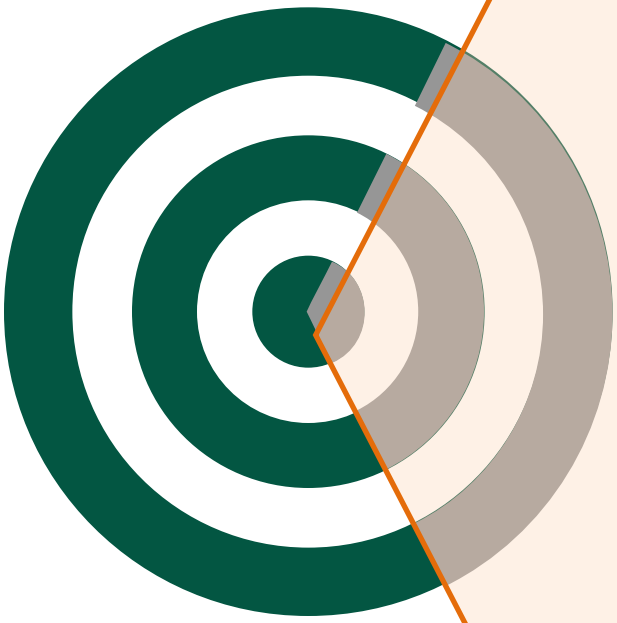
RM Onboarding

Module 1.2: Introduction to Banking

Learning Objectives



In this session, you will learn about:

- Meaning of Banks and their functions
- Reserve Bank of India
- Term-Lending Institutions
- Banking Structures in India
- Bank Deposit Accounts
- Types of Advances

Definition of Banks

In India, the definition of the business of banking has been given in the Banking Regulation Act, (BR Act), 1949.

According to Section 5(c) of the BR Act, 'a banking company is a company which transacts the business of banking in India'.

Section 5(b) of the BR Act defines banking as, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, order or otherwise.'

Definition of Banks

Salient features arising out of the definition which distinguish a bank from other financial institutions are:

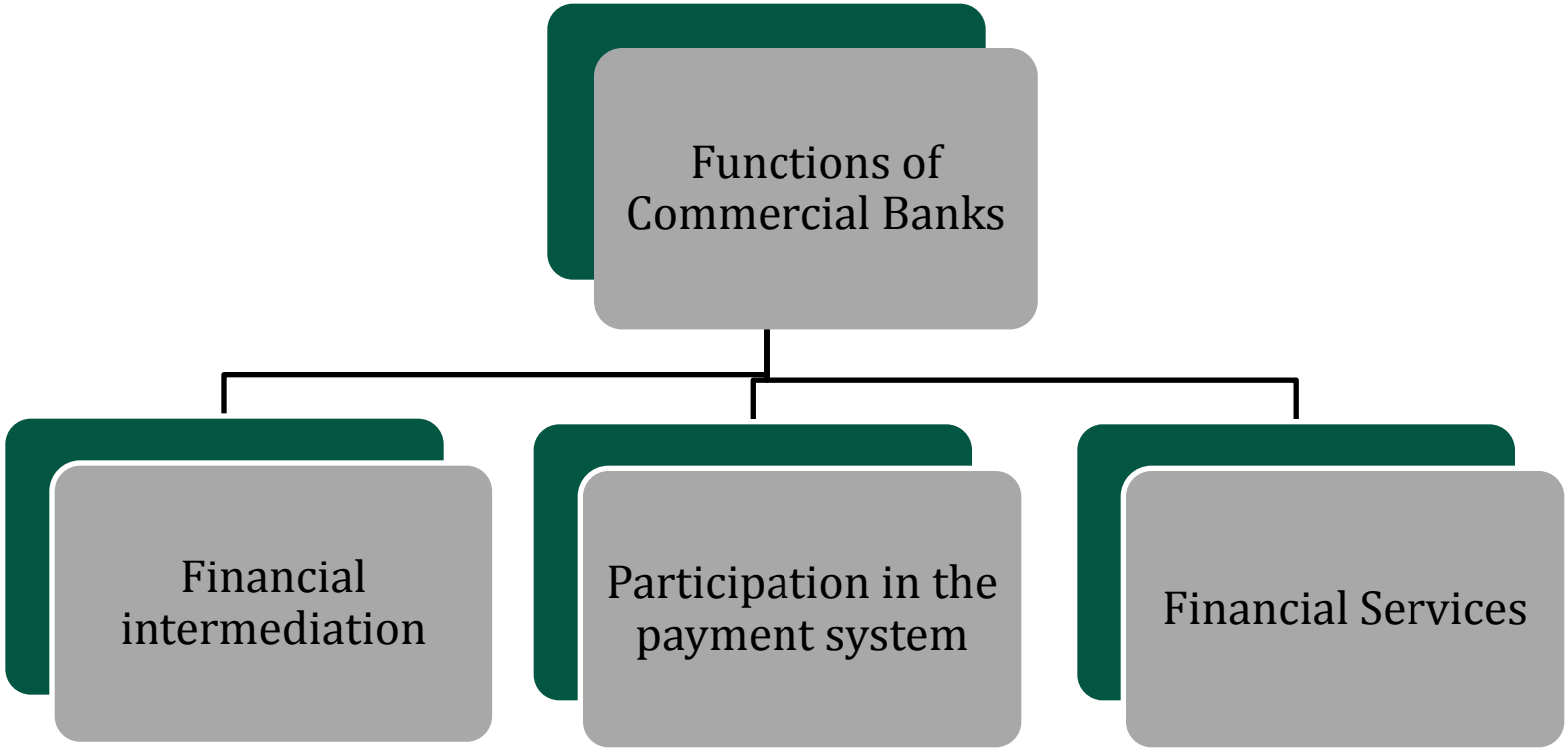
(i)Acceptance of deposits

(ii) Deposits are repayable on demand or otherwise.

(iii) Deposits are withdrawal by cheque, demand draft or order or otherwise.

(iv)Lending or investments.

