CHAPTER – 1
OVERVIEW:
BANKING SECTOR & FINANCIAL PERFORMANCE ANALYSIS
1.1 INTRODUCTION

The banking industry in India has a huge canvas of history, which covers the traditional banking practices from the time of Britishers to the reforms period, nationalization to privatization of banks and now increasing numbers of foreign banks in India. Therefore, Banking in India has been through a long journey. Banking industry in India has also achieved a new height with the changing times. The use of technology has brought a revolution in the working style of the banks.

Nevertheless, the fundamental aspects of banking i.e. trust and the confidence of the people on the institution remain the same. The majority of the banks are still successful in keeping with the confidence of the shareholders as well as other stakeholders. However, with the changing dynamics of banking business brings new kind of risk exposure.

In recent time, we have witnessed that the World Economy is passing through some intricate circumstances as bankruptcy of banking & financial institutions, debt crisis in major economies of the world and euro zone crisis. Indian banking is not an exception to this vulnerability and has to face critical issues like NPA, Inflation, money laundering and what not. The scenario has become very uncertain causing no man’s land kind of situation for the people who are not keeping it up with changing scenes. This poses some serious questions about the performance of banks and their role as economic facilitator.

However, amidst all this turmoil India’s Banking Industry has been amongst the few to maintain resilience. The tempo of development for the Indian banking industry has been remarkable over the past decade. It is evident from the higher pace of credit expansion; expanding profitability and productivity similar to banks in developed markets, lower incidence of non-performing assets and focus on financial inclusion have contributed to making Indian banking vibrant and strong. Indian banks have begun to revise their growth approach and re-evaluate the prospects on hand to keep the economy rolling.
1.2 HISTORY AND DEVELOPMENT

1.2.1 BANKING IN ANCIENT INDIA - Evolution

The banking history is interesting and reflects evolution in trade and commerce. It also throws light on living style, political and cultural aspects of civilized mankind. The strongest faith of people has always been religion and God. The seat of religion and place of worship were considered safe place for money and valuables. Ancient homes didn't have the benefit of a steel safe, therefore, most wealthy people held accounts at their temples. Numerous people, like priests or temple workers were both devout and honest, always occupied the temples, adding a sense of security. There are records from Greece, Rome, Egypt and Ancient Babylon that suggest temples loaned money out, in addition to keeping it safe. The fact that most temples were also the financial centers of their cities and this is the major reason that they were ransacked during wars. The practice of depositing personal valuables at these places which were also functioning as the treasuries in ancient Babylon against a receipt was perhaps the earliest form of “Banking”.

Gradually as the personal possession got evaluated in term of money, in form of coins made of precious metal like gold and silver, these were being deposited in the temple treasuries. As these coins were commonly accepted form of wealth, ‘lending’ activity to those who needed it and were prepared to ‘borrow’ at an interest began. The person who conducted this ‘lending’ activity was known as the “Banker” because of the bench he usually set. It is also observed that the term ‘bankrupt’ got evolved then as the irate depositors broke the bench and table of the insolvent banker.

With the expansion of trade the concept of banking gained greater ground. The handling of “banking” transcended from individual to groups to companies. Issuing currency was one of the major functions of the banks. The earliest from of money – coins, were a certificate of value stamped on a metal, usually gold, silver, and bronze or any other metal, by an authority, usually the king. With the increasing belief and faith in such authority of their valuation and the necessities of wider trade a substitute to metal was found in paper. The vagaries of monarchical rule led to the issues of currency being vested with the banks since they enjoyed faith, controlled credit and
trading. All forms of money were a unit of value and promised to pay the bearer of specified value. Due to failure on account of unwise loans, to rule and organize, a stable banking system arose. The word’s earliest bank currency notes were issued in Sweden by stock holms Banco in July 1661.

1.2.2 Coinage

The story of Indian coinage itself is very vast and fascinating, and also throws tremendous light on the various aspects of life during different periods. The Rig Veda speaks only gold, silver copper and bronze and the later Vedic texts also mention tin, lead, iron and silver. Recently iron coins were found in very early levels at Attranji Kheri (U.P.) and Pandu Rajar Dhibi (Bengal). A money economy existed in India since the days of Buddha.

In ancient India during the Maurya dynasty (321 to 185 BC), an instrument called “adesha” was in use, which was an order on a banker desiring him to pay the money of the note to a third person, which corresponds to the definition of a bill of exchange as we understand it today. During the Buddhist period, there was considerable use of these instruments. Merchants in large towns gave letters of credit to one another.

Trade guilds acted as bankers, both receiving deposits and issuing loans. The larger temples served as bankers and in the south the village communities economically advanced loans to peasants. There were many professional bankers and moneylenders like the sethi, the word literally means “chief”. It has survived in the North India as “seth”. Small purchases were regularly paid for in cowry shells (varataka), which remained the chief currency of the poor in many parts of India. Indigenous banking grew up in the form of rural money lending with certain individuals using their private funds for this purpose. The scriptures singled out the vaishyas as the principal bankers. The earliest form of Indian Bill of Exchange was called “Hundi”. Exports and import were regulated by barter system.

Kautilya’s Arthasastra mentions about a currency known as panas and even fines paid to courts were made by panas. E. B. Havell in his work: The History of Aryas Rule in
India says that Muhammad Tughlaq issued copper coin as counters and by an imperial decree made them pass at the value of gold and silver. The people paid their tribute in copper instead of gold, and they bought all the necessaries and luxuries they desired in the same coin. However, the Sultan’s tokens were not accepted in counties in which his decree did not run. Soon the whole external trade of Hindustan come to a standstill. When as last the copper tankas had become more worthless than clods, the Sultan in a rage repealed his edict and proclaimed that the treasury would exchange gold coin for his copper ones. As a result of this thousands of men from various quarters who possessed thousands of these copper coins bought the m to the treasury and received in exchange gold tankas. The origin of the word "rupee" is found in the Sanskrit rūpya"shaped; stamped, impressed; coin" and also from the Sanskrit word "rupa" meaning silver. The standardization of currency unit as Rupee in largely due to Sher Shah in 1542.

