UNIT -I

BANKING REGULATION

INTRODUCTION:

The banking system in India is regulated by the RBI, the central banking authority in the country in keeping with the reserve bank of India Act, 1934 and Banking Regulation Act, 1949. Regulation of banking is not peculiar to India. Banking system in every country is regulated by some authority in terms of the laws of the respective country concerned. Even in UK, where banking has not been defined under any statute book, the banking system is regulated by the bank of England in terms on enactment. Similarly the Federal Reserve Board (FRB) regulates the banking system in the federation of States off USA.

It is essential to exert reasonable regulation on the banking system to delete the possible imprudence on the point of the players. The absence of such regulations Presents a danger of jeopardizing public trust in the banking system.

The financial system deals with the people's money and it Is necessary to generate, maintain and promote the confidence and trust of the people in the banking system all the times, and with great care by preventing and curbing all possibilities of misuse and even imprudence by any of the players in the financial system. Thus the rationale of regulation of financial/ banking system is:

1) To generate, maintain and promote confidence and trust of the public in the financial/banking system.

2) To protect investors interest through adequate/timely disclosure by the institutions and access to revenue information by the investors.

3) To ensure that the financial markets are both fair and efficient.

4) To ensure that the participants measure up to the rules of the market place.

In a developing country like ours, the role of the banking regulator (RBI), as also of the securities market regulator, Securities and Exchange Board of India (SEBI) is crucial in achieving the aforesaid objectives. RBI has to shoulder an additional responsibility of smoothening and aiding the process of economic development of the country via the banking system in tune with the national economic policies.

RBI'S MAIN FUNCTIONS

Following are the essential functions of the reserve bank of India

1) Issuing notes: The RBI has the sole authority to issue, circulate, withdraw and the currency notes. RBI has issued and put in circulation, note in the denomination of RS. 2 ,5 ,10 ,20, 50 ,100 ,500 ,and 1000 except Re.1 notes and coins, which are issued by Government of India, but put into circulation by the RBI. The RBI has about 17 Issue Offices and over 4000 currency chests, where new and re-issuable notes are stored. The currency chests, are kept in custody of varies banking groups who function a agent of the RBI . The SBI Group has over 2,800 currency chests, and nationalized banks about 800, Treasures abut 420 and private sector banks about 20. As a cover for notes issue, RBI keeps a minimum value of gold coins and bullion and foreign securities as part of total approved assets.

2) G0vernment's banker: RBI acts as the banker to the central and state Governments. In this role, it provides them banking services of deposits, withdrawal of funds, making payments and receipts,

collection and transfer of funds and management of public debt. Government deposits are received free of interest and RBI does not receive any remuneration for the routine banking business of the government. The RBI also makes ways and means advances to the central and state governments, subject to certain rules and limits on the amount of overdrafts in order to contain the fiscal deficit as decided by the central government. The RBI charges commission for managing the public debt and interest on overdrafts from the concerned governments.

3) Banker's bank : RBI, like all other central banks, acts as a 'banker's bank'. The commercial and state co-operative banks which are scheduled banks(appearing in the second schedule of the RBI Act) have to maintain, stipulated reserves in cash and approved securities as a percentage of their demand and time liabilities (DTL). These reserves,

regulate banks ability to create credit and affect money supply in the economy.RBI can also change its Bank Rate to regulate the cost of bank credit and their by indirectly, its volume. It also acts as a 'lender of the last resort' for banks by rediscounting bills and through enforcement of refinance mechanism for certain kind of credit, subject to the conditions laid down in the policy statement that is announced annually (and reviewed once mid-year).

4) Banks' supervision:- From November 1993 the RBI's supervisory function has been separated from its traditional central banking functions. In 1994 Board of Financial Supervision (BFS) has been established to------ the Indian Financial System, comprising not only commercial and state cooperative banks, but also the All-India Financial Institutions(AIFIs) and non-banking finance companies (NBFCs) and non-banking finance companies (NBFCs).

The BFS is chaired by the Governor of RBI and consists of a full time Vice chairman, and six other members

5) Development of Financial system:- Apart from the regulatory and supervisory role over banks, RBI also has a developmental role to play.RBI has created specialized financial institutions for:

i) Industrial finance : Industrial Development Bank of India (IDBI)1964, Small Industries Development Bank of India (SIDBI), 1989.

ii) Agricultural Credit : National Bank for Agricultural and Rural Development (NABARD),1981.

iii) Export- import finance: Export- Import Bank of India (EXIMBank), 1981.

iv) Deposits Insurance Corporation of India (1961), which later became Deposit Insurance and Credit Guarantee Corporation of India (DICGC).

6) Exchange Control:- The RBI is responsible for maintaining stability of the external value of the national currency; the Indian Rupee. Earlier it used to regulate the foreign exchange market in the country as per the foreign Exchange Regulation Act (FERA), 1947 which was amended and enlarged in 1973.

The FERA 1973 which has been replaced by the Foreign Exchange Management Act, 1999 (FEMA) provisions, would now guide RBI in this regard.

7) Monetary policy- RBI controls the money supply, the volume of bank credit and also the cost of bank credit (via Bank Rate) and thereby the overall money supply in the economy. Changing the volume of money supply is a technique to control the inflationary or deflationary situations in the economy.

Policy Statements of the Reserve Bank announced every year, were known as the Credit policy statements till 1992- the year which marked the initiation of financial sector reforms.

With the move towards a more market oriented financial system and operating procedures for monetary policy, the policy was renamed as the Monetary and Credit policy as to highlight the growing linkages between the two. Apart from credit pricing and credit delivery, regulatory policies were also recognized to be important for channeling the flow of credit.

In the succeeding years, the Reserve Bank policy statements become increasingly comprehensive reflecting links between monetary policy, credit policy and regulatory regime in a dynamic situation involving overall structural transformation of the real sector, the financial sector and the opening of the economy.

Recognising the overall interplay of these factors, the Reserve Bank policy statement since 2004-05 has been renamed as the Annual Policy Statement.

Changes in Monetary Policy Framework- As mentioned above , India has seen significant change in the policy environment since 1991. We have moved from a system of tight control and regulations to that of a fairly deregulated and liberal system. The objectives of monetary policy continue to remain the same (that of ensuing adequate availability of credit for growth and price stability, in the main) . The difference is in terms of the emphasis on the two (changing as per requirements) and the instruments\ policy tools used to achieve the objectives among others. For instance, previously money supply or M3 used to be the intermediate target to send impulses of the monetary policy. The emphasis on M3 is considerably lowered. Also, since 1998-99, the RBI has moved to a multiple-indicator approach in devising its monetary policy. Which means that along with M3, the RBI also uses interest rates (in various markets and of various horizons), credit outlay by banks, exchange rate, current account deficit, fiscal deficit, etc. in order to modulate the monetary policy. Moreover, along with long-term growth in money supply, the RBI also places considerable emphasis on short-term liquidity management. To this end, a liquidity Adjustment

Facility (LAF) was introduced since 2000 to manipulate short-term liquidity and send interest rate signals for the short-term. The LAF operates mainly through repo and reverse repo auctions setting a corridor for movement of short-term interest rates.

TOOLS OF MONETARY CONTROL:-

RBI uses its monetary policy for controlling inflationary (i.e. tare of growth of Prices) or deflationary (rate of fall of prices) situations in the economy by using one or more of the following tools of monetary control. These are discussed below.

1. Cash Reserve Ratio (CRR)- CRR refers to the cash that all banks (Scheduled and Non-Scheduled) are required to maintain with RBI as a certain percentage of their demand and time liabilities(DTL). As discussed earlier, demand liabilities of a bank represent its deposits which are payable on demand to depositors (viz. current and savings deposits) and time liabilities refer to its time deposits which are repayable on attainment of specific maturities.

In order to meet these liabilities in time (i.e. to keep liquidity), a bank has to keep the regulatory cash reserve with RBI. The CRR can be varied by the RBI from3% to 15% of banks ’DTL. As of June 2005, it is 5% for scheduled commercial banks and the rate is lower for RRBs, cooperative and non-scheduled banks. If a bank fails to maintain the prescribed CRR at prescribed intervals, penal interest is levied on the shortfall by adjustment from the interest receivable on balances with the RBI. A cut in the CRR enhances loanable funds with banks and reduce s their dependence on the call (i.e. overnight market) and term (i.e. long-term) Money market, which helps to bring down the call rates. An increase in CRR squeezes the liquidity in the banking system, reduces their lending operations and tends to increase call rates.

2) Statutory Liquidity Ratio(SLR) :- It refers to the liquid reserve requirement of banks, in addition to CRR.SLR is maintained by all banks (scheduled and non-scheduled) in the form of cash in hand (exclusive of the minimum CRR), current account balanced with SBI

and other public sector commercial banks, unencumbered approved securities and gold.

RBI can prescribe SLR from 25% to 40% of the bank's DTL (as of June 2005 SLR is25%). SLR has three objectives:

1) To restrict expansion of banks credit,

2) To increase banks" investment in approved securities, and

3) To ensure solvency of banks.

Increase in SLR results in the reduction of the lending capacity of banks by preempting certain portion of their DTL for government or other approved securities. This has a deflationary impact on the economy, not only by reducing the supply of loanable funds of banks, but also by increasing the lending rates in the face of an increasing demand for bank credit. The reverse Phenomenon happens in case of a slash in SLR.

3) Bank Rate :- Bank Rate is the standard rate at which the RBI is prepared to buy or rediscount bill of exchange or other eligible commercial papers from banks. It is the basic cost of rediscounting and refinance facilities provided by the RBI.

Bank Rate is used by RBI to vary the cost and the availability of refinance and to change the loanable resources of banks /other financial institutions. Change in Bank Rate affects the interest rates on loans and deposits in the banking system across the board in the same direction, if not to the same extent

Post-deregulation and induction of banking reforms in 1991, the RBI has gradually loosened its direct regulation of deposit and lending rates and these are left to the banks to decide through their Boards, with only few exceptions. However, the RBI can still affect interest rates ,via changes in its Bank rate, whenever the situation of the economy warrants it.

4) Open Market Operations (OMO) This refers to the sale or the purchase of Government securities (of Central or State Governments or both) by the RBI in the open market with a view to increase or decrease the liquidity in the banking system and thereby affect the loanable funds with banks. RBI can also alter the interest rate structure through its pricing policy for open market sale| purchase.

5) Selective Credit Control (SCC):- RBI issues directives, under sections 21 and 35A of Banking Regulation Act, stipulating certain restrictions on bank advances against specified sensitive commodities as follows:

Pulses, other food grains (viz. coarse grains), oilseeds, oils including Vanaspati , all imported oil seeds and oils, sugar including imported sugar(excepting buffer stocks and unreleased stock of sugar with sugar mills), gur , Khandsari , cotton| kapas , paddy| rice, wheat.

RBI issues Selective Credit Control (SCC0 directives with an objective to prevent speculative holding of essential commodities which results in rise in their prices.

The RBI general guidelines on SCC are:

i) Banks should not grant the customers dealing in SCC commodities, any credit facilities (including those against book debts| receivables or even collateral securities like insurance policies, shares stocks and real estate) that would directly or indirectly defeat the purpose of the SCC directives.

ii) Credit limits against each commodity covered by SCC directives should be segregated and the SCC restrictions be applied to each of such segregated limits.

Presently only buffer stocks of sugar, unreleased stocks of sugar with sugar mills representing free sale sugar and Levy sugar are covered by the SCC directives

6) Other tools:-The RBI did use other tools of regulation in the past but after the liberalization policy of 1991, usage of most of these tools has been discontinued by the RBI. These tools are:

1) Credit Rationing| allocation.

2) Credit Authorization scheme.

3) Credit Planning.

4) Inventory and Credit Norms.

PRIORITY SECTOR ADVANCES (PSV)

The RBI has instructed the scheduled commercial banks that their total advances to the priority Sector should be at least 40% of their net bank credit. It has also specified lending to minimum sub-targets for Agriculture (18%), for weaker sections of the society (10%) and for very poor persons (1%). The targets and sub-targets are minimum levels of advances that every bank has to attain from year to year in relation to its Net Bank Credit.

Though no sub-targets has been prescribed for small scale industrial (SSI) units, yet advances made to these units from part of priority sector credit.SSI units are defined as 'those units which are engaged in manufacture, processing or preservation of goods and whose investment in plant and machinery(excluding Land) at original cost does not exceed Rs. 1 crore (Rs 5 crore in specified items under hosiery, hand tools)'.

Small business (equipment cost not exceeding Rs. 20 lacks), retail traders(advances not exceeding Rs 10 lacks), self-employed professionals (Borrowings not exceeding Rs. 10 lacks), education, housing (loans up to Rs. 5 lacks in rural and Rs 10 lacks in urban areas) and micro credit, are also treated as priority sector.

Advances to weaker sections (10% of net bank credit) are reserved mainly for productive purposes or for Government-state sponsored employment oriented schemes, e.g. PM's Rozgar Yojna. Weaker sections include small and marginal farmers with land holdings of 5 acres or less, landless labourers, artisans (whose individual credit requirements do not exceed Rs. 25000), families living below the poverty line (Whose family income does not exceed Rs 11000 p.a.), scheduled castes|tribes, etc.

There is a poorest class of society for whom bank loans a9Rs. 6500 per individual) are to be granted at fixed interest rate of 45 P.a. under the Differential Rate of Interest (DRI) scheme and such loans should constitute at least 1% of a bank's net bank credit.

The RBI has also prescribed certain operational guidelines and lending norms involving concessionary terms| conditions for PSA which include the following:

1) No service charge| inspection charge |insurance charge| penal interest to be levied on PSAs up to Rs 25000.

2) Collateral may be waived on loans to SSI units up to Rs. 25 lacks.

3) A register of PSA loan applications showing receipt, sanction |rejection etc. is required to be maintained at branch level.

4) Bank should have a Cell at regional | Corporate level to monitor the flow of credit to SC|ST and other minority communities, to verify the implementation of the guidelines regarding Priority Sector and for redressing the grievances of such borrowers.