Functions of Commercial Banks



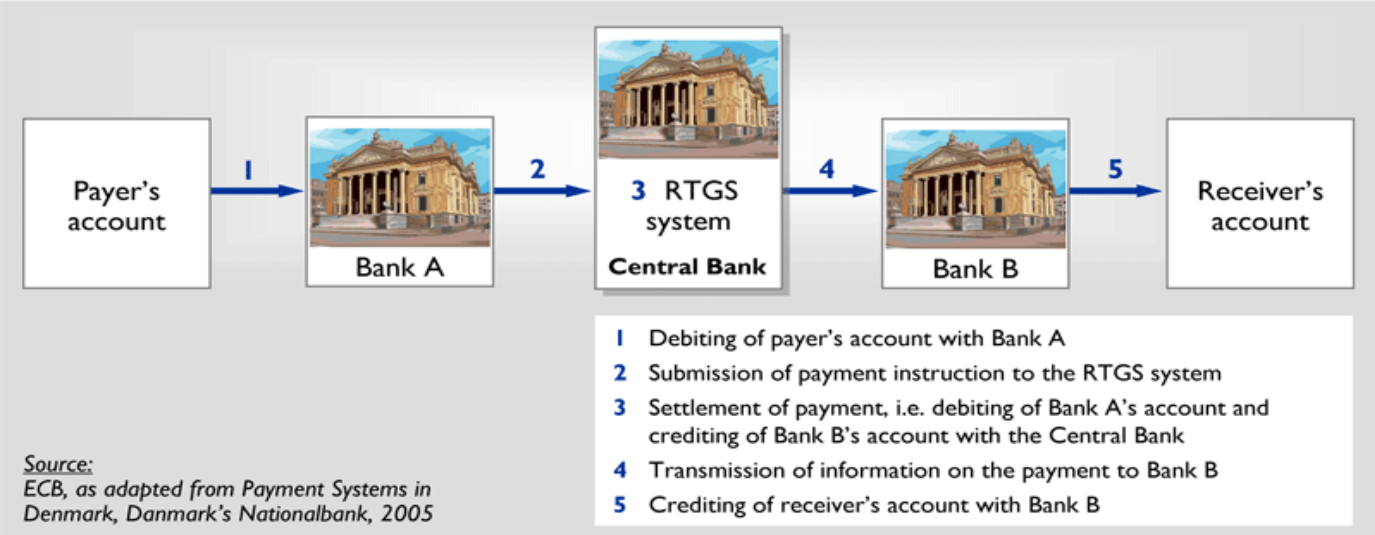
Financial Intermediation

Intermediation between the savers and the users of funds.

Bank deposits serve the useful purpose of addressing the needs of those savers or depositors who are relatively risk averse and look for liquidity, safety and reasonable returns (interest).

Funds so raised are channeled in to assets in the form of loans and investments thus facilitating productive use of the savings of the general public.

Payment System

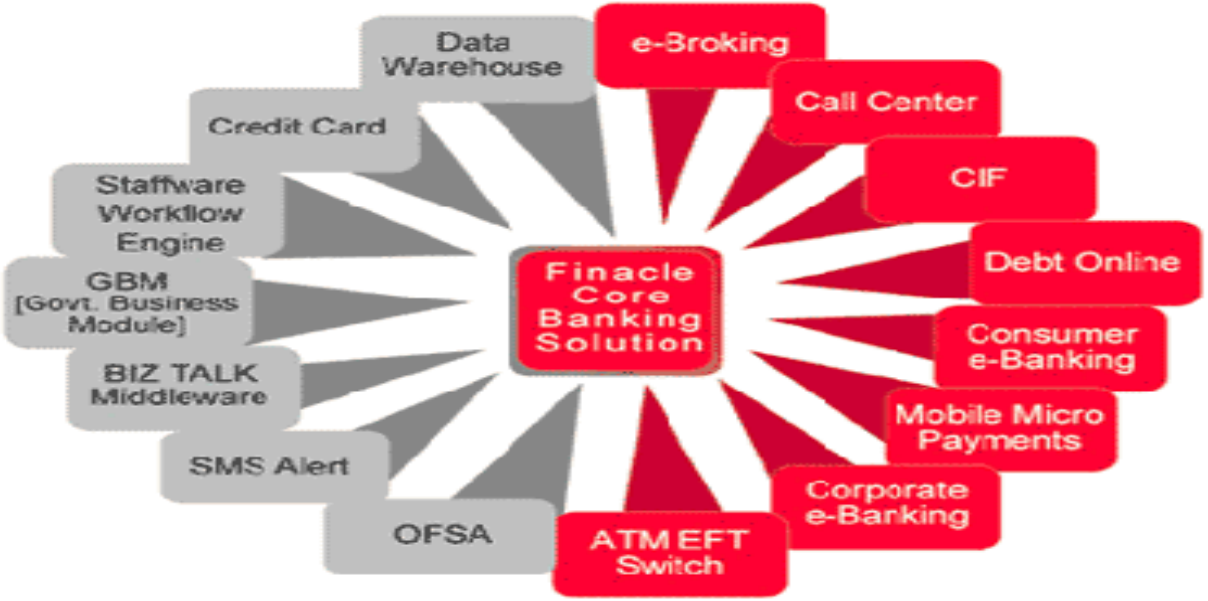


Commercial transactions between two entities need to be settled either by cash or other means. Banks play a vital role in facilitating non cash settlement.

A fundamental method by which banks help in settling the financial transaction process is by collecting and paying cheques on behalf of customers.

Banks play similar role in collecting and paying funds through electronic mode like NEFT,RTGS, Wire transfer, card based payments , ECS and cheque truncation.

