CHAPTER NO.3
# CHAPTER NO.3

## LITERATURE REVIEW

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3.1) INTRODUCTION:

This chapter presents an overview of the literature that related to the topic under investigation. This chapter consists of two main sections; the first section discusses the conceptual theoretical framework of banking like; meanings of banks, role of banks, objective of banks, financial statements of banks and audit of banks…. and the second section covers the previous research studies related to the topic.

I. FIRST SECTION (THEORETICAL LITERATURE):

Faced with a set of diverse observations, we can establish a set of tentative explanations which help to make sense of the diversity. Such explanations constitute theory. In any set of circumstances there will usually be multiple theories available to explain the observations. The systematic collection of further data allows for the testing of the alternative theories so that we can establish which of the exiting theories best explains the facts. A layman‘s perspective of _theory_ is cynically expressed in Michael Crichton’s _The Lost World_ as: —A theory is nothing more than a substitute for experience put forward by someone who does not know what they are talking about” (1995, p. 67). Without some theoretical foundations we have a problem-solving exercise or a consultancy project, neither of which should be gracing the pages of a refereed journal. There must be some theoretical justification for the question being addressed and the research approach adopted. Theory will often not come first in the research process – it will frequently be preceded by an interesting idea or a perplexing observation. But we require some theoretical explanation for the relationships under investigation before we have the basics of a refereed journal article.
3.2) MEANINGS OF BANKS:

A bank is a financial intermediary and appears in several related basic forms:
1) A central bank issues money on behalf of a government, and regulates the
money supply. 2) A commercial bank accepts deposits and channels those
deposits into lending activities, either directly or through capital markets. A
bank connects customers with capital deficits to customers with capital
surpluses on the world's open financial markets. 3) A savings bank, also
known as a building society in Britain is only allowed to borrow and save
from members of a financial cooperative.

. History: banking in the modern sense of the word can be traced to medieval
and early Renaissance Italy, to the rich cities in the north like Florence,
Venice and Genoa. The Bardi and Peruzzi families dominated banking in 14th
century Florence, establishing branches in many other parts of Europe.
Perhaps the most famous Italian bank was the Medici bank, set up by
Giovanni Medici in 1397. The earliest known state deposit bank, Banco di San
Giorgio (Bank of St. George), was founded in 1407 at Genoa, Italy.

. Standard activities: Banks act as payment agents by conducting checking or
current accounts for customers, paying cheques drawn by customers on the
bank, and collecting cheques deposited to customers' current accounts. Banks
also enable customer payments via other payment methods such as telegraphic
transfer, EFTPOS, and automated teller machine (ATM). Banks borrow
money by accepting funds deposited on current accounts, by accepting term
deposits, and by issuing debt securities such as banknotes and bonds. Banks
lend money by making advances to customers on current accounts, by making
installment loans, and by investing in marketable debt securities and other
forms of money lending. Banks provide almost all payment services, and a bank account is considered indispensable by most businesses, individuals and governments. Non-banks that provide payment services such as remittance companies are not normally considered an adequate substitute for having a bank account. Banks borrow most funds from households and non-financial businesses, and lend most funds to households and non-financial businesses, but non-bank lenders provide a significant and in many cases adequate substitute for bank loans, and money market funds, cash management trusts and other non-bank financial institutions in many cases provide an adequate substitute to banks for lending savings too.

. **Economic functions:** The economic functions of banks include:

1) Issue of money, in the form of banknotes and current accounts subject to cheque or payment at the customer's order. These claims on banks can act as money because they are negotiable or repayable on demand, and hence valued at par. They are effectively transferable by mere delivery, in the case of banknotes, or by drawing a cheque that the payee may bank or cash.

2) Netting and settlement of payments – banks act as both collection and paying agents for customers, participating in interbank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economise on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables the offsetting of payment flows between geographical areas, reducing the cost of settlement between them.

3) Credit intermediation – banks borrow and lend back-to-back on their own account as middle men.

4) Credit quality improvement – banks lend money to ordinary commercial and personal borrowers (ordinary credit quality), but are high quality borrowers. The improvement comes from diversification of the bank's assets and capital which
provides a buffer to absorb losses without defaulting on its obligations. However, banknotes and deposits are generally unsecured; if the bank gets into difficulty and pledges assets as security, to raise the funding it needs to continue to operate, this puts the note holders and depositors in an economically subordinated position. 5) Maturity transformation – banks borrow more on demand debt and short term debt, but provide more long term loans. In other words, they borrow short and lend long. With a stronger credit quality than most other borrowers, banks can do this by aggregating issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemptions of banknotes), maintaining reserves of cash, investing in marketable securities that can be readily converted to cash if needed, and raising replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets).

. Types of banks: Banks' activities can be divided into retail banking, dealing directly with individuals and small businesses; business banking, providing services to mid-market business; corporate banking, directed at large business entities; private banking, providing wealth management services to high net worth individuals and families; and investment banking, relating to activities on the financial markets. Most banks are profit-making, private enterprises. However, some are owned by government, or are non-profit organizations.

Commercial bank: the term used for a normal bank to distinguish it from an investment bank. After the Great Depression, the U.S. Congress required that banks only engage in banking activities, whereas investment banks were limited to capital market activities. Since the two no longer have to be under separate ownership, some use the term "commercial bank" to refer to a bank
or a division of a bank that mostly deals with deposits and loans from corporations or large businesses.

**Community banks:** locally operated financial institutions that empower employees to make local decisions to serve their customers and the partners.

**Community development banks:** regulated banks that provide financial services and credit to under-served markets or populations.

**Credit unions:** not-for-profit cooperative owned by the depositors and often offering rates more favorable than for-profit banks. Typically, membership is restricted to employees of a particular company, residents of a defined neighborhood, members of a certain labor union or religious organizations, and their immediate families.

**Postal savings banks:** savings banks associated with national postal systems.

**Private banks:** banks that manage the assets of high net worth individuals. Historically a minimum of USD 1 million was required to open an account; however, over the last years many private banks have lowered their entry hurdles to USD 250,000 for private investors.

**Offshore banks:** banks located in jurisdictions with low taxation and regulation. Many offshore banks are essentially private banks.

**Savings bank:** in Europe, savings banks took their roots in the 19th or sometimes even in the 18th century. Their original objective was to provide easily accessible savings products to all strata of the population. In some countries, savings banks were created on public initiative; in others, socially committed individuals created foundations to put in place the necessary infrastructure. Nowadays, European savings banks have kept their focus on retail banking: payments, savings products, credits and insurances for individuals or small and medium-sized enterprises. Apart from this retail focus, they also differ from commercial banks by their broadly decentralised
distribution network, providing local and regional outreach—and by their socially responsible approach to business and society.

**Building societies and Landesbanks:** institutions that conduct retail banking.

**Ethical banks:** banks that prioritize the transparency of all operations and make only what they consider to be socially-responsible investments.

**Direct or Internet-Only bank:** is a banking operation without any physical bank branches, conceived and implemented wholly with networked computers.

