c. Special Committee for Monitoring Large Value Frauds
   d. Strategy Committee

3. Match the following

| 1. Principle 3 | A. Board members should be qualified for their role in corporate governance and be able to exercise sound judgement in handling the affairs of the bank. |
| 2. Principle 1 | B. The board of directors should approve and oversee the bank’s strategic objective and corporate values that are communicated throughout the organisation. |
| 3. Principle 4 | C. The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation. |
| 4. Principle 1 | D. The board should ensure that there is appropriate oversight by senior management consistent with board’s policy. |

   a. 1-C, 2- A, 3- D, 4-A
   b. 1- A, 2- B, 3- C, 4-D
   c. 1- B, 2- D, 3- A, 4-B
   d. 1- D, 2- C, 3- B, 4-C

4. Which of the following influences an individual or group of persons?
   a. Friends
   b. Family
   c. Religious faith
   d. Culture

5. Which of the following committee guidance provides a foundation for sound corporate governance practices for various banking system across countries?
   a. Strategy
   b. The Basel
   c. Audit
   d. Customer service
6. The expertise of auditors’ of the audit division might be used by the consultancy division in valuations and this may be considered as an example of _________.
   a. conflict of interest
   b. transparency
   c. insider trading
   d. golden parachute

7. Which of the following statement is true?
   a. ‘Price’ is the link between the customer and producer, through appropriate delivery.
   b. ‘Place’ is the link between the customer and producer, through appropriate delivery.
   c. ‘Promotion’ is the link between the customer and producer, through appropriate delivery.
   d. ‘Product’ is the link between the customer and producer, through appropriate delivery.

8. Which of the following committee assists the Board to track the progress of the Bank’s IT initiatives?
   a. Customer service
   b. Remuneration
   c. Nomination
   d. Strategy

9. The ____________ Committee reviews ongoing improvements on a continuous basis in the quality of customer service provided by the Bank.
   a. Customer service
   b. Remuneration
   c. Nomination
   d. Strategy

10. Which of the following statement is false?
    a. Remuneration committee is set up for evaluating the performance of Whole-time Directors of the Bank.
    b. Green mail is a process through which the management of the target company sends green mails to prevent a shareholder or group of share holders to take over a company.
    c. Reaching out to the customers through effective network and attractive communication is the major role of the marketing mix called ‘price’.
    d. Ethics involves a discipline that examines good or bad practices within the context of a moral duty.
Case Study I

Punjab National Bank

About Punjab National Bank
Punjab National Bank (herein referred to as PNB) is one of the leading banks in India and offers a wide variety of banking services, which include corporate and personal banking, industrial finance, agricultural finance, financing of trade and international banking. Among the clients of the Bank are Indian conglomerates, medium and small industrial units, exporters, non-resident Indians and multinational companies.

Punjab National Bank was incorporated in the year 1895. Since its humble beginning over hundred years ago, the bank has grown in stature to become one of the leading banking institutions in India. PNB is the second largest PSU bank in India with a dominant presence in north India. Keeping in tune with changing times and to provide its customers more efficient and speedy service, the Bank has taken major initiative in the field of computerisation. All the Branches of the Bank have been computerised. The Bank has also launched aggressively the concept of “Any Time, Any Where Banking” through the introduction of Centralised Banking Solution (CBS) and over 2000 offices have already been brought under its ambit.

System Prior to the Introduction of FineDocs-Document Management System
Punjab National Bank (herein referred to as PNB) is one of the leading banks in India and offers a wide variety of banking services. Punjab National Bank is serving over 3.5 crore customers through 4062 branches and 447 extension counters. PNB generates enormous amount of customer-related documents and reports. For any new banking services requested by the customer a new application form is created with all his details. This application form is the key document that contains all information regarding the customer, for the purpose of customer service and settlement of legal disputes.

To access any vital information related to the client, the company had to retrieve the original hard copy of the application. The regular procedure included taking out a page from the entire set of documents of original application forms and then working on it. This leads to papers being misplaced or left them in a dilapidated state, due to constant wear and tear. Many a times the original was missing and at times, the photocopy also got stapled to a wrong application form.