Financial Services



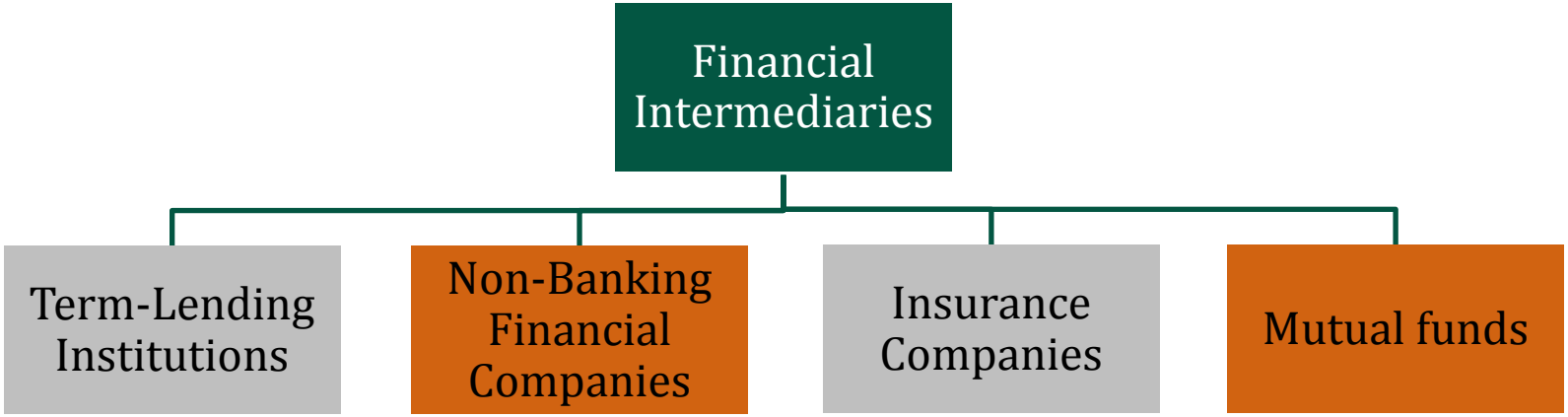
In addition to acting as financial intermediaries, banks today are increasingly involved with offering customers a wide variety of financial services.

It including investment banking, insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc.

Income from providing such services improves a bank's profitability.

Competitive Landscape of Banks in India

Some of these intermediaries also include:



Term-Lending Institutions

- Term lending institutions exist at both state and all-India levels.
- They provide term loans (i.e. loans with medium to long-term maturities) to various industry, service and infrastructure sectors for setting up new projects and for the expansion of existing facilities and thereby compete with banks.
- At the All-India level, these institutions are typically specialized, catering to the needs of specific sectors, which make them competitors to banks in those areas.

Term-Lending Institutions

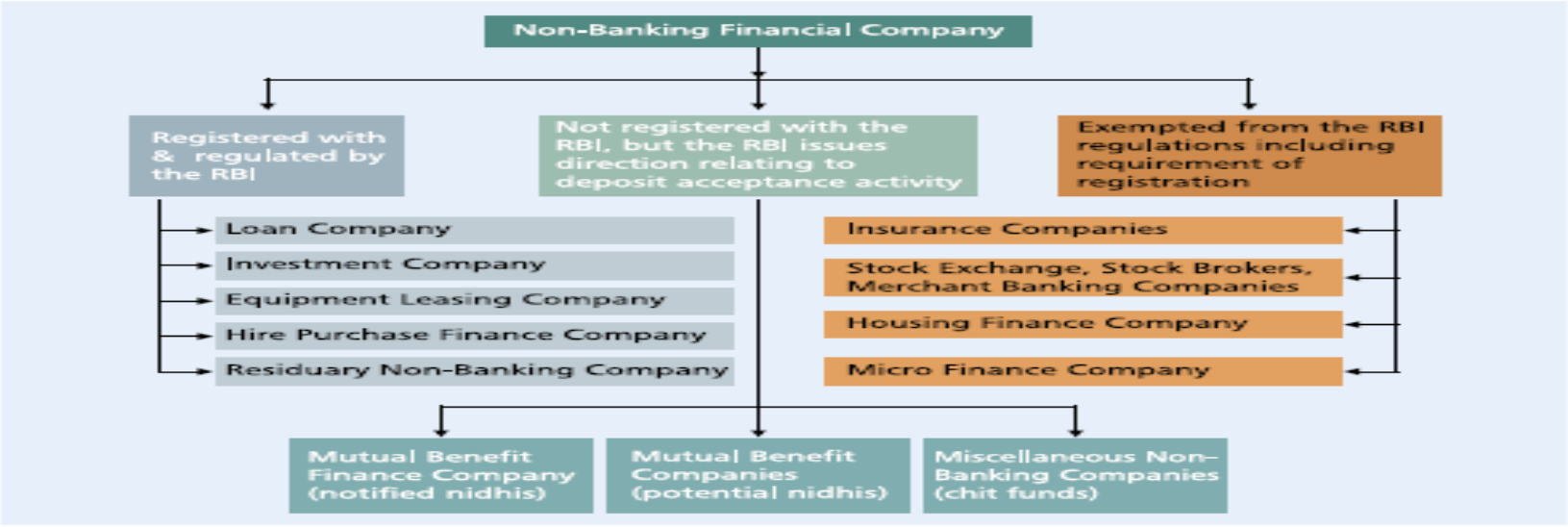
- These include the Export Import Bank of India (EXIM Bank), Small Industries Development Bank of India (SIDBI), Tourism Finance Corporation of India Limited (TFCI), and Power Finance Corporation Limited (PFCL).

- State Financial Corporations (SFCs) have been set up to finance and promote small and medium-sized enterprises. There are also State Industrial Development Corporations (SIDCs), which provide finance primarily to medium-sized and large-sized enterprises.

- In addition to SFCs and SIDCs, the North Eastern Development Financial Institution Ltd. (NEDFI) has been set up to cater specifically to the needs of the north-eastern states.

Non-Banking Finance Companies (NBFCs)

Exhibit 2.1: Industry Structure



Source: RBI

NBFCs are required to register with RBI in terms of the Reserve Bank of India (Amendment) Act, 1997.

Their business includes equipment-leasing, hire purchase, loan and investment and asset finance. It have been competing with and complementing the services of commercial banks for a long time.

All NBFCs together currently account for around nine percent of assets of the total financial system.

