

# Banking concepts and practices

[Finance](#), [Banking](#)



XITE, Gamharia Banking Concepts & Practice [Paper 11: Elective II, AcademicSession 2011-12] 1. Evolution of Banking: Bank-Meaning, Definition, Features & Classification, Concept of Different Types of Banking System, Overview of Indian Banking System 2. Commercial Bank: Basic Concept of Commercial bank, Role of Commercial bank in Financial System, Credit Control by Central Bank 3. Central Bank: Meaning, Functions, Methods of Credit Control 4. Monetary Policy: Meaning, Objectives and Instruments 5. Customer Relationship: Definition, Features of Contractual Customer Relation, Customer Orientation, Retail Banking 6. E-Banking: Concept, ATM, Core Banking, Virtual Banking, Electronic Payment System Reference Books: 1. Banking Law and Practice- P. N. Varshney 2. Indian Banking- P. Parameswaran & S. Natarajan 3. Money, Banking & International Trade- M. C. Vaish 4. Banking Concepts & Practices- Shekhar & Shekhar 5. Banking Concepts & Practices- Canon Notes prepared by: Fr. Alex Mascarenhas SJ, Loyola Nivas, H-15, St Mile Road, Sakchi, Jamshedpur 831 001 INDEX | | | EVOLUTION OF BANKING | NEGOTIABLE INSTRUMENT | | MEANING OF BANKING | BILL OF EXCHANGE | | CLASSIFICATION OF BANKS | PROMISSORY NOTE | | SYSTEMS OF BANKING | CHEQUE | | | CROSSING & ENDORSEMENT | | INDIAN BANKING: PROFILE | | | INDIGENOUS SYSTEM | BANKING PRACTICE | | MODERN FINANCIAL SYSTEMS | BANK ACCOUNTS | | CHANGING PROFILE | TIME DEPOSITS | | CHALLENGES AHEAD | LOANS & ADVANCES | | | CHARGE CREATION | | COMMERCIAL BANK | TYPES OF SECURITIES | | FEATURES | BILLS COLLECTION | | ROLE IN FINANCIAL SYSTEM | PAYING BANK | | MULTIPLE CREDIT CREATION | COLLECTING BANK | | | GRIVANCE REDRESSAL | | CENTRAL BANK | | | CONCEPT & MEANING RETAIL BANKING | | FUNCTIONS

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A. MEANING OF BANKING: Banking was first associated only with the lending activity. The idea of accepting deposits from the public in order to lend it to others on credit developed much later. Modern banks have gone way beyond traditional banking and have added fee based financial as well as ancillary services to banking which are very much within the limits of their expertise.

A1. DEFINITION: Dictionary gives multiple meanings of a BANK- • It is a heap or storage of goods. • It is the shallow edge of the sea. • It is the raised edge of a river or a road. • It is a blockage of sandbags to a flow of water.

Though none of these explanations speak directly about financial dealings, all of them give a common meaning that it is a sort of CUSHION provided to PROTECT something. Hence, there can be a grain bank, a blood bank, a sperm bank, a question bank, a river bank, money bank, etc. The exact origin of the word bank is not certain. Some trace its origin to German word 'Banck' which means heap or mound, others trace it to Italian word 'Banco' which means heap of money while some others trace it to the French word 'Banque' which means a bench for keeping things. Jewish bankers and money changers transacted their business of lending and exchanging money on

benches in the marketplace in Lombardy and so the bench became the banking counter.

Bible has a reference to money changers who were transacting business on their benches inside the Jewish temple and Jesus throws their benches and scatters them. If a banker failed by losing all his money, his bench was broken up by the people which gave birth to the word 'bankrupt'. Monetary banks derive their meaning from all the above concepts. They provide facility to the customers to 'store' their wealth and give 'protection' to it and in the mean time they lend it to others to 'gain' some returns. • According to Kent, "bank is an organization whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditure. • According to Crowther, "bank is one that collects money from those who have it to spare or who are saving it out of their incomes and lends the money so collected to those who require it. " • According to Hart, "banker is one who in the ordinary course of business honors cheques drawn upon him by persons from and for whom he receives money on current accounts. " • According to John Paget, "no person or body corporate otherwise can be a banker who does not take deposit, does not take current accounts, does not issue and pay cheques and does not collect cheques for his customers. " All these definitions have described the meaning of a bank but have not given a precise definition.

Banking Regulation Act of 1949 u/s 5(1) has given the meaning of banking as follows- "Banking means accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and

withdrawable by cheque. ” Hence, bank in the technical sense can be defined as “ an institution that accepts refundable deposits for lending or investing. ” The concept of offering fee based services has no direct connection to traditional banking; it evolved much later due to the financial expertise available with the banks. A2. HISTORY OF BANKING: The concept of banking is as old as the authentic history of humanity. ANCIENT WORLD: The system was started by the Babylonians before 2000 BC. The practice of granting credit was widely prevalent in ancient Greece and Rome.

Credit by compensation and by transfer orders is traced to Assyria, Phoenicia and Egypt even before its development in Greece and Rome. EUROPE: Many European countries established public banks either for facilitating commerce or to serve the government. Begun as an office for transfer of public debt, The Bank of Venice [1157] is the most ancient bank. The Bank of Amsterdam was established in 1609 to meet the needs of the merchants of the city. It accepted all kinds of specie deposits to be withdrawn or transferred to another account later using a certificate valid for six months. These written orders in the course of time got transformed into modern day cheques.

ENGLAND: English banking began with the London Goldsmiths who accepted customer’s valuables for safe custody and issued ‘ payable to bearer’ receipts which in course of time enjoyed considerable circulation. Actual growth of private commercial banking began with the establishment of Bank of England in 1694. INDIA: The first reference to banking in India is found in the book ‘ Arthashastra’ by Chanakya in the year 300 BC. He mentions about guilds of merchant bankers who received deposits and advanced loans. The

traditional indigenous bankers and money lenders were active in India since time immemorial. The first bank in today's understanding to be established in India was Bank of Hindustan in 1770. Unfortunately it failed subsequently.