The English traders that came to India in the 17th century could not make much use of the indigenous bankers, owing to their ignorance of the language as well the inexperience indigenous people of the European trade. Therefore, the English Agency Houses in Calcutta and Bombay began to conduct banking business, besides their commercial business, based on unlimited liability. The Europeans with aptitude of commercial pursuit, who resigned from civil and military services, organized these agency houses.

A type of business organization recognizable as man aging agency took form in a period from 1834 to 1847. The primary concern of these agency houses was trade, but they branched out into banking as aside line to facilitate the operations of their main business. The English agency houses, that began to serve as bankers to the East India Company had no capital of their own and depended on deposits for their funds. They financed movements of crops, issued paper money and established joint stock banks. Earliest of these was Hindustan Bank, established by one of the agency houses in Calcutta in 1770.

Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1790; both are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India.

1.2.3 Swadeshi Movement

The period between 1906 and 1911, saw the establishment of banks inspired by the Swadeshi movement. The Swadeshi movement inspired local businessmen and political leaders to found banks for the Indian community. A number of banks established then have survived to the present such as Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India. Ammembal Subbarao Pai founded “Canara Bank Hindu Permanent Fund” in 1906. Central Bank of India was established in 1911 by Sir Sorabji Pochkhanawala and was the first commercial Indian bank completely owned and managed by Indians. In 1923, it acquired the Tata Industrial Bank. The fervour of Swadeshi movement lead to establishing of many private banks in Dakshina Kannada and Udupi district which were unified earlier and known by the name South Canara (South Kanara) district. Four nationalized banks started in this district and also a leading private sector bank. Hence, undivided Dakshina Kannada district is known as “Cradle of Indian Banking”.

1.2.4 Development after Freedom

The second milestone in history of Indian banking was India becoming a sovereign republic. The Government of India initiated measures to play an active role in the economic life of the nation, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted into greater involvement of the state in different segments of the economy including banking and
finance. The banking sector also witnessed the benefits; Government took major steps in this Indian Banking Sector Reform after independence.

- First major step in this direction was nationalization of Reserve Bank in 1949.
- Enactment of Banking Regulation Act in 1949
- Reserve Bank of India Scheduled Banks’ Regulations, 1951.
- Nationalization of Imperial Bank of India in 1955, with extensive banking facilities on a large scale especially in rural and semi-urban areas.
- Nationalization of SBI subsidiaries in 1959.

Government of India took many banking initiatives. These were aimed to provide banking coverage to all section of the society and every sector of the economy. The Industrial Credit and Investment Corporation of India Limited (ICICI) was incorporated at the initiative of World Bank, the Government of India and representatives of Indian industry, with the objective of creating a development financial institution for providing medium-term and long-term project financing to Indian businesses.

As creators of money, depositories of public savings, allocators of credit and conduits of the payment system, the banks have a unique position in the economy of any country. To bolster the larger public interest, public policy for banks is put in place by the government, the goals of which may vary depending on the nature of economy and priorities of the government.

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865, was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with head-quarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was
run by European Shareholders. After that the Reserve Bank of India was established in April 1935.

At the time of first phase the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority.

After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government’s ownership.

On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus the gates for the new private sector banks were opened.

The following are the major steps taken by the Government of India to Regulate Banking institutions in the country:-
1949: Enactment of Banking Regulation Act
1955: Nationalisation of State Bank of India
1959: Nationalization of SBI subsidiaries
1961: Insurance cover extended to deposits
1969: Nationalisation of 14 major Banks
1971: Creation of credit guarantee corporation
1975: Creation of regional rural banks
1980: Nationalisation of seven banks with deposits over 200 Crores.

1.2.5 Nationalisation

By the 1960s, the Indian banking industry has become an important tool to facilitate the development of the Indian economy. At the same time, it has emerged as a large employer, and a debate has ensured about the possibility to nationalise the banking industry. Indira Gandhi, the then Prime Minister of India expressed the intention of the Government of India (GOI) in the annual conference of the All India Congress Meeting in a paper entitled "Stray thoughts on Bank Nationalisation". The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalised the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayaprakash Narayan, a national leader of India, described the step as a "Masterstroke of political sagacity". Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August, 1969.

A second step of nationalisation of 6 more commercial banks followed in 1980. The stated reason for the nationalisation was to give the government more control of credit delivery. With the second step of nationalisation, the GOI controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalised banks and resulted in the reduction of the number of nationalised banks from 20 to 19. After this, until the 1990s, the nationalised banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy.

The nationalised banks were credited by some; including Home minister P. Chidambaram, to have helped the Indian economy withstand the global financial crisis of 2007-2009.
1.2.6 Liberalisation

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalisation, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of commerce, Axis Bank (earlier as UTI Bank), ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 49% with some restrictions.

The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more. Currently (2007), banking in India is generally fairly mature in terms of supply, product range and reach—even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in its region.