. **Accounting for bank accounts:** Bank statements are accounting records produced by banks under the various accounting standards of the world. Under GAAP and MAIC there are two kinds of accounts: debit and credit. Credit accounts are Revenue, Equity and Liabilities. Debit Accounts are Assets and Expenses. This means you credit a *credit account* to increase its balance, and you debit a *credit account* to decrease its balance. This also means you credit your savings account every time you deposit money into it (and the account is normally in credit), while you debit your credit card account every time you spend money from it (and the account is normally in debit). However, if you read your bank statement, it will say the opposite—that you credit your account when you deposit money and you debit it when you withdraw funds. If you have cash in your account, you have a positive (or credit) balance; if you are overdrawn, you have a negative (or deficit) balance. Where bank transactions, balances, credits and debits are discussed below, they are done so from the viewpoint of the account holder—which is traditionally what most people are used to seeing.
3.3) THE ROLE OF BANKS:

A country's economic and financial vitality depends on banks and their roles are discussed as follows:

1. Banks play an important role in the mechanism of receiving and paying regarding the companies' and private/public business companies' activities.

2. Banks receive the deposits in the form of money and are expected to pay the money completely on due date. It had been agreed to leave part of the deposit as asset with the Central Bank.

3. Banks have been considered as a crucial element in allocation of financial resources and as an intermediary between depositors' funds and credit givers. And considering the active internal transfers, banks are eventually able to compensate.

The most important operations and activities performed by business banks are as follows:

1. **Intermediary**: collected resources are allocated to generate profits.

2. **Safe keeping/trust**: protecting people's properties/assets, board of trustees, pension funds, etc.

3. **Security**: undertaking banking operations through economic relations between people.

4. **Offering services** via using different tools.

The operations and activities which are mentioned require a bank to equip itself with a distinct accounting system. This system has three main duties: control, data, services, and is designed in a way so that users at different levels can make use of accounting data.
3.4) OBJECTIVES OF BANKS:

Public trust and belief in bank is the most valuable asset for bankers. People may regard a little inefficiency on the part of banks as a weak point. Such weak points may overshadow people's trust in banks and make competition in the market so tough (for bankers). Lack of trust in banks may compel people to withdraw their deposits and this condition can place bank's liquidity under pressure. Furthermore, it may lead to more insurance demands and consequently resulting in an increase in bank's expenditure.

Lack of trust in banks may also encourage the potential loanees to rely on different banks in order to protect their own resources for self-financing. Therefore, since the best customers are more capable of diversifying their financial resources, the most reliable source of bank's income will be adversely affected. Publicizing the bank's financial condition may endanger the bank's situation. In order to maintain people's trust in banks, the most sensible policy is to release the least amount of data to the public, and this public revelation/disclosure of data/information is usually reduced to a few items in the financial statements. Thus, the financial reports partly reveal a developing picture of trends from the inadequate data.

Otherwise, the data cannot be concealed if the financial condition of bank is critical. Revealing and analyzing the financial statements to shareholders with the aim of pinpointing problems (especially in countries where shareholders' rights have not been defined and respected) is not often the bank's primary objective.
3.5) THE BANK'S FINANCIAL STATEMENTS:

The reasons for the use of financial statements are manifold. Giving brief and classified data about the financial status, (financial) functions, and (financial) flexibility of the business unit (bank) is one of the reasons which help the great majority of the users of financial statements to make the best economic decisions. Financial statements also show the results conductorship between Management and Accounting, considering the resources granted to them. The complete set of financial statements includes:

1. Fundamental Financial Statements
   a. Balance sheet
   b. A comprehensive statement of profit and loss
   c. Statement of currency flow

2. Explanatory Notes

In order to offer the financial statements ideally, the following rules must be followed:

1. The management of the business unit must choose and enforce the accounting procedures in a way that the financial statements are consistent with all the standard requirements of accounting. Accounting procedures are particular strategies that the business unit chooses to provide and offer the financial statements with. In case of lack of standards, the management must determine the procedures in a manner that they lead to the most useful data in financial statements.

2. Additional data is offered. When following the determined requirements and standards of accounting for understanding the effect of transactions or other particular events on the financial condition and function of the business unit by the users of financial statements are not sufficient. Banks use different procedures in order to measure and identify the elements and items of their financial statements. In order for users to be informed about
the preparatory steps in a bank's financial statements, it may be necessary to reveal the accounting procedures for some items:

1. Identifying the different sources of income.
2. The means by which investment bonds and negotiable bonds are assessed.
3. The basis of distinction between transactions and other events which lead to the recognition of items as assets or liabilities. Transactions and other events which increase the potential items and de facto liabilities.
4. The basis of determining the losses due to liabilities (the granted loans and loans on account) and omitting bad (irrecoverable) items from accounts.
5. The basis of determining the usual/normal banking risks and the approach of accounting toward expenses/costs.

3.6) ANALYSIS OF FINANCIAL STATEMENTS:

1 Balance sheet analysis:
1.1 Ratio of loans to deposits:
This ratio evaluates the extent to which a bank is able to support loaning, for equipping deposits and the extent to which it can grant a loan from deposits, as well. This ratio being high indicates a low liquidity, a desirable economic trend or the result of deposits withdrawal, while being low however it shows not enough opportunities for loaning (over 60 percent shows the balance of this ratio).

1.2 Capital to asset ratio:
This ratio is certainly smaller in banks rather than other smaller commercial companies.
It is divided into two branches:

a) stock holders’ equity to total assets

b) equity + securities to total assets

In the event that total asset is regarded as risky asset, this ratio changes to capital adequacy ratio, which indicates the degree of protection of investors and creditors against unexpected losses that bank may encounter. Both ratios-loans to deposits-and-capital to assets-totally are key ratios of a bank and they should be calculated together. Separate analysis is of low effect in this case.

1.3 Saving for probable loss of loans:

Bank balance sheet analysis is not completed without forecasting loss of loans. Some analysts suggest one percent loans, but saving amount should be based on previous trend and future forecast.

1.4 Properties and equipments:

Properties and equipment ratio is equal to 50 percent of equity.

1.5 Investing in securities stock exchange

Accounting investment portfolio is of crucial importance for anticipating a bank liquidity. Hence, it is optimum when incomes are maximum and debt of income tax is minimum.

1.6 The combination of deposits:

In a bank this combination is divided into interest and interest free deposits. The best combination is found in banks where their interest-free deposits-current and saving accounts are more. The combination of demand deposits is also very significant, because some of them include prizes. Classifying interest deposits based on term is also important. In Iran less-than-one-year deposits
are called short-term, between one to three years are mid-term and upto 5 years are called long-term.

1.7 Deposits growth:
The rate of deposits growth shall be compared with the rate of inflation. In the event that deposits growth rate is less than inflation rate, it is a sign of decrease in the value of the deposits.

1.8 Profitable assets ratio:
The key index for profitability of a bank is when profitable assets are more than total assets. Some assets are profitable and some are not. Profitable assets prevent cash down. Cash down is costly and therefore it should be avoided.