Presidency Bank established in 1806 which then became Imperial Bank and finally State Bank of India is the first successful bank in India. Co-operative credit banks started playing significant role since II world war. A3. FEATURES OF A BANK: Features of a bank are the services they offer to their customers. Traditional banks have just two features: accepting deposits and lending money on credit. Modern banks have introduced a third feature of fee based services. A3a. DEPOSITS are basically of two types- Demand deposits & Time Deposits. Demand deposits are in the form of running accounts like Savings Bank A/c, NRE A/c, Current A/c and Overdraft A/c depositing or withdrawing money without any advance notice.

On Savings Bank A/c and NRE a/c banks offer interest on the balance amount where as for an overdraft a/c they charge interest on the money overdrawn. Current A/c and the credit balance in Overdraft A/c fetch no interest to the account holders. All these accounts will have cheque book and passbook facility. Now one can do banking transactions from the comforts of ones own office or room or while traveling even without entering the bank premises, pay bills anywhere and anytime and draw cash from ATM day and night and even during holidays through e-banking. Time deposits are always accepted to mature on a due date. Banks give interest on time deposit. Longer time deposits usually [but not necessarily] fetch higher interest.

All banks allow pre-maturity withdrawals of time deposits and give whatever interest is applicable for the duration the deposit was with the bank with or without a penalty interest for pre-maturity withdrawal. A3b. CREDITS can be further sub-grouped duration-wise or security-wise: Duration-wise credits can be short term for less than a year or medium term for one to three years or long term for beyond three years. Banks usually prefer short term credits as they give better liquidity. Long term credits are usually given for capital requirements. Customers are charged interest on credit which is little higher than the interest banks give on deposit. Security-wise credit may be secured, partially secured or clean. When credit is given against a collateral tradable security of at least equal value it is termed as secured credit.

If the securities offered against the credit do not cover the credit amount completely then it is partially secured credit. If personal guarantees are offered instead of any tradable securities, it is a clean credit. Banks usually prefer secured credit to ensure the capital safety. A3c. FEE BASED SERVICES may or may not be linked directly to banking activities. These features are unique to commercial banks and are on offer because of the expertise they have and also because their primary aim is profit. Cooperative banks usually do not offer such services except cheque book and bill collection facility. Some of the fee based services offered by them are- Financial Services are those involving money through the customer's accounts like Cheque, Bill Pay, Bill Collection, Debit Card, Fund Transfer, etc. Free availability of sufficient funds in the account is pre-condition for these services. • Utility Services are those financial services which are provided by the bank to the general public even without having an account in the bank like Foreign

exchange, Bank Pay Order, Bank Drafts, Traveler Cheque, etc. Funds and the bank charges have to be provided at the time of availing these services. •

Agency/Fiduciary Services are those services in which the bank acts like an agent/trustee on behalf of its customers like Letter of Credit, Bank Guarantee, Originator/ Underwriter of Capital Issues, Safe Deposit Locker, Safe Custody, etc. Investment Services are those agency services where bank guides the customers in making investments outside the bank for higher returns like D-Mat A/c, Brokerage and Advisory Service. B.

CLASSIFICATION OF BANKS: There are various types of banks depending on the purposes of their businesses. But such a classification may or may not be exclusive since some overlapping is always possible- B1. COMMERCIAL

BANKS by their very name mean business and so perform all kinds of banking functions such as accepting deposits, advancing credits, offering fee based ancillary services including foreign exchange and foreign currency remittances. They are organized in the manner of joint stock companies.

Their main aim is to maximize profit from their banking business. Hence, they have expanded their network through branches wherever there is a possibility of better banking business. In many developing countries like India, commercial banks are obliged to contribute to the economic growth of the country through various regulations of the regulatory authorities. These banks may be govt. owned, public sector or private sector or even foreign banks. Private sector and foreign banks vie with each other in providing personalized services in order to expand business. B2. FOREIGN EXCHANGE BANKS are specialized in foreign exchange and financing foreign trade in addition to the normal banking services.



They also offer other information collecting services to their customers on foreign trade prospects, foreign agents, and foreign collaborators and provide foreign currency remittance facilities. Foreign exchange banks usually have their head offices outside the country. Their branch network is usually bare minimum; restricted only to big urban centers with great potential for foreign exchange business. B3. INDUSTRIAL BANKS are also known as development banks and are specialized in providing long term loans to industries for the purchase of assets. They are usually not into ordinary banking services; they basically underwrite shares and debentures of industries and also subscribe to them.

Some of the industrial banks are- Industrial Finance Corporation of India-IFCI, Industrial Development bank of India-IDBI, Industrial Credit & Investment Corporation of India-ICICI [now merged with ICICI Bank Ltd. ] and Small Industries Development Bank of India-SIDBI. These are more of finance companies set up by government than banks. B4. AGRICULTURAL BANKS like State Cooperative Banks-SCB, District Central Cooperative Banks-DCCB, State Cooperative Agricultural & Rural Development Banks-SCARDB, Primary Cooperative Agricultural & Rural Development Banks-PCARDB and Regional Rural Banks-RRB provide all types of agricultural credits to the farmers for their short term, medium term and long term agricultural needs. They also offer limited ordinary banking services that are required by the farmers.