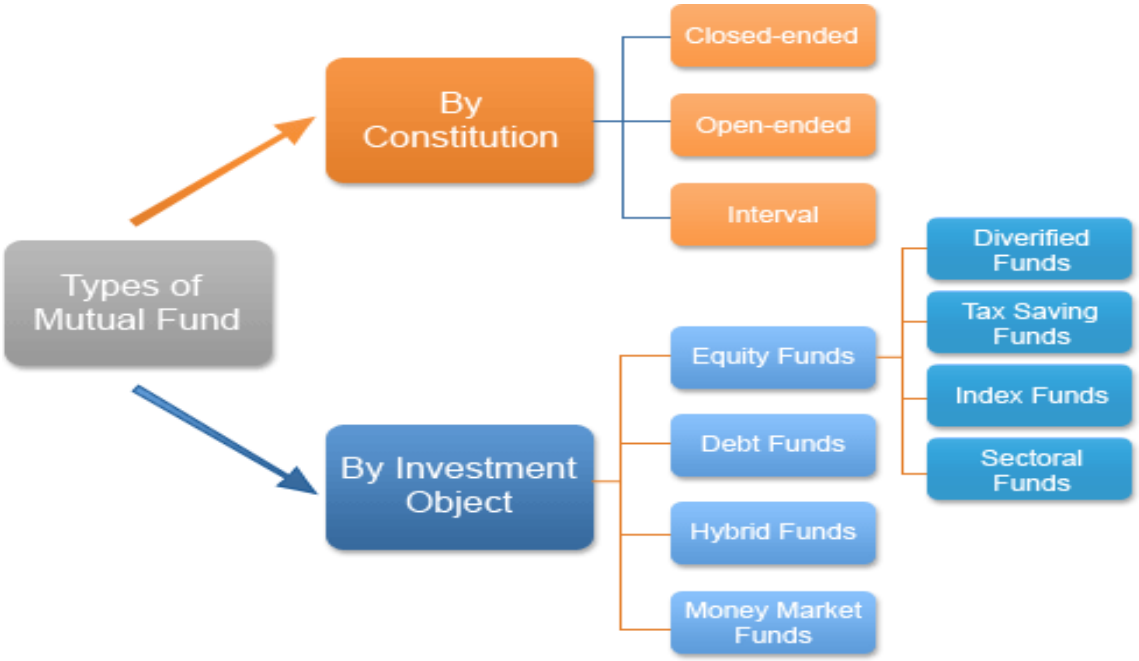
Insurance Companies

Insurance/reinsurance companies such as Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GICI), National Insurance corporation and others.

It provide substantial long-term financial assistance to the industrial and housing sectors and to that extent, are competitors of banks.

LIC is the biggest player in this area.

Mutual Funds



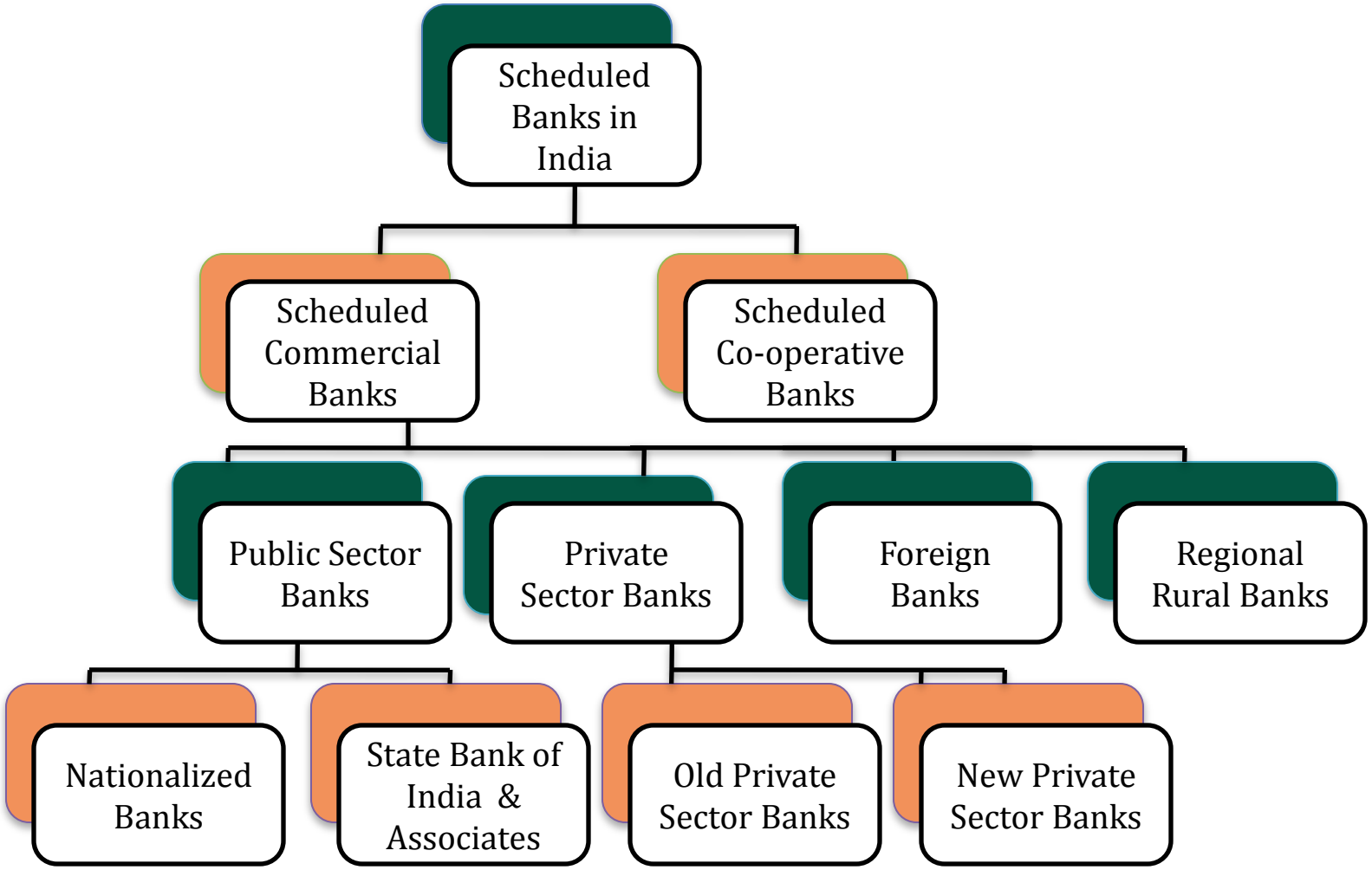
Mutual funds offer competition to banks in the area of fund mobilization, in that they offer alternate routes of investment to households.

Most mutual funds are standalone asset management companies.

Banks have also entered the asset management business, sometimes on their own and other times in joint venture with others.