The PSAs represent directed lending by banks as per RBI prescribed targets |sub-targets for specific business sectors or segments of population. The rational behind PSAs is that, banks as responsible corporate citizens, should help economically disadvantaged sections for undertaking productive activities and improving their economic condition

REGULATORY RESTRICTIONS ON BANK LENDING:

RBI directives or Banking Regulation Act, 1949(BRA) lays down the following regulatory restrictions on lending by banks:

i) No advance or loan can be granted against the security of the bank's own shares or partly paid shares of a company.

ii) No bank can hold shares in a company:

a) As pledge or mortgagee in excess of the limit of 30% of the Bank's paid-up capital and Reserves, whichever is less.(sec. 19 (ii) of BRA)

iii) Bank's aggregate investment in shares, Certificate of Deposit (CDs), bonds etc. should not exceed the limit of 5% of a bank's total advances outstanding as the end of the previous year.

iv) No bank should grant loans against:

a. Certificate of Deposits (CD)

b. Fixed Deposits (FDs) issued by other banks

c. Money Market mutual funds (MMMF)

v) Banks should adhere to the RBI guidelines relating to the level of credit, margin and interest rate etc. for loans against the security of commodities covered by Selective Credit Control Directives of RBI.

vi) No loan should be granted by banks to:

a) The bank's directors or firms in which a director is interested as a partner| manager | Employee |guarantor (certain exemptions allowed)

b) Relatives of other bank's directors ('relatives' as defined by RBI) such loans can be sanctioned by higher authorities or the bank's Board as per RBI guidelines.

vii) Banks should not sanction a new or additional facility to borrowers appearing in RBIs list of "Willful Defaulters" for a period of 5 years from the date of publication of the list by RBI.

QUESTIONS:

1) Explain the various reasons for regulating the banking system in a country.

2) Enumerate the main supervisory powers of RBI over commercial banks

3) Explain Cash Reserve Ratio.

4) Explain Statutory Liquidity Ratio.

5) Explain the effect of an increase in the CRR and SLR on the banking system.

6) What is an open market operation?

7) Explain the rational of PSA

UNIT-II

Banker customer Relationship

Introduction

In addition to the primary functions, a banker renders a number of services to his customers. The relationship between a banker and a customer may be divided into two types. They are

1) General Relationship
2) Special Relationship

General relationship between a banker and a customer

The general relationship between a banker and a customer may be sub-divided into

1) Primary general relationship
2) Subsidiary general relationship.

Primary General relationship between a banker and a customer

The various features of primary general relationship between a banker and a customer are:

1) Commencement of primary general relationship
   The primary general relationship between a banker and a customer starts from the time the customer opens a bank account by depositing money.
2) Contractual primary general relationship
   The primary general relationship between a banker and a customer arises from a contract between the two. So, it is a contractual relationship. As it is a contractual relationship, it is governed by the various terms of agreement between the two parties.
3) Nature of primary general relationship
   a) The primary general relationship between a banker and a customer is that of a debtor and a creditor. When a banker receives deposits of money from a customer, he is neither a bailee nor a trustee nor an agent, but only a debtor.
   b) Customer is only a general creditor of the banker
      It is true that the customer is the creditor of the banker, when he has some deposit in the bank. But he cannot be a secured creditor of the

banker, because he does not get any charge on any asset of the banker. He cannot be even a preferential creditor of the banker, as he does not get priority of claim over the other creditors of the bank in the event of liquidation of the bank. He is just an ordinary, general or unsecured creditor of the banker.

However, a banker can be a secured creditor of the customer, when an advance is granted by him to the customer against some tangible securities. That means, even when he becomes a creditor, he becomes a privileged creditor.

c) Demand for repayment of deposits is necessary

   For the repayment of the deposit due from the banker to the customer, an express demand for repayment is required to be made by the customer.

d) Customer can demand repayment of deposits whenever he wants :

   The customer of a bank can demand the repayment of his deposits (i.e. current deposits or savings bank deposits) whenever he wants and the banker is bound to repay the same by honouring the customers cheques.

Subsidiary general relationship between a banker and a customer

Introduction:

When a deposit of money is received and an account is opened by a banker in the name of a customer, the primary relationship between the banker and the customer is created and that relationship is that of a debtor and a creditor. But this does not mean that there cannot be any other relationship between the banker and the customer. In fact, besides the primary debtor and creditor relationship, the banker and the customer can also enter into subsidiary relationship like that of bailee and bailor, trustee and beneficiary, and agent and principal by special agreements or arrangements.

The various subsidiary relationships that can exist between the banker and the customer.

1) *Bailee and Bailor relationship:*

   When a banker accepts valuables and documents from a customer for safe custody, he becomes a bailee, and the customer becomes a bailor.

As a bailee, the banker owns some duties and liabilities to the customer. They are:

a) He is required to safeguard the safe- custody deposits of the customer in his hands with reasonable care.
b) If he fails to take reasonable care in the preservation of the safe custody deposits, and the customer suffers a loss as a consequence, he becomes liable to compensate the customer for the loss.
c) He is required to handover the safe custody deposits to the depositor, whenever he demands them back.

2) *Trustee and Beneficiary relationship*:
A banker becomes the trustee of his customer, when he is entrusted with some trust work. For instance, when a customer deposits a certain some of money with the banker with specific instructions to use the same for a specific purpose, the banker becomes the trustee of the customer in respect of that money until that purpose is fulfilled.

3) *Agent and Principal relationship*:
When a banker undertakes agency services, such as collection of cheques, drafts and bills, collection of interests and dividends on securities, Payment of premium and subscriptions and sale of securities, etc. For a customer, he becomes the agent and the customer becomes the principal.

SPECIAL RELATIONSHIP BETWEEN A BANKER AND A CUSTOMER

Meaning of special relationship:

Special relationship between a banker and a customer refers to the special obligations and rights of the banker against the customer and vice versa. In other words, it means the mutual obligations and rights of the banker and the customer arising out of their general debtor and creditor relationship.

Various features of special relationship:

The various features of special relationship between a banker and a customer can be explained under three heads:

I) Banker's obligation
II) Banker's rights
III) Banker's obligations coupled with his rights or bankers rights coupled with his obligations.

I Bankers obligations

The various obligations of a banker are:

1. Bankers obligation to honour his customers cheques

Introduction

When a current account is opened by a banker in the name of a customer, there is an obligation on the banker to honour the customer's cheques as long as there are sufficient funds available in the customer's account for meeting the cheques.

Banker's obligation to honour cheques is subject to certain conditions:

a) Sufficient funds must be available
b) Funds must be properly applicable to the payment of the cheque
c) Banker must be duly required to pay the cheque
d) There must be no legal bar preventing the payment of the cheque

2. Bankers obligation to maintain the secrecy of the customer's account:

   A bankers obligation to maintain the secrecy of his customers account means that he should not disclose to any outsider the details concerning the customer's account, such as the amounts deposited, cheques, drafts and bills deposited for collection, the parties from whom the cheques, drafts and bills are received, the cheques issued, the parties to whom the cheques are issued, the balance in the account, the overdraft, loan or any other advance granted, the securities deposited by the customer against the advance, etc. In short it means that the banker should not disclose the state of the customer's account to any outsiders.

Exception to banker's obligation to observe secrecy

The circumstances which justify disclosure, and release the banker from the obligation of secrecy are as follows:

1) When there is an express consent of the customer:
   A banker is justified in disclosing the state of his customer's account to a third party when there is an express consent of the customer for such disclosure.
2) When there is an implied consent of the customer
   A banker is justified in disclosing the state of his customer's account to an outsider even when there is an implied consent of the customer for such disclosure.
3) when he is compelled by the laws of the country:
   A banker can disclose the state of his customer's account to public authorities when he is compelled by the laws of country.
4) When he is under a public duty to disclose:
   A banker is justified in disclosing the state of his customer's account when he is under a public duty to disclose. For instance, if a banker comes to know from his customer's bank account that his customer is engaged in trading with an enemy country during war or is engaged in anti-national or prohibited trading activity, he can disclose the state of the customer's account to the government in the interest of the state.
5) When his own interest requires disclosure:
   A banker is justified in disclosing the state of his customer account when his own interest requires disclosure. For instance, when a banker takes a legal action against the customer for the realisation of the amount due, he is permitted to disclose the exact state of his customer's account to his (i.e. banker's) lawyer , the court, etc.
6) When an enquiry is received from a fellow banker:
   Bankers have the practice of exchanging information amongst themselves about customer's because of common courtesy. So, when an enquiry is received by a banker from a fellow banker about the state of a customer's account, the banker can answer that enquiry as a matter of common courtesy.

II **Banker's Right's**

1) Bankers right of general lien

   Meaning of lien

   Lien is the right of a person to retain the property, in his possession, belonging to another, until the debt due from the owner of that property is repaid. In other words it is the right of a creditor to retain the property , in his possession. Belonging to the debtor until the debt due from the debtor is repaid.

   Types of lien:

   Lien is of two types viz.

   a) Particular lien, special lien or conventional lien
   b) General lien

   Particular lien:

   A particular lien is the right of a creditor to retain a particular property(i.e. the property in respect of which the debt is incurred) until the particular debt (i.e, the debt incurred is in respect of the property retained) is repaid.

   General lien:

   A general lien is the right of a creditor to retain any property until the general balance (i.e, all the debts due from the owner of the property) is repaid. It is enjoyed by bankers , factors (i. e. Mercantile agents) wharfingers (i.e those who own or take care of wharves or lending places for loading and unloading of goods).

   Bankers general lien

   Is the right of a banker to retain the goods and securities entrusted to him as a banker by a customer in respect of the general balance (i.e. all the debts) due from the customer.

2) Bankers right of set-off or bankers right to combine accounts.

   Right of set-off is the right of a debtor to adjust the amount due to him from a creditor against the amount payable by him to the creditor to determine the net balance payable by one to the other.

Like any other debtor, a banker also has a right of set-off. A bankers right to set-off refers to the right of a banker to adjust the amount due to him from a customer on one account against the amount due from him to the customer on another account. In short, it is a right of a banker to combine or adjust the debit and credit balances of two or more similar accounts held by a customer in the same name and in the same capacity.

3) Bankers right to charge compound interest

   When a banker grants an advance to a customer, he becomes the creditor of the customer. When he is the creditor of the customer, the banker has an implied right to charge interest on the customer by virtue of banking custom. Besides the implied right provided by the banking custom, in practice, every banker enters into an express agreement with the customer and gets the right to charge interest on the amount due to him from the customer.

4) Bankers right to charge incidental charges on unremunerative accounts

   Incidental charges may take the form of service charge, ledger folio charges, penal charges, stop payment charges, etc.

   A banker has an implied right to charge incidental charges on the customer for meeting the costs involved in keeping their accounts. Incidental charges are levied in the case of unremunerative current accounts.

5) Bankers right to levy commitment charges.

   In the case of an overdraft as well as a cash credit, the banker is required to keep at the disposal of the borrower the full amount of the overdraft or the cash credit sanctioned. But he can charge interest only on the amount actually overdrawn or withdrawn by the borrower. On account of these features a banker is likely to suffer loss of interest, in case the overdraft or the cash credit sanctioned is not utilised by the borrower in full. So to protect himself against the loss of interest and to discourage the borrower from borrowimg more than their requirements, generally a clause known as commitment charge clause is included in an overdraft as well as in cash credit arrangement.

As per the commitment charge clause, a banker has the right to charge to the borrowers account commitment charge on the unutilised portion of the overdraft or cash credit limit. The commitment charges is nominal, about 1% of the unutilised portion of the sanctioned credit over a certain limit.

6) Bankers right to charge commission

   As a banker renders certain services for a customer, he has an implied right to collect from the customer a reasonable commission for his services.

7) Bankers right not to produce books of accounts under bankers books evidence Act of 1891

   Before the passing of the bankers book evidence Act 1891, a banker could be called upon by a court to produce his original books of accounts, such as the day book, cash books, ledger, etc before the court even in a legal proceeding to which the banker was not a party. This caused a great hardship to bankers, as they have to continuously work on their books of accounts. This hardship of bankers was sought to be removed by the bankers book evidence Act of 1891.

   By virtue of the provisions of the bankers books evidence Act ordinarily a banker cannot be compelled by a court to produce his original books of accounts or to appear as a witness to prove the matters recorded in his books in a suit to which he is not a party. All that the court can do is to permit any party to the suit to inspect and to take copies of any entry in the bankers books of accounts or to require the banker to produce before the court a certified copy of the relevant entry in his books.

III BANKERS OBLIGATIONS COUPLED WITH HIS RIGHTS OR BANKERS RIGHTS COUPLED WITH HIS OBLIGATIONS

There are certain cases in which a banker has obligations coupled with his rights or rights coupled with his obligations. Such cases are:

1) **Bankers obligations and rights regarding appropriation of payments**

   The general rule regarding the appropriation of payment is that the party who makes the payment, i.e., the debtor, has the right to appropriate the payment to any debt or or account which he likes. So, when a payment is made by a customer to a banker the customer has a right to instruct the banker to appropriate the payment in settlement of any particular debt which he likes. Similarly the customer can instruct the banker to credit the amount to any account which he likes. Even if one of his account shows a debit balance, the customer can direct the banker to credit the amount to another account which shows credit balance. So also the customer can instruct the banker to apply the deposit towards any withdrawal which he likes. If such a specific appropriation is made by the customer at the time of making the payment, the banker is obliged to appropriate the payment in accordance with the customers instructions. He should not appropriate the payment against the customers instruction. If he is not prepared to appropriate the payment in accordance with the customers instructions, he must refuse to accept the payment, and must enforce his rights against the customer in the ordinary course of law.

   It is true that the customer has the first choice in appropriating the payment made by him to the banker. But he should make his appropriation at the time of making the payment. He cannot exercise his right of making the appropriation after the banker has appropriated the payment to any other debt, account or withdrawal.

2) **Bankers obligations and rights when a customer's account is attached by a garnishee order**

When a debtor fails to pay the amount due from him to his creditor and when the creditor knows that some money due to his debtor from another party (i.e. the debtor of his debtor) he may apply to the court for the issue of a garnishee order on the debtor of his debtor attaching the amount due from him (i.e. the debtor of his debtor) to his debtor (i.e. preventing the debtor of his debtor from paying the amount due from him to his debtor) and directing him to pay the same to the judgement creditor.