Land Development Bank of India-LDBI gives long term loans on mortgage of agricultural land and National Bank of Agriculture & Rural Development-NABARD gives refinance to other institutions which give direct agricultural

loans to the farmers. Both these banks do not provide retail banking services. B5. COOPERATIVE BANKS work on the principle of cooperation among a group of shareholding members usually confined to a small geographical locality and the purpose of their cooperation. Their activities are largely restricted to their own members. They do not come under the strict regulatory controls of Central Bank since they are separately covered under Cooperative Societies Act. But they do have regulatory norms to satisfy, though not of the same level as that of the commercial banks. Cooperative banks are basically of two types- Urban Cooperative Banks that cater to the needs of urban population and • Rural Cooperative Banks which cater to the needs of the rural population. B6. SAVINGS BANKS promote small savings and mobilization of resources. They may not lend on credit; they may invest the entire sum to produce returns enough to pay good interest to their deposit holders. They are very successful in Japan, Germany and India. Post Office Savings Bank, Employee Provident Fund and Public Provident Fund are some examples of Savings Banks. B7. INVESTMENT BANKS are financial organizations which assist business houses to raise funds for their long term capital requirements from the market through the sale of their shares and bonds. Hence, they certainly conduct other ordinary banking business in order to collect funds for their business. These banks act basically as middlemen or agents. They function in two ways- • Originator- They act as originators of the capital issue by bringing out the new issue and managing it until the shares are finally allotted for a fee for the services provided by them. They have nothing to do with the gain or loss of the capital issue which goes directly to the company. • Underwriter- They under-

write the entire capital issue for a mutually agreed price and re-issue the shares to the public for the market price.

The entire gain or loss made in the process is the gain or loss of the bank and not of the issuing company. Commercial Banks are also eager to provide investment banking facilities since these are basically wholesale banking activities with definite sources of large gain in a short p of time with or without committing one's own funds. B8. MERCHANT BANK is a loosely used term. Some merchant banks may neither be a merchant nor a bank.

Merchant banks mainly deal with corporate financial advice such as share issue, capital re-construction, mergers and acquisitions. Merchant banks also accept deposits and are involved both in money market operations and foreign exchange dealings. They also manage funds on behalf of their clients. B9.

CENTRAL BANK is not a commercial bank; it is the apex bank of a country which controls nation's monetary and banking structures, like Reserve Bank of India. It is owned by the central government in most of the countries but not necessarily always. For example, in USA it is owned collectively by the member banks. Central banks work in the national interest in developing the nation's economy. Central bank does not deal with ordinary banking activities. It issues and regulates currency, provides banking services only to the central government, the state governments and the member banks, keeps cash reserves of the member banks, holds gold reserves of the country and nation's forex reserves, acts as clearing house and acts as a lender of last resort. C.

SYSTEMS OF BANKING: There is no uniform system in commercial banking. They have evolved based on the needs of a particular place. Philosophically there are two banking systems- Capital based Western Banking System and Service based Islamic Banking System. Islamic banking system is the only banking system in the world that is totally fee based and does not pay or give interest. Islamic banks collect fees for all the services offered by them since giving or receiving interest is against the Islamic Law- Shariat. Most commercial banks follow capital based banking systems: they accept deposits from the public at lower interest rate and give out credit on higher interest.

The difference in interest rate is their profit which is gained by from their capital. They also charge a fee for all the value added services rendered by them. In practical sense we come across three major western banking systems worldwide- C1. GROUP BANKING is commonly found in USA. It is a federal system favored mostly by banks in USA. Under this system, a group of banks come under a centralized management of a holding company may or may not be affiliated to a larger bank or any government controlled agency. Holding company exerts control over all the subsidiary banks though each subsidiary bank maintains its own distinctive identity. The group may also include non banking financial corporations.

In some cases instead of a holding company, individuals or a group of individuals take the control over administration of the member banks through ownership of their stocks. Such a system is known as CHAIN BANKING. For all practical purposes, both mean the same except for their

ownership pattern. MERITS- 1. Parent bank pools the resources and helps the member banks. 2. Large credits more than a member's capital can be handled through consortium basis. 3. CRR, SLR and capital requirement is centrally maintained by the parent bank. 4. Parent bank provides service on research, legal matters and investments, reducing individual member bank's cost. DEMERITS- 1.

It is a step towards monopoly, not healthy from economic point of view. 2. Decline in business of one member in the group affects the entire group. 3. If the parent body is not a bank, it may divert funds to further its own interest. C2. UNIT BANKING system is an individualistic system also favored largely in USA. In this system each bank is a centralized unit without branches; it may have service centers like ATM at multiple convenient places or even a few branches within a strictly limited area. All functions of the bank are performed at one centralized place. For remittances they are linked through correspondent banks. MERITS- 1. Every type of banking service is available under one umbrella 2.

It is competitive and highly efficient. It can take prompt decisions. 3. Continuity in personal relation helps in customer care. 4. Even unique local needs are addressed by this system. DEMERITS- 1. Being localized, it can not spread risk and its resources are limited. 2. They can not diversify services, can not have large scale operations 3. Mobilization of funds is limited to their own area and so fear of failure exists. 4. They have to depend upon their correspondent bank for remittances, increasing cost. 5. Very difficult to run

unit banking in rural areas since rural resources are limited. C3. BRANCH BANKING system is followed almost universally.

In this system banks will have their head office at one place and branches at multiple convenient places. Each branch functions like any other full fledged bank and yet is fully controlled by the head office. They even have specialized branches to take care of specific requirements of customers, like NRI branch, SSI branch etc. This is very convenient to the customers. In some branches even the weekly holiday is changed to suit the people of the area. MERITS- 1. This system can spread risk, diversify services, can have large scale operations. 2. It can have specialized branches for exclusive purposes. 3. They can move cash reserve from less required branch to more required branch. 4.

Remittance through branch system is easy, cheap and efficient. 5. Brings uniformity in the functioning supported by centralized system. 6. There will be an efficient head office control and less fear of failure due to its size.

DEMERITS- 1. Centralization of command delays decision making process. 2. Every branch may not be in a position to offer all banking services 3.

Administration tends to be bureaucratic, sticking to the rules at the cost of the need. 4. More the branches, difficult will be monitoring and supervision 5.

Unique local needs may not be well taken care of From the above analysis we can safely conclude that branch banking system is the best system and so is favored world over.