The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate—and this has mostly been true. With the growth in the Indian economy expected to be strong for quite some time—especially in its services sector—the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong.
1.2.7 Government policy on banking industry
(Source:-The federal Reserve Act 1913 and The Banking Act 1933)
Banks operating in most of the countries must contend with heavy regulations, rules enforced by Federal and State agencies to govern their operations, service offerings, and the manner in which they grow and expand their facilities to better serve the public. A banker works within the financial system to provide loans, accept deposits, and provide other services to their customers. They must do so within a climate of extensive regulation, designed primarily to protect the public interests.
The main reasons why the banks are heavily regulated are as follows:

• To protect the safety of the public’s savings.
• To control the supply of money and credit in order to achieve a nation’s broad economic goal.
• To ensure equal opportunity and fairness in the public’s access to credit and other vital financial services.
• To promote public confidence in the financial system, so that savings are made speedily and efficiently.
• To avoid concentrations of financial power in the hands of a few individuals and institutions.
• Provide the Government with credit, tax revenues and other services.
• To help sectors of the economy that they have special credit needs for eg. Housing, small business and agricultural loans etc.

1.2.8 Law of banking
Banking law is based on a contractual analysis of the relationship between the bank and customer—defined as any entity for which the bank agrees to conduct an account. The law implies rights and obligations into this relationship as follows:

• The bank account balance is the financial position between the bank and the customer: when the account is in credit, the bank owes the balance to the customer; when the account is overdrawn, the customer owes the balance to the bank.
• The bank agrees to pay the customer's cheques up to the amount standing to the credit of the customer's account, plus any agreed overdraft limit.
• The bank may not pay from the customer's account without a mandate from the customer, e.g. cheques drawn by the customer.
• The bank agrees to promptly collect the cheques deposited to the customer's account as the customer's agent, and to credit the proceeds to the customer's account.
• The bank has a right to combine the customer's accounts, since each account is just an aspect of the same credit relationship.
• The bank has a lien on cheques deposited to the customer's account, to the extent that the customer is indebted to the bank.
• The bank must not disclose details of transactions through the customer's account—unless the customer consents, there is a public duty to disclose, the bank's interests require it, or the law demands it.
• The bank must not close a customer's account without reasonable notice, since cheques are outstanding in the ordinary course of business for several days.

These implied contractual terms may be modified by express agreement between the customer and the bank. The statutes and regulations in force within a particular jurisdiction may also modify the above terms and/or create new rights, obligations or limitations relevant to the bank-customer relationship.

1.2.9 Regulations for Indian banks
Currently in most jurisdictions commercial banks are regulated by government entities and require a special bank license to operate. Usually the definition of the business of banking for the purposes of regulation is extended to include acceptance of deposits, even if they are not repayable to the customer's order—although money lending, by itself, is generally not included in the definition.

Unlike most other regulated industries, the regulator is typically also a participant in the market, i.e. a government-owned (central) bank. Central banks also typically have a monopoly on the business of issuing banknotes. However, in some countries this is not the case. In UK, for example, the Financial Services Authority licenses banks, and some commercial banks (such as the Bank of Scotland) issue their own banknotes in addition to those issued by the Bank of England, the UK government's central bank. Some types of financial instit
Some types of financial institutions, such as building societies and credit unions, may be partly or wholly exempted from bank license requirements, and therefore regulated under separate rules. The requirements for the issue of a bank license vary between jurisdictions but typically include:

- Minimum capital
- Minimum capital ratio
- 'Fit and Proper' requirements for the bank's controllers, owners, directors, and/or senior officers
- Approval of the bank's business plan as being sufficiently prudent and plausible.

1.3 Classification of Banking Industry in India

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks, and Specialized Financial Institutions (IDBI, ICICI, IFC etc). The 28 unorganized sector, which is not homogeneous, is largely made up of money lenders and indigenous bankers.

An outline of the Indian Banking structure may be presented as follows:-

1. Reserve banks of India.
2. Indian Scheduled Commercial Banks.
   a) State Bank of India and its associate banks.
   b) Twenty nationalized banks.
   c) Regional rural banks.
   d) Other scheduled commercial banks.
3. Foreign Banks
5. Co-operative banks.

1.3.1 Reserve bank of India

The reserve bank of India is a central bank and was established in April 1, 1935 in accordance with the provisions of reserve bank of India act 1934. The central office of RBI is located at Mumbai since inception. Though originally the reserve bank of India was privately owned, since nationalization in 1949, RBI is fully owned by the
Government of India. It was inaugurated with share capital of Rs. 5 Crores divided into shares of Rs. 100 each fully paid up. RBI is governed by a central board (headed by a governor) appointed by the central government of India. RBI has 22 regional offices across India. The reserve bank of India was nationalized in the year 1949. The general superintendence and direction of the bank is entrusted to central board of directors of 20 members, the Governor and four deputy Governors, one Governmental official from the ministry of Finance, ten nominated directors by the government to give representation to important elements in the economic life of the country, and the four nominated director by the Central Government to represent the four local boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Board consists of five members each central government appointed for a term of four years to represent territorial and economic interests of co-operative and indigenous banks.

The RBI Act 1934 was commenced on April 1, 1935. The Act, 1934 provides the statutory basis of the functioning of the bank. The bank was constituted for the need of following:

- To regulate the issues of banknotes
- To maintain reserves with a view to securing monetary stability
- To operate the credit and currency system of the country to its advantage.

Functions of RBI as a central bank of India are explained briefly as follows:

**Bank of Issue:**
The RBI formulates, implements, and monitors the monetary policy. Its main objective is maintaining price stability and ensuring adequate flow of credit to productive sector.

**Regulator-Supervisor of the financial system:**
RBI prescribes broad parameters of banking operations within which the country’s banking and financial system functions. Their main objective is to maintain public confidence in the system, protect depositor’s interest and provide cost effective banking services to the public.

**Manager of exchange control:**
The manager of exchange control department manages the foreign exchange, according to the foreign exchange management act, 1999. The manager’s main
objective is to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

**Issuer of currency:**
A person who works as an issuer, issues and exchanges or destroys the currency and coins that are not fit for circulation. His main objective is to give the public adequate quantity of supplies of currency notes and coins and in good quality.