Meaning of garnishee order

It is said that the word "garnishee" is derived from the latin term "garnire" which means " to warn" so a garnishee order is an order issued by a court at the instance of (i.e. request) of a judgement creditor (i.e. the creditor who has applied to the court for the issue of the garnishee order) to the garnishee(i.e. judgement debtors debtor) warning him (i.e. the garnishee) not to pay the money owed by him to the judgement debtor(i.e. the party who owes money to the judgement creditor) until the claim of the judgement creditor is disposed of. In other words, a garnishee order is an order issued by the court, at the instance of the judgement creditor, to the garnishee, first attaching the funds of the judgement debtor lying with the garnishee, and later directing him(i.e. garnishee) to pay the same to the judgement creditor, if he (i.e. the garnishee) does not have any objection to do so.

Questions

1. What are the various features of primary general relationship between banker and a customer?

2. Explain the subsidiary relationship that can exist between the banker and the customer?
3. What is special relationship between a banker and a customer?
4. What are the features of special relationship between the banker and a customer?
5. Explain the bankers obligations towards its customers.
6. Explain the various rights enjoyed by the banker against the custom

UNIT-III

Meaning of Loans Advances

Secured Loans – According to section 5(n) of the Banking Regulation Act, 1949, a secured loan or advance means a, "loan or an advance made on the security of assets the market value of which is not at any time less than the amount of such loan or advance.

Unsecured Loan – An Unsecured loan means a loan or advance not so secured. A partly covered loan or advance is partly covered by the security of assets, the market value of such securities being less than the amount that has been lent or outstanding at any time .

Importance of Lending

The previous unit has death with various kinds of deposits and their importance for a bank. Lending is very important (core) function of bank. Funds mobilized from deposits are deployed by banks in making loan and advances to various businesses, trade and commerce. The main purpose of loans and advances is to earn profit by way of interest spread, i.e. the differential between the average interest rates receivable on loans and payable on deposits.

Banks are 'financial intermediaries' and lend the funds of depositors who themselves do not want to take risk lending directly to businesses. Banks undertake the risk of directly lending a major portion their deposits in the form of loans / advances and thereby earn interest spread as a reward for risk – taking. Lending function is thus an important element of the intermediary role that banks play in a financial system.

Lending function of banks is also important for the economic development of a country. The lending activities also play an important role in determining the velocity of circulation of money in the monetary system of a country.

The importance of Bank lending can be explained as follows:

For the bank – Loans/advances constitute a major chunk of a bank's assets. These also yield returns by way of interest income which contributes the largest percentage of bank's profits.

Bank levies interest at periodic intervals (generally monthly) on the funds lent to borrowers and the total interest collected during a financial year constitutes a major portion of its gross interest income. After the bank deduct the total interest payable on its deposits from such interest income, the net interest income is arrived at, which generally represent the highest percentage of its operating profits.

For development of the Economy – By lending the savers' (depositors) money to the users (borrowers), banks help the latter in setting up and expanding businesses and trade in the country, thereby contributing to its economic development. Without bank-loans, the country's industry, trade and commerce will languish and tend to stagnate or grow very slowly, as the own savings or retained earnings of business are inadequate for the required growth. Bank loans to the various sector (industrial / agricultural / infrastructure / trade etc.) increase the pace of economic development in a country.

For the monetary system- In the process of lending (or credit creation), banks also create fresh deposits on account of the fractional reserve system under which banks are required to keep only a specified small portion of their deposits in cash as cash Reserved Ratio (CCR) and the remainder is lent out. The funds lent out accrue as fresh deposits in the banking system and these deposits are again lent out, leaving only a small portion as cash or liquidity reserves with banks. The money supply in the economy thus increases due to acceleration in the velocity of its circulation (called 'credit creation' by banks). The actual extent of 'credit creation' by banks would depend on the demand of credit in the economy and also how widely the people are inclined to use bank deposits and negotiable instruments like cheques, bank drafts, bill of exchange, promissory notes etc. (as opposed to cash transactions) for settling transactions. The extent of 'monetization' of the economy would also determine the velocity of circulation and credit creation by banks, as, the 'non-monetized' segment (e.g. hoarding of money, commodities/bullion etc.) contributes to seepages by the blocking some portion of money supply from not coming back to the banking system at all or coming back after a prolonged period.

For the Society - Bank's lending functions helps the society indirectly through employment and income generation which increases as the economy develops. Banks, as responsive corporate citizens, plough back portion of their profits (which mainly comes from lending) in community welfare activities, like beautification of gardens / other public places, public sanitation, environmental up gradation, support to charitable organizations engaged in uplifting the under-privileged sections of the society (orphans, aged and disabled)etc. Banks also give loans at very low / concessionary interest rates for the government's poverty alleviation programmes.

Principles of Lending - Banks follow the basic principle of prudence while lending, as the money banks are lending belongs to their depositors and has to be repaid on maturity as per the terms of the deposits. The bank also follow certain other principles of lending, as described below, that help banks in honoring their commitments to the depositors and earning some profit from their lending activities.

Safety and Security Principle – Safety principles means timely return of the funds, lent by a bank. While granting a loan, a bank carefully examines the economic, commercial and financial viability of the applicant's business, quality of its management (integrity, honesty, willingness to repay loan, reputation in market, business acumen etc.) and the past track record. The applicant's financials (balance sheet, profit and loss account, Funds flow statement) of the previous years, its present trend and its future projections are critically scrutinized, to establish business viability. These form essential processes of sanctioning a loan with an objective to ensure the safety of the funds lent and guarantee their timely repayment by the borrower, so that the bank in turn, may be able to repay money to the bank, on turn, may be able to repay money to the depositors in time. Assets acquired from bank loan are changed / hypothecated to the bank by way of its security in the form of mortgage of immovable property and pledge / hypothecation of goods / receivable of the borrowers. Wherever necessary, additional collateral securities of tangible asset and / or third party guarantees are also obtained by the bank.

In case of default in repayment of the loan by the borrower, the bank can take recourse to the securities and recover its due of the principal and the interest. If the realized value of the securities is less than dues and the balance amount remain unpaid by the borrower /guarantor, it is eventually written off by the bank out of the provision made for bad / doubtful debt, thereby reducing its reserves.

Risk diversification Principle- Lending involves risk taking and banks always strive to minimize such a risk. The main risk in lending is, credit risk, arising from the business failure of the default in repayment of the principal / interest by the borrowers due to other reasons. The credit risk is sought to be diversified by banks avoiding concentration of loans to a few borrowers / industries / sectors, as per the prudential norms set internally and stipulated by the regulatory authorities. This is in keeping with old saying ‘do not pull all your eggs in one basket’.

Profitability Principle- Profit-earning is necessary for any business to sustain and grow. Further, the logical corollary to risk-taking, is profit making. Banks seek to earn profit by charging an interest higher than that payable by them on their deposits. The difference between the average interest earned on loans / investments (yield) and paid by deposits (cost of funds) is the gross interest spread. After deducting administrative and statutory reserves cost (by way of providing for bad and doubtful loans, SLR,CRR etc.), remaining portion is the net spread, which represents the bank’s profit. After paying taxes, the remainder net profit is used for paying dividend to its shareholders and the balance profit is retained in business in the form of various reserves.

Liquidity Principle – A bank has to manage its assets and liabilities in a such manner that it can meet all its deposits liabilities in time, out of the money acquired as repayment of loans. It has to attune the maturities of its assets (loans) with the maturities of its liabilities. No bank can afford a delay or default in meeting its deposits or other liabilities, as this would result in loss of trust and faith of the depositors / customers, on which the rest the edifice of banking business. Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR), etc. are maintained by all banks as prescribed by the regulatory authority (RBI) in order to maintain financial soundness.

Loan Purpose Principle – Banks grant loans and advances for lawful purposes as per public policy and its own objectives. Unlawful activities include ‘money laundering’ (for terrorist activities, illegal trafficking in drugs) or for activities, banned or restricted by the RBI and other regulatory and statutory authorities are not financed. While avoiding giving loans for unlawful or restrictive purposes, a bank may have special knowledge and expertise of certain industries and would therefore lend mainly to the units in these segments. Every bank's loan portfolio is therefore different as per its objectives and credit policy.

TYPES OR STYLES OF CREDIT

Commercial banks finance working capital requirements of their customers. The main style of credit of systems of financing in our country are: –

1. Cash credit system
2. Overdrafts
3. Loans
4. Purchase and discounting of bills.

The terms and conditions, the right and privileges of the borrower and the banker differ in each case. In India, the category of loans, cash credit and advances accountants for the bulk of bank credit. Purchase and discounting of bills is not as popular a means of Bank credit of India, as it is in foreign countries. Efforts have been made to popularize the use of bills of exchange for extending bank credit.

Cash Credit

Cash credit is one of the most important methods of lending in India. Under this method, the banker fixes a limit for a customer, called the cash credit limit is generally specified after taking into account the important feature of the borrowing concern, for example, production, sales, inventory, past credit limits, etc. The customer is allowed to withdraw money from cash credit account according to his requirements. Similarly, he may deposit money in the account as and when surplus fund are available with him. The cash credit account is, thus, an active running account to which deposits and withdrawals may be effected frequently. But the customer has to provide tangible asset as security for the amount borrowed from the banker. The interest is charged on the actual amount utilized by the customer and it is calculated and it is calculated only for the period of actual utilization only.

Commitment Charge

Since banks have to keep funds idle up to the credit limits sanctioned to customers, they may levy a commitment charge on utilized limits of credit.

Reserve bank of India had made it obligatory for all scheduled commercial bank to levy a commitment charge @ one per cent per annum on the unutilized portion of the credit limits in excess of Rs.10 lakh with effect from 1st April, 1970. This levy of commitment charge was withdrawn by the Reserve Bank of India with effect from 1st Nov. 1975.

With effect from January 1, 1991 commitment charge was reintroduced with two objectives, namely :- (1) to bring about discipline in availing bank finance by borrowers, and (2) to facilitate better funds management by banks. The salient features of the directive given by the reserve Bank to banks in this regard are as follows :-

(1) It will apply to all borrowers with working capital limit of Rs.1crore and over.
(2) It will imposed @1% p.a. on the unutilized portion of working capital sanctioned to borrowers, subject to a tolerance level of 15% of the quarterly operating limit. It means that no charge is to be made if the operating limit specified by the borrower for a given quarter remains unutilized within the range of 15% only.
(3) The ''unutilized portion'' of the operating limit shall be ascertained by the banks by calculating the average utilization during the quarter after excluding there form utilization in excess of the operative sanctioned limit. The difference between the average utilization thus determined and the operative sanctioned limit. The difference between the average utilization thus determined and the operative sanctioned limit, as the case may be, shall be treated as utilized portion.
(4) Where the utilized portion (as determined above) exceeds the tolerance level of 15%, the charge to be imposed on the entire unutilized portion of operative /sanctioned limit and not only on the portion in excess of the tolerance level.
(5) This charge will not be imposed on the following limits:-
    (a) Working capital limits sanctioned to sick/weak units
    (b) Limits sanctioned for export credit and against export incentives
    (c) Inland limits
    (d) Credit limits granted to commercial banks, financial institutions and co-operative banks.

The above mandatory requirement to a levy a commitment charge on unutilized portion of the cash Credit limits was withdrawn with effects from July 1, 1996.

The Reserve Bank has advised the banks to evolve their own guidelines to ensure credit discipline and a levy a commitment charge. Thus, the commitment charge now depends upon the discretion of individual banks.

Advantages of Cash Credit

1. Flexibility :- The borrowers need not keep their surplus funds idle with themselves. They can recycle the funds quite efficiently and can minimize interest charges by depositing all cash accruals in the bank account and thus keeping the drawals at the minimum level. The system thus ensures lesser cost funds to the borrowers and better turnover of mind for the banks.
2. Operative convenience : Banks have to maintain one account for all the transactions of a customer. The repetitive documents can be avoided.

Disadvantages of Cash Credit

1. Fixation of credit limits :- The cash credit limits are prescribed once in year. Hence, it gives rise to the practice of fixing large limits than is required for most part of the year. The borrowers misutilise unutilized gap in times of credit restraint.
2. Bank's liability to verify the end-use of funds : Under this system the stress is one security aspect. Hence, there is no conscious effort on the part of the banks to verify the end-use of funds. Funds are diverted, without the banker's knowledge, to unapproved purposes.
3. Lack of proper management of funds : Under this system the level of advances in a bank is determined not by how much the banker can lend at a particular time but by the borrower's decision to borrow at the time. The system, therefore does not encourage proper management of funds by banks.

These weaknesses of the cash credit system were highlighted by a number of committees appointed for this purpose in India. Guidelines have been issued by the Reserve Bank for reforming the cash credit system on the basis of recommendation of the tendon Committee and the chore committee.

Overdrafts

When a current account holder is permitted by the banker to draw more than what stands to his credit, such an advance is called an overdrafts. The banker may take some collateral security or may grant such advance on the personal security of the borrower. The customer is permitted to withdraw the amount as and when he needs it and when he needs it and to repay it by means of deposit in his account as and when it is feasible for him. Interest is charged on the exact amount withdrawn by the customer and for the period of its actual utilization.

Generally, an overdraft facility is given by a bank on the basis of a written application and a promissory note signed by the customer. In such cases an express contract comes into existence. In some cases, in the absence of an express contract to grant overdraft, such an agreement can be inferred from the course of business. For example, If an accountholder, even without any express grant of an overdraft facility, overdraws on his account and his cheque is duly honoured by the bank, the transaction amounts to a loan. In Bank of Maharashtra vs. United Construction Co. and Others (AIR 1985 Bombay 432), the High Court concluded that there was an implied agreement for grant of overdraft or loan facility.

Bank should therefore, obtain a letter and a promissory note cooperating the terms and conditions of the facility including the rate of interest including the rate of interest chargeable in respect of the overdraft facility. This is to be complied with even when the overdraft facility might be temporary in nature.

Loans on Guarantee

Section 126 of the Indian Contract Act, 1872, defines a contract of guarantee as "a contract to perform the promise, or discharge the liability, of a third person in case of his default".

The person who gives the guarantee is called the surety; the person in respect of whose default the guarantee is given is called principal debtor, and the person to whom the guarantee is given is called the creditor. A guarantee may be either oral or written.