NOTE: State Bank of India is planning to bring itself and its subsidiary banks with all their branches under one Holding Bank which will be like a Central

Bank with full policy control over its member banks and yet with administrative freedom given to each of the member bank to maintain their unique identity. This will also be a group banking system with an important change that the holding company is a bank whose majority stake is held by the government. Hence, this system is going to combine the advantages of all the three systems discussed above. INDIAN BANKING: PROFILE In India, ancient scripts as old as 'Manu Smriti' deal with regulations on credit like-credit instruments, judicial proceedings on credits, renewal of commercial papers, interest on loans, etc. Chanakya's Arthashastra refers to accepting deposits for lending.

This was mainly money lending where as the modern concept of banking came to India with the colonial rulers. Though Chanakya's Arthashastra speaks both about deposit and credit, it is basically money lending. INDIAN BANKING SYSTEM – AN OVERVIEW v v v INDIGENOUS SYSTEM BANKING SYSTEM NBFIs v v v Indig. Banker Money Lender. \_\_\_\_ \_v\_\_\_\_ DFI NFFC MF. v Cooperative Scheduled v v Rural, Urban, LTCCS Coop Commercial v v v SCB, DCCB, PACS SCARDB, PCARDB Public, Private, Foreign, RRB v Nationalized Banks, SBI, SBI Group A. INDIGENOUS SYSTEM is the oldest system of banking in India. It is basically a business for profit controlled by a few upper caste communities. Hence, it got degenerated into highly exploitative system against the lower castes and accepted by the masses out of helplessness. A1. INDIGENOUS BANKERS are individuals or firms who lend money against securities- hundis, promissory notes and legal bonds which state the amount of loan, due date, rate of interest and penalty interest beyond due date. They may or may not accept deposits from the public.

It is a monopoly of certain castes among Multanis and Marwaris, in the West, Gujratis and Bengalis in the East and Chettis and Brahmins in the South. The interest rates of these bankers range from 6% to 150% depending on the nature of the security. Many of them have trading interests and control the marketing of the borrower's products. They operate mainly in big trading centers with their offices and branches. A2. MONEY LENDERS are individuals usually from Mahajan, Sowcar and Pathan communities. They do not accept deposits and their methods of business are not uniform. Others with surplus funds too are involved in money lending occasionally.

Money lenders usually lend small amounts on personal security without any written agreement with prohibitive interest ranging from 75% to 300%, invariably quoted and collected on a monthly basis. They operate mainly among peasants and urban labor class. The lenders in both these categories are not interested in increasing productivity through credit. They are not even bothered about the principal amount as long as the interest keeps coming on time. Most of their credit goes for non-productive consumption activities. They are willing to give fresh credit to pay off the old credit with interest as it enhances their earning. There are enough cases where illiterates get cheated by them.

Money lending now requires a govt. license and has a cap on interest rates. In spite of such restrictions, money lending business it still continues illegally among the low income groups because of easy access, absence of paper work and familiarity with the lenders. B. NON BANKING FIN. INSTITUTIONS or NBFIs consist of development finance institutions, non-banking finance



companies and mutual funds governed under SEBI. They do not come under direct RBI control like the commercial banks.

**B1. DEVELOPMENT FINANCE INSTITUTIONS:** established by the central government for specific priority sector developmental activities. They are EXIM Bank, NABARD, NHB & SIDBI. EXIM Bank derives its name from Export-Import and its main activity is direct lending by way of long term loans and investments in export and import activities.

- NABARD is abbreviation for National Bank for Agriculture & Rural Development and is involved in refinancing banks and non banking financial institutions for agricultural and rural developmental activities.
- NHB stands for National Housing Bank refinancing banks and non banking finance institutions on housing credits.
- SIDBI is short form for Small Industries Development Bank of India and it extends refinance to banks and non banking finance institutions for small scale industries.

**B2. NON-BANKING FINANCE COMPANIES:** come under the regulations and supervision of RBI since 1998 but not under the II schedule like the scheduled banks.

They are private or public limited companies and are allowed by RBI to accept deposits and offer 1% higher interest than the banks. They give credit only for the specific activities for which they are established like- equipment leasing companies, hire purchase finance companies, investment companies, loan companies, housing finance companies, etc.

**B3. MUTUAL FUNDS:** are trusts that accept funds from the investors and redeploy them both in equity market as well as non-equity securities in a pre-determined pattern made available to the investor in advance and fully share the accrued profits with the investors after deducting their legitimate expenses.

Hence, gain from mutual funds depends on the types of securities purchased by them. Broadly speaking there are three types of Mutual Funds. Equity Funds invest at least 65% of their funds in various equities and may give superlative returns or make one lose one's own money depending on the market situation. Debt Funds invest in non equity securities and give low but steady returns. Balanced Funds are combination of both equity & debt funds. For a detailed discussion on Mutual Funds please see appendix at the end. C. BANKING SYSTEM consists of both cooperative and scheduled banks. C1. COOPERATIVE BANKS received momentum after the 2nd World War.

They are formed by the cooperation of any group under the Co-op Societies Act. Such groups are largely localized and the success depends on their own expertise. Urban Co-op Banks catering to the needs of the urban population and Rural Co-op Banks such as State Co-op Banks and District Central Co-op Banks catering to the needs of the rural population fall in this category. Co-op Banks are not listed under the second schedule of RBI Act, 1934 but they come under RBI supervision separately. They are required to allocate 40% of their credit to the priority sector of the government like any other commercial bank, work within the jurisdiction of their state and are primarily into short term credit to its members.

They are allowed to offer cheque book facility and interest 1% higher than commercial banks on deposits, but they do not offer all the banking and other ancillary facilities of a full fledged bank. All co-op banks/ credit societies have to be registered under Cooperative Societies Act of the respective states. They work on the basis of cooperation and can be

established by any group of people by forming a co-op society and subscribing for their shares. The main difference between a co-op bank and a co-op credit society is that the former can receive deposit from general public and give cheque book facility but give credit only to the members where as the latter provides its services and benefits only to its members.