Problems Faced by Punjab National Bank

- Punjab National Bank generates a lot of physical documents for their existing clients. Managing these documents (Sorting, Indexing and Filing, etc) was a very hectic process for them.
- The regular procedure included taking out a page from the entire set of documents of original application forms and then working on it. This leads to papers being misplaced or left them in a dilapidated state, due to constant wear and tear.
- For searching or locating any document/file was a hassle for the staff involved in this process.
- As paper based files/documents were accessible to each and every person, they were liable to be tampered, and resulted sharing of any internal information with any unauthorised person.
- Physical documents were prone to damage with time, moisture, rodents, etc.
- There was also a problem of disaster recovery.

Pyramid’s Solution
Pyramid IT Consulting proposed Punjab National Bank to automate manual Record/Document keeping process by providing its Document Management Solution – FineDocs & Scanning Services – FineScan. After the implementation of the DMS, the application form and other related documents got scanned and indexed with the user defined indexed values. After this whenever there was a need to refer to the original document, a search feature of the DMS helped to retrieve the scanned copy of the document to the user. Search in Document Management Solution has been carried out on the basis of title, as well as, keywords.
We proposed a multi-user web-based Document Management Solution, i.e., FineDocs that encompass strong searching and distribution modules. All the documents would be stored in a server and thus this application shall act as a central repository of storage of Data & Documents.

**Document Retrieval**
Whenever the document is required to be referred by the branch, the user logs in to our DMS could see the scanned copy of the original document very easily. The request for retrieval of the document is routed to the Central FineDocs Database and Image Server client while requesting for a connection, specifies a preferred site, to which it wants to get connected.

For document retrieval, the user specifies the Index of the document he wants to retrieve. Whenever a request for document retrieval is made, the Image server checks whether the document resides on the client’s preferred site. If the document resides on the preferred site, then it is fetched from there or else it is fetched from the Home site of the repository.

**Benefits to Punjab National Bank**
- **Documents Security:** FineDocs system facilitated role-based access on all the records/documents through a user name and a password.
- **Easy Sharing and Collaboration:** All documents were stored in FineDocs with proper access control. This way authorised users were able to view/refer/share and modify the documents.
- **Audit Trail:** FineDocs has the functionality by which each and every operation, event performed by the user like, user logins into the system, action done, etc., were recorded with the time, thus increasing the accountability.
- **Saved Courier Cost:** FineDocs System provided an option to email documents both within office and outside cutting down on courier cost. As the documents were in non-editable TIFF format, users were in relief that they will not be tampered and were as safe as any printed document.
- **Saves Duplication and Photocopying Cost:** Since electronic documents could be shared among several users at the same time, there was no need to photocopy the documents for sharing, thus resulting in a huge saving on the duplication of documents.
- **Disaster Management:** FineDocs provided an all-in-one solution for Punjab National Bank’s document protection from disasters like Natural & accidental calamities, etc. There is a fully fledged backup and restore facility provided.


**Questions**
1. What was the regular procedure to access any vital information related to the client and why was it difficult?
   **Answer**
   To access any vital information related to the client, the company had to retrieve the original hard copy of the application. The regular procedure included taking out a page from the entire set of documents of original application forms. This page was either photocopied or used and then kept back with the original form. This led to papers being misplaced or left them in a dilapidated state, due to constant wear and tear. Many a times the original was missing and at times, the photocopy also got stapled to a wrong application form.

2. What were the issues faced by the Punjab National Bank?
   **Answer**
   Punjab National Bank generates a lot of physical documents for their existing clients. Managing these documents (Sorting, Indexing and Filing, etc) was a very hectic process for them. The regular procedure included taking out a page from the entire set of documents of original application forms and then working on it. This leads to papers being misplaced or left them in a dilapidated state, due to constant wear and tear.
For searching or locating any document/file was a hassle for the staff involved in this process. As paper-based files/documents were accessible to each and every person, they were liable to be tampered, and resulted sharing of any internal information with any unauthorised person. Physical documents were prone to damage with time, moisture, rodents, etc.

There was also a problem of disaster recovery.

3. Explain in detail about Pyramid’s Solution.

Answer

Pyramid IT Consulting proposed Punjab National Bank to automate manual Record/Document keeping process by providing it’s Document Management Solution FineDocs & Scanning Services – FineScan. After the implementation of the DMS, the application form and other related documents got scanned and indexed with the user defined indexed values. After this, whenever there was a need to refer to the original document, a search feature of the DMS helped to retrieve the scanned copy of the document to the user. Search in Document Management Solution has been carried out on the basis of title, as well as, keywords.
Case Study II

Union Bank of India Achieves High Goals through Diebold’s Managed Services

**Business Objective:** With the challenge of establishing and retaining tools and resources to internally manage its rapidly growing ATM channel, Union Bank of India was looking for an innovative and cost-effective way to provide its customer with the most efficient, reliable and technologically superior ATM network possible.