**Developmental role:**
The RBI performs the wide range of promotional functions to support national objectives such as contests, coupons maintaining good public relations and many more.

**Related functions:**
There are also some of the related functions to the above mentioned main functions. They are such as, banker to the government, banker to banks etc....

- Banker to government performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks maintains banking accounts to all scheduled banks.

**Controller of Credit:** RBI performs the following tasks:

- It holds the cash reserves of all the scheduled banks.
- It controls the credit operations of banks through quantitative and qualitative controls.
- It controls the banking system through the system of licensing, inspection and calling for information.
- It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

**Supervisory Functions:**
In addition to its traditional central banking functions, the Reserve Bank performs certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act 1934 and the banking regulation act 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. The RBI is authorized to carry out periodical inspections of the banks and to call for returns and necessary information from them.
The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

Promotional Functions:
With economic growth assuming a new urgency since independence, the range of the Reserve Bank’s functions has steadily widened. The bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies

1.3.2 Scheduled Banks
Scheduled Banks in India constitute those banks which have been included in the second schedule of RBI act 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42(6a) of the Act. “Scheduled banks in India” means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined in the State Bank of India (subsidiary banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve bank of India Act, 1934 (2 of 1934), but does not include a co-operative bank”. For the purpose of assessment of performance of banks, the Reserve Bank of India categories those banks as public sector banks, old private sector banks, new private sector banks and foreign banks, i.e. private sector, public sector, and foreign banks come under the umbrella of scheduled commercial banks.

Regional Rural Bank
The government of India set up Regional Rural Banks (RRBs) on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural laborers, and small entrepreneurs. Initially,
five RRBs were set up on October 2, 1975 which was sponsored by Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank of India. The total authorized capital was fixed at Rs. 1 Crore which has since been raised to Rs. 5 Crores. There are several concessions enjoyed by the RRBs by Reserve Bank of India such as lower interest rates and refinancing facilities from NABARD like lower cash ratio, lower statutory liquidity ratio, lower rate of interest on loans taken from sponsoring banks, managerial and staff assistance from the sponsoring bank and reimbursement of the expenses on staff training. The RRBs are under the control of NABARD. NABARD has the responsibility of laying down the policies for the RRBs, to oversee their operations, provide refinance facilities, to monitor their performance and to attend their problems.

1.3.3 Unscheduled Banks

“Unscheduled Bank in India” means a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank”

Banks occupy the pride of place in any financial system by virtue of the significant role they play in spurring economic growth by undertaking maturity transformation and supporting the critical payment systems. The specificity of banks, the volatility of financial markets, increased competition and diversification, however, expose banks to risks and challenges. The protection of depositors’ interests and ensuring financial stability are two of the major drivers for putting in place an effective system of supervision of banks. In the wake of recurring bank failures and consequent financial crises over the last two decades, there have been resolute attempts by bank supervisors across the globe to limit the impacts of bank failure and contagion through ‘safety nets’ in the form of deposit insurance and liquidity support by Central Banks/Governments. An effective supervisory system is, however, critical for preventing bank failures by ensuring the safety and soundness of banks.

1.4 Bank Supervision Process in India

The Reserve Bank of India has been entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act,
1949 and RBI Act, 1934. This responsibility is discharged through the Department of Banking Supervision (DBS), which covers 87 commercial banks (including local area banks) and 4 select financial institutions (FIs) through its 16 Regional Offices.

1.4.1 Objectives of Supervision
Depositor protection and systemic risk are the two main reasons that are normally cited for putting in place a system of regulation and supervision of banks. In the wake of financial crisis and bank failure during the last two decades, there have been attempts to limit the impacts of bank failure and contagion through ‘safety nets’ in the form of deposit insurance and the lender of last resort function by Central Banks. While the safety nets are triggered during crisis situations, supervision plays a vital role in preventing the occurrence of a crisis situation or bank failure.

In the context of banking supervision, the policy has to contend with the dilemma in choosing the authority responsible for supervision of banks, the ambit of its supervisory jurisdiction and its autonomy/independence from the Central Government. Theoretically, each of the possible options and choices has its own merits and demerits, with no clear evidences to suggest that any single option is a better alternative. Different countries have adopted different options best suited to their economic and political environments and India too has adopted its own model wherein bank supervision is entrusted to the Reserve Bank of India (RBI) with adequate functional autonomy. However, there is no unified supervisor for a variety of financial services offered by different entities in the country.

RBI’s inspection of banks under section 35 of B.R. Act is undertaken as a follow up of the bank licensing regulation and objectives as laid down in Section 22 of the Act. The substantive objective of the statutory inspections is to verify whether the conditions subject to which the bank has been issued license to undertake banking business [vide sub-section 3, and for foreign banks also 3A of Sec.22] continue to be fulfilled by them. Another implicit objective of bank supervision is to ensure that the various regulatory norms prescribed by the regulatory authorities are being adhered to including financial soundness and operational viability. The stability of the banking system is an oblique aggregation of sound individual banks which is rather altruistic.
1.4.2 Evolution of Supervision of Commercial Banks in India

Subsequent to the economic liberalization of the 1990’s, RBI has been pursuing a steady and cautious approach towards banking liberalisation. This has been evident in the implementation of the report of the Narasimham Committee (1991) which granted operational autonomy to banks and Financial Institutions. Other reforms during the early 1990s included: (a) shift in supervision from intrusive micro level intervention towards prudential regulation and supervision (b) interest rate and entry deregulation (c) adoption of prudential norms (d) establishment of the Board of Financial Supervision (BFS) in the RBI (e) diversification of activities by banks and (f) private sector ownership of Indian banks. During the last decade, the Indian banking industry has recorded a compounded average growth rate (CAGR) of 18 percent as compared to the country’s average GDP growth of 7.2 percent during the same period. The overall development in banking industry has been supplemented with greater efficiency and productivity of the banking sector.