Besides these, there are also Primary Agricultural Credit Societies, Primary Cooperative Agriculture & Rural Development Banks and State Cooperative Agriculture & Rural Development Banks in the cooperative sector.

Cooperative banking structure, particularly the rural sector cooperative banking is quite complex in India. It can be broadly classified as follows- Urban Cooperative Banks alone have a single tier structure catering to all types of needs of the urban population through their branches in major cities spread all over the state, just like any other bank. Rural Cooperative Banks have three tier structures of delivery- State Cooperative Bank at the Apex level, District Central Cooperative Bank at the Intermediary level and Primary Agricultural Credit Societies at the Base level.

Long Term Cooperative Credit Societies usually have two tier system- Primary Cooperative Agriculture & Rural Development Banks at the base level and State Cooperative Agriculture & Rural Development Banks at the state level. Some states have unitary system with State level banks working through their own branches and some other states have a mixture of both systems. C2. SCHEDULED BANKS are those which are registered as joint stock companies under Indian Companies Act and are also listed under 2nd schedule of the RBI Act, 1934. They are licensed by RBI to have branches all

over India or even abroad and perform all banking activities including foreign exchange.

They are required to lend 40% of their credit to the priority sectors of the government. They directly come under RBI regulations and supervision. RBI control over the scheduled banks is so efficient that we do not have any example where a scheduled bank has ever applied for liquidation since the inception of RBI. Scheduled banks are basically of two types- a. SCHEDULED COOPERATIVE BANKS are those cooperative banks with a large capital base and listed under the 2nd schedule of RBI Act of 1934. They can offer all banking facilities just like any other commercial bank. b. SCHEDULED COMMERCIAL BANKS are those private or public limited joint stock companies listed under the 2nd schedule of RBI Act of.

They are further classified into 4 groups: Public Sector Banks, Private Sector Banks, Foreign Banks and Regional Rural Banks. b1. PUBLIC SECTOR BANKS are public limited companies whose majority shares are held by the government. Hence, their board of directors is fully controlled by the govt. and they come directly under govt. regulations. They are further classified into State Bank of India, Subsidiary Banks of SBI and Nationalized Banks. • STATE BANK OF INDIA: The East India Company established three banks- Presidency Bank of Bengal in 1809, Presidency Bank of Bombay in 1840 and Presidency Bank of Madras in 1843 as bankers to the respective Presidency Governments.

In 1921 they were amalgamated into Imperial Bank of India which also functioned as the central bank till RBI was formed in 1935. In 1955 it was

nationalized and re-named as State Bank of India, popularly known as SBI. It also acts as the banker to the government wherever RBI does not have its offices. • SUBSIDIARY BANKS OF SBI or SBI Group was formed by SBI with majority shareholding in them. State Banks of Saurashtra / Indore have merged with SBI in 2008 & 2010 respectively. State Banks of Mysore / Travancore / Hyderabad / Patiala / Bikaner & Jaipur are in the process of merger. SBI European Bank is their foreign subsidiary bank. • NATIONALIZED BANKS: 14 commercial banks were nationalized in 1969.

They are- Allahabad Bank, Bank of India, Bank of Baroda, Bank of Maharashtra, Canara Bank, Central Bank of India, Dena Bank, Indian Bank, Indian Overseas Bank, Punjab National Bank, Syndicate Bank, United Commercial Bank, United Bank of India and Union Bank of India. 6 more were nationalized in 1980. They are Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab & Sind Bank and Vijaya Bank. b2. PRIVATE SECTOR BANKS do not have any govt. stake in their share holdings. Most of them are owned and controlled by business groups and follow aggressive corporate culture in their functioning to maximize their profits. The promotion prospects of their employees are directly linked to the business they promote unlike in public sector.

Hence, they are far ahead of public sector banks in value added services, customer care and at the same time they also charge a host of hidden costs unlike the public sector banks. b3. FOREIGN BANKS are those banks whose head offices are located outside India and are allowed to do banking business under certain conditions. Prominent among them is lending 32% of

their credit to the priority sector including export credit. Financing foreign trade remains their main business in India. They can fulfill their priority sector lending requirement by lending to priority sector export business and investing in priority sector government financial institutions. b4.

REGIONAL RURAL BANKS were created to provide institutional credit and other facilities to the small and marginal farmers, agricultural laborers, artisans and small entrepreneurs in rural areas under 20 point Economic Program of the central government. 19 such banks were established in 1976, one in each state. They were given a jurisdiction to work, freedom to have branches or agencies within their jurisdiction and were put under the sponsorship of a nationalized bank. Ownership pattern of the capital was 35% with sponsor bank, 50% with the central govt. and 15% with the state govt. D. CHANGING PROFILE: Indian economic policy has been founded on the philosophy of economic growth and social justice. Indian banking sector has undergone a dynamic change over the years based on the needs of its economy. Most important among them are- REACH- The branch network of Indian banking system is so extensive, it covers almost all remote corners of India. It is one of the largest networks in the world. • DEVT- The diversification and development of our economy and its rapid growth is all because of our banking system's credit to various priority sectors. These achievements have become a reality because of the changing profile of our banking system over the years. We shall discuss the major changes in the profile as under- D1. CHANGE IN SECURITY ORIENTATION: Traditionally personal creditworthiness of the borrower mattered a lot for any credit to be

released. It meant, safety of the credit alone mattered for the banks and this safety came from the wealth the customers possessed.

It effectively meant that only moneyed people could borrow from the bank.

Now, banks have now changed their orientation from safety to purpose.

Credit is now made available to make them creditworthy. Hence, technical competence of the borrower, operational flexibility and economic viability of the project has become more important than the security offered by the borrower. D2. CHANGE IN REGIONAL IMBALANCES: Private Banks opened their branches in urban locations because of the business potential. As a result Rural India remained unconnected by the banks. For example, pre-nationalization of banks there were only 12555 branches of banks in the entire country and they were located mainly in the urban centers.