**Solution:** Diebold’s Managed Services provided Union Bank of India with comprehensive maintenance and expert support services, including round the clock monitoring, incident management and help desk support, consumable replenishment, cash management and cash optimisation analysis and consulting and monitoring to help the financial institution achieve the highest level of availability for its ATM fleet, enhancing customer satisfaction and facilitating a streamlined ATM channel expansion.

To meet these imperatives, UBI relied on Diebold Managed Services’ longevity in the financial self-service industry and its proven expertise in managing, monitoring and servicing ATM channels as complex and far-reaching as UBI’s. To increase optimum uptime, Diebold is providing round the clock monitoring of UBI’s fleet, as well as managing consumable replenishment and cash optimisation and forecasting, which allows for tighter management and reduced cash levels at the most critical points of the replenishment process. It also allows for easier monitoring and more accurate prediction of cash demands by establishing and maintaining customer-specific historical data. These services, in conjunction with Diebold’s Help Desk Support, are helping UBI minimise the total cost of ownership associated with managing its extensive ATM channels.

Diebold also is providing incident management and first line maintenance services to help prevent problems from ever happening, which can significantly improve the financial institution’s operational efficiencies. To further boost UBI’s self-service channel availability, Diebold technicians coordinated with all entities in the financial institution’s extensive roster of network vendors to provide greater continuity in its ATM operations.

**Service History:** Union Bank of India (UBI) is a leading, innovative commercial bank, with a proactive approach to the changing needs of the society. Over the years, the bank has earned the reputation of being techno-savvy and a front runner among public sector banks in modern-day banking trends. It has aggressively expanded its branch network to become one of India’s largest state-run banks.

As UBI’s presence expanded, its commitment to continually enhancing customer satisfaction increased as well. Lacking the tools and resources to internally manage its rapidly growing ATM channel, the financial institution recognised the need to partner with an organisation that had a proven track-record of successfully managing large self-service networks. Additionally, because UBI’s short-and long-range plans included continued aggressive expansion, it required an outsourcing partner that could offer such capabilities as remote channel management as well as the ability to meet regulatory approvals for handling cash replenishment and other necessary functions to keep its ATM fleet at the highest possible level of availability.

“To ensure our customers’ loyalty and keep confidence in our rapidly growing financial institution high, it was essential that our ATM fleet operates at the highest-level availability and we had confidence that Diebold could leverage its expertise to make that a reality,” said Lalit Sinha, deputy general manager, UBI. “With Diebold Managed Services, our ATM channel has experienced an average of 150 hits per ATM per day, which is an increase of more than 90% as compared to the average hits per ATM prior to our partnership with Diebold. To us, those numbers underscore the exceptional value that can be gained from relying on Diebold for its exceptional management abilities.”

At the beginning of the five-year agreement with UBI, Diebold managed 500 ATMs in a fleet that today has grown to 1435 terminals. This growth can be attributed, in part, to the marked reduction in downtime across the financial institution’s self-service channel, which boosted customer satisfaction and allowed for faster deployment of new ATMs.
“Our relationship with Diebold has offered us considerable benefits, both in the superior efficiency of our ATM channel, and in the steady increase in our customers’ level of satisfaction,” Sinha said. “With the continued efficiencies provided by Diebold’s Managed Services, we’re on target to successfully achieve our goal of 2500 ATMs by the end of 2009.”


Questions
1. What were the challenges Union Bank of India had to meet?
2. How did Diebold Managed Services improve the efficiency of Union Bank of India?
3. What did Union Bank of India achieve through Diebold Managed Services?
Case Study III

State Bank of India

Executive Summary
The State Bank of India (SBI) has extended collaboration without borders to the next level. It has adopted an enterprise wide IT strategy aimed at integrating its service channels, ramping up its efficiency levels, and enabling it to roll out a new generation of products by building a converged IP network. In doing so, the bank has demonstrated the true meaning of unified communications as distinct from simply allowing a proliferation of different communications capabilities.

Client Overview
SBI is India’s largest and the world’s fifth largest bank, with more than 90 million customers, 15,000 branches and 7,000 ATMs in India and 40 other countries.