Significance of guarantee as a security for loans granted has greatly increased in recent years. Since the introduction of social control on the banks and specially after the nationalization of major banks, greater attention is being paid towards augmenting bank advances for a small and neglected borrowers who are enable to provide sufficient tangible assets as security. To safeguard the interests of the lending bankers arrangement has been made for providing guarantees in respect of such advances by the Deposit Insurance and Credit Guarantee Cooperation of India.

Another contract, which appears analogous to the contract of guarantee, is the contract of indemnity. Section 124 of the Indian Contract Act, 1872, defines the contract of indemnity as “a contract by which one party promises to save the other from loss caused to him by the conduct of any other person”.

Like any other contract, the contract of guarantee must be supported by a consideration. According to section 129 of the Indian Contract Act, 1872, “anything done, or any promise made, for the benefit of the principal debtor may be sufficient consideration to the surety for giving the guarantee”.

Difference between Contracts of Indemnity and Guarantee

In the case of a contract of guarantee, there are three parties, viz.,

(i) The surety or guarantor;
(ii) The principal of debtor; and
(iii) The creditor.

In the case of a contract of indemnity, there are only two parties, viz.,

(i) The promise or the indemnifier; and
(ii) The party to be indemnified or insured.

In the case of indemnity contracts, the promisor undertakes to indemnify or make good the loss of the other party in certain circumstances. All contracts of insurance are indemnity contracts.

It will be seen, therefore, that in the case of a guarantee, the primary responsibility lies on the principal debtor and the surety’s obligation depend substantially on the default of the principal debtor. It is necessary that contracts of indemnity and guarantee should be supported by a consideration like all other simple contracts. It would be sufficient consideration if anything is done or promised by the creditor for the benefit of the principal debtor, surety or any other person. It may be noted here, that the guarantor is collaterally liable, and, therefore, if he pays out the debt, the principal debtor is not released from his liability, but the guarantor steps in the place of the creditor.

Precautions to be taken by Banker

The banker should never accept the guarantee of a minor or a lunatic because contracts with such a person are void. Although married women can give a valid guarantee which will bind their separate property (stridhan), A banker should avoid such a guarantee because to evade liability, a married woman may plead that when she signed the contract she acted under coercion or under the influence of her husband, particularly when he himself or a relative or a friend of his happened to be the principal debtor. A banker should also be very cautious before he accept the guarantee of registered companies, for such a guarantee requires a careful scrutiny of the powers of the company stated in its memorandum and Article of Association. In the case of a partnership standing as surety, all partners must join unless the giving of a guarantee forms the part of partnership business, or all copartners definitely authorize one particular partner to sign a particular partner to sign a particular guarantee. The banker should take care to see that the authority given by the copartners is in writing.

Specific and Continuing Guarantee

A specified guarantee is a promise to be collaterally answerable only for one specific transaction, or one which comes to an end on the repayment of the advances for which it was given.

A continuing guarantee is a guarantee which extends to a series of transactions.

Disclosure of Material Facts

An important factor in a guarantee contract is that the guarantor should enter into his agreement with the full knowledge of the facts and the nature of the responsibility of his undertaking. No alteration in the contract should be allowed to be made without due notice to and the consent of, the guarantor; otherwise the guarantor is freed from his liability. In the case of certain alterations, such as extension on credit, or a larger overdraft given that guaranteed, the banker would be safe if the power is taken by him in the guarantee bond; otherwise the guarantor should be a consenting party.

Misrepresentation or Concealment of Material Facts

According to section 142 of the Indian contract Act, 1892, “any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of transaction is invalid”.

Section 143 of the same Act states that, “any guarantee which is the creditor has obtained by means of keeping silence as to material circumstances is invalid”.

Thus, it becomes clear that a creditor must not represent the material facts and also must not keep silent about any material fact.

The following Point Are to be noted in this regard:

1. It is important that the misrepresentation or concealment must relate to the material part of the transaction. What is material in a particular transaction depend upon the circumstances of each case. However, it may be stated that any fact or information which may affect the willingness of the surety to enter into a contract of guarantee or not, is considered to be a material fact.
2. Under both the sections, it is the creditor (rather than the debtor) who is required not to misrepresent or not to keep silence as regards any material fact.
3. The words “keeping silence” in section 143 mean intentional concealment of facts. It means not disclosing a certain fact with purpose to defraud the other party.
4. In order to avoid a contract of guarantee under section 143, it is essential to prove that the guarantee was obtained by means of keeping silence as to the material circumstances. In other words, it is to be proved that the surety might not have entered into the contract of guarantee ,if silence was not kept as regards material fact.

Example: Indian Bank grants to loan of Rs. 1lakh to Y on the guarantee of Z, but without disclosing to the surety that Y had deceived the bank in the past by giving false description of the securities pledged with the bank. A material fact was thus concealed. The contract of guarantee is invalidated.

Joint and Several Guarantee

A guarantee may be given by more than one person, either jointly and severally, in which case the ordinary rules of joint and several contracts would apply. In joint guarantee, the banker would have to sue the guarantors jointly and obtain a decree against then in order to make them all responsible, because if he chooses to select one or two in the first instance, and fails to get satisfaction for the whole debt out of the decree so obtained, he cannot sue the others for the balance. In a joint and several guarantees, however, he can sue each of them in rotation until his full claim is paid. The usual guarantee forms of bankers are joint and several.

Death or Insolvency of Guarantee

The death or insolvency of a guarantor does not release his estate from liability for advances made by a banker. The banker should, as soon as he hears of either of incidents, close the account guaranteed until a fresh guarantee bond is given. In the event of the insolvency of guarantor, the banker, after closing the guarantor account, should demand immediate payment from the debtor and, failing to recover the money, put in a claim on the estate of the guarantor, his estate is freed from liability and the banker has to look to the remaining guarantors for the whole amount; but in the case of a joint and several guarantee, he can move against the estate of the insolvent or the deceased guarantor.

Application of Law of Limitation

Where the creditor fails to sue the principal debtors within the period fixed by the Limitation Act, the surety is not discharged. This is according to the judgments of Indian Courts.

Right of Banker against Surety

Lien - A banker can exercise his right of lien on the balance of account of the guarantor in his possession notwithstanding the fact that his claim under the guarantee is time-barred. The right of general lien can be exercised only when the default has been made by the principle debtor, in which case the banker should immediately inform the guarantor that the former has exercised his lien of the latter's money or securities deposited with him.

Right of Surety

In case the principal debtor makes a default makes a default in the fulfillment of promise and the surety has to meet his liability to the creditor, the surety steps into the shoes of the creditors and acquires all right of the creditor against the principal debtor. According to section 140 of the Indian Contract Act, "where a guaranteed debts has became due, or default of the principal debtor to perform a guaranteed duty has taken place, the surety, upon payment, or performance of all that he is liable for, is invested with all the rights which the creditor had against the principal debtor". Regarding the surety's right to the benefit of the creditor's securities Section 141 states as follows, "A surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of surety ship is entered into, whether the surety knows of the existence of such security or not; and if the creditor loses, or, without the consent of the security, parts with such security, the security is discharged to the extend of the value of the security".

According to the previous of Section 145, the surety has a right to recover from the principal debtor the amounts which he has rightfully paid under a contract of guarantee, but he cannot claim the amounts which he has wrongfully paid. The surety has also a right to revoke at any time a continuing guarantee by giving a notice of such revocation to the creditor. But according to Section 130, the surety may revoke a continuing guarantee as to future transactions only; he remains liable in respect of the transactions which have already taken place. According to Section 131, "the death of surety operates in the absence of any contract, as a revocation of a continuing guarantee, so far as regards to future transactions".

Surety's Right to be Discharged

In the following instances, a surety is entitled to a complete discharge-

(i) According to section 134 of the Indian Contract Act, 1872, if a creditor discharges the principal debtor, or acts in a manner the legal consequence of which is to discharge the principal debtor, the surety is discharged.

(ii) Section 135 of the Indian contract Act, 1872, says that if creditor without the consent of the surety, arrives at a compromise with or without promises not to sue the debtor, the surety is released.

(iii) Under Section 139 of the Act, if a creditor does any act which is inconsistent with the rights of the surety or omits to do any act which his duty to the surety requires him to do and thereby the eventual remedy of the surety against the principal debtor is impaired, the surety is liable.

(iv) In Anirudham vs. The Tomo's Bank Ltd, (I.M.& J.S.C., p. 137), the point for consideration was whether the surety was discharged by reason of the principal debtor having altered the amount in letter of guarantee without the concurrence of the surety. It was held that the surety eas liable.

Liability of the Surety

The liability of the surety is up to the same extend to which the principle debtor is liable to the creditor, provided the surety does not restrict his liability in the contract of guarantee. Section 128 of the Indian contract Act states "the liability of the surety is co-extensive with that of the principal debtor unless otherwise provided contract". As regards the time when the liability of the surety arises, it may be noted that the liability of the surety arises as soon as the principal debtor makes a default, it cannot be postponed. The creditor need not exhaust all remedies against the principal debtor before recover4ing the amount from the surety. In the bank of Bihar Ltd, vs. Damodhar Prasad and Another (Civil Appeal No.1109 of 1965) it was held by the supreme Court that "the liability of the surety is immediate and cannot be deferred until the creditor has exhausted his remedies against the principal debtor." In case the guarantee of the debts is given by more than one person, the liability of the co-sureties is determined according to the provisions of sections 146 and 147 of the Contract Act. According to Section 146 " where two or more persons are co-sureties for the same debt or duty either jointly or severally whether under the same or different contracts, and whether with or without the knowledge of each other, the co-sureties, in the absence of any contract to the contrary, are liable, as between themselves, to pay each in equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor." Provisions in Section 147 state that the co-sureties are liable to contribute equal amounts towards the liability of the debtor, provided there is no agreement to the contrary; and they are co-sureties for the same amount of debt. It is immaterial whether the contract of the guarantee was the same or separate between each of them and the creditor and whether they knew about the guarantee given by the other person or not.

Termination of Guarantee

The guarantee may be terminated by-

(a) Revocation (Under Section 130 of the Contract Act); or
(b) Death of Surety : In this case, the banker should stop the account so that the amount borrowed may not be wiped out by any further payment made by the customer to his credit. The same position obtains in the event of insanity of the surety.

The insolvency of a surety terminates his guarantee so far as further advances to the principal debtor are concerned.

If only one of the parties who has signed the guarantee jointly becomes insolvent, the banker can seek his remedy against the solvent guarantor as well as the estate of the insolvent.

Reserve Bank's Guidelines on Personal Guarantees

A review of practices of commercial banks regarding personal guarantees taken from directors and other managerial personnel borrowing concerns at time of sanctioning loans conducted by the Reserve Bank revealed that in some cases, the guarantees had been taken essentially to make up for the insufficiency of tangible security offered or the weak financial position of the borrowing concern. In other cases, guarantees had been taken as matter of routine even where the financing institutions possessed the security of the company's tangible assets. Banks feel that with the signing of the guarantees, personal interest of the directors and other managerial personnel in the company is strengthened and hence continuity of good management in future may reasonable be expected.

In the view of the Reserve Bank of India the practice of taking guarantees of all cases is not necessary because of the following changed circumstances-

(i) There has been gradual rise of an entrepreneurial class in the place of Managing Agency System and the managerial cadres have been professionalized :
(ii) Financially sound units are able to offer adequate security of meeting their banking needs; and
(iii) The techniques of financial and technical appraisal by the lending institutions have improved.

In 1970, the Reserve Bank of India had issued detailed guidelines to commercial banks as regards personal guarantees from the directors. Guarantee should be obtained only in circumstances absolutely warranted after a careful examination of the circumstances of each case and not as a matter of course. Detailed credit analysis should be undertaken by the banks to determine the need of guarantees. The following broad considerations may be taken into account in this connection:

(a) Guarantees need not be considered necessary in the following cases:
    (i) Ordinarily in case of public limited companies no personal guarantee need be insisted upon if the lending institutions are

satisfied about the management, its stake in the concern, economic viability of the proposal and the financial position and the capacity for cash generation. In case of widely owned public limited companies, which may be rated as first class and which satisfy the above conditions, guarantees may not be necessary even if the advances are unsecured.

(ii) In case of companies – private or public – which are under professional management, guarantees may not be insisted upon from the persons who are connected with the management solely by virtue of their professional/technical qualifications and not consequent upon any significant shareholding in the company concerned.

(iii) Where the lending institutions are not convinced about the above-mentioned aspect of loan proposals they should seek to stipulate conditions to make the proposals acceptable without such guarantees. In some cases, more stringent forms of financial discipline like restrictions on distribution of dividends, further expansion, aggregate borrowings, further charge on assets and stipulations of maintenance of minimum net working capital may be necessary. The parity between owned funds and capital investment and the overall debt-equity ratio may have to be taken into account.

(b) Necessity of guarantee: The Reserve Bank has indicated that guarantees may be considered helpful in the following cases:

(i) Closely held companies – the guarantee should preferably be that of the principal members of the group holding shares in the borrowing company;

(ii) In case of other companies, in order to ensure continuously of management;

(iii) Public limited companies other than first class companies where advances are on an unsecured bases;

(iv) Public limited companies, whose financial position and/or capacity for cash generation is not satisfactory even through the advances are secured;

(v) In case where considerable delay in the creation of a charge ojn assets likely;

(vi) The guarantee of parent companies in the case of subsidiaries whose financial condition is not considered satisfactory, and

(vii) Where the balance sheet or financial statement of company concerns owned or managed by group.

Other Instruction: (a) The guarantees should bear reasonable proportion to the estimate worth of the person.

b) Banks should obtain an undertaking from the borrowing company as well as from the guarantor that no consideration in the form of commission, brokerage, fees, etc., will be paid by the company to the guarantor directly or indirectly.

Keeping in view the increasing loan losses being suffered by the banks on account of sticky or stagnant accounts due to industrial sickness, the Reserve Bank advised the bank (July 1986) as follows:

(a) The banks may, at their discretion, obtain guarantees from directors (excluding the nominee directors) and other managerial personnel in their individual capacities whenever they consider necessary.