2. Profit and loss statement analysis

2.1 Assets output average:
Assets output average is the result of bank operating income ratio-including fees, interest and investment profit-divided by bank profitable assets average which should usually be over 6 percent. Profitable assets average such as loans and investments are seasonally recognized and the result is recorded in denominator. This ratio can be broken into other ratios as shown hereunder:

a) Investment profit ratio divided by investment average.
b) Fees ratio divided by profitable assets.
c) Interest ratio divided by loans average.
2.2 **Payment Rate:**
This rate is the average point of profitable assets output and it is the result of the cost of interest over the interest liabilities average. This ratio can be broken into two other ratios:
   a) Interest ratio over liability
   b) Interest ratio over deposits average

2.3 **Brokerage operation profit margin:**
Brokerage operation profit margin is known as the difference between received interest rate average and paid interest rate average. To support an internal branch banks are able to constantly observe reducing operating costs and increasing interest-free income, for protecting and promoting brokerage operation profit margin.

2.4 **Securities ratio over assets average:**
Banks usually invest long-term in exchangeable securities. Selecting and timing securities affects profit and loss on sales. This ratio is used for operating measures.

2.5 **Assets output ratio:**
Net profit ratio over assets average in order to measure the operating and managing ability of a bank to use net profit.

2.6 **Stockholders’ equity output ratio:**
Stockholders consider this ratio more important than other ratios. In order to approach this ratio accounting to reality, financial period first value should be examined.
2.7 Personnel costs:

After interest costs, personnel costs take the biggest part of a bank expenditures. In order to account and measure this cost, branches costs should be seperated from headquarters costs. If the ratio is not rationally congruent, it should be modified. Every kind of payment except year-end-profit is included in personnel costs. Hereunder ratios may be useful to examine this ratio:

a) Personnel costs over paid loans
b) Personnel costs over attracted deposits
c) Personnel costs over total assets.

2.8 Non-constant profit and loss:

Profit and loss from other activities and gaining extra sources have always been considered by banks and its may include profit and loss on sales, movable and immovable properties, exchange transactions and other items.

2.9 Volume/ratio analysis:

Ratio changes over time can be examined and explained through this analysis. Changes happen in ratio and volume, and they are directly related to the items on the right part of the balance sheet. Generally, if accounting rate is possible, volume or ratio analysis can be applied.

Changes from rate increases(decrease)

\[ = \text{balance average increase(decrease)} \times \text{Previous year's rate} \]

Changes from volume increase(decrease)

\[ = \text{rate average increase(decrease)} \times \text{the current year balance} \]

Items used in rate and volume analysis include:

Governmental bonds, loans, rents, savings and deposits.
3. **Cash flow statement:**
Every activity in a bank requires cash transmission. Changes in liquidity may simply be influenced by interest rate increase or decrease, or market changes.

3.1 Sources from Operations

3.2 Activities related to investing in stock exchange

3.7) **BANK AUDIT:**
There are various types of Banks. Those Banks which are nationalized, the Banking Companies Act 1970 and Banking Regulation Act 1949 only specific provisions, are applied. Other than nationalized Banks, Banking Regulation Act, 1949 and some Provisions of Indian Joint Stock Companies Act, 1956, are applicable. For Co-operative Banks, Co-operative Act 1912, and Part V of Banking Regulation Act, 1949. For Regional Banks, Regional Rural Bank Act, 1976 is applied. For state Banks & its subsidiaries, State Bank of India Act, 1955 and 1959 and some portions of Bank Regulation Act, 1949 is applied. Before starting actual Audit work, an auditor is expected to confirm, that the Internal Audit an Internal check system are well and efficiently operated. In this regard he should be satisfied.

**Bank Internal Audit:**
As number of branches and the number of transactions is large, it is not possible for an auditor to check each and every transaction of the Bank. Further, three copies of the published audit final accounts have to be handed over to the Reserve Bank of India and the Registrar of the companies within three months. Therefore, Banks appoint their own internal auditor and inspectors who examines the accounts during the financial year. Further, the own staff also helps the system by checking the Bank transactions daily in detail.
In such situation the auditor can safely rely on the report of the Internal Auditor. Because of –

1. Insufficient internal audit system
2. Internal auditor may be under influence of management.
3. Standard systems not adopted by the internal auditor,
4. Loss action maybe taken by the management on the report of the internal auditor.

**Bank Internal Check System:**

In every Bank there must be an efficient internal check system in operation.

Following is the procedure of Internal Check System:

a) All the work of the day of one employee should be checked by another employee at the end of the day,

b) Cashier should not be given charge of client’s Accounts for recording the cash transactions,

c) And Accounts keeper should not have charge of writing of cash book,

d) There should be “Receiving Cashier” and “paying Cashier” separately.

e) Every clerk’s table of work should be changed from time to time.

f) There should be a surprise visit of Internal Auditor, to the branches, then he can send the report to the Head Office.

g) The Balances on three types of deposits and loans and advances, cash credits, overdrafts, should be examined by the responsible officers,

h) On loans, Advances, Cash credits and overdrafts the securities are accepted, those securities should be examined and verified by a responsible officer.

i) Bills Receivables and Bills Payables should be under the control of a responsible officer

j) Clearing house transactions should be adjusted daily.
Other Special Points to be noted in Bank Audit:

The Bank audit is mainly related to the Bank B/S and its P&L A/C.

Audit of Balance Sheet Items:

This covers Audit of Balance sheet Assets and Liabilities.

Audit of Balance Sheets:

Following points should be noted in Audit of Bank Assets on by one-

a) **Cash in hand:** It covers actual cash in cash box, cash with Reserve Bank of India, State Bank of India including foreign currency notes. On the last day of Accounting year, an auditor should count himself currency notes, coins should be weighed, and foreign currency notes should be accurately converted into our currency with current exchange rate after correctly counting them. The statement should be obtained form the Reserve Bank and State Bank of India to confirm the amount shown are correct.

b) **Cash with other Banks:** He should compare the amount with the pass book of the same Bank and the statement Received from them showing the balance.

c) **Money at all & Short Notice:** He should examine certificates and loan Receipts.

d) **Investments and Gold:** He should examine this item very carefully, all sorts of investments should be entered in the B/S, he should examine all securities, Bonds, Certificates of investments, mode of
valuation should be checked. He should check that the amount of interest and Dividend on investments is correctly taken.

This item is to be shown in B/S in Five Groups:

i) Central and State Government Securities, Trust Securities, Treasury Bills,

ii) Fully paid or partly paid equity shares or preference shares,

iii) Debenture and Bonds,

iv) Other investment securities,

v) Gold, etc.

e) **Advance**: this item cover two groups:

i) Cash Credits, loans, overdrafts &

ii) Bills discounted and purchased. He should confirm that all formalities are complied with U/S 21 and interest rate is correct, every loan must be sanctioned properly. He should check the borrowers Ledger Accounts and compare same with the schedule of Advances, the minimum and maximum limits of advances must have been observed by the Bank. He should verify loans against security of Bonds, Goods and Fixed Assets, Gold Loan etc. And confirm that the valuations are correct. For bills discounted and purchased, he should examine bills with the Bank, overdue bills should be checked carefully, and the amount of interest and Discount should be separately recorded. Sufficient R.D.D. must be provided and the “Particulars of Advances must be prepared with 4 Main Groups and 5 Sub-Groups.

f) **Bills Receivable being Bills for collection**: There are shown in B/S as “per contra” with similar amount. He should examine himself all
the Bills and see that the commission received on Bills collected is taken as income correctly.