The Indian banking sector has two kinds of scheduled banks i.e. Scheduled Commercial Banks (SCB) and scheduled Co-operative banks. The SCBs can further be classified into four types based on their ownership and mandate as:

i) Public Sector banks
ii) Private Sector Banks
iii) Foreign Banks in India and
iv) Regional Rural Banks.

All the SCBs are under the supervisory jurisdiction of the Department of Banking Supervision of RBI and are, thus, the primary subject of deliberations of the Steering Committee.

Until the early 1990s, the focus of RBI’s regulation of commercial banks in India was mainly on licensing, minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements. Under such regulatory regime, banking supervision had to focus essentially on solvency issues. Since 1988 Basel-I Accord, however, RBI has been taking steps to realign its supervisory and regulatory standards with international best practices in a phased manner taking into consideration the economic conditions of the
country. In this context, few expert groups have conducted reviews of the supervisory processes viz. systems and procedures relating to the statutory inspections, during the last two decades.

Reserve Bank of India is entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act, 1949 and RBI Act, 1934. Subsequent to the economic liberalization since the 90s which also manifested in greater operational autonomy for banks and Financial Institutions, RBI’s approaches to supervision of banks has also gradually shifted from a more intrusive micro-level intervention towards prudential regulation and supervision in line with the international best practices. An expert group (under Shri S. Padmanabhan) also conducted reviews of RBI’s supervisory processes viz. systems and procedures relating to the statutory inspections during the 90s and recommended measures for improving the efficiency and effectiveness of RBI’s approach to supervision of banks.

The last two decades had been characterized by increased integration of global financial markets and cross-border banking activities, diversification of banks into other financial market segments, increased complexity of products, processes and group structures. Though the banking landscape has changed considerably, the supervisory approaches and processes within RBI have remained more or less stagnant resulting in a mismatch between supervisory responsibilities and available resources necessitating a review of the supervisory processes and rationalization of the organizational structure for bank supervision. The existing supervisory framework for commercial banks in India has fared rather well over the years and drawn praise from peer supervisory agencies, standard setters and the FSAP assessors for the tightly controlled regulatory and supervisory regime. However, in view of the growing complexities in the banking business and lessons from the recent financial crisis that has led a thorough overhaul of the global regulatory and supervisory benchmarks viz. revised prescriptions for more resilient banks and banking systems (Basel III), revised Core Principles for Effective Bank Supervision, Principles for Supervision of Financial Conglomerates and planning for Recovery and Resolution of global systemically important banks, there is a felt need for a relook at RBI’s extant
supervisory processes and mechanism in order to make it more robust and capable of addressing emerging challenges.

In light of the above, a High Level Steering Committee (HLSC) was constituted under the Chairmanship of Dr. K. C. Chakrabarty, Deputy Governor for Review of Supervisory Processes for Commercial Banks with representation from RBI, commercial banks and the academia. The Committee was mandated to review the extant approaches, methodologies, processes/tools for onsite and off-site supervision, Supervisory Rating & Stress Testing Frameworks and recommend measures for a gradual progression to a Risk Based Supervision Framework.

1.4.3 Experiment with RBS
As a part of the monetary and credit policy for 2000-01, the Reserve Bank of India had announced its intention to move towards a Risk-based approach to banking supervision. Risk Based Supervision (RBS) envisaged the monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the riskiness of each banking institution. The Department of Banking Supervision conducted two rounds of pilot runs of RBS covering a few banks however, due to lack of adequate Risk Management Architecture in banks, the RBS experiment was discontinued.

1.4.4 Supervisory Set up
The Board for Financial Supervision (BFS) which came into being in November 1994 is the apex body responsible for Consolidated Supervision of the financial sector under the jurisdiction of RBI (commercial banks, financial institutions and non-banking finance companies). The Governor, RBI is the Chairman of the BFS, and the Deputy Governor in charge of banking regulation and supervision, is nominated as the Vice-Chairman. The other deputy governors of the Reserve Bank are ex-officio members and four directors from the Central Board of the RBI are co-opted as members for a term of two years. DBS acts as the secretariat of the BFS which normally meets once every month to deliberate various supervisory issues and approve the rating of banks.
Prior to 1993, the Department of Banking Operations & Development (DBOD) looked after the supervision and regulation of commercial banks. In December 1993, the Department of Supervision (DoS) was carved out of the DBOD with the objective of segregating the supervisory role from the regulatory functions of RBI. The supervisory role of the Department of Banking Supervision includes:

- Planning for and conducting onsite inspection,
- Off-site surveillance, ensuring follow-up and compliance,
- Determining the criteria for the appointment of statutory auditors and special auditors and assessing audit performance and disclosure standards and monitoring of major financial sector frauds
- Exercising supervisory intervention in the implementation of regulations, which includes recommendation for removal of managerial and other persons, suspension of business, amalgamation, and merger / winding up, issuance of directives and imposition of penalties.

While majority of the offsite supervision work is undertaken from central office of DBS, the regional offices of the department at various locations across the country assist the Central Office by undertaking AFI of banks and inspections of branches under their respective jurisdictions.