Post nationalization of banks number of branches has rapidly risen and as of Mar-09 it stands at 82408 branches. It is important to note that over 49% of these branches are now in the rural areas. It gives evidence that banking network has now spread uniformly to cover the entire nation without rural-urban bias. D3. CHANGE IN BANKING HABIT: As a natural corollary to the development in the field of branch banking, development of banking habits in India have grown at an unparalleled pace. Banks have successfully induced the customers to save a part of their earning in banks for the future. Some banks even sent their agents door to door to collect the savings. This helped the banks to diversify their lending portfolio considerably.

If the deposits & advances counted for 13% & 10% of GDP respectively in 1969 they shot up to a whopping 50% & 25% respectively in 2002. D4.

**CHANGE IN BANKERS ATTITUDE:** A welcome change is the change in the attitude of the bankers. Earlier lending had a wholesale character coupled with the security of the credit. This attitude of the bankers made the banking facilities almost the exclusive prerogative of the elite classes. With the branches reaching the rural areas banking went retail and for the ordinary masses. Grant of credit no more became a matter of privilege; it became available for genuine production need based purely on technical norms. D5.

**CHANGE IN BANKING PRODUCTS:** As the focus got shifted from wholesale to retail banking, private banks in particular came up with novel products to suit the needs of the retail customers, like- home loan, auto loan, credit card, etc. Pigmy deposit introduced by Syndicate Bank and imitated by others in its various forms for example aimed at pooling idle money and inculcate saving habits among people. Banks sent their agents door to door to collect the deposit money on a daily basis and without setting a minimum. Bank deposits grew substantially because of this scheme. Such innovative products were considered a tough proposition earlier by the banks due to the volume of operations involved. Now, computerization of banking system has removed this difficulty.

Some of the banks have started offering even auto FD where amounts above a pre set limit gets converted automatically into FD to fetch higher interest and gets redeemed automatically when cheques are presented and the account runs short of balance. D6. **CHANGE IN MODE OF BANKING:** When the banking system was manually operated, almost all services were time consuming except depositing money into the account in the base branch



where the account is maintained. Computerization of banking has made service faster; the entire country is made to appear like one branch and even the necessity to go to the bank during banking hours for transactions is becoming redundant. Cash can be drawn from ATM anytime, even during holidays and bills can be paid directly to the account from one's own office. D7.

**CHANGE IN NON-BANKING ACTIVITIES:** Many banks have diversified their activities beyond traditional banking activities like equipment leasing, hire purchase financing and factoring [acting as agents for the customers. ] A major step in this direction is the merger of ICICI with ICICI Bank D8. **CHANGE IN APPROACH TO CREDIT:** As a corollary to the shift from security orientation to purpose orientation, bank's approach to credit also changed from lending to development in the recent past. Banks started lending for the purpose of industrial development, providing access to capital market and long term savings of the economy. They even started specialized branches to cater to the specific needs of the customers, like- NRI Branch, Overseas Branch, SSI Branch, Recovery Branch, etc. D9.

**CHANGE IN CUSTOMER SERVICE:** Private Banks started giving more focus to customer care in order to win more business. They even gave free collection and delivery facilities to HNI customers. To cope with the increasing banking habit, RBI too came up with a Banking Ombudsman scheme to redress the customers' complaints. E. **CHALLENGES AHEAD:** Banks have sacrificed some qualitative aspects of growth while expanding the banking system to achieve development and increase its reach. Prudent regulations have no doubt

helped to ensure systemic stability, but enhanced efficiency would necessitate institutional changes in the internal functioning of the banks in the following fields- E1.

**ORGANISATIONAL STRUCTURE:** Centralized structures work wonders under uniform conditions. As the banks diversify their business into the field of agriculture, rural development and other priority sectors they have to deal with different types of customers who need different kind of treatment. They can not afford to force the standard sophisticated practices on all the customers uniformly. For example, to finance rural development it is very much essential that banks evolve simple and meaningful procedures to the comfort of the rural folks. The most common complaint against banks is the under-financing and non-availability of timely credit to meet the borrowers' need based requirements.

Hence, banks must revamp their organizational structures by delegating power, decentralizing control and monitoring performance. E2. **EXCELLENCE IN MANAGEMENT:** Quality of management is another challenge in the face of fast expansion. Here are ten critical characteristics of a good bank management- 1. An open culture and extensive vertical and horizontal communication, 2. Strong shared values, 3. Profit performance as a value, 4. Customer focused business orientation, 5. Willingness to invest in new products, 6. Strong sense of direction and consistent leadership, 7. Commitment to recruit best persons, 8. Investment in training, 9. Product information system and 10. Strong credit risk management. E3.

**CORPORATE GOVERNANCE:** There are instances where the boards have shown reluctance to ratify and adopt RBI circulated covenants on professionalization of bank boards. Corporate governance can not be enforced through regulations, it must spring from within. E4. **EMPLOYEE COMPETENCY:** Together with the change in organizational structure there is a need to increase employee competency also. When new entrants into the market like Mutual Funds are cutting into the business of the banks, contemporary banking is becoming more and more skill sensitive and information technology is throwing new challenges to the banking systems, employee competency has become all the more important to retain the existing business of the banks and expand it. E5.

**APPROPRIATE TECHNOLOGY:** Well established banks are facing stiff competition from the new entrant banks in terms of use of appropriate technology that makes banking convenient. The established banks do use modern technology but are way behind in maintaining pace and are challenged by these new entrants in order to remain in business. E6.

**NONPERFORMING ASSETS:** These are popularly known as NPA, the loans that do not perform- loans under litigation or bad loans that are doubtful of recovery. 6. 2% of loans of scheduled commercial banks were NPA and the public sector banks had to write off 42. 5% of the NPA as on 31. 3. 2002. It reflects on the quality of the loan portfolio. At 5% NPA, 17 out of 21 major banks in Japan were on the red.