g) **Constituents Liabilities for Acceptance Endorsements and Other Obligations:** This item is also “per contra” item in both sides of B/S with same amount. He should verify letter of credit and guarantees, given on behalf of the client. He should check the Register, security given by client, guarantee letter; sufficient provisions should have been made against the collections of the same.

h) **Premises:** It also covers freehold land and Buildings. He should examine title deed, documents, other papers and evidence. Sufficient provision should have been made for Depreciation and Repairs. After confirming the verification he should obtain certificate of valuation from a valuer.

i) **Furniture and Fixture:** He should examine the furniture Register, Receipts; Vouchers of new furniture purchased provision for Depreciation and Repairs should be made properly, and get it confirmed by verification and valuation.

j) **Other Assets and Silver:** He should examine the necessary documents, papers, other evidences and Receipts, etc. He should count the stock physically, and get it confirmed about its value.

k) **Non-Banking Assets:** It covers machinery acquired in satisfaction of the claim. The amount equal to disposable value is taken in B/S or the amount receivable can also be taken. Either of the two values is
taken in B/S. The name of method of valuation should recorded in B/S. He should examine conditions of Repayment of loan, court decree and title deeds of the property forfeited, etc. should be in the name of the Bank.

Audit of Balance Sheet Liabilities:

It covers Share Capital and Outside Liabilities as under –

a) Share Capital: All the provisions of section 11, 12 and 14 should be complied with, Share Capital must be disclosed in B/S as (i) Authorized Capital, (ii) Issued Capital, (iii) subscribed Capital, (iv) Called up Capital, less : call in arrears, Add: share forfeiture accounts.

b) Reserve Fund and Other Reserve: The statutory Reserve is created as per the provisions of sec. 17-20% of current profits should be transferred to statutory Reserve. The funds must be properly utilized.

c) Deposits and Other Accounts: It covers Fixed Deposits, Savings Deposits, current Deposits + contingency Account. He should examine Register, counterfoils of Deposits, certificates, interest should be correctly recorded. Compare savings Bank ledger with statement of Balance, the interest on savings bank should be calculated accurately. He should examine and check the individual accounts and confirm that the Balance on current accounts in correct. There is contingency Account regarding provision for Taxation, Reserve for Doubtful Debts, Investment
fluctuation Reserve etc. the same is to add in Current Deposits A/C.

d) **Borrowings from other Banks and Agents:** For verification and valuation purpose he should examine necessary documentary evidences, interest calculation should be checked.

e) **Bills Payable:** He should examine the Register, for the terms like Travelers Cheques, Demand notes, etc.

f) **Current Liabilities:** He should verify all the liabilities are brought properly into the Accounts and also obtain the certificate from the responsible officer showing the correct values and all liabilities belonging to this year are recorded.

g) **Contingent Liabilities:** These are always inner column items. He should verify these items carefully, as there are changes of fraud. He should confirm that no contingent liability is shown as actual liability or vice versa to misappropriate the same. These are disclosed in the B/S as a footnote inside column item.

**Audit of Profit and Loss Account Item**

All the items on the P&L A/c are vouched as usual. For vouching purpose, Receipts, Register, Minute Book, other documentary evidence should be examined carefully. For vouching of P&L items he should adopt the system of “Routine Checking” and “Test Checking”. Following are the important items of P&L A/C to which due attention must be given by him.
1. **Interest on Deposits:** The amount of fixed, saving and current Deposits is frequently changing one. The rate of interest is also changing frequently. The accurate amount of interest applicable to the Current Accounting year is very important and must be calculated with due care. Otherwise amount of Net Profit will be also incorrect. The o/s interest, accrued interest must be adjusted in the Accounts properly similarly, the amount of interest on the borrowings from Bank and other Agents, must be included. He should get in confirmed.

2. **Income Tax Provisions:** There is no provisions to disclose this item directly on debit side of P&L A/C, it should be deducted from the income side fro Interest and Discount received item silently and again added in “Current Deposits” item silently.

3. **R.D.D.** : Reserve for doubtful Debts, is not also debited to P&L A/C, but it is silently deducted from Interest and Discount received. Similarly, the amount of R.D.D. is also deducted silently from loans, advances, cash credits and overdrafts.

4. **Loss on Sale of Investments, Gold, Furniture, etc.:** It can not be debited to P&L AC as there is no provision on the debit side; hence this loss is shown by way of deduction from the Income, Interest and Discount Received. He should examine this item carefully.

5. **Interest, Dividends and Discounts:** He should check these amounts very carefully, and also, certificates of investments,
Loans, advances, Receipts, etc. to get it confirmed that the interest amount, Dividend amount and Discount amount are taken together very correctly, he should check carefully, hat “Rebate on Bills Discounted” is deducted form the income and taken to liability side of B/S

**Auditor’s Qualified Report:**
If you take the following points in the Report it will be qualified Report-

1. Inadequate Provisions of Depreciation,
2. Provision for Taxation in inadequate,
3. Reserve for Doubtful Debts funds excessive,
4. The amount of loan given to the Director’s is not within the limits of law etc.

**Publication of Bank Final Accounts**
The Balance sheet & Profit & Loss A/c of a Bank must be prepared in the prescribed forms given as per Indian Banking Companies Act, 1949. General Manager should sign the Balance Sheet and Profit & Loss A/c. These also must be signed by three or less, directors, which ever is more. Three copies of Balance Sheet, three copies of Profit and Loss A/c and the Auditor’s Report shall be sent to the Reserve Bank of India and the Register of companies within three months and the same are to be published in any news paper of the state in which the head office of the company is situated. This published final A/Cs must be displayed in the Head-Office and at all Branches.
Special Liabilities of a Bank Auditor:

i) An Auditor of a Bank have similar duties, responsibilities and powers also same penalties as that an auditor a Joint Stock Company;

ii) R.D.D. should be examined carefully, as loans and advances are excluding these;

iii) Bank can create secret Reserves, the auditor should carefully examine that such reserves are not misused by it;

v) Any false statement, by an auditor, in a Return or B/S, he is liable to imprisoned upto a period of three years along with fines;

vi) U/S 45 G if, during the course of winding up, it is found that a loss has been caused by any act or omission on the part of an auditor, he has to answer the public examination on oath all the questions raised by creditors and shareholders, etc;

iv) If an auditor is not fit for his duties, the High-Court may pass an order removing him from the office for a maximum period of five years;

3.8) CUSTOMER RELATIONSHIP MANAGEMENT (CRM) IN BANKING SECTOR:

Customer relationship management (CRM) is a widely-implemented strategy for managing a company’s interactions with customers, clients and
sales prospects. It involves using technology to organize, automate, and synchronize business processes—principally sales activities, but also those for marketing, customer service, and technical support. The overall goals are to find, attract, and win new clients, nurture and retain those the company already has, entice former clients back into the fold, and reduce the costs of marketing and client service. Customer relationship management describes a company-wide business strategy including customer-interface departments as well as other departments. Measuring and valuing customer relationships is critical to implementing this strategy.