Banking Structure in India

Banking Structure in India



Banking Structure in India

Scheduled banks comprise scheduled commercial banks and scheduled co-operative banks.

Scheduled Commercial Banks form the bedrock of the Indian financial system, currently accounting for more than three-fourths of all financial institutions' assets.

Scheduled Co-operative Banks are present throughout India, and their branches, having grown more than four-fold in the last 40 years now number more than 80,500 across the country.

Banking Structure in India

Public Sector Banks

- Public sector banks are those in which the majority stake is held by the Government of India (largest category in the Indian banking system).
- There are currently 27 public sector banks in India.
- They include the State Bank of India and its 5 associate banks, 19 nationalized banks and IDBI Bank Ltd

TOP 10 PUBLIC SECTOR BANKS

Scores for public sector banks are not as high as their private counterparts

Rank		Total satisfaction Score
01	Bank of Baroda	758
02	State Bank of India	752
03	Indian Overseas Bank	751
04	Dena Bank	749
04	Punjab National Bank	749
04	IDBI Bank Limited	749
04	UCO Bank	749
08	Union Bank of India	747
09	Indian Bank	744
10	Vijaya Bank	736

Banking Structure in India

Private Sector Banks

- In this type of banks, the majority of share capital is held by private individuals and corporates.
- The private banks which were not nationalized are collectively known as the Old Private Sector Banks.
- RBI permitted the private sector to enter into the banking system which are collectively known as the New Private Sector Banks.

Banking Structure in India

Foreign Banks

- Foreign banks have their registered head offices in a foreign country but operate their branches in India.
- Foreign banks in India are required to adhere to all banking regulations, including priority-sector lending norms as applicable to domestic banks.

Regional Rural Banks

- Each RRB is owned jointly by the Central Government, concerned State Government and a sponsoring public sector commercial bank.
- RRBs provide credit to small farmers, artisans, small entrepreneurs and agricultural labourers.

Reserve Bank of India

Reserve Bank of India (RBI) is the central bank of the country. The following roles are played by RBI:

- Monetary Authority.
- Issuer of Currency.
- Banker and Debt Manager to Government.
- Banker to Banks.
- Regulator of the Banking System.
- Manager of Foreign Exchange.
- Regulator and Supervisor of the Payment and Settlement Systems.
- Maintaining Financial Stability.
- Developmental Role.

Reserve Bank of India

Regulator of the banking system

To ensure a sound banking system and financial stability in the country, the RBI exercises powers of supervision, regulation and control over commercial banks.

Regulator and Supervisor of the Payment and Settlement Systems

RBI focuses on the development and functioning of safe, secure and efficient payment and settlement systems.

Bankers Bank:
As the bankers' bank, RBI holds cash reserves of banks and provides liquidity facility by either lending or borrowing for short terms , maintains banks' current accounts and provides funds remittance and settlement facilities.

Bank Deposit Accounts

Bank Deposit Accounts - Introduction

One of the primary functions of a commercial bank is to accept deposits from the public, mainly for the purpose of lending and investing.

Deposits from the public are the principal sources of funds for banks. This is an unsecured liability of a bank.

A bank pays interest on the deposit as consideration.

Banks have freedom to fix interest rate payable by them on deposits

Types of Deposit Accounts

The bank deposits can also be classified into:

Demand Deposits are defined as deposits payable on demand through cheque or otherwise. They have no fixed term to maturity.

Time Deposits are defined as those deposits which are not payable on demand and on which cheques cannot be drawn. They have a fixed term to maturity.

The underlying contract at the time of opening a deposit account determines the abovementioned classification.

Types of Deposit Accounts

Current Account

Savings Bank Account

Term Deposit Account

Current Account

A current account is basically a running and actively operated account with very little restriction on the number and amount of drawings. Balance in the account does not earn interest generally.

Current accounts are generally suited for business segment for collecting funds by depositing cheques or through electronic channels or payment through cheques or electronic mode for business purposes without any restriction on number of transactions.

Savings Account

Savings deposit is a form of demand deposits, which is subject to restrictions on the number of withdrawals as well as on the amounts of withdrawals during any specified period.

Savings deposit is used by a large segment of small depositors as they can put their regular incomes into these accounts, withdraw the money on demand and also earn interest on the balance left in the account.

Term Deposits

A "Term deposit" is a deposit received by the Bank for a fixed period, after which it can be withdrawn.

It include deposits such as Fixed Deposits / Reinvestment deposits/Recurring Deposits etc.

Strategies of Mobilizing Deposits

- Current and savings deposits are known as CASA deposits. Savings deposit is low cost deposit while current account is no cost deposit.
- Banks strive to increase the ratio of CASA deposit to minimize the cost of deposits and maximize profits.
- Higher the CASA ratio, lower the cost of funds and higher the profits.
- While mobilizing deposits, banks should comply with guidelines issued by the RBI, the Indian Bank Association (IBA) and the prescriptions of Government of India and other statutory authorities/agencies.

Deposit Services Offered to Non-Resident

Banks actively seek banking business from Non-Resident Indians (NRIs) by offering different types of deposit accounts with RBI guidelines, including:

- Non-Resident Ordinary Account
- Non-Resident (External) Rupee Account
- Foreign Currency Non Resident Account (Banks)

Definition of Non-Resident Indian (NRI)

As per the Foreign Exchange Management Act (FEMA), 1999, an NRI means:

Non-Resident Indian National (i.e. Non-resident Indian holding Indian passport)

Persons of Indian Origin (i.e., Non-residents holding foreign passports)

Types of Deposits

Non Resident Ordinary Accounts (NRO)

These are Rupee accounts and can be opened by any person resident outside India.

Typically, when a resident becomes non-resident, his domestic Rupee account gets converted into an NRO account.

Types of Deposits

Non-Resident (External) Rupee Accounts

This is a rupee account. Any NRI can open an NRE account with funds remitted to India through a bank abroad.

An NRE rupee account may be opened as current, savings, recurring or term deposit account. This account is maintained in Rupees, the depositor is exposed to exchange risk.

Types of Deposits

Foreign Currency Non Resident Account (Banks)

These are foreign currency accounts, which can be opened by NRIs in only designated currencies: Pound Sterling, US Dollar, Canadian Dollar, Australian Dollar, EURO and Japanese Yen.