(b) In cases where a guarantee is not considered expedient by the bank at the time of sanctioning an advance, an undertaking should be included in the loan agreement that in case the borrowing unit shows cash losses or adverse current or diversion of funds, the directors would excute guarantees in their individual capacities, by the banks.

(c) Banks may also obtain guarantees at their discretion from the parent holding company, when credit facilities are extended to borrowing units in the same group.

The Reserve Bank further advised the banks that ordinarily banks need not insist on personal guarantees from professional managers/directors except in cases where they have a significant shareholding in the company. If the management commits serious malpractices, the right remedy would be to have them removed or replaced.

LOAN

Loan is a method of lending under which the bank gives credit to borrower for fixed period and for a specific purpose. Many a times, as a borrower needs fund for fixed asset or non-repetitive type of activities and thus, seeks money from the bank which is withdrawn in one lump sum. If the borrower needs again funds for such purpose, he has to negotiate with the bank for a loan again or to get his existing loan renewed. The loan amount is normally repaid in installments. Loans may be short-term, medium-term or long-term loans are generally taken for meeting the capital investment requirements. Such loans are called “term loans”. When a loan is meant for meeting both fixed capital and working capital requirements of a borrower, it is called composite loan.

Advantages of Loan System

1. Financial discipline on the borrower: As the time of repayment of the loan or its installments is fixed in advance, this system ensures a greater degree of self-discipline on the borrower as compared to the cash credit system.
2. Periodic Review of Loan Account: Whenever any loan is granted or its renewal is sanctioned the banker gets an opportunity of automatic reviewing the loan account. Unsatisfactory loan accounts may be discontinued at the discretion of the banker.
3. Profitability: The system is comparatively simple. Interest accrues to the bank on the entire amount lent to a customer.

Disadvantages

1. Inflexibility: Every time a loan is required, it to be negotiated with the banker. To avoid it, borrowers may borrow in excess of their exact requirements to provide for any contingency.
2. Banks have no control over the use of funds borrowed by the customer. However, banks insist on hypothecation of the asset/vehicle purchased with loan amount.
3. Though the loans are for fixed periods, but in practice they roll over, i.e. they are renewed frequently.
4. Loan documentation is more comprehensive as compared to each credit system.

Types of Loans

Banks grants loans for different period – shorts, medium and long, and for different purposes. Broadly, the loans granted by banks are classified as follows:

Bank Loans

Short-term Medium and Bridge composite Consumption

Loans Long-term Loans Loan Loans

Short-term Loans

Short-term loans are granted to meet the working capital needs of the borrowers. These loans are granted against the security of tangible assets – mainly the movable assets like goods and commodities, share, debentures etc. Since April 1995 Reserve Bank of India has made it mandatory for the banks to grant a portion of bank credit to big customers in the form of loans, which may be for various maturities. The Reserve Bank has also permitted the banks to rollover such loans, i.e. , to extend the loan for another period at the expiry of the tenor of first loan.

Term-Loans

Medium and long-term loans are usually called Term Loans. These loans are granted for more than a year and are meant for purchase of capital assets for the establishment of new units and for expansion or diversification of an existing unit. Banks usually grant such loans together with specialized financial institutions like Industrial Finance Corporation of India, Industrial Credit and Investment corporation, etc. Such loans constitute a part of the project finance which industrial enterprises are required to raise from different sources. These loans are usually secured by the tangible assets like land, buildings, plant and machinery, etc.

In recent years, Reserve Bank for India had encouraged banks to lend for projects as well. Exposure limits have been laid down at Rs.200crore for each bank lending to a project and Rs.500crores is the overall exposure limit for all banks to a single project.

Bridge Loans

Bridge loans are essentially short-term loans which are granted to industrial undertaking to meet their urgent and essential needs during the period when formalities for availing of the term loans sanctioned by financial institutions are being fulfilled or necessary steps are being taken to raise the funds from the capital market. These loans are automatically repaid out of amount of the term loan or the funds raised in the capital market.

In April 1995 Reserve Bank of India banned bridge loans granted by banks and financial institutions to all companies. But in October 1995 Reserve Bank permitted the banks to sanction bridge loans/interim finance against commitment made by the financial institution or another bank where the lending institution faces temporary liquidity constraint subject to the following conditions:

(i) The prior consent of the other bank/financial institution which has sanctioned a term loan must be obtained.
(ii) The term lending bank/financial institution must give a commitment to remit the amount of the term loan to the bank concerned.
(iii) The period of such bridge loans should not exceed four months.
(iv) No extension of time for repayment of bridge loan will be allowed.
(v) To ensure that bridge loan sanctioned is utilized for the purpose for which the term loans has been sanctioned.

Composite Loans

When a loan is granted both for buying capital assets and for working capital purposes, it is called a composite loan. Such loans are usually granted to small borrowers, such as artisans, farmers, small industries, etc.

Consumption loans

Though normally banks provide loans for productive purposes only, but as an exception loans are also granted on a limited scale to meet the medical needs or the educational expenses or expenses relating to marriages and other social ceremonies, etc, of the needy persons. Such loans are called Consumption loans.

Classification of Loans and Advances: Secured and Unsecured

The loans and advances granted by banks are broadly classified into:

i) Secured, and (ii) Unsecured, According to Section 5 (a) of the Banking Regulation Act, 1949, a secured loan or advance means a loan or advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance; and unsecured loan or advance means a loan or advance not so secured. Thus, the distinguishing features of the secured loan or advance as follows:

(i) The loan must be made on the security of tangible assets like goods and commodities, land and buildings, gold and silver, corporate and government securities, etc. A change on any such assets offered as security must be created in favour of the banker.

(ii) The market value of such security must not be less than the amount of the loan at any time till the loan is repaid. If the former falls below the latter because of decline in the market prices, the loan is considered as partly secured.

The distinction between secured and unsecured loan is made on the bases of legal title or charge created in favor of lender. Under the traditional principles of lending, the borrowing capacity of the person is judged on the basis of the tangible assets in the possession of the borrower, i.e., the larger is the creditworthiness of a borrower, if larger is the value of his tangible assets. However, it should not be understood that unsecured loans, also called clean loans and advances, are granted to persons without observing the above-mentioned creation of creditworthiness. In fact, unsecured loans are also granted to persons of sufficient means, possessing tangible assets and with sound financial position, but no charge or right is created on any such assets the borrower in favor of the banker. In such cases, the security happens to be the personal obligation of the borrower in the borrower which is sometimes supported by a guarantee given by a third party regarding the payment of the loan. Clean advances are obviously granted to parties enjoying high reputation and sound financial position. Unsecured advances are granted with caution and within certain limits only because in case of the default by the borrower, the banker stands at par with other unsecured creditors.

In case of secured advances, the legal states of the banker is that of secured creditors; he gets the first and absolute right to recover his dues out of the sales proceeds of the assets over which a charge is crated in favor of the banker. Where money is advanced on (for the repayment of loan) is ruled out because that would frustrate the very purpose of taking security (Central Bank of India vs. M/s. P.R. Garments Industries Pvt. Ltd., 1985 (2) xxvi Gujarat Law Reporter p. 919.)

Secured Advances:

Modes of Creation of Charge

The various methods by which a bank's advance may be secured are:

(i) Lien;
(ii) Pledge; and
(iii) Mortgage.

(i) **Banker's Lien**: The right to retain goods is known as lien. The phrase general line is used to distinguish it from a particular lien of craftsman of goods on which he has expended labour, time or money. The banker's general lien confers upon him the right to retain the securities, etc., in respect of the general balance due from their owner to the banker. It is purely possessory and does not transfer the property or the right of ownership to the banker. By usage and statute, the banker's lien is an implied pledge conferring upon him the power of sale in certain events.

Negative lien: Negative lien is to be distinguished from lien. Under the negative lien, the banker does not get the right to retain any asset of the borrower. The borrower gives a declaration to the banker that his assets of mentioned therein are free from any charge or encumbrance. He also gives an undertaking that he shall not create any charge over them or dispose them of without the permission of the banker. The borrower cannot dispose of the assets or crate any charge thereon without the consent of the banker. The banker on the other hand, is not entitled to realize his dues from the said assets of the customer. His interests are thus partly safe by securing a negative lien.

(ii) **Pledge**: A pledge is defined as a bailment of goods for security for the payment of a debt or performance of promise. The ownership remains with the pledger, subject only to the qualified property passes to the pledge by virtue of the bailment to him. (Section 172 of the Contract Act).

Delivery is necessary before a pledge is deemed to have been completed. There is one distinction between a lien and a pledge, viz., in the case of lien, the property, though in possession of the creditor, is still in the full ownership of the borrower. In the case of pledge, however, not only the exclusive possession of the property is with the lender, but the lender also acquires the right or power to sell, without express agreement, by the end of a transaction after giving a reasonable notice to the pledger.

In the case of a pledge, there should be bailment of goods on behalf of a debtor a debtor and the objective of such bailment should be to hold the goods as security for the payment of a debt or a performance of a promise. The person (customer) who offers the security is called the "pledger" – or "Pawner" – and the bailee is called the "pledge" or the "pawnee".

The banker as pledge has a right (vide section 173 of the Indian Contract Act) to retain the goods pledged for the payment of the debt or the performance of the promise and also from the amount of interest due to on the debt and the necessary expenses incurred by him in connection with the possession or for the preservation of the goods pledged. According to section 174, this right is applicable only in case of a particular debt for which the debt for which the goods are pledged in the absence of an agreement to the contrary. In case of default by the pledger, the banker as a pledge has a right (vide Section 176) either to file a civil suit against the pledger for the amount of due and retain the goods as a collateral security or to sell the goods pledged after giving a reasonable notice of sale to the pledger.

Goods can be pledged by any one who is in legal possession of the same, namely,

1. The owner of the goods himself.
2. **The mercantile agent of the owner**: According to Section 178, "where a mercantile agent is, with consent of the owner, in possession

of goods or the document of little of goods, any pledge made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorized by the owner of the goods to make the same, provided that the pawnee acts in good faith and has not, at the time of pledge, notice that the pawner has no authority to pledge".

3. **Joint**-owner with the consent of other co-owner: If the interest of the pledger in the goods is to a limited extend only, he can pledge the same to the extent of his limited interest. But in such cases the rights of an innocent third party are well protected, if a second pledge is made to him.
4. If a person obtains possession of the goods by fraud, misrepresentation, coercion or undue influence, such a contract is voidable at the option of the goods provided the following conditions are fulfilled:
   (a) The contract has not been rescinded before the contract of pledge is entered into.
   (b) The pledge acts in good faith and without notice of the defective title of the pledger.
5. If a buyer leaves the goods or document of title to goods after sale in the possession of the seller, the latter may make a valid pledge of the goods provided the pledge acts in good faith and he has no notice of sale of goods of the buyer.
   Similarly a buyer, who obtains possession of the goods with the consent of the seller, before the title of the goods passed on to the buyer, may also make a valid pledge.
6. A pledge can himself repledge the goods but such repledge will be valid only up to extend of his interest in the goods pledged.

Rights of a Banker as a Pledgee

1. The pledgee has the right to retain the goods pledged for the payment of the debt or the performance of the promise and also for the amount of interest due on the debt and the necessary expenses incurred by him in connection with the possession or for the preservation of the goods pledged (Section 173). This right is applicable only in case of particular debt for which the goods are pledged, in the absence of an agreement to

the contrary (Section 174). The pledge can also claim any extraordinary expenses incurred by him for the preservation of the security.

2. In case of default by the pledge to make payment of the debt, the pledgee has the the right either –
    a) To file a civil suit against the pledger for the amount due and retain the goods as collateral security; or
    b) To sell the goods pledged after giving the pledged after giving the pledger reasonable notice of sale (Section 176).

The pledgee can resort to these steps only when the pledger defaults in making payment of the debt and not earlier. In case of loans repayable after a fixed period, default takes place if the loan remains unpaid after the expiry of the stipulated period. In case of loan repayable on demand, default takes place if, on receipt of notice from the creditor demanding the repayment of the loan by a specified date, the debtor fails to do so within the period allowed by creditor.

3. The pledger is bound to disclose to the pledgee the faults, if any to the goods pledged which are within his knowledge and which materially interfere with the use to those goods or expose the pledgee to extraordinary risks. If the pledgee suffers any damage as a result of non-disclosure of such fault by the pledger, the latter shall be responsible for it.
4. If the title of the pledger to the goods pledged is defective and the pledgee suffers any loss due to this fact, the pledger shall be responsible for such loss.
5. If the pledgee has given his consent as a result of inducement by fraud or misrepresentation in this regard or in regard to pledger's interest in the goods, the contract would be voidable at the option of the pledgee.
6. A pledgee's rights are not limited to his interest in the pledged goods but he would have all the remedies that the owner of the goods would have against a third person for deprivation of goods or injury to them. In Morvi Mercantile Bank Ltd., vs. Union of India, the Supreme Court held that the bank (pledgee) was entitle to recover the full value of the consignment from the railways, namely, Rs.35000 and not only the amount due to it he from the customer, namely, Rs.20000.

Duties of the Pledgee

1. The pledgee is bound return the goods on payment of the debt. It is the duty of the pledge to restore the goods to the pledger or to deliver the goods according to the directions of the pledger as soon as the obligation to repay the amount is discharged.
2. The pledgee is responsible to the pledger for any loss, destruction or deterioration of the goods, if the goods are not returned by the pledge at the proper time (Section 16).
3. The pledge is bound to use the goods pledged according to the agreement between the two parties. If he violates any of the conditions of the pledge, the contract would be voidable at the options of the pledger. He is also liable to make compensation to the pledger if he suffers any damage due to the unapproved use of the goods pledged (Section 153).
4. The pledgee is also bound to deliver to the pledgee any increase of profit which may accrued from the goods bailed in the absence of an agreement to the contrary (Section 163). In M.R. Dhawan vs. Madan Mohan and Others (A.I.R.1969 Delhi 313), the borrower pledged certain shares with banker. The right of the pledge to the dividends and the rights and bonus shares issued in respect of pledged shares was disputed by the pledger.
5. The pledge is bound to take as much care of the goods pledged as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quantity and value as the pledged goods (Section 151). If he has done so, he is not responsible for the loss, destruction of deterioration of the goods pledged (Section 152).