Benefits of CRM:

A CRM system may be chosen because it is thought to provide the following advantages:

- Quality and efficiency
- Decrease in overall costs
- Decision support
- Enterprise agility
- Customer Attention

Today, many businesses such as banks, insurance companies, and other service providers realize the importance of Customer Relationship Management (CRM) and its potential to help them acquire new customers, retain existing ones and maximize their lifetime value. At this point, close relationship with customers will require a strong coordination between IT and marketing departments to provide a long-term retention of selected customers. This paper deals with the role of Customer Relationship Management in banking sector and the need for Customer Relationship Management to increase customer value by using some analytical methods in CRM.
applications. CRM is a sound business strategy to identify the bank’s most profitable customers and prospects, and devotes time and attention to expanding account relationships with those customers through individualized marketing, reprising, discretionary decision making, and customized service— all delivered through the various sales channels that the bank uses.

In literature, many definitions were given to describe CRM. The main difference among these definitions is technological and relationship aspects of CRM. Some authors from marketing background emphasize technological side of CRM while the others consider IT perspective of CRM. From marketing aspect, CRM is defined by [Couldwell 1998] as “.. a combination of business process and technology that seeks to understand a company’s customers from the perspective of who they are, what they do, and what they are like”. Technological definition of CRM was given as “.. the market place of the future is undergoing a technology-driven metamorphosis” [Peppers and Rogers 1995].

Consequently, IT and marketing departments must work closely to implement CRM efficiently. Meanwhile, implementation of CRM in banking sector was considered by [Mihelis et al. 2001]. They focused on the evaluation of the critical satisfaction dimensions and the determination of customer groups with distinctive preferences and expectations in the private bank sector. The methodological approach is based on the principles of multi-criteria modeling and preference desegregation modeling used for data analysis and interpretation. [Yli- Renko et al. 2001] have focused on the management of the exchange relationships and the implications of such management for the performance and development of technology-based firms and their customers. Specifically the customer relationships of new technology-based firms has
been studied. [Cook and Hababou, 2001] was interested in total sales activities, both volume-related and non-volume related. They also developed a modification of the standard data envelope analysis (DEA) structure using goal programming concepts that yields both a sales and service measures. [Beckett-Camarata et al. 1998] have noted that managing relationships with their customers (especially with employees, channel partners and strategic alliance partners) was critical to the firm’s long-term success. It was also emphasized that customer relationship management based on social exchange and equity significantly assists the firm in developing collaborative, cooperative and profitable long-term relationships. [Yuan and Chang 2001] have presented a mixed-initiative synthesized learning approach for better understanding of customers and the provision of clues for improving customer relationships based on different sources of web customer data.

They have also hierarchically segmented data sources into clusters, automatically labeled the features of the clusters, discovered the characteristics of normal, defected and possibly defected clusters of customers, and provided clues for gaining customer retention. [Peppers 2000] has also presented a framework, which is based on incorporating e-business activities, channel management, relationship management and back-office/front-office integration within a customer centric strategy. He has developed four concepts, namely Enterprise, Channel management, Relationships and Management of the total enterprise, in the context of a CRM initiative. [Ryals and Knox 2001] have identified the three main issues that can enable the development of Customer Relationship Management in the service sector; the organizational issues of culture and communication, management metrics and cross-functional integration especially between marketing and information technology.
CRM Objectives in Banking Sector:

The idea of CRM is that it helps businesses use technology and human resources gain insight into the behavior of customers and the value of those customers. If it works as hoped, a business can: provide better customer service, make call centers more efficient, cross sell products more effectively, help sales staff close deals faster, simplify marketing and sales processes, discover new customers, and increase customer revenues. It doesn't happen by simply buying software and installing it. For CRM to be truly effective an organization must first decide what kind of customer information it is looking for and it must decide what it intends to do with that information. For example, many financial institutions keep track of customers' life stages in order to market appropriate banking products like mortgages or IRAs to them at the right time to fit their needs. Next, the organization must look into all of the different ways information about customers comes into a business, where and how this data is stored and how it is currently used. One company, for instance, may interact with customers in a myriad of different ways including mail campaigns, Web sites, brick-and-mortar stores, call centers, mobile sales force staff and marketing and advertising efforts.

Solid CRM systems link up each of these points. This collected data flows between operational systems (like sales and inventory systems) and analytical systems that can help sort through these records for patterns. Company analysts can then comb through the data to obtain a holistic view of each customer and pinpoint areas where better services are needed. In CRM projects, following data should be collected to run process engine: 1) Responses to campaigns, 2) Shipping and fulfillment dates, 3) Sales and
purchase data, 4) Account information, 5) Web registration data, 6) Service and support records, 7) Demographic data, 8) Web sales data.

**Need for CRM in Banking:**
A Relationship-based Marketing approach has the following benefits:
. Over time, retail bank customers tend to increase their holding of the other products from across the range of financial products / services available.
. Long-term customers are more likely to become a referral source.
. The longer a relationship continues, the better a bank can understand the customer.
. Customers in long-term relationships are more comfortable with the service, the organization, methods and procedures.

**Private banking and CRM:**
.Private Banks have traditionally viewed themselves as exceedingly 'Customer Centric'.
. They believe in the concept of “The wealthier the customers, the more demanding they are”
. The first step towards successfully winning, of private banking is to understand what customers wants and needs are.
. Their prime focus is to create differentiated customer experience.

**II. SECOND SECTION (PREVIOUS RESEARCH):**
The outline literature review may be incomplete but it must none the less identify the key motivating literatures and theories. Research candidates must
recognize that the literature review is a constantly moveable feast and something that will be added to right up to final presentation of the research findings. One of the major deficiencies of both papers and dissertations is that they frequently overlook the most recent relevant publications: it can be a heart-stopping moment when one is about to submit and the latest issue of a journal appears to report the outcomes of a research project very similar to one’s own! At the very least this new paper must be cited. A common complaint from inexperienced researchers is that there is no literature available. If this is true, it may mean that the projected topic may be too trivial to consider. More likely, however, is that the literature review should drill down further and search on different keywords. That there is a dearth of recent literature on a topic may foreshadow problems. For example, papers on decision-making heuristics were common in the late 1970s and early 1980s, and papers on group decision-making common in the mid-1980s, but progress in both of these research areas has slowed, and publications are relatively rare because the psychological theories underlying the research have not developed sufficiently to facilitate new approaches. With respect to apparently new projects, for example, research into e-commerce related topics, students must recognize that e-commerce is just a new way of doing business, and that their review must address the implementation of prior business innovations.

**Previous researches related to this subject are:**


Lots of research has been conducted on the evaluation of competitiveness, mostly focusing on the industry section, but not much has been done on
banking industry. These two researcher using Rosse-Panzar method tried to assign the structure of banking industry in Iran, they also tried to investigate the impact of private banks on the competitiveness and market structure in Iran. They tried to evaluate the impact of private banks on the performance of the state banks by using the features of performance evaluation such as assets efficacy rate and concentration proportion. It has been hypothesized that state banks performance had been improved after the entrance of private banks. The researcher tried to investigate the impact of private banks on the structure and performance of banking industry by using empirical statistics on the panel data and also regression statistics. To do so, the researcher used the data collected from five states Tejarat Banks which hold a share of sixty percent of banking network business resource during 1999-2008.