Deposits are in foreign currency and are repaid in the currency of issue. Hence, there is no exchange risk for the account holder.

Basics of Bank Lending

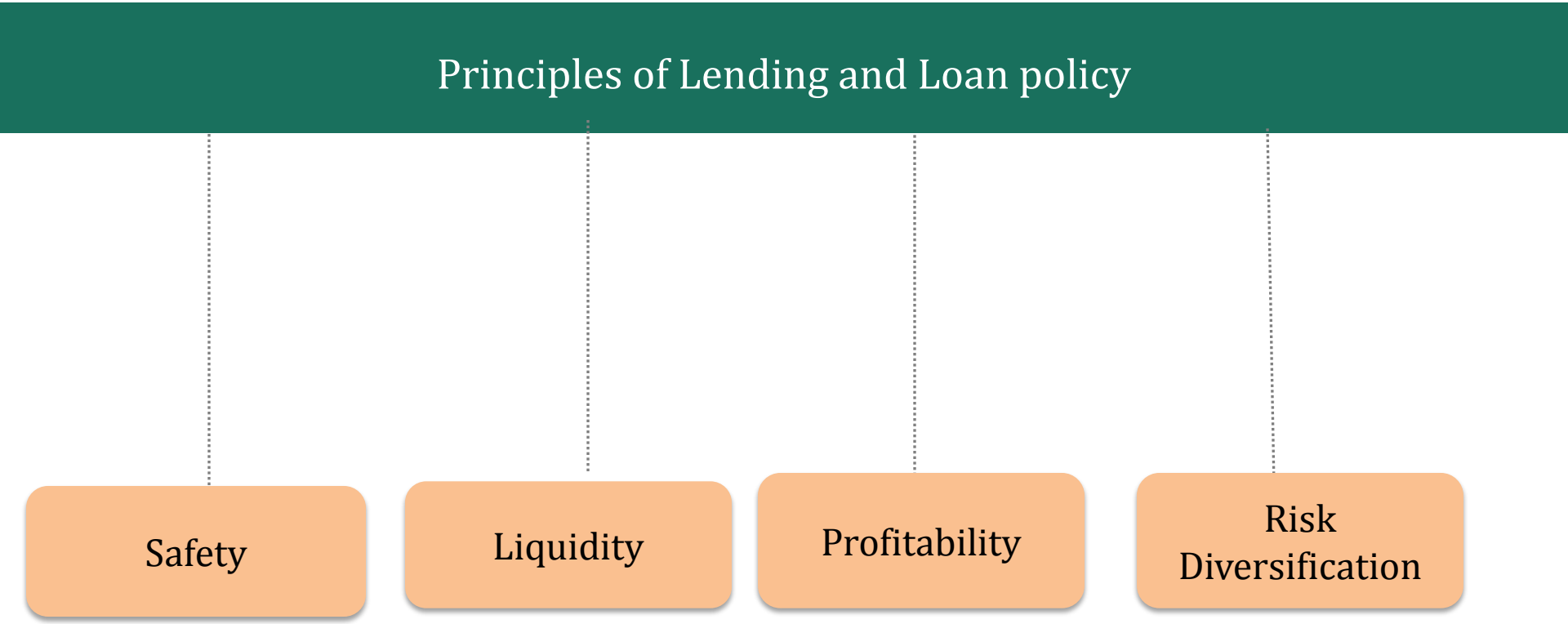
Introduction

Banks extend credit to different categories of borrowers for a wide variety of purposes.

Bank credit is provided to households, retail traders, small and medium enterprises, corporates, the Government undertakings etc. in the economy.

Retail loans are accessed by consumers of goods and services for financing the purchase of consumer durables, housing or even for day-to-day consumption.

Principles of Lending



Principles of Lending

Safety

- Banks need to ensure that advances are safe and money lent out by them will come back.

  The security must be adequate, readily marketable and free of encumbrances.

Liquidity

- To maintain liquidity, banks have to ensure that money lent out by them is not locked up for long time by designing the loan maturity period appropriately.

Principles of Lending

Profitability

- To remain viable, a bank must earn adequate profit on its investment. This calls for adequate margin between deposit rates and lending rates.

Risk Diversification

- To mitigate risk, banks should lend to a diversified customer base. For Example, all the borrowers of a bank are concentrated in one region, gets affected by a natural disaster, the bank's profitability can be seriously affected.

Loan Policy - Introduction

The loan policy outlines lending guidelines and establishes operating procedures in all aspects of credit management.

It including standards for presentation of credit proposals, financial covenants, rating standards and benchmarks, delegation of credit approving powers etc.

The lending guidelines reflect the specific bank's lending strategy (both at the macro level and individual borrower level) and have to be in conformity with RBI guidelines.

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Loan Policy - Introduction

The loan policy typically lays down lending guidelines in the following areas:

Level of credit-deposit ratio

Hurdle ratings

Targeted portfolio mix

Loan pricing & Collateral security

Level of credit-deposit ratio

Credit Deposit Ratio

Table 8:

Group	Credit Deposit Ratio (%)	
	FY06	FY07
PSBs	68.20	72.20
Private Sector Banks	73.30	75.10
Foreign Banks	85.80	83.80
Aggregate	70.10	73.50

Source: Reserve Bank of India

- A bank can lend out only a certain proportion of its deposits, Some part of deposits should statutorily be maintained as Cash Reserve Ratio (CRR).
- A bank should also invest a part of the deposits in prescribed securities (known as Statutory Liquidity Ratio).
- These are minimum requirements. Further, banks also have the option to invest in non-SLR securities.