Business Challenge
Executing an enterprise wide IT strategy to integrate one’s service channels is no mean feat for any organisation. When your operations are scattered across a myriad of geographies and time zones, it’s even trickier. SBI recognised that success required the company to enlist the expertise of a partner to design, build, and manage a converged network capable of carrying all its present and future traffic. The integrator would also be responsible for bandwidth, all networking equipment, software, and management as well as a 24x7 helpdesk, service level agreements, and the management of scheduled and unscheduled network outages.

Solution Delivered
Over a period of eight years, starting in 2002, Dimension Data worked with the Cisco Internet Business Solutions Unit, built and deployed an integrated IP network that powers all the bank’s business processes in some of the world’s most high-tech cities as well as in India’s most remote rural areas. Applications powered by the network range from core banking, treasury operations and trade finance to inter-branch voice communication and unified messaging. The project, which has met all budget and timeline requirements, was executed in five phases. Phase I covered 1,400 branches in 49 cities. Phase II covered 3,400 branches in more than 300 cities. Phase III involved networking the remaining 6,100 branches. Phase IV covered an additional 2,800 branches, and phase V, which touches 2,000 branches, is currently ongoing.

The new network has been designed to give SBI a seamless flow of transactions, streamline data gathering and dissemination and support an integrated view of products across all channels. The system is based on a three-tier, self healing corporate wide area network (WAN), which has a centralised data centre in Mumbai and a backup in Chennai. The three tiers comprise a core linking the country’s four main cities, a distribution network linking local head offices and zonal offices back to the core metro cities, and an access network for the end branches. SBI’s converged system is based on IP telephony, with some 15,500 IP phones being deployed and a closed user group (CUG) voice solution providing 24 x 7 availability for voice. This has enabled standardisation of voice equipment across the organisation and drastic cutting of the costs of inter-branch voice communications.

Value Derived
The system allows advanced integrated applications, such as billing and accounting, XML-based services, voicemail, unified messaging, conferencing and collaboration solutions, and directory support, to be rolled out as services on the network when the bank requires them. Future manageability and scalability have therefore become simple and cost effective. The bank is now optimally positioned for future deployment of a single infrastructure for voice communication while still complying with regulatory obligations.

Management of the bank’s IP telephony system is monitored through Dimension Data’s Global Service Centre in Bangalore. Bank executives are provided with a dashboard that enables them to see at any time whether any part of the system is down and what sort of fault is the cause. This enables the bank to immediately take remedial action within its own departments when the cause is not network related. Seamless connectivity is assured through the use of leased lines and bandwidth is provided by three separate Telcos coordinated by Dimension Data.
Unbroken service is guaranteed by Dimension Data’s Uptime maintenance service, which incorporates detailed service level agreements, including penalties for network downtime. Dimension Data’s service level management responsibilities include partnering with the telecommunications service provider, Telco, and other third-party vendors to ensure that all service level agreement requirements are fully aligned and delivered upon. Dimension Data acts as a single point of billing from Telco, on the bank’s behalf. Dimension Data’s vendor-management responsibilities include managing the bank’s contract with third-party spares suppliers, synchronising all logistical arrangements for delivery of spares, and recovering any penalties from the banks spares suppliers.

In addition, through its managed service, Dimension Data takes ownership and accountability for all processes and service outcomes. In total, Dimension Data has over 700 engineers across the region, covering 150 cities working on behalf of SBI.


Questions
1. What were the business challenges faced by SBI?
2. How did Dimension Data solve the issues faced by SBI and enhance the banking experience of the customers?
3. How did SBI benefit through the changes made by Dimension Data?)
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Recommended Reading

Self Assessment Answers

Chapter I
1. a
2. b
3. c
4. c
5. d
6. b
7. c
8. a
9. c
10. a

Chapter II
1. b
2. a
3. c
4. b
5. a
6. b
7. a
8. d
9. b
10. d

Chapter III
1. b
2. a
3. a
4. c
5. b
6. a
7. b
8. d
9. a
10. c

Chapter IV
1. b
2. a
3. c
4. b
5. a
6. b
7. a
8. d
9. b
10. c
Chapter V
1. a
2. b
3. c
4. c
5. d
6. b
7. c
8. a
9. c
10. a

Chapter VI
1. a
2. b
3. c
4. b
5. d
6. a
7. b
8. c
9. d
10. a

Chapter VII
1. a
2. b
3. c
4. a
5. b
6. c
7. a
8. b
9. d
10. c

Chapter VIII
1. b
2. a
3. a
4. c
5. b
6. a
7. b
8. d
9. a
10. c