Hypothecation

Another term analogous to the pledge is hypothecation. In the case of hypothecation, a charge is given on property or goods for the amount of the debt, the owner, however, retaining their ownership as well as possession. The pledge, as discussed above, implies the transfer of possession to the creditor. Where possession is not so transferred but a mere charge is given on property retained by the owner, the property is said to be hypothecated. The instrument which creates such a charge is known as the letter of hypothecation. In actual business practice however, this term is used loosely. The memorandum giving a charge on documents of title pledged with a banker as security and authorizing him to dispose of the goods if the pledge fails to meet his obligation is commonly known as letter of hypothecation.

In hypothecation (which is also called an open loan), possession is not transferred to the banker, and, therefore, such an advance is no better than a clean loan. Such an advance is, therefore, granted only to a person in whose integrity the banker has full confidence. Moreover, certain other precautions should be taken by the banker; for example, he must ascertain the specific goods hypothecated; an undertaking should be taken from the borrower that he would not borrow elsewhere; insurance against all risks, including fire, should be effected on all the goods; it is necessary to have a regular periodical inspection of the goods as well as the books of accounts and the stock disclosed by the books should be verified with the stock on hand; a careful watch should be kept to ensure that the goods hypothecated do not stagnate or clog and became and unsaleable.

In case of a pledge, possession of goods and not ownership passes to the creditor (banker). This form of advance also calls for great care on the part of the banker who should make the proper arrangements for the stocking of pledged goods in a godown. The godown must be properly insured. It is also necessary to ascertain that the borrower has a proper title to the goods pledged.

It was noticed by the Reserve Bank of India that in practice many businessmen hypothecated same stocks with more than one bank. Many banks had granted loans to shopkeepers and small traders without verifying whether they were getting the benefit of similar credit facilities from other banks. This type of double financing was considered undesirable by the Reserve Bank, and the banks were advised to observe the following precautions in this regard:

(a) Before sanctioning any credit limit, the bank should ensure that the applicant is not enjoying similar facilities with other banks. In case he is having credit facilities from any other bank/banks, detailed information should be called from by the bank from those banks. As far as possible, parties should be advised to restrict their borrowing to only one bank.
(b) The bank should obtain from the borrower a written application accompanied by a declaration about the existing credit arrangements and an undertaking that the stocks will not be hypothecated to any other bank without the prior approval of the bank. The undertaking should also be incorporated in the stock statements which the borrower is required to

submit to the bank periodically. The terms of transaction should also stipulate that the advance will be recalled forthwith in case it is subsequently found that he has made a false statement in this regard.

(c) Before granting credit facilities to the party, as also during the pendency of the advance, an officer of the banks should inspect the stocks with a view to ensuring that the same stocks have not been hypothecated to other banks. He should record such information in his report relating to his periodical inspection.

(d) In case the borrower is allowed to avail himself of credit facilities against hypothecation of stocks from various banks, it should be ensured that such stocks are segregated or demarcated in different godowns/shops and the same are properly recorded in separate stock books so as to facilitate easy verification by the banks officials.

Mortgage: In Section 58 of the Transfer of Property Act, 1882, the term mortgage has been defined as, "the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of engagement which may give rise to a pecuniary liability."

Except in the case of an equitable mortgage, a mortgage has to be effected by a registered deed, signed by the mortgager and attested by at least two witnesses. Unlike a pledge, a mortgage does not necessarily involve the transfer of possession, although in certain forms of mortgage the creditor does, as a matter of fact, gain possession of the mortgage property. Furthermore, unlike a pledge and a hypothecation which are in respect of movable property, a mortgage is effected always in respect of immovable property.

Mortgage by Deposit of Title Deeds

Mortgage by deposit of title deeds is, in essence, a simple mortgage, whereby a charge in equity is created on the property, for it is provided under Section 96 of the Transfer of property Act that the provisions as regard redemption of mortgages by deposit of title deeds. The mortgage in this case is created by the deposit of documents of title along with a memorandum in which the debtor undertakes to pay a sum of money by a certain date, together with interest at the agreed rate. It is mode of creating a legal mortgage under which the interest in the mortgaged property is transferred to the mortgagee.

English Mortgage

Under Section 58 of the Transfer of Property Act, when the mortgagor binds himself to repay the debt on certain date and transfers the mortgaged property absolutely to mortgagee, but subject to the proviso that, he will retransfer it to the mortgager upon repayment of the mortgage money as agreed, the right created is known as an English mortgage. Thus, an English mortgage is, in form, transfer of ownership to the mortgagee, with a covenant to repay the debt on a certain date and a proviso that, on condition being fulfilled, the mortgage will retransfer the property to the mortgage. The remedy available to the mortgagee is sale through the intervention of the court in a normal legal manner, but not a foreclosure (i.e., forfeiture of the mortgaged property by way of appropriation by the mortgagee against the debt). This is because, in the case of sale, the mortgagor has the right to the surplus in the sale proceeds of the mortgaged property left over after the appropriation of the debt.

Equitable Mortgage

A bare deposit of title deeds, with an intent to create a security on the property comprised therein, amounts to an equitable mortgage of the property. Equitable mortgages have received statutory recognition in India.

Simple Mortgage

In the case of a mortgage, the mortgagee has two rights:

(i) To sue mortgagor personally on his personal convent to repay; and
(ii) to recover the amount from the property itself which is virtually hypothecated with him.

Both these remedies may Resorted to at the same time or in succession. Here, the transfer is said to be that of the right of sale. A simple mortgage differs from a charge in this that a charge may not necessarily be given on a specific property but may extend over all the property, including movables, and it does not involve a transfer which is essence of a mortgage.

Mortgage by Conditional Sale

In the case of mortgage by condition sale, the mortgagor ostensibly sells the mortgaged property on the condition that **-**

(i) The sale shall become absolute on default in mortgage money; or
(ii) On payment of such money, the sell shall become void; or
(iii) That on such payment being made, the buyer shall transfer the property to the seller.

These condition must be embodied in the document which effects or purports to effect the sale.

Usufructuary Mortgage

In the case of a usufructuary mortgage, the repayment of the loan begins as soon as mortgage is effected. Here the mortgagor delivers possession of the mortgaged property to the mortgagee, or expressly or impliedly agrees to do so, and authorizes him to retain it until the repayment of the mortgage money. Meanwhile, he is authorized to receive the rents and profits and accruing from the property or any part of it, in payment of the interest or part of the mortgage money or both.

The main element in this type mortgagee is the transfer of possession over the mortgaged property to the mortgagee, who is entitled to receive income accruing there from. By this arrangement the liability of the mortgagor is gradually reduced. In *Arumugam pillai vs.Maruthakutti Gownder* (AIR 1973, Madras 242) the Madras High Court held that "when the mortgagor and mortgagee agree that the entire amount due for payment to letter, should be recouped by the mortgagee by the enjoyment of the usufructs from the mortgaged property over a specified number of years, the documents may not refer any to interest payable on the principal, even though an element of interest and its rate and income from the property might have gone into their calculation. They may agree to limit the period of such enjoyment, and thereafter deliver the possession to the mortgagor. As the mortgagor binds himself personally to repay the mortgage money, no suit for repayment of the mortgaged money can be filled against him. The mortgagee has only one remedy, i.e., to retain his possession over the property and to recover his dues from income accruing there from.

Anomalous Mortgage

A mortgage which is not simple mortgage, mortgage by conditional sale, usufructuary mortgage, English mortgage deposit of the title deeds (Equitable mortgage) as per the provisions of Section 58 of the Transfer of

Property Act is Anomalous mortgages. Even a slight variation from the terms prescribed in Section 58 for different types of mortgages, a mortgage will be called Anomalous mortgage, Shri Ram Dayal and Others vs. Bhanwar Lal and Others (AIR 1973, Rajasthan 73) both the principle and interest were secured by the mortgage of the properties, the possession of which was handed over to the mortgagee, who in additional took personal liability for the payment of the interest which was the part of the mortgaged money and also secured by the mortgage of the property. The mortgage deed stipulated that if the rents and profits were less than the amount of interest, then the mortgagor would be liable to pay the balance every year and be liable for compound interest, if the were not deposited in time. The Rajasthan High Court held it an anomalous mortgage and not a pure usufructuary mortgage. In anomalous mortgage, the rights and liabilities of the parties are determined by their contract as evidenced in the mortgaged deed, and if such contract does not extend, by local usage, according to the provision of Section 98 of the Transfer of Property Act.

Sub-mortgage

The mortgagee may himself like to sub-mortgaged to him by the mortgagor, for example, a company may mortgage its book debts to the bank for a loan. The need for such sub-mortgage may arise when a customer is unable to furnish any better security to the banker. The precautions to be taken by banker in cases of sub-mortgage include a notice to the mortgagor for confirmation of the amount due from him to the mortgagee. The banker should ask the mortgagor not to make payment to the mortgagee but to the bank. The banker should take the original mortgage deed and the title deed from the mortgagee. The sub-mortgage shall be subject to the terms and conditions stipulated in the original mortgage deed entered into between the mortgagee and the mortgagor.

Rights and Liabilities of Mortgagor

The mortgagor has the right of redemption; that is, at any time after the principal money has become due, he has a right on payment or tender, at a proper time and place, of the mortgage money, to require the mortgagee to deliver to the mortgagor deed and all documents relating to the mortgaged property which are in possession or power of the mortgagee to the mortgagor and at the cost of mortgagor either to retransfer the mortgaged property to him, or to such third person as he may direct, or to execute and where the mortgage has been effected by a registered instrument, to have registered an acknowledgement in writing that any right in derogation of his interest transferred to the mortgagee has been extinguished. Provided that the right conferred by this Section has not been extinguished by any act of the parties or by an order of a Court. The right conferred by this section is called the right of redemption.

The right of redemption can be claimed only when the money becomes payable and due and cannot be insisted upon before that date. A mortgagor cannot be deprived of his right of redemption, and no clause in the mortgage agreement which impeded or prevents redemption would be allowed by a court on the ground its being oppressive and unreasonable.

Implied Contracts by the Mortgagor

In the absence of a contract to the contrary, the mortgagor shall be deemed to contract with the mortgagee –

(i) That the interest which the mortgagor professes to transfer to the mortgagee subsists and that the mortgagor has the power to transfer this interest;

(ii) That the mortgagor will defend, or if the mortgagee be in possession of the mortgaged property, he will be enabled to defend the mortgagor’s title thereto;

(iii) That the mortgagor will, so long as the mortgagee is the mortgagee is not in possession of the mortgaged property, pay all public charges that may due in the property;

(iv) That where the mortgaged property is a lease for a term of years, the rent payable under the lease, the conditions contained therein and the contracts binding on the lessee have been paid, performed and observed up to the time of the commencement of the mortgage; and that the mortgagor will, so long as the security exists and the mortgagee is not in possession of the mortgaged property, pay the rent reserved by the lease, or if the lease is renewed, performs the contracts binding on the lessee, and indemnify the mortgagee against all claims preferred by reason of the non-payment of the said rent or the non-performance or non-observance of the said conditions and contract; and

(v) That where the mortgage is a second or subsequent encumbrance on the property, the mortgagor will pay the interest that accrues from time-to-time on each prior encumbrance as and when it becomes due, and will, at the proper time, discharge the principal money due on such prior encumbrance.

Mortgagor in Possession

A mortgagor in possession of the mortgaged property is not liable to the mortgagor for allowing the property to deteriorate; but he must not commit any act which is destructive or permanently injurious thereto, if security is insufficient or will be rendered insufficient by such act (Section 66).

Rights and Liabilities of the Mortgagee

The mortgagee has the right of foreclosure or sale; but this right is restricted only to a mortgage by conditional sale and/or to an anomalous mortgage. He has the right to sue for mortgage money. In the case of a subsequent mortgage, the subsequent mortgagee has the right to pay-off the prior mortgagee. Further, the mortgagee has a right against prior and subsequent mortgagees.

Precautions to be taken by Banker in the Mortgage of Immovable Property

The banker, when dealing with the mortgages and title deeds connected with immovable property, should take the following precautions:

(i) The title deeds should immediately shown to a competent authority for a report as to their genuineness and correctness.
(ii) The property should be valued at frequent intervals. Certain classes of house property rapidly deteriorate in value if they are not kept in proper condition of repair.
(iii) In dealing with lease-hold properties, allowance must be made for the fact that their value declines as the term of expiry approaches.
(iv) The customer should be required to produce a receipt for the ground rent of lease-hold property as soon as the period for payment has passed, for if this is not paid, the lease may forfeited.
(v) All house property should be insured against fire, and the customer should produce for the banker's inspection the receipt for each annual premium as it falls due.

(vi) Second mortgages of all kinds should be avoided, for the first mortgage may elect to foreclose and a forced sale may leave nothing for the second mortgage.

Sub-mortgage

The mortgagee may himself like to sub-mortgage the property mortgaged to him by the mortgagor. In certain cases, banks accept such sub-mortgages, when a customer is unable to furnish any better security. In accepting sub-mortgage the banker should take the following precautions:

(a) A notice should be given to the mortgagor who should be required to confirm the amount due from him to the mortgagee.
(b) The banker should direct the mortgagor not to make payment to the mortgagee but to the bank, being the sub-mortgagee.
(c) The sub-mortgage shall be subject to the terms and conditions stipulated in the original mortgage deed entered into between the mortgagee and the mortgagor. The banker should therefore scrutinize these terms very carefully.