As per developed country standards it has to be around 2%. Hence, banks have to bring down the NPA ratio drastically. E7. **DIRECTED CREDIT:** NPA as

discussed above is a direct result of the quality of the loan portfolio of the banks. The system of directed credit to priority sector has no doubt brought impressive performance in quantitative terms but qualitatively it has brought more loan delinquencies since the relation between credit expansion and productivity has become weak. Political interference in credit decision-making is pointed out as a factor. The populist phenomenon of 'loan mela' is certainly contrary to the professional appraisal of bank credit needs.

What is required to improve the quality of loan is- 1. Serious appraisal of credit need, 2. Potential productive activity and 3. Effective post credit supervision. E8. RISK MANAGEMENT: Risk is intrinsic to any business; all the more to banking. Risks encountered by banks have increased with the diversity of banking business and growing sophistication of banking operations. The major risks encountered by banks are credit risk, interest rate risk, operational risk, forex risk and liquidity risk. While deregulation has opened up new vistas for banks to shore up more revenue, it has entailed greater competition and greater risks too. Hence, greater attention needs to be given in strengthening of internal controls of risk management. E9. SICK INDUSTRIAL UNITS: Funds locked up in industrial sickness has reached a staggering 2% of the entire credit of the banking system in March 2000. When sick units have to be nursed for 'social objectives' banks should not be forced to suffer; actual stakeholders must bear the burden of nursing them. When sick units are nationalized for protecting the employment or they are public sector entities, govt. must give adequate compensation to the banks to cover their dues which rarely happens in reality. It is neither legitimate nor practical for the banks to nurse sick units in all circumstances. E10.

**PROFIT PLANNING:** Banking can not run like other profit making business since excessive and unjustified profits can only be at the cost of development of the society so far as the lending rates push up the production cost and ultimately is passed on to the customer. At the same time strong operating profits allow for allocations to capital and reserves which are very much essential for any bank to maintain its competitive viability. This setback was realized in the 90's when the nationalized banks posted declining profits. Nevertheless, concerted efforts by these banks improved the situation by 2002. Stiff competition makes the banks to work on thin interest rate margins but to increase their profitability, they have to increase their fee based non-fund services substantially. E11.

**CUSTOMER SERVICE:** Though entry of new private banks no doubt has increased the quality of customer service, it is by and large confined to urban areas and to wealthy customers. Only the educated and wealthy customers have access to detailed information on all the banking facilities available. Customer care is very much wanting in public sector banks where the unionized employees are sure of not losing their jobs on this count. Efforts must be made to collect customer feedback on regular basis and remedy the defects pointed out if any, at the earliest wherever possible. E12.

**GLOBAL STANDARDS:** Computerization has revolutionized in banking in India. But it has not yet made much progress in expanding it beyond the national boundaries. Not many branches of Indian banks are found outside India. Just like its progress in Information Technology and software, India has to make good progress in the banking sector internationally since allocation of capital can not be bound by geographical boundaries. COMMERCIAL BANK A.

FEATURES: Commercial banks are private or public limited joint stock banking companies registered under Indian Companies Act. There are three distinct features of a commercial bank- they accept DEPOSITS on lower cost and give CREDIT on higher cost and the cost difference between deposit and credit is their GAIN. [For more details refer features of a bank]

Its capacity to earn profits depends on its investment policy which in turn depends on the manner in which it manages its investment portfolio.

Portfolio management refers to prudent management of a bank's profit, liquidity and safety. But most commercial banks have gone way ahead of their basic functions introducing a host of fee based ancillary financial services in order to maximize their profits. Thus a commercial bank now may be defined as “ an institution that accepts deposits from the public on lower cost and lends it on credit on higher cost as well as offers ancillary services for a fee in order to increase its profits. ”

**B. ROLE IN FINANCIAL SYSTEM:**

Commercial banks strive to earn a profit.

At the same time their entire business of credit depends on public money deposited with them. Hence, they can not afford to risk public money just to increase their own profits. It is common knowledge that national level bank strikes throttle the lifeline of the nation's economy and inflict heavy losses on the GDP. The significance of banks' role in the financial system must be understood in the words of Walter Leaf, who says “ The banker is the universal arbiter of the world's economy” Commercial banks have to play a major role in three distinct areas- • Providing fiscal liquidity to the financial

system, • Giving capital protection to the economy and • Speeding up economic growth of the nation. B1.

FISCAL LIQUIDITY: By fiscal liquidity we mean the capacity to produce cash on demand. The most important role of any bank is to provide liquidity to the financial system. Banks pool around idle money in small pockets through their wide spread branches into a large capital and redeploy it wherever needed. For better management of credit, banks like to have as much funds in liquid as possible while maximization of gain is possible only by deploying maximum available funds on credit. Both are important for the bank. Hence, bank has to strike an effective balance between them so that neither its profitability suffers nor the liquidity of the market is affected. Liquidity of the assets of the bank is planned in three stages- a.

CASH is the most liquid asset. But it is an idle asset earning no returns for the bank. Yet certain percent of deposits must be always kept in reserve with the Central Bank in addition to cash in hand to meet immediate withdrawal of deposit. This is known as Cash Reserve Ratio or CRR. It is decided by the Central Bank. b. CALL MONEY is the investment in Money Market, Bond Market and Reverse Repo. # Money Market securities include short term securities like Certificate of Deposit [CD] of banks, Commercial Papers [CP] of companies, treasury bills of the govt. which give stable but low returns and long term govt. securities whose yield depend on the interest scenario. Bond Market securities include Medium Term as well as Long Term bonds of any banks or companies tradable in the secondary bond market. They are bought and sold at discount or premium and hence, their yield also depends

on interest scenario. # Reverse Repo is the system through which RBI borrows from commercial banks to absorb excess liquidity at lower interest rate. These funds are made available to commercial banks through bills repurchase under repo system on a little higher interest. These securities are the next best liquid assets but the returns from these securities are low. But it is important to select only those securities which give a fairly stable return.