Two instruments of Rosse-Panzar statistics for evaluation of the structure of banking industry and also assets efficiency feature was used in order to evaluate the performance of the banks. Based on the results taken from this research and considering that the market in banking industry in ‘Iran is a king of exclusive (multi facets) one and also regarding the fact that after entrance of private banks into market that exclusiveness(statistic taken) gradually decreased, it can be concluded that these banks as predicted, affected the performance of other banks and it is expected that the emergence of policy of private sector in banking system would enhance competitiveness and would improve the general operation in this industry.

It can also be conducted that the state bank profitability has significantly decreased since the foundation of private banks. These findings match with the findings in structural evaluation which show that the exclusiveness of state banks has decreased since the appearance of private banks. The correction
between assets and facilities is significant in 90%. In general, the results of structured evaluation reveals that the industrial banking structure in Iran is exclusive and the degree of exclusiveness has been significantly decreased since the foundation of private banks in 2000(1381). But the null hypotheses regarding the improvement of operation in state banks is not rejected based on the present data.

2. Research by “Jeny” about banks operations during 1991-1997 done in Chicago state bank emphasizing on accounting profit, shows certain differences exist between banks’ characteristics and their operations. She has concluded that there is a negative correlation between the output of stockholders’ equity and the output of securities and on the other hand there is a positive correlation between the output of securities and the loss of loans. Most of assessments and the relation between assets quality and accounting output rate are direct and linear, but the relation between banks operations and other general and economical variants is vague and the testimonies are contradictory and mysterious. Questions raised in this research are:

   a) Which accounting activity influences financial status of Japanese banks?
   b) How was the relation between stock exchange operation and financial status of banks?
   c) How was the value of stock exchange, considering financial status of banks?
   d) Is the relation between stock value and accounting ratio meaningful?

To answer these questions, banks operation measurement method including assets quality examination, capital quality, liquidity, operative efficiency and measurement of the size of the bank has been applied and the relations among
financial ratio have been studied. The study is done during 91-94 and 95-97. In the first phase accounting to economical status of Japan answers are totally assisted positive but in the next phase because of economical crisis and preventive rules and regulations the results are contradictory and in some cases unimportant. Total conclusions of the examinations illuminate that accounting operation method, revealing finance information and rules and regulations in this country have been fluctuating and also rules controlling the banks do not accord with accounting rules and methods. Statistic results also represent financial information are not related so that in some cases the relation between accounting profit and stock value has been meaningful but in other cases it has not.

Operation indexes results represent other measurements relating to assets quality have not been noticeable and calculated dependence degrees are not compatible with information. In some cases accounting output ratio is unexpectedly congruent with stock exchange value index and its amount has increased with bankruptcy of the banks. In some other cases in spite of the increase in stock exchange value and profitability loans output has decreased. These conclusions show policies-related to profit management and rules are not agreeable, which has made crisis in financial institutions. Preventive rules and regulations have caused disagreeableness between accounting values and banks stocks values. Based on reformed rules in 2001, Crisis period was left behind and omission of preventive rules and substitution efficient rules influenced a new life for Japanese banks.

3. Professor “Mahdi.M. Hadi” in 2004, studied investments in banks which includes dependence tests between stock exchange value of Kuwait banks and selected accounting ratio. Questions raised in the research are as follow:
a) Is information about profitable assets output of any importance for investors?
b) Is information about net profit margin and banks’ general cost ratio for investors?
c) Which information is more significant for investors; information about profitable assets output or about the said assets ratio?
d) Is information about anticipated loss of loans significant for investors?

This research apparently illuminates the relation between accounting information and market information and it is an accounting contemplation in financial part because it has been approved by international standards in any basis and cases. The results of this research declares accounting information has been of great value for investors in Kuwait banks and most of selected ratio except expected loss of loans and the ratios are correlated to the value of stock exchange of banks.

4. Science and research assistant manager of Iranian Banking Supreme Institution, “Ali Yaseri” in an essay has studied criterion of financial efficiency assess in banking system. These criterion are for profitability criterion of Iranian Commercial-governmental banks in 1374 which include assets output, capital output, efficiency ratio, comparison of paying and receiving profit, capital adequacy ratio, liquidity ratio, (assets to cashable liabilities) and he has also measured bankers’ efficiency including income, personnel cost per banker and comparison of personnel cost and bank income. Unfortunately he has not come to any conclusion.

5. Prasad and Ghost (2005) conducted a research entitled “the evaluation of competitive conditions in Indian Banking Industry” they used Rosse-Panzar
method for the performance of the banks in 1996 to 2004. The results showed that competition in Indian banking industry which started since the reformation in financial section in 1992 is increased and the Indian banks are performing under competitive condition and they acquire profits in an exclusive competition condition.

6. In another research, Khoshtinat, Shadkam, Toosi and Afzali investigated the relationship between accounting information and stock market value in private banks in Iran. The sample data were collected from three private banks of Eghtesad Novin, Karafarin and Parsian banks. These samples were select as the stocks of these banks were available in stock market of them and the stock values of these banks were clear. The provided dates were subjected to coefficient. The result revealed that there exist a significant between the accounting information and the efficiency of private banks stock value. The provided information is very important in investor’s decision making in financial institutes and banking systems.

So the main objective of this study is:

1) To collect tangible date based on financial statements of private banks as an information source to assign accounting ratios.

2) To evaluate the significance of accounting information and the balance sheet related information of private banks for the investors decision making.

3) To recognize the relationship between financial proportions (independent variable) and efficiency of stocks and also the relationship between some economical and general features and the efficiency of bank accounts.

The hypotheses in this research are as follows:
1) There is a significant relationship between the ratio of the assets (ROTA) and the efficiency of the private banks stocks.

2) There exists a significant relationship between the NIM (Net Interest Margin), and burden costs and the efficiency of private (non governmental) banks stocks.

3) There is a significant relationship between loan resources (LR) and the efficiency of the private (non governmental) banks stocks.

4) The relationship between proficiency of income generation assets and the efficiency of private banks stocks in Iran is more significant than the relationship between the ratio of income generation assets and the efficiency of these banks stocks.

A hybrid data analysis was implemented using views software due to the features of the provided data. Hybrid data analysis is done under regression model.

Results and Conclusions:

Hypothesis One: there is not a significant relationship the stock market value of private banks and the ratio of efficiency of total assets.

Hypothesis two: the relationship between efficiency of net interest margin (NIM) and the ratio of general expenditure (burden) is not significant.

Hypothesis three: the relationship between the ratio of general saving and the efficiently of the private banks stock is not significant.

Hypothesis four: the relationship between efficient stocks in private banks for both the growth of income generating assets with the efficiency of these assets is not significant.

Based on the hypothesis which presupposed a relationship between accounting proportions as an important parts of information and also based on the results.
Achieved from the similar researches conducted in and out of the country, it was expected that investors in banking section would use the information included in financial statements of the banks as well as the information available in stock market, but the results taken from the data analysis in this research revealed that the expected objectives i.e. using the information in decision making investors was not fulfilled and the investors mostly rely on the information regarding financial features and also the information available in stock market.