1.4.5 Supervisory Processes

Offsite Supervision

As a part of the supervisory strategy, an off-site monitoring system for surveillance over banks was operationalized in RBI in March 1996. As a tool for “early warning signals” the Offsite Surveillance and Monitoring System (OSMOS) plays a key role in identification of risks and monitoring banks on a continuous basis. OSMOS consists of a set of 28 structured returns that capture prudential and statistical information of banks at periodical intervals. The information gathered is populated into the OSMOS database, enabling the offsite supervisor to undertake prudential analysis of bank’s Capital, Assets, Earnings, Liquidity, etc. on both solo and consolidated basis. Issues of concern arising out of such analyses are flagged for consideration of Top Management and also placed before the BFS. Along with bank specific analysis, certain macro-level analysis of the banking sector are also undertaken periodically to assess and identify the risks and potential concerns. Various statistical tools are
deployed to extract and analyse data for use in various RBI publications and for policy inputs.

Onsite Supervision
On-site supervision of banks is a key process in the overall supervisory framework. The on-site supervision involves an Annual Financial Inspection (AFI) of banks that is presently modelled around the CAMEL (Capital Adequacy, Asset classification, Management, Earnings appraisal, Liquidity) framework with an additional parameter of Systems and Controls (modified as CAMELS for Indian commercial banks and CALCS for Foreign banks). The present CAMELS is a transaction-based examination with a matrix used for arriving at a rating of each of the CAMELS components to give a final adjusted supervisory rating for each bank. Of late, the AFI has been giving considerable importance to risk management system in banks. Based on the concerns highlighted by the AFI reports and discussions with banks, a monitorable Action Plan (MAP) is drawn for compliance and a memorandum covering supervisory concerns from AFI including supervisory rating is compiled for perusal of the BFS. In addition to AFI, a few need based targeted inspections and scrutinies at the banks are also undertaken.

1.4.6 Supervisory Rating
A rating system for domestic and foreign banks based on the CAMELS model combining financial management, systems and control elements has been in place since July 1998. The present rating of banks is done on a 10-point scale i.e. A+ through D in ascending order.
### Significant changes in Supervisory Rating adopted by the RBI over the years

<table>
<thead>
<tr>
<th>Year</th>
<th>Methodology</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>S. Padmanabhan Committee (1995) recommended for Indian banks, six rating factors viz. Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Controls (i.e. CAMELS), and for Foreign banks, four rating factors viz., Capital Adequacy, Asset Quality, Compliance, Systems and Controls (i.e. CACS)</td>
</tr>
<tr>
<td>1999</td>
<td>Circular on CAMELS and CACS rating framework including components rating and composite rating issued. As per the circular, each of the component was to be rated separately on a scale of 1 to 100 in ascending order of performance. Each of these six Components was to consist of several parameters with individual weightage i.e. 100 marks distributed among these parameters – depending on their relative importance in that particular Component. Composite rating of ‘A’ to ‘D’ to be computed calculating weighted average of Components Ratings.</td>
</tr>
<tr>
<td>2002</td>
<td>The rating model of CACS modified to include the component ‘Liquidity’.</td>
</tr>
<tr>
<td>2006</td>
<td>In order to appreciate nuances between two different banks having the same composite rating and to show granularity in the rating, 3 rating scales each were introduced under A, B and C making a total of ten rating scales including D.</td>
</tr>
<tr>
<td>2007</td>
<td>The parameters and markings in respect of ‘Earnings Appraisal’ component of the rating revised for CAMELS</td>
</tr>
<tr>
<td>2009</td>
<td>The parameters and markings in respect of ‘Earnings Appraisal’ component of the rating revised once again only for CAMELS.</td>
</tr>
</tbody>
</table>
1.4.8 Present Regime of RBI Inspection

The main objective of banking supervision by the RBI under various statutory provisions is to ensure that depositors’ interests are protected at all times. RBI also has the implicit role of ensuring financial stability and consumer protection. RBI has adopted CAMELS framework (i.e. Capital adequacy, Asset quality, Management, Earnings, Liquidity, Systems and controls) for supervision of commercial banks in India. RBI’s supervisory processes include evaluation of banks’ performance by way of an on-site Annual Financial Inspection broadly with reference to the following:

- Banks’ financial condition and performance highlighting Asset Quality, Solvency and Capital Adequacy, Earnings Performance and Liquidity;
- Management and operating conditions focusing on Management (board and senior management), Systems and Internal controls, including risk management strategies;
- Compliance to Regulations including integrity of reporting and compliance to guidelines.

Based on the above evaluation, a Summary assessment is made which mainly highlights the supervisory concerns and identifies areas for corrective action. The AFI findings are recorded under CAMELS framework and a supervisory rating of the public/private sector banks is done on the basis of scores obtained by them under relevant parameters of CAMELS. The foreign banks operating in India are rated under the CALCS (i.e. Capital adequacy, Asset quality, Liquidity, Compliance and Systems & Controls) model.

The CAMELS / CALCS based on-site inspection (AFI) is normally conducted with reference to the last audited balance sheet date. The onsite inspection is transaction-based, compliance-focused and involves review of systems and procedures prevailing in the bank. The on-site AFI is conducted by a team of RBI Inspecting Officers led by a Principal Inspecting Officer (PIO).
1.4.9 Inspection Report, Supervisory Rating and Follow up

The findings of the AFI are formally discussed by the AFI team with the CMD / CEO of the bank. Areas of divergence remaining unresolved are indicated separately in the draft Inspection Report. At the respective Bank Monitoring Division of Central Office, the Report is further processed. This involves final resolution of significant divergences, identification of Monitorable Action Plan (MAP), issue of supervisory letter to the bank, conduct of AFI discussion with top management of the bank, preparation of BFS memorandum on the findings of the AFI, finalization of rating and approval by BFS. The BFS approved supervisory rating is then communicated to the bank.
1.5 SUPERVISORY RATING

Bank supervisors have legal powers to collect extensive off-site information about bank’s financial health, business plan and strategies etc. which are normally not available to other stakeholders. Additionally, onsite inspections are also undertaken by the supervisors to verify the accuracy of off-site data and observe the business processes, governance systems & control from close quarters for gathering further supervisory information. The information gathered by the supervisor is used to identify current and potential problems that the bank faces/may face, for appropriate supervisory attention and effective resource allocation. Generally, supervisors in most jurisdictions use the information gathered by them through various sources to arrive at a composite measure of overall health of the bank. This composite score is often termed as ‘Supervisory Rating’ and is exclusively used for supervisory purposes including intervention. The ‘CAMEL’ system of supervisory rating is one such internationally recognized and popular supervisory rating system which is in vogue in many jurisdictions including India.