These securities can easily be liquidated in the Market with short notice. RBI prescribes a Statutory Liquidity Ratio or SLR for banks by which banks have to maintain certain percent of their deposits as liquid assets. c. CREDIT and investments give maximum gain to the bank but they are the least liquid. Hence, these assets should be created only in required proportion, never as a priority. Among them, short term credits are preferred by banks over long term credits for the sake of liquidity. B2. CAPITAL SAFETY: Commercial banks strive to earn profit. But this must be done through prudent ways without risking the deposits of their customers. They have an important role to play in the capital protection. Hence, 1.

Protection of deposits must be the top priority for the banks. Deposit Insurance and Credit Guarantee Corporation set up by the govt. gives guarantee only up to Rupees one lakh per customer in case a bank fails and has to be closed down. 2. Banks must avoid investing in equity related instruments or giving loan for speculative business since equity market weakens capital safety to a large extent. This is required to increase stability of the capital. 3. Banks have to use self restraint in their credit to other



volatile businesses like real estate, film industry, etc. Similarly they must be extra cautious while accepting volatile securities as surety for credit. 4.

Banks must restrict long term credits and investments to a small percent since capital safety in short term credits is higher than the long term credits.

5. Before giving clean loans, banks must have a thorough reality check on the creditworthiness of the borrowers to repay the loan on time. 6. Banks

must maintain a fair margin between their interest rates on deposits and

credits. B3. ECONOMIC GROWTH: Banks have a greater role to play in the

economic growth of the nation through economic development of all the

sectors. Hence, they must provide more credit to developmental and

productive activities than non-productive or consumption oriented activities.

Basically there are three types of developmental activities- Large capital based corporate activities, medium or small capital based priority sector

activities and export activity. a. CORPORATE SECTOR- While funding

developmental activities, banks find it easy to provide credit to large capital based profit making corporates in industry & trade since timely repayment of

credit received by them with interest is almost guaranteed. Funding is

required not only for corporates but also for other sectors like industry,

trade, service, infrastructure, transport, housing, power, finance, technology,

etc and the banks can not overlook one sector at the expense of the other.

Besides, corporate sector companies also have the capacity to increase its

capital base or raise funds from the open market by issuing their own bonds.

In other words they do not depend heavily on banks for their capital

requirements where as others heavily depend on banks. Hence, banks must

use their prudence while deciding percentages for corporate credit. Large capital companies, particularly industry contribute to the economic growth of the nation not only by increasing production but also by increasing job opportunities. But their main drawback is that they are basically profit oriented and development is a byproduct of their activity. They are reluctant to venture into non-profit sectors that are essential for a balanced growth of economy. b. PRIORITY SECTOR- For all-round and real development there are certain priority sectors of the nation that require funding assistance by the banks.

They are- infrastructure development like housing, rail and road construction, power, transport, etc. as well as small scale industry, trade, technology, agriculture, etc. From the profit perspective these priority sectors may not be always lucrative. It will not be always easy for these sectors either to increase their capital or borrow from open market; they depend heavily on banks for their capital requirements. RBI has mandated 40% of the total credit of all cooperative & scheduled banks and 32% for foreign banks towards priority sector lending. Banks are allowed to invest in special bonds or investment instruments of these sectors to meet these requirements. c. AGRICULTURE SECTOR is surely a super priority sector.

It must attract special attention of the banks since self sufficiency in agriculture has to be a top priority of any nation. Agricultural production is commercially unprofitable at least in Indian context. Small and medium farmers produce just enough to sustain since their personal labor in agricultural production gets them no returns. Any other production can wait,

not food; it has to be produced proportional to the population irrespective of the cost. For the same reason, governments are providing subsidy and refinance facilities for agriculture. Banks must ensure that the government benefits really reach the medium and small farmers. d. EXPORT SECTOR is not an exclusive sector like corporate or priority sector.

It can pervade both corporate as well as priority sectors. Economies of the world are so interdependent that each country must have enough reserves in the currencies of other countries to pay the bills for supplies received from those countries. In its absence they end up in raising foreign debt which in turn has a cost by way of interest; or else they end up in depleting nation's gold reserves. If a country depends on foreign supplies, it must give high priority to exports to that country to strengthen their balance of payment. In such a situation banks must step in to provide credit to export activities in a preferred manner to increase country's reserves in that currency. C.

**MULTIPLE CREDIT CREATION:** There are two views on whether banks can create credit- • One view held by Walter Leaf is that banks can not create money out of thin air. They can lend what they have in cash. • Another view held by Hartley Withers is that banks can create credit by opening a deposit every time they advance a loan. It is interesting to know that in an effort to maintain lowest possible idle cash, banks end up in increasing the money in circulation without increasing tender cash currency while creating credit! In fact, credit creation is one of the most important functions of a commercial bank. They increase the purchasing power of people. Let us see how does this happen. C1.

METHOD: When bank gives a loan it pre-supposes that bank has cash through deposits. From the deposit bank gives loan which in turn gets deposited in the bank account. It creates an asset as well as a deposit with the bank. The beneficiary customer can issue cheques for payments in addition to the existing customers who have originally deposited the money. Thus money available in circulation superficially becomes more than the actual tender cash currency. This is the view of practical bankers. Concrete Example: Let us presume that our country has only one bank B and all the citizens are heavily into banking making the cash requirement of B just 10%.

B gets total demand deposit of R. 10000 and that is the only currency in circulation in our country. Balance sheet of B will read as follows: |

LIABILITIES | ASSETS | | Deposits 10000 | Cash in Hand 10000 | | TOTAL

10000 | TOTAL 10000 | B has to maintain 10% of its deposit of 10000 which is 1000 as cash reserve. It implies that B can give 9000 as loan. It creates an additional deposit as it is released to the deposit account while creating a credit of 9000 and the new balance sheet will read thus: LIABILITIES | ASSETS | | Deposits 19000 | Cash in Hand 10000 | |