7. Hossein Zadeh Bahraini (1387/2008), using data envelopment analysis (DEA), investigated the economical performance of private banks state banks. Data envelopment analysis in a type of linear planning which was applied in this research. This research not only surveys the present structure of banking system in Iran, it also investigates and compares the economical efficiency of two groups of private and state banks based on the hypothesis that efficiency compared to the investigated scale is varied. Two approaches of mediation with income perspective and mediation with increased value have been used in this study. The time span for this research had been (1380/2001) to (1384/2005). The sample subjects were active banks in Iran to central banks in two groups of state and private banks. Ten state banks of Tejarat, Refah, Sepah, Saderat, Sanat o Madan, Keshavarzi, Maskan, Melat, Meli, Toseeh Saderat and four private banks of Eghtesad Novin, Parsian, Saman and Karafarin were investigated in this research efficiency in a general sense means the degree and quality of achieving a desirable goal.

The main hypothesis of this research was that the economical efficiency (performance) of private banks was better that the state banks, but the results shown that based on an income-oriented approach, the economical productivity of state banks compared to private banks was much better while
on value added approach private banks proved better. So in this research a value added approach is applied as the results in that research shown that the economical performance of private banks is better that state banks and also because private banks spent a large amount on the improvement of their performance compared to state banks.

8. Hadizadeh and Shahedi (2009) conducted a research on the comparison between state and private banks in the quality of banking services provided based on a customer point of view. The main objective was to interpret the quality of banking services. The subjects in this study were the banking customers who hold at least an account in both private and state banks and used banking services of these two simultaneously. A questionnaire containing 39 items in scoring and based on quality of services index was prepared to collect the required date. In order to provide a scientific analysis of the quality of banking services, a number of hypothesis were formed the results after empirical statistics are as follows:

1) There is a significant difference between banking services in state and private banks. i.e. the effectiveness of banking service in private banks is more than state banks.

2) The guaranty of banking services in private banks is more than state banks.

3) There is a significant difference between private and state banks in availability of banking services and the quality of this service in private banks is much better than state banks.

4) There does not exist a significant difference between private and state banks in the price of provided services.

5) The quality of physical dimension of banking services in private banks is much better than state ones. The most difference is observed in this
part and the beauty of decorations in branches is an index which shows the most difference between private and state banks.

6) The variety of banking services provided by private banks is more than state banks. The main difference is observed in providing appropriate internet services in private banks.

7) The reliability of banking services in private banks is more than state ones. The main difference is observed in providing service in a due time as promised and the efficiency of ATM systems.

So it’s vividly clear that the quality of banking services in private banks is much better but the private banks should try their best to keep such a positive attitude by their customers with updating and expansion of their services.

9. Dr. Ali Saghafi and Seif conducted a research on the recognition and evaluation of financial ratios and the basic economical variables affecting the safety and the stability of banking system in Iran.

They tried to use theoretical concepts and the basic principles of supervision of banks in economically developed and developing countries. They also tried to apply the theories and regulations analyzed in international societies like World Bank BAL committee and the other criteria introducing the safety and stability of the banks. The required data were collected through the intentional observation of the documents in ten states banks during 12 years. The hypotheses were formed based on the relationship between sixty eight financial ratios classified into seven basic factors influencing the evaluation of the safety and stability of banks. The seven hypotheses raised can be summed up as: There are not significant relationship between financial rations introduced in investment sufficiency, the quality of assets and financial structures, stability, sustainability of management, profitability, liquidity,
sensitivity of the operation to the market risk and other fundamental criteria in safety and stability of the banks in Iran.

Statistical samples were selected among managing directors, member of managing committee of state banks, manager’s society, and exports in supervision of banks office, CPA and senior supervisors in Tehran. Tow instruments were used simultaneously in this research. First comprehensive questionnaire constructed based on the factor analysis was distributed to the sample subjects and then intentional observation and document logy related to the selected area. The main limitations concerning banking researches are unavailability of an accepted or proper norm or any of the financial ratios and economical variables to be used as a basis for comparison and evaluation of the situation of banks. In order to provide a norm, there must be an imaginary bank with the most appropriate amount of each of the financial ratios and economical variables. These ratios and variables must be introduced using the results extracted from the collected data.

In other words by application of the data collected for each year in these then banks, an ideal structure for all financial ratios were assigned to be a basis for comparison of the banks i.e. a norm to evaluate the other cases with. The research shown that these seven factors are important in the safety and stability of the banks in Iran, but the ranking of these factors and the importance of each one is different from developed countries. The ranking of ten state banks in Iran based on safety and stability factor during this ten year period reveals between banks and also between one bank in different years.

10. Some Previous studies have identified the benefits of customer retention by banks. (See Colgate et al., 1996; Reichheld and Sasser, 1990; Storbacka et
al., 1994). For example, the longer a customer stays with an organisation the more utility the customer generates (Reichheld and Sasser, 1990). This is an outcome of a number of factors relating to the time the customer spends with the organisation. These include the higher initial costs of introducing and attracting a new customer, increases in both the value and number of purchases, the customer’s better understanding of the organisation, and positive word-of-mouth promotion. Apart from the benefits that the longevity of customers brings, research findings also suggest that the costs of customer retention activities are less than the costs of acquiring new customers. For example, Rust and Zahorik (1993) argue the financial implications of attracting new customers may be five times as costly as keeping existing customers. However, maintaining high levels of satisfaction will not, by itself, ensure customer loyalty. Banks lose satisfied customers who have moved, retired, or no longer need certain services. As a consequence, retaining customers becomes a priority. Previous research shows, however, that longevity does not automatically leads to profitability (Colgate et al., 1996). On the other hand, Beckett et al. (2000) draw tentative conclusions as to why consumers appear to remain loyal to the same financial provider, even though in many instances they hold less favourable views toward these service providers.

For example, many consumers appear to perceive little differentiation between financial providers, making any change essentially worthless. Secondly, consumers appear to be motivated by convenience or inertia. Finally, consumers associate changing banks with high switching costs in terms of the potential sacrifice and effort involved. Clearly, there are compelling arguments for bank management to carefully consider the factors that might increase customer retention rates, with research providing ample justification
for customer retention efforts by banks (see Marple and Zimmerman, 1999; Fisher, 2001). However, there has been little empirical research that investigates the constructs leading to customer retention. Previous empirical work has focused on identifying constructs that are precursors to customer retention. Other studies have focused on developing measures of customer satisfaction, customer value and customer loyalty without specifically looking into other potential meaningful constructs.

11. Some previous studies about the roles of banks in financial systems. An argument that is often put forward in favor of bank-based systems is that banks allow various informational problems to be solved. One important problem is if borrowers must take some action to make proper use of the funds they have borrowed. This action could be the level of effort or choice of project from among various different risky alternatives. The borrower can always claim that a low outcome is due to bad luck rather than from not taking the correct action. Lenders cannot observe the borrower's action unless they pay a fixed cost to monitor the borrower. In a financial market with many lenders, there is a free-rider problem. Each lender is small, so it is not worth paying the fixed cost. Everybody would like to free-ride, leaving it to someone else to bear the monitoring cost. As a result, no monitoring will be done. A possible solution is to hire a single monitor to check what the borrower is doing. The problem then becomes one of monitoring the monitor, to make sure that she actually monitors the borrowers. Diamond (1984) develops a model of delegated monitoring to solve this problem. Intermediaries have a diversified portfolio of projects for which they provide finance. They precommit to monitor borrowers by promising lenders a fixed return. If the intermediary does not monitor, then it will be unable to pay the promised return to lenders. Diamond's model thus illustrates how banks have an
incentive to act as a delegated monitor and produce the information necessary for an efficient allocation of resources.