Assignment

Assignment is another mode of providing security to the lending banker. “Assignment means transfer of right, property or a debt-existing or future.” The customer of a bank may assign any of his rights, properties or debts to the banker to secure loan. The transferer of such a right is called the “assignor” and transferee the “assignee”. The borrowers generally assign the “actionable claims” to the banker. Section 130 of the Transfer of Property Act, 1882 permits such assignment to anyone except to a judge, a legal practitioner or an officer of the court of justice. Section 3 of the Act defines, an “actionable claim” as a “claim to any debt, other than a debt secured by mortgage of immovable property by hypothecation or pledge of movable property, or to beneficial interest in movable property not in possession, either actual or constructive, of the claimant, which the civil court recognize as affording ground for relief, whether such debt or beneficial interest be existent, accruing conditional or continent.” In banking business, a borrower may assign to the banker (i) the book debts (ii) money due from Government department or Semi-government organization, and (ii) life insurance polici

ADVANCES AGAINST COLLATERAL SECURITIES

Securities may be classified asunder:

1. **Personal Security**: There is a personal right of action against the customer or a third party, e.g., a promissory note, guarantee, etc.
2. **Impersonal Security**: Here, the security can be realized by sale or transfer, e.g., land, shares, goods, etc.
3. **Direct Security**: Here, the security is deposited by the customer himself.
4. **Indirect or Third-Party Security**: Security deposited by another person, e.g., guarantee by an elder brother or securing the younger brother's account at the bank.
5. **Continuing Security**: According to the rule in Clayton's case, the secured advance would be decreased by subsequent payments into the account and all payments to the customer would from new advances, unsecured by the above-mentioned security. In order to provide against this effect of the rule in Clayton's case, the form of the bank security should be so worded as to make it a continuing one, covering the liability of the customer to the bank.

A Banker Usually secures his Advance by:

(i) Stock exchange securities
(ii) Bullions;
(iii) Goods;
(iv) Documents of the title to goods;
(v) Immovable property; and
(vi) Life policies

A banker can minimize his risk by spreading advances over a large variety of securities, deposited either by the borrower himself, or by someone else on his behalf as a guarantor. A **collateral security** is a security belonging to and deposited by a third party to secure a customer's account. These collateral securities are advantageous from the banker's stand-point because, the case of insolvency of the customer, he can prove for his whole debt in insolvency and receive from the customer's estate all he can in the course of distribution by the official assignee, and thereafter realize the securities with respect to the balance.

The usual practice should be to obtain a memorandum of deposit in a proper form. This is most essential because even though in law such memorandum is not necessary, the banker, by using it, protects himself by inserting in it the clauses necessary for such protection. According to statute, a banker has general lien on the cash and securities to his customer, which come into his possession in the regular course of his business for any debt that may be due to him. If, however, there is a specific agreement with the banker to the effect that he will not have a general lien or that he gives it up, this agreement will be binding on him. (Kuham vs. Bank of Madras). In the case of valuables or securities deposited only for safe custody, this lien does not arise. With regard to securities on which the banker is given the authority to collect interest and dividend, however, such a lien would extend to the dividend also, but not to the title deeds casually left with him on which he had previously refused to make an advance.

We shall now consider the banker's point of view on the various type of securities offered to secured advances.

Stock Exchange Securities: The term stock exchange securities include gilt-edged securities, such as government loans, municipal, ports trust and improvement trust bonds, and such other securities as are issued by a Government and public bodies, and shares and debentures of industrial and commercial companies, banks and insurance companies in which dealings take place on the stock exchange.

Advantages

(i) Reliability: These securities are more reliable than a guarantee where the banker has to depend entirely upon the solvency of the security for the recovery of the advance, in case the borrower makes a default.

(ii) Valuation: The market price of these securities is published in the daily papers and other economic journals. Hence, a valuation of these securities comparatively easier.

(iii) Ascertainment of Title: It is easier for a banker to satisfy himself whether the title of the customer to the securities offered is good.

(iv) Realisability: Stock exchange securities are more easily realizable than those of certain other kinds, viz., land, buildings and certain kinds of goods, because there is always a ready market for good stock exchange securities.

(v) Stability in Prices: Stock exchange securities are less liable fluctuations than commodities such as cotton, sugar, etc.

(vi) Transferability: These securities can be more easily transferred than certain other partially negotiable securities or land buildings.
(vii) Portability: The release of securities can be effected with a minimum of expense and formality.
(viii) Reduction in Indebtedness: These securities yield interest or dividend which, when received, reduces the borrower's indebtedness towards interest and often towards the principal as well.

Disadvantages

(i) Partly Paid-up Shares: In the case of partly paid-up shares, the banker may be called upon to pay the uncalled amount.
(ii) Company's Lien: The article association of a company generally provide that its shares will be subject to its lien in case of default in the payment of calls of them or of any other amounts due to them. A banker may, therefore, find that he cannot get the full benefit of securities if he fails to give a proper notice of his charge on them to the company concerned.
(iii) Non-Negotiable Securities: If the securities are not negotiable, their transfer cannot give to the transferee a better title than his own.
(iv) Transferee's Liability: A banker renders himself liable as transferee to indemnify the company against any loss it may suffer, if transferor's signature on the instrument of transfer turns out to be a forged one.
(v) Forged Scrips: Certain unscrupulous persons resort to the forging of scrips to obtain advances against them. In such cases, it becomes difficult for a banker to find out whether a particular scrip is genuine and in case of default, the advance may become difficult of realization.

Precautions to be Taken

A banker should take the following precautions if he is offered stock exchange securities as a cover for an advance:

(i) A banker should ascertain whether shares are partly paid-up. In the case of partly paid-up shares, he should make sure that no call has been made which the shareholder has failed to meet, because unpaid shares can be forfeited to the company. Moreover by getting such shares transferred in his name, a banker makes himself liable to any calls that may be due on them. When he is only an equitable mortgagee, has to find money for the payment of the calls on the shares to prevent their forfeiture.

(ii) With a view to eliminating the acceptance of undesirable securities, a banker has to be careful in selecting only those which he should accept as cover for his advances. He should consider the following factor in selecting securities.

(a) Study of Final Accounts: It is necessary for a banker a study the profit-and-loss account and balance sheet of a company for a number of years. Such a study gives him reliable estimate of the future prospects of the company.

(b) Study of Market Prices: A banker should also carefully study the market prices of stocks and shares. The market prices of the shares which are frequently dealt in are far more reliable than those in which stray transactions take place.

(iii) Between shares and debentures, a banker should prefer debentures, and in choosing between different kinds of shares, he should prefer preference shares are better than non-cumulative preference shares. A banker should also see to it that the shares selected as security are included in the approved list of one or two stock exchanges, and are freely dealt in; otherwise, it will become difficult for him to sell them in case of need.

(iv) A banker has to ascertain the market price of the securities offered against an advance. He should not always rely for the valuation of securities on the quotations given in daily or weekly papers. Particularly in the case of securities which do not appear in the "business done" column of the stock exchange quotation list. In the case of shares in which the business is done very infrequently, it is better to ascertain from the secretary of the company the rate at which the last transfer of its shares was registered.

(v) The next problem before a banker is about the charge of securities. In the case of fully negotiable securities, the property in them can be transferred by mere delivery, if they are bearer securities. But in the case of securities payable to a certain person or to his order, the delivery, complete with the endorsement of the person, is essential for transfer of property in them. If a banker takes such securities in good faith and for value, he gets a good title to them.

(vi) There are occasions where a banker has to accept to blank transfer. In such cases, he should take the precaution to give an immediate notice to the company concerned, informing it of the pledge to its shares with him. These will protect the banker, if the debtor is not already indebted to the company at the date of receipt of the notice, against subsequent debt with the company, the latter's lien will be deferred to that of the banker's claim.

Negotiable Securities

Negotiable securities are of four kinds:

(i) Bearer bonds;
(ii) Scripts to bearer. The term scrip generally employed to denote provisional certificates or documents indicating the subscription to so much of a loan or to so many shares. When the allotment money is paid, a scrip or provisional certificate is generally issued. Bonds are issued after the payment of the final installment. Scrip are held to be negotiable by the usage of bankers and dealers in public securities;
(iii) Shares and stock warrants to bearer generally;
(iv) Debentures payable to bearer generally.

Non-negotiable Securities

These are:

(i) Inscribed Stocks: Inscribed are so-called because the names of the holders of such stocks and amounts of their holdings are "inscribed", i.e., recorded, in the books kept either with the Government or with the corporation issuing them, or its agents. When such stock is to be transferred, it is necessary for its owner or his duly constituted attorney to go to the office where the books for the transfer of the securities are kept, and authorize the transfer of the stock he has sold.
(ii) Registered Stocks and Shares: Most of the stock exchange securities belong to this category, viz., registered stocks and shares. They are so-called because the registration of their transfer in the books of the

issuing company is necessary before a legal title is acquired to them. They are evidenced by certificates given under the seal of the issuing body.

Government securities from an excellent and the most liquid security from a banker's standpoint. In the case of the Indian Government securities, an endorsement is necessary, for they are made out as payable to order. Bearer securities accompanied by a memorandum need only to be deposited with a bank. The actual credit may be in the form of either an advance, an overdraft or a loan at the option of the customer. In the case of registered stocks and shares, a bank has either to take a blank transfer for shares duly signed by the borrower, together with the memorandum of deposit and the share certificates, or gets the shares transferred to it or to its nominee, stating that this transfer is effected by way of mortgage or pledge and that on the repayment of a loan, the shares would be retransferred to the borrower or his nominee. It would be better for a bank to adopt the latter course in the case of a blank transfer arrangement.

When the shares of a joint-stock company are offered as security for an advance, a banker should carefully study the nature of the business of the company, its past history, location, management and future prospects. Consideration should also be given to the type of shares offered and their marketability. From the banker's point of view, preference shares, especially cumulative preference shares, are safer than ordinary shares. Partly paid up shares are not very safe as a security for an advance. The reason is the contingent uncalled liability on the shares, which sometimes result in sharp fluctuations in their value and also in the market value.

According to Section 19(2) of the Banking Companies Act, 1949, a banking company is not permitted to hold, whether as a pledge, mortgagee or absolute owner, shares in any company (except of its subsidiary company) of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less. Section 19(3) further provides that, except in respect of a subsidiary, a banking company must not hold shares (whether as pledge, mortgagee or absolute owner) in any company in the management of which any managing director or manager of the banking company is in any manner concerned or interested.

The shares of public utility companies (electricity, gas, tramways) are considered quite safe as securities for advances because their business is generally quite sound and because they have generally the monopoly of supplying a particular utility or a product in a specified area.

Advances against Units of the Unit Trust of India

Banks make advances against the units of the Units Trust of India up to 90 percent of the current repurchase price by the Units Trust of India. All the leading newspapers regularly publish quotations of the current repurchase price of the units. Except in special cases, units must be transferred to the bank's name before an advance is allowed against them.

Advances against National Savings Certificate, etc.

Customers often approach banks for small advances against National savings Certificates, National Defence Certificates, Defence Deposit Certificates, etc. Whenever such advances are granted, they are considered a service to customers rather than a remunerative business in itself. In all cases, the surrender value of the certificates from the bases on which an advance is considered.

Before making an advance on the security of the National Saving Certificates, the banker should take an application in the prescribed form from the borrower in whose name the certificates stand. These certificates should then be sent to the concerned post office or the issuing authority for transfer to the lending bank's name. The banker should grant the advance only after the necessary endorsement by the post office or the issuing authority has been made on the certificates or after new certificates are issuing in the name of the bank, if permitted by the rules. These certificates should be accompanied a letter addressed by the post master of the concerned post office, authorizing the bank to encash the certificates at any time.

It may be noted here that, there are restrictions on the transfer and surrender of these certificates. Banker should acquaint themselves with the various rules governing their transfer, pledge, surrender, etc. It is advisable to obtain a copy of such rules for reference before granting an advance against these certificates. The procedure in respect of the transfer of National Defence Certificates, Defence Deposit Certificates, etc., to the lending bank is almost the same as in the case of the National Savings Certificates. The margin on the above advances is usually maintained between 10 percent 20 percent.

Advances against Debentures

A debenture is a document issued by company acknowledging its indebtedness to the person to whom it is issued. Debentures carry a fixed rate of interest payable at given periods. Interest is payable whether the company makes profit or not. Debentures may be secured either by a fixed charge or a floating charge on the company's assets. If there is no such charge, debentures are clean or unsecured; these are sometimes called naked debentures. Debentures are accepted by banks as security if they are readily marketable. Their marketability, however depends upon their safety and yield, the reputation and profits of the company and the public opinion about the integrity and capacity of company's directors. In considering the value of a debenture as security, it is necessary to know the terms on which it has been issued and the manner in which it has been secured. Unsecured debentures may be accepted by a bank as security only when the creditworthiness of the borrowing company is very good.

When considering debenture as security against advances, the banker should take into account the following factors:

(i) The company's powers to issue debentures and restrictions on such power, if any;
(ii) The financial position of the company;
(iii) The popularity and marketability of debentures;
(iv) The date of redemption, if debentures are redeemable;
(v) Regularity in the payment of interest;
(vi) Study of the Debenture Trust Deed (a debenture trust deed is a registered mortgage deed which is executed for the purpose of securing a charge on the assets of a company, against the specific security of which the debentures are issued. The names of the trustees are mentioned as mortgages in the debenture trust deed. The trustees hold the property in the trust for the debenture holder).
(vii) Whether debentures are secured or unsecured.

A margin of 15 percent to 25 percent is usually maintained, provided that the debentures are marketable.

Advances against Goods

A modern banker does a large business in advances against goods. Divergent views are held by experts on the suitability of goods as security. A leading banking expert, while discarding this type of security, observes (according to Mr. Gilbert's, Journal of the Institute of Bankers, 1922):

"No banker should really make advances upon such securities. Now and then, they may take such a collateral security for an advance to a customer who is otherwise respectable, but if such customer requires such an advance frequently, not to say constantly, it shows that he is conducting his business in a way that will not ultimately be either for his own advantage or that of his customer."

Approximately two-thirds of the secured advances of the scheduled banks in India are against goods and commodities. The term goods is very broad in its connotation and refers to the following four categories of material:

(i) Food articles;
(ii) Industrial raw materials;
(iii) Plantation products;
(iv) Manufactures and Minerals.

The prejudice against this form of security based on the ground that as the value of these commodities is subject to constant fluctuations, they do not afford a sufficient protection to the to the lender. There is no doubt some justification for this attitude; but the modern tendency happens to be that, with due caution and care, this risk can be safeguarded against. Besides, it is argued that, under present conditions, a bank must come forward to finance agriculture, trade and small industry.

This type of security has the advantage of being a tangible security which is a better form of security than a guarantee or bill of exchange because a banker can rely upon something tangible in the case of the failure of the customer borrowing against such securities. Another advantage of this type of security is that goods can be sold more easily than certain other types of securities, such as land and buildings. Yet another advantage is that the price of goods can be more easily ascertained from the market than price of certain other types of securities, viz., immovable property, etc.