1.5.1 CAMEL Rating Framework

CAMEL model of rating was first developed in the 1970s by the three federal banking supervisors of the U.S (the Federal Reserve, the FDIC and the OCC) as part of the regulators’ “Uniform Financial Institutions Rating System”, to provide a convenient summary of bank condition at the time of its on-site examination. The banks were judged on five different components under the acronym C-A-M-E-L:

C – Capital Adequacy
A – Asset Quality
M – Management Soundness
E – Earnings Capacity and
L – Liquidity

The banks received a score of ‘1’ through ‘5’ for each component of CAMEL and a final CAMEL rating representing the composite total of the component CAMEL scores as a measure of the bank’s overall condition. The system of CAMEL was revised in 1996, when agencies added an additional parameter ‘S’ for assessing “sensitivity to market risk”, thus making it ‘CAMELS’ that is in vogue today.
Based on the recommendations of the Padmanbhan Committee, the commercial banks incorporated in India are presently rated on the ‘CAMELS’ model (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Systems & control), while foreign banks’ branches operating in India are rated under the ‘CALCS’ model (Capital adequacy, Asset quality, Liquidity, Compliance, and Systems & control). As mentioned above, the Committee had originally recommended a CACS model, which was subsequently modified to also include Liquidity (L) as an additional parameter. Further modifications, in the form comprising additional granularities in the rating scale of parameters under CAMELS have since been introduced by RBI. Presently, each of the components of CAMELS is rated on a scale of 1-100 in ascending order of performance. The score of each CAMELS element is arrived by aggregating (by assigning proportionate weights) the scores of various sub-parameters that constitute the individual CAMELS parameter. Each parameter is awarded a rating A-D (A-Good, B – Satisfactory, C -unsatisfactory, and D-poor). Further, to bring granularity in rating, there are modifiers by way of (+) and (-) under each of A, B and C making a total of ten scales A+ through to D. The composite “CAMELS rating” is arrived by aggregating each of the component weights as indicated in the table below. Further the overall composite score is adjusted downwards for poor performance in one or more components.

1.5.2 CAMEL
The CAMEL rating is a supervisory rating system originally developed in the U.S. to classify a bank's overall condition. It's applied to every bank and credit union in the U.S. (approximately 8,000 institutions) and is also implemented outside the U.S. by various banking supervisory regulators.

The ratings are assigned based on a ratio analysis of the financial statements, combined with on-site examinations made by a designated supervisory regulator. In the U.S. these supervisory regulators include the Federal Reserve, the Office of the Comptroller of the Currency, the National Credit Union Administration, and the Federal Deposit Insurance Corporation.
Ratings are not released to the public but only to the top management to prevent a possible bank run on an institution which receives a CAMELS rating downgrade.\textsuperscript{[1]} Institutions with deteriorating situations and declining CAMELS ratings are subject to ever increasing supervisory scrutiny. Failed institutions are eventually resolved via a formal resolution process designed to protect retail depositors.
1.6 FUNCTIONS OF BANKS

Chart 1.6A

### Primary functions and Secondary Functions of a Bank

<table>
<thead>
<tr>
<th>Primary Functions</th>
<th>Secondary Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. These are the main activities of the bank.</td>
<td>These are secondary/supportive activities of the bank.</td>
</tr>
<tr>
<td>2. These are main sources of income for the bank.</td>
<td>These are not the main sources of income for the bank.</td>
</tr>
<tr>
<td>3. These are obligatory on the part of bank to perform.</td>
<td>These are not obligatory on part of bank to perform. But generally all commercial banks perform these activities.</td>
</tr>
</tbody>
</table>

Eg. Accepting deposits, granting loans and advances

Eg. Agency Functions and Utility functions

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1.6.1 Primary Functions of Banks

a. Accepting Deposits: The most significant function of a bank is to mobilize deposits from the public. The persons having surplus funds and savings find it handy to deposit the amounts with banks. On the basis of the nature of deposits, funds that have been deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, people are encouraged to deposit even more money with the bank. Banks also ensure safety of funds deposited with the bank.

- Savings account: Meant for those people who wish to save money for future. Generally, here there are no restrictions on the amount that can be withdrawn at any point of time and also how often can it be withdrawn (frequency of withdrawals). Savings account holder receives a pass book which includes rules with respect to its operations. Minimum amount for account opening in a nationalized bank: Rs. 500. If you want cheque book facility as well, then it may cost Rs.1000. The interest rates range from 4-6%. In private banks, minimum balance required is generally higher and can be as high as Rs.10,000. One can have single or joint accounts.

- Fixed Deposits/Time Deposits/Long Term Deposits: As the name suggests, they have been made for a specific time period and one cannot withdraw funds before maturity of that period for which they have been deposited in the bank. One earns higher rate of interest depending on the period of deposit. For this account, one does not get a pass book or cheque book, instead he will receive a Fixed deposit Receipt that will be duly signed by manager of the bank and will contain details like name/address of depositor, amount deposited, rate of interest, maturity date, etc. On maturity, the holder can claim his funds by producing this receipt.