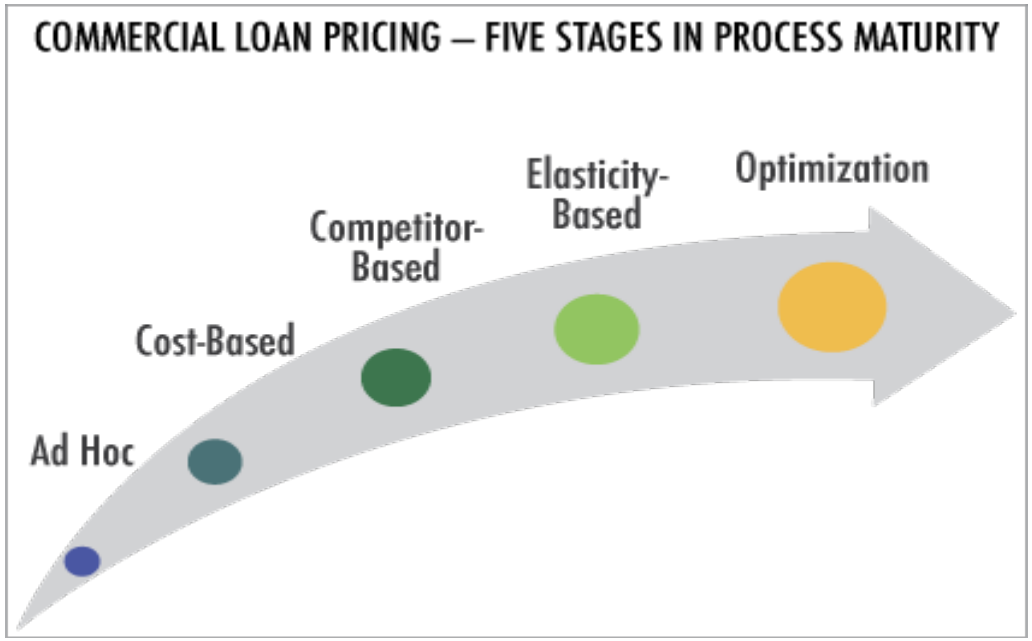
Targeted Portfolio Mix

- The CPC aims at a targeted portfolio mix keeping in view both risk and return
- For example, the CPC of a bank may be of the view that the bank is already overextended in a particular industry and no more loans should be provided in that sector.
- It may also like to avoid certain kinds of loans keeping in mind general credit discipline, say loans for speculative purposes, unsecured loans, etc.

Hurdle ratings

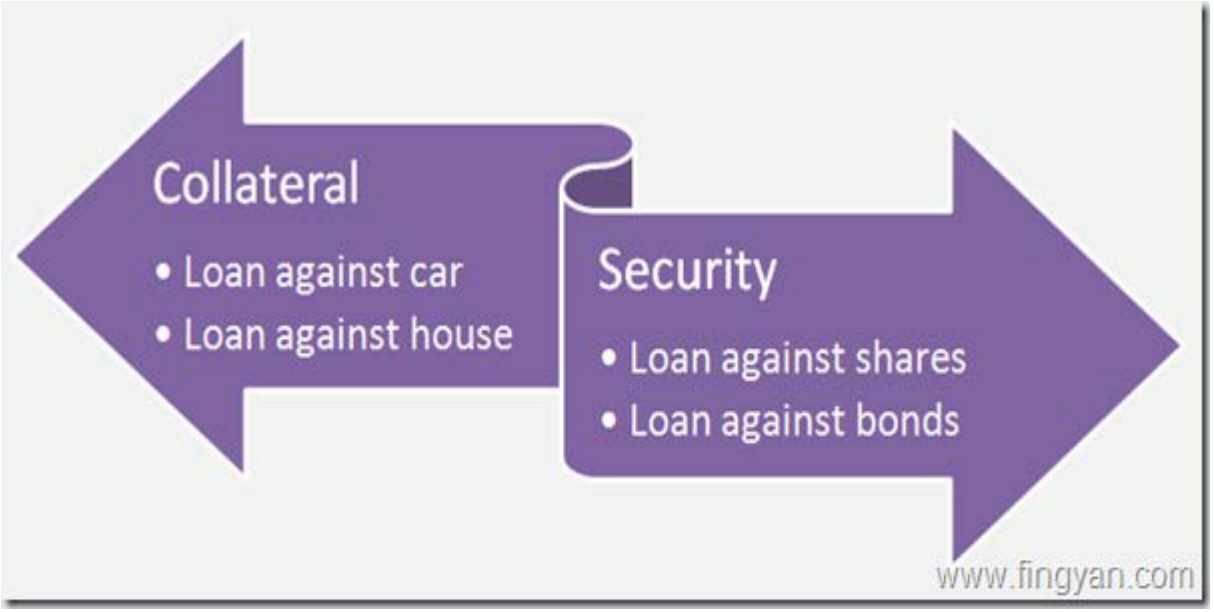
- For new borrowers, a bank usually lays down guidelines regarding minimum rating to be achieved by the borrower to become eligible for the loan.
- This is also known as the 'hurdle rating' criterion to be achieved by a new borrower.

Pricing of loans



- Risk-return trade-off is a fundamental aspect of risk management. The higher the credit risk of a borrower the higher would be his cost of borrowing.
- In other words, if the risk rating of a borrower deteriorates, his cost of borrowing should rise and vice versa. Loan pricing is also dependent upon competition.

Collateral Security



- As part of a prudent lending policy, banks usually advance loans against some security.
- In the case of term loans and working capital assets, banks take as 'primary security' the property or goods against which loans are granted.
- In addition to this, banks often ask for additional security or 'collateral security' in the form of both physical and financial assets to further bind the borrower.

Compliance with RBI Guidelines

The credit policy of a bank should conform to RBI guidelines; some of the important guidelines of the RBI relating to bank credit are:

- Directed credit stipulations
- Capital adequacy
- Credit Exposure Limits
- Lending Rates
- Guidelines on Fair Practices Code for Lenders

Basics of Loan Appraisal

Basics of Loan Appraisal, Credit decision-making and Review:

- Credit Approval Authorities
- Credit Appraisal and Credit Decision-Making
- Monitoring and Review of Loan Portfolio

Credit Approval Authorities

The usual structure for approving credit proposals is as follows:

- Credit approving authority: multi-tier credit approving system with a proper scheme of delegation of powers.

- In some banks, high valued credit proposals are cleared through a Credit Committee approach consisting of, say 3/ 4 officers. The Credit Committee should invariably have a representative from the CRMD, who has no volume or profit targets.

Credit Appraisal and Credit Decision-Making

1. When a loan proposal comes to the bank, the banker has to decide how much funds does the proposal really require for it to be a viable project and what are the credentials of those who are seeking the project.