Boot and Thakor (1997) develop a model of financial system architecture that builds on this view of banks as delegated monitors. They assume there are three types of information problem. The first is that there is incomplete information about the future projects a firm has available to it. Outside investors can gather information about these possibilities. The second problem is that lenders cannot observe whether borrowers invest the funds in a risky or safe project. The third problem is the likelihood that borrowers will have the opportunity to invest in a risky project. Boot and Thakor are able to show that the first problem can best be solved by a financial market and the second and third problems can best be solved by intermediaries. They argue that banks will predominate in an emerging financial system, while the informational advantages of markets may allow them to develop in a mature financial system.

12. Allen and Carletti (2006) rely on cash in the market pricing to show how financial innovation in the form of credit risk transfer can create contagion across sectors and lower welfare relative to the autarky solution. They focus on the structure of liquidity shocks hitting the banking sector as the main mechanism determining contagion. When banks face a uniform demand for liquidity, they keep a sufficient amount of the short term asset and do not need to raise additional liquidity in the market. In this case credit risk transfer is beneficial as it improves risk sharing across sectors. Differently, when banks face idiosyncratic liquidity shocks, they invest also in the long risk-free asset and trade it in the market. The presence of credit risk transfer turns out now to be detrimental as it induces a higher need of liquidity in the market and
consequently a greater variability in the asset prices. This in turn affects banks' ability to face their liquidity shocks as it implies a severe reduction in the price of the long asset which banks use to hedge their liquidity risk. The banks that are selling the long asset receive a lower amount and may be unable to pay their depositors. The effect of introducing credit risk transfer depends crucially also on the accounting system in use, be it historical cost or mark-to-market accounting, as shown by Allen and Carletti (2007). The intuition is similar to the one in the previous chapter. When banks need to liquidate a long-term asset on an illiquid market, it may not be desirable to value such assets according to market values as it reflects the price volatility needed to induce liquidity provision. The second approach to modeling contagion focuses on indirect balance-sheet linkages. Lagunoff and Schreft (2001) construct a model where agents are linked in the sense that the return on an agent's portfolio depends on the portfolio allocations of other agents. In their model, agents who are subject to shocks reallocate their portfolios, thus breaking some linkages. Two related types of financial crisis can occur in response. One occurs gradually as losses spread, breaking more links. The other type occurs instantaneously when forward looking agents preemptively shift to safer portfolios to avoid future losses from contagion.

Similarly, de Vries (2005) shows that there is dependency between banks' portfolios, given the fat tail property of the underlying assets, and this carries the potential for systemic breakdown. Cifuentes et al. (2005) present a model where financial institutions are connected via portfolio holdings. The network is complete as everyone holds the same asset. Although the authors incorporate in their model direct linkages through mutual credit exposures as well, contagion is mainly driven by changes in asset prices.
13. Demirgüç-Kunt and Maksimovic (1998) show that more developed stock markets tend to be associated with increased use of bank finance in developing countries. There is a large theoretical literature on the relative merits of bank-based and market based systems for innovation and growth. Bhattacharya and Chiesa (1995) consider a model of R&D incentives and financing. In a market system lenders learn the value of each firm's R&D at the interim stage after R&D has been undertaken but before production takes place. The lenders can share the information among the firms and will do so if it is in their interest. Bhattacharya and Chiesa show that their incentives to do this correspond to maximizing the aggregate value of the firms' R&D projects. Also, a collusive agreement can be structured so that only one firm actually produces at the production stage. However, this collusion creates a free-rider problem and reduces incentives to undertake the R&D at the first stage. If this incentive problem is severe enough, bilateral financing may be preferable. Under this arrangement, each firm is financed by one bank and there is no scope for information sharing. As a result, each firm's R&D information remains proprietary. Allen and Gale (1999, 2000a, Chapter 13) ask whether financial markets or banks are better at providing finance for projects where there is diversity of opinion as in the development of new technologies. Diversity of opinion arises from differences in prior beliefs, rather than differences in information. The advantage of financial markets is that they allow people with similar views to join together to finance projects.

This will be optimal provided the costs necessary for each investor to form an opinion before investment decisions are made are sufficiently low. Finance can be provided by the market even when there is great diversity of opinion among investors. Intermediated finance involves delegating the financing decision to a manager who expends the cost necessary to form an opinion.
There is an agency problem in that the manager may not have the same prior as the investor. This type of delegation turns out to be optimal when the costs of forming an opinion are high and there is likely to be considerable agreement in any case. The analysis suggests that market-based systems will lead to more innovation than bank-based systems. The empirical evidence on the effectiveness of the main bank system is mixed (see, e.g., Hoshi, Kashyap and Scharfstein (1990, 1993), Aoki and Patrick (1994) and Hayashi (2000)). Overall, the main bank system appears important in times of financial distress, but less important when a firm is doing well. In Germany the counterpart of the main bank system is the hausbank system. Banks tend to have very close ties with industry and form long-run relationships with firms not only because of the loans they make and the shares they directly own but also because of the proxies they are able to exercise. A number of studies have provided evidence on the effectiveness of the outside monitoring of German banks (see, e.g., Gorton and Schmid (2000)). There is a growing literature that analyzes the advantages and disadvantages of relationships in banking (see, for reviews, Boot (2000), Gorton and Winton (2003), Degryse and Ongena (2008)). If on the one hand, close and durable relationships provide better access to firms and ameliorate some of the information problems characterizing lending relationships, on the other hand, they also involve inefficiencies related to the hold-up and the soft-budget-constraint problems.

The hold-up problem refers to the possibility that a relationship bank uses the superior private information it possesses about the firm to extract rents, thus distorting entrepreneurial incentives and causing inefficient investment choices (Sharpe (1990) and Rajan (1992), Von Thadden (1995)). Multiple-bank relationships can help mitigating the drawbacks of single-bank relationships in terms of the hold-up and the soft-budget-constraint problems.
As for the former, borrowing from multiple banks can restore competition among banks and, consequently, improve entrepreneurial incentives (Padilla and Pagano, 1997). As for the latter, Dewatripont and Maskin (1995) argue that, by complicating the refinancing process and making it less profitable, multiple-bank lending allows banks to commit not to extend further inefficient credit. Similarly, Bolton and Scharfstein (1996) show that multiple-bank lending reduces entrepreneurial incentives to default strategically because it complicates debt renegotiation. The number of bank relationship has also important implications for banks’ role as monitors. In a context where both firms and banks are subject to moral hazard problems, Carletti (2004) analyzes how the number of bank relationships influences banks’ monitoring incentives, the level of loan rates and a firm’s choice between single and multiple bank relationships. Multiple-bank lending suffers from duplication of effort and free-riding but it benefits from diseconomies of scale in monitoring, thus involving a lower level of monitoring but not necessarily higher loan rates than single lending. Since banks choose their monitoring multiple bank relationships in order to reduce the overall level of monitoring.
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