- Current Deposits/Demand Deposits: Businessmen generally open these accounts. Here, one can withdraw funds anytime by means of cheques. Here, deposits can be made to any extent and bank does not pay interest on current deposits. In fact, it charges a small amount as fees from operators of this account on the basis of transactions they carry out. They also enjoy overdraft facilities. They are provided
with cheque book, pass book and a pay-in slip book. Cheque book contains blank printed cheques with counterfoils which are used to withdraw money from banks. Pass book is copy of customer’s accounts in bank’s ledger. It shows entries of all deposits and withdrawal of money and balance outstanding on any particular day. It is written by the bank from its own record and is meant for use of customer. Pay in slip book contains printed forms with perforated counterfoils which are meant to deposit cash or cheque into the bank. The pay in slip contains details of deposit and also serves as a receipt for the deposit made. Opening of this account not only requires an introduction from old customer of the bank, but also maintenance of minimum balance in this account at all times.

- **Recurring Deposits**: Normally salaried employees and small traders open this account. Periodically, they deposit a certain amount of money in the bank. On the expiry of certain time period, withdrawals are allowed. This account earns a higher rate of interest.

**b. Grant of loans and advances**: Loans and advances are given to people and to companies at a higher rate of interest than what banks give on various deposit accounts. The rate of interest charged on loans and advances shall vary on the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the Loans is the main source of a bank’s income.

**i) Loans**: A loan is given for a certain time period. Normally, banks give short-term loans. Though term loans, meaning, loans for more than one year, shall also be given. The borrower/debtor can pull out the total amount in lump sum or in instalments. Nonetheless, interest will be charged on the entire loan amount. Loans are normally given against the security of certain assets i.e. Collateral. A loan can be repaid either in lump sum or in instalments.

**ii) Advances**: An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but advances are normally granted for a short period of time. Further the purpose of
granting advances is to meet the day to day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount.

- **Cash Credit:** It is a financial arrangement through which banks allow borrower to borrow money up to a certain limit. Cash Credit arrangement is ordinarily made against the security of commodities hypothecated or pledged with the banker. The borrower has to pay interest on the total amount of advance.

- **Bank Overdraft:** Overdrafts are advanced to holders of current accounts. If borrower requires temporary finance, banker may allow him to overdraw on his account with or without security. As compared to Cash Credit, overdraft is advantageous to borrower as he has to pay interest only on the actual amount withdrawn by him and not total amount.

- **Loans:** A loan is an advance sanctioned by the bank to the customer with or without security. In respect of loan, banker makes lump-sum payment to the borrower or credits his deposit account with the money advanced. Loan is advanced for a fixed period at an agreed rate of interest. Repayment can be done either in installments or at the end of expiry period. Borrower has to pay interest on the total amount of advance. Interest has to be paid whether he withdraws money from his account or not.

- **Letter of Credit:** A letter of credit is an assurance from a bank that a particular debt will be honored by the bank if the borrower defaults/fails to pay. Letters of credit are beneficial when dealing with new, unfamiliar vendors who might not be sure of a company’s credit worthiness.

*Chart 1.6B*
If company X were supplying goods to company Y, company Y would wish to get credit from company X. Company X does not have regular supply to Y and hence does not have enough comfort to extend credit to Y. In such case, banker of Y may come forward to guarantee payments to X on behalf of Y. Since the payments are now guaranteed by a bank, X would not hesitate to extend credit to Y.

It is evident that bank does not supply any funds in this facility. It is only the contingent risk that is assumed by the bank. So, risk of bank is lower as compared to cash credit facility where bank’s funds are also involved in addition to the risk assumed. Hence, it is an indirect way of financing working capital.

- **Discounting of Bills:** In a particular transaction, company A supplies goods to company B. Company B accepts the goods, also accepts the bill of company A and agrees to pay after a specified credit period. However, A requires money immediately. He approaches a banker who pays him up front against the accepted bill. Banker does not pay him full amount but adjusts its interest payment for the value and period and pays A. This is called as banker discounts the bill. This is a fund based facility as banker actually pays upfront. Suppliers’ working capital is thus not stuck up for that credit period. Supplier has to get prior limit set for such bill discounting facility. Discounting may be done either by supplier’s banker or purchaser’s banker. It is diagrammatically represented as follows:

![Chart 1.6C](chart.png)

Bankers sanction the above mentioned facilities based on their assessment of the business entity. The creditworthiness of the business, profitability, sales projections, and promoter’s track record are some of the considerations for sanctioning any of
these facilities. Usually the inventory is either hypothecated or pledged to the lender/banker to avail of such facility. Thus banker’s funds are provided against adequate security cover.

1.6.2. Secondary Functions of Bank:

a) Agency Functions: These functions are provided by banks as agents to its customers. They are as follows:

- Collect/pay cheques/bills on client’s behalf; facilitate funds transfer from one place to another.
- Buy/sell shares and securities on behalf of clients.
- Collect interest, dividend, rent etc. to aid customers, if they instruct so.
- Pay interest, insurance premiums, rent etc. in the best interests of customers in accordance to their instructions.
- Collect Government dues- Taxes, telephone/other bills etc.
- Act as a trustee, advisor, executor and administrator.
- Act as agent/correspondent in aid of clients for other banks/financial institutions within the country and abroad.

b) General Utility Functions: Apart from the above mentioned services, banks provide certain other services as well; not only to their clients but to the general public. They are:

- Underwriting of shares/debentures etc.
- Providing Locker facilities.
- Collect and Publish relevant economic data from time to time.
- Issue drafts, traveler cheques etc. to tourists.
- Assist in foreign trade by dealing in foreign exchange, subject to provisions of FERA ACT.
- Acting as a referee for its clients thereby strengthening their creditworthiness.
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