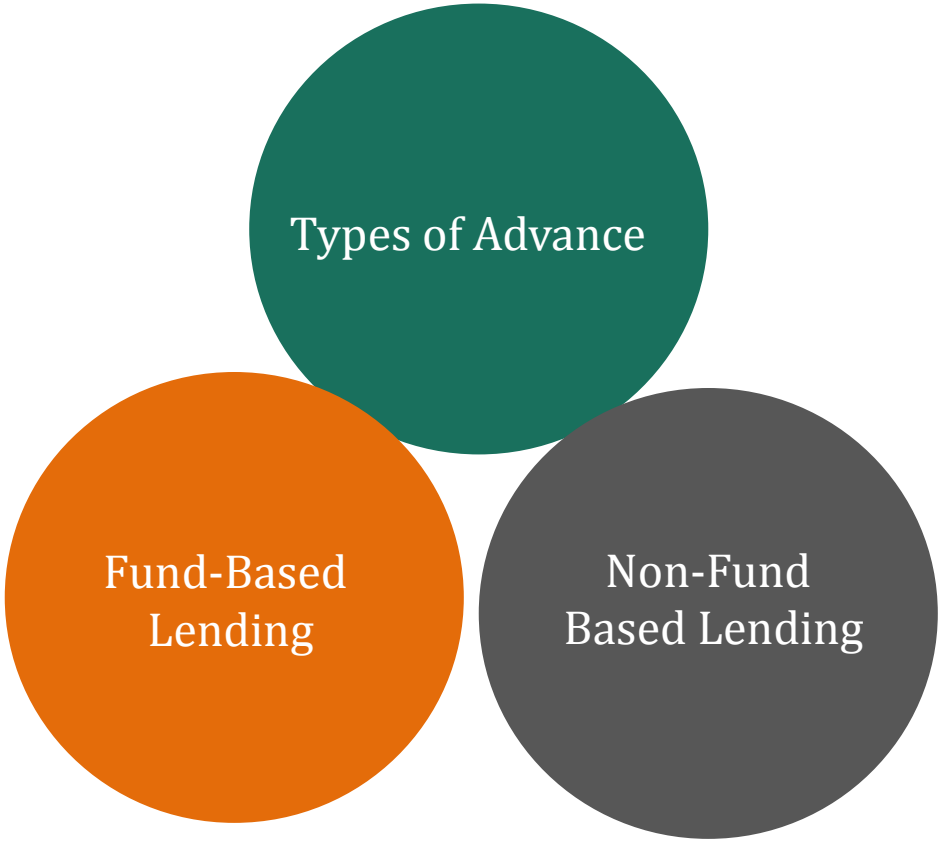
2. In checking the credentials of the potential borrowers, Credit Information Bureaus play an important role.

Monitoring and Review of Loan Portfolio

- Banks to follow due processes at the time of sanctioning and disbursing loans.
- It is equally important to monitor the loan portfolio on a continuous basis.
- Banks need to constantly keep a check on the overall quality of the portfolio.
- They have to ensure that the borrower utilizes the funds for the purpose for which it is sanctioned and complies with the terms and conditions of sanction.
- Such a surveillance and monitoring approach helps to mitigate credit risk of the portfolio.

Types of Advances

Types of Advances



Types of Advances

Fund-Based Lending

Banks provide finance for purchase of Homes, Cars and Two wheelers Commercial vehicles to customers.

In most cases, such a loan is backed by primary and/or collateral security.

The loan can be to provide for financing capital goods and/or working capital requirements.

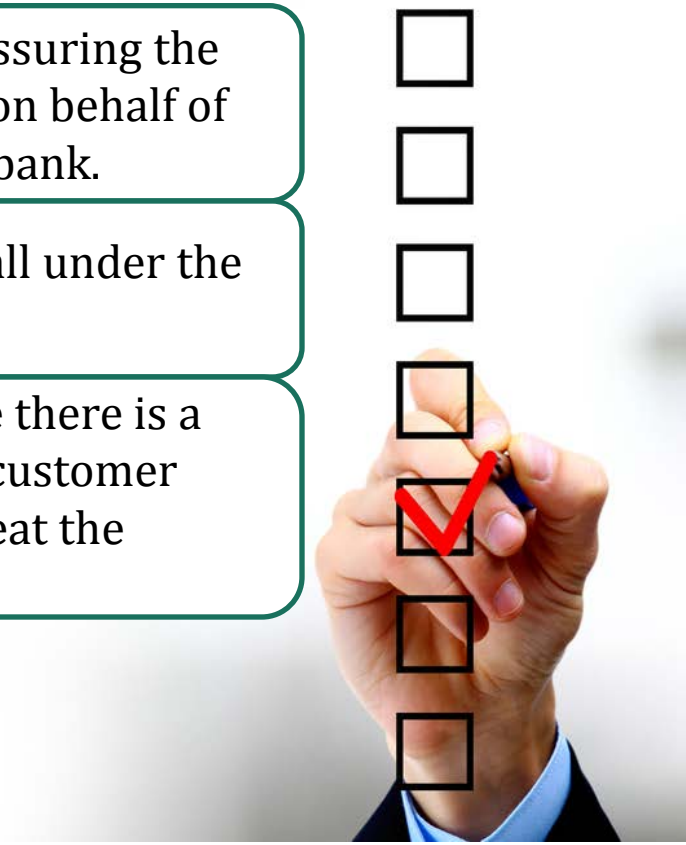
Types of Advances

Non Fund-Based facilities

In this type of facility, the Bank only lends its name assuring the supplier or a vendor payment for goods or services on behalf of the bank's customers. There is no funds flow for the bank.

Facilities such as 'letters of credit' and 'guarantees' fall under the category of non fund based credit.

These are in the nature of contingent liabilities, since there is a possibility of default in payment by the beneficiary/customer upon which the bank needs to settle payment and treat the payment as fund based facility.



Non Fund-Based facilities

Example : Bank Guarantees

A supplies a boiler to B for Rs.10 lacs. A requires a bank guarantee from B's bank. B's Bank issues a guarantee in favour of A and A supplies Boiler vessel to B.

The guarantee is for 3 months. At the end of 3 months, B will pay the amount to A who will return the guarantee letter issued by the bank. Since B gets a credit for 3 months, he is prepared to pay a commission to the bank issuing guarantee.

Thank You For Your Attention

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