This type of security has certain disadvantages as well, for they are liable to deterioration and damage, and often to wide fluctuations in demand. Another important disadvantage of goods as security is that there is a greater risk of fraud both as regards the quantity and the quality of the pledged goods than in other types of securities. Moreover, the storage of goods in a godown entails risk about their deterioration as well as verification.

Precautions to be Taken

(i) A banker should advance loans against the security of goods only to a person whose character is absolutely free from suspicion, for there will be many opportunities available to the borrower to practice fraud and deceit.

(ii) A banker should actively study the market in order to follow the price trends. During the period of a speculative rise or fall in prices, advances should not be made on the basis of the inflated value, and the margin should be increased in such cases.

(iii) Before accepting goods as security, the banker should ascertain the title of the borrower to the goods, say, by an inspection of the original invoices or cash memos.

(iv) If the goods are under pledge, extra care should be taken against pilferage, damage by insects, rain, and damage by passage of time because of the bank's responsibility as a pledge.

(v) Goods should be fully insured against the risk of fire unless the cover may be safely waived; as, for example, in the case of such heavy steel goods as steel beams and girders. The godown should contain only goods which are pledged to the bank, unless all the goods are fully insured.

(vi) Godown-keepers and watchmen should be selected carefully. They should be honest and possess a high sense of responsibility.

(vii) In case of hypothecation account, a written undertaking from the borrower should be obtained that the goods are not charged to any bank or creditor and will not be so charged till the accounts continues with the bank. Periodical certificates indicating the quantity and valuations of items should be received from the borrower and property checked against the hypothecated stocks. The banker should tally the stocks hypothecated to him with the borrower's books.

(viii) In case of certain commodities, dealers are required to obtain a license from the government. The banker should verify whether the borrower has obtained the necessary license.

(ix) From time-to-time, the Reserve Bank of India issues directives, imposing restrictions on advances against certain commodities. Banks should observe, in letter and spirit, the conditions laid down in such directives. For example, the directive may stipulate a higher margin on advances against certain goods. The banker should not accommodate, on a clean basis, the borrower in whose account margin has been raised and thus indirectly provide him with funds to meet the extra margin in the secured account.

The nature of the commodity offered as a security to cover a bank advance is an important factor to be borne in mind. Some commodities, e.g., rice, become more valuable with the passage of time, while others deteriorate – their market value declines and it becomes difficult to see them when the occasions demands it. A banker should deal with the owner of goods or his authorized agent and should insist on taking possessions of the goods before granting a loan. This is necessary in his own interest, for the transferor except in the six cases dealt within Sections 27 to 30 and Section 54(3) of the sale of Goods Act, 1930. These six exception are:

(i) Those who, having sold goods, continue in possession of the goods or the goods documents of title to goods [Section 30 (10];
(ii) Those who, having brought or agreed to buy goods, obtain with the consent of the seller possession of goods or the document of the title to the goods [Section 30(2)];
(iii) Those who have obtained possession of goods under a voidable contract which has not been rescinded at the time of the transfer [Section 29];
(iv) Part owners, who with the permission of co-owners, are in sole possession of the goods [Section 28];
(v) Mercantile agent who, acting in the ordinary course of business as mercantile agents, have, with the consent of the owner, possession of the goods or the documents of title to the goods [sec. 54(3)];
(vi) Where an unpaid seller, who has exercised his lien or right of stoppage in transit, exercises his statutory right of resale, the second buyer gets a good title though the unpaid seller is neither the owner nor acting under the authority of the owner [Section 54(3)].

In all the six cases stated above, a good title to property can be passed on to all the bonafide purchasers or pledges for value without notice.

Documents of Title of Goods

Section 2 of the Sale of Goods Act, 1930, defines documents of title to goods as follows:

"A bill of lading, dock warrant, ware housekeeper's certificate, wharfinger's certificate, railway receipt, warrant or order for the delivery of goods and any other documents used in the ordinary course of business as proof of the possession or control of goods, or authorizing or purporting to authorize, either by endorsement or delivery, the possessor of document to transfer or receive goods thereby represented."

To test whether a document is a document of title to goods is whether its possession is recognized by law or business practice as the possession of the goods, and whether, by endorsement or delivery (or both) of the documents, the person in possession of the goods can transfer the goods represented thereby to any person so as to enable that person to take delivery of them in his own right.

As distinguished from the documents of title mentioned below, there are some other documents, for example, the ware housekeeper's non-transferable receipts, which are mere acknowledgements of goods. The possession of the receipt does not constitute possession of the goods. The distinction between documents which recognized as documents of title of goods and those which are not is very important from the lending banker's point of view. If the banker is in possession of the documents of title to goods duly endorsed in his favor, where necessary, at the time of customer's insolvency, such possession gives him a legal title to the goods and to take such goods "out of the order and disposition of insolvent" under section 52(2) (c) of the Presidency Town Act, 1909, and Section 28(3) of the Provincial Insolvency Act, 1920.

By virtue of being in possession of such documents while the goods are in transit, the banker is entitled to take delivery of them on their arrival in his own right because the legal transfer of the documents has the effect of transferring the goods represented by the documents. Documents of title to goods can be effectively pledged either by the owner (Morvi Mercantile Bank Ltd., vs. Union of India, 1965, 35 Company Case 629) or by his mercantile agent, and an advance against the pledge of the goods themselves. (A mercantile agent refers to an agent who, in the normal course of his business as such agent, has the authority to sell goods, or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods. A broker, a factor or an auctioneer having such authority may be covered by the definition of a mercantile agent).

The following are the principal documents of title to goods:

(i) Bill of Landing;
(ii) Dock Warrant;
(iii) Ware housekeeper's Certificate or Warehouse Receipt;
(iv) Delivery Order; and
(v) Railway Receipt.

Bill of Lading

In the case of a bill of lading, the goods are made deliverable to the bearer; they may be transferred by the original holder to anyone he chooses, and the transferee in his turn can also transfer it. The transfer can be made by the endorsement or delivery, as the case may be, and the transferee acquires, by such a transfer, all the rights to goods shipped that the transferor had. He is also subject to the same liabilities as those of the transferor.

A bill of lading is not a negotiable instrument in the real sense of the term, though there are many points of resemblance between a bill of lading and a negotiable instrument, viz., its transferability by delivery with or without endorsement, and without any notice to the person liable on it; also transferee of a bill of lading can use it in his own name. Thus, some authors call it a quasi-negotiable instrument.

Bill of Lading and Bill of Exchange

A bill of lading differs from a bill of exchange in point of negotiability, because in the case of bill of lading, a holder cannot give a better a title than he himself has, whereas in the case of the bill of exchange, a holder in due course, who receives it for value and in good faith, receives it free from all defences as to defect in title that may have been successfully pledged against a previous holder, except, of course, forgery.

Dock Warrant

A dock warrant is a document issued by dock, ware housekeeper or wharfinger stating that the goods, as described therein, have been received and are deliverable to the person mentioned therein or his assigns, by endorsement.

Ware housekeeper's Certificate or Warehouse Receipt

A ware housekeeper's certificates is a receipt certifying that the goods are held by the ware housekeeper, which is usually expressed to be non-transferable, though in same cases, it is transferable with an endorsement. This mere statement as to the holding of the goods on behalf of the owner in so sense makes it a document of title. It is for this reason that a bank does not consider this certificate to be a proper security for a loan.

Before making an advance against a ware house receipt, a banker should see to it that the person approaching him for the advance is entitled to receive the goods in his own name and that he obtains, in addition, a declaration from the borrower that the goods mentioned in the receipt are his absolute property. The genuineness of the warehouse receipt should also be verified.

Delivery Order

It is an order on the warehouseman from the owner to deliver the goods mentioned therein to a particular person. A banker before making an advance on such an order should see to it that the goods are transferred to his own name; otherwise the holder of a second delivery order for the same goods who has no notice of the banker's claim may obtain the goods by giving his copy to warehouse.

Railway Receipt: Railway receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein. It is transferable but not a negotiable instrument. It can be transferred by endorsement and delivery. As the receipt is to be produced before the railway authorities to clear the goods at the destination advances sought against such receipts are for very short periods. Generally, the consignor of the goods draws a bill of exchange or a hundi on the consignee for the amount of the goods consigned and discounts the bill/hundi with the banker. The Railway Receipts is enclosed with the bill which is called a documentary bill. The banker releases the Railway Receipts to the consignee against payment/acceptance of bill. The Bombay High Court held that an endorsee of a Railway Receipt could not file a suit for damages for short delivery in consignment of the goods unless he had been shown to be the owner of the goods. Though this right of action is ordinarily vested in the consignor but the consignee, who is in possession of a Railway Receipt duly endorsed by the consignor, may maintain an action, but he could so not because he is the consignee, but because he is the owner of the goods. A bare consignee who is not the owner of the goods could not maintain a suit for such compensation. The banker should take the following precautions in this connection:

(i) The consignor may give a wrong description of the goods consigned. The banker should, therefore, discount such documentary bill with Railway Receipt which are drawn by parties of repute.

(ii) Sometimes the goods are delivered by the railway authorities on the basis of Indemnity Bond furnished by wrong party. In such circumstances, the banker shall have to file a suite in the court of law. To avoid such situation, the banker should inform the railway authorities at the destination about his interest in the goods and ask them not to release the goods without the railway receipts duly discharged.

(iii) The railway receipt should be on railway risk and without any alterations. The banker should prefer "Freight Paid" railway receipt because he will not required to pay the freight, if he is forced to take the delivery of the goods at the destination.

Trust Receipts: The goods or documents of title to goods pledged with a banker as security for an advance are usually released by the banker on the repayment of the borrowed amount. Sometimes the borrowers wishes to get the security released before he actually repays the loan. In such cases, the banker may at his discretion, allow the customer to get back the goods or documents and ask the letter to execute a Trust Receipt. By signing such receipt, the customer undertakes to receive the goods or the documents of title to goods in trust for the lender. The borrower promises to hold the goods or their sale proceeds as trustee for the banker and to pay the same to the latter as and when received.

The legal position of the Trust Receipts from the banker's point of view, however, remains unsatisfactory. As regards the ineffectiveness of a Trust Receipt as security of the banker, the Banking Commission, 1972 opined that: "The present position seems to be that advances against trust receipts do not create any trust, that goods released against trust receipt would be affected by the reputed ownership clause under the insolvency laws in India, that the borrower may validly create unauthorized pledge of the documents of title to goods released to him under a Trust Receipt and nay wrongful dealing with the goods it may not be possible to prosecute the borrower".

The Commission, therefore, concluded that "from the banker's point of view, the trust receipt is considered practically valueless as a document creating a security interest in their favor". Banks treat advances against trust receipts as unsecured and grant this facility only to well established customers.

Risks in Advances against documents of Title of goods

There are certain risks in making advances against documents of title to goods, for these documents to be forged, or the number of bags or packages stated in the bill of lading or railway receipt may be fraudulently increased. Moreover, the documents of title are not negotiable securities, and title to the goods cannot, under any conditions, may acquired if the documents are stolen. But because such documents are transferable, they can be taken as security from the owner of goods, the transferee or the mercantile agent in possession of the documents as an agent.

Precautions to be taken

The should take the following precautions while advancing money against documents to title to goods:

(i) Advances should be given to only known customers who are honest and reliable.
(ii) The banker should always ask for a certificate of a reliable packer in order to ascertain the contents of the packages; or representative of the bank should be present to supervise the packing.
(iii) The banker should procure all the copies of a bill of lading. The captain of ship is under no obligation to inquire into the title of the holder of the bill of lading, and will ordinarily give the delivery of the goods to the person presenting it, provided that he does not know that another copy is pledged with the banker.
(iv) The banker should get the bill of lading endorsed in blank by the consignee. In such a case, the liability for paying the freight falls on the customer and not upon the consignor.

(v) The banker should get the insurance policy in respect of the goods. It is not to have an open insurance policy, the insurance company should state that such and such goods are covered under that policy.

Immovable property

Though immovable property, e.g., land and buildings, legally a sound and valid security for advances by a bank, it is not popular because of the following reasons:

(i) Legal enactments have put some checks on such transfers, e.g., a non-agriculturist cannot acquire agricultural land from an agriculturist.
(ii) Hindu and Mohammedan customs and laws relating to succession and transfer of property place serious obstacles in the way of the banker providing financial accommodation on the security of what is ordinarily considered to be a normal and sound security.
(iii) Another important difficulty regarding this security is about the ascertainment of the title of the customer.
(iv) The valuation of the property is also very difficult. The banker cannot rely upon his own judgement but has to depend on the valuation of experts.
(v) There are a variety of land tenures, e.g., freehold, jazandari, sanedi, khoti, inami, toka, ryotwari, patidari, and the banker has to take into consideration all this tenures.
(vi) Another problem is the delay and difficulty in the realization of such security.
(vii) While accepting land and building as security for an advance, the banker expects to get some rent from the property; but there is always the difficulty of finding suitable tenants and collecting rent from them. The banker has also to incur costs on the repair and upkeep of the property.

Because of the difficulties discussed above, immovable property is not popular security for bank advances.

Life Policies

A life policy is a security against advances on the basis of its surrender value. The other consideration for the banker is to make sure that the policy was effected by the person himself on his own life. In case the policy is effected on the life on some other party, it should be ascertained whether the party effecting this insurance had an insurable interest in life insured

Insurable interest

"Insurable interest is a certain peculiar interest in the life f the person r thing insured mere natural love and affection would not suffice the insure should stand in such relation with the subject matter of insurable that in the event of its loss he will sustain some peculiar loss it is essential that the interest should exist at the time the time the insurance is effected."

The banker should also see it to it that premium receipts are deposited with him and that the policy is not allowed to lapse. The various clauses of the policy should be examined to find out whether there are conditions or clauses vitiating the policy as a form of security. It is better to obtain proof that the age of the assured has been admitted by the insurance company. If the policy has been assigned to someone, a reassignment in favor of the life assured and a subsequent assignment in favor of the banker should secured.

A simple deposit of the policy with the banker as security for a debt does not constitute an assignment but only gives him lien. To create an equitable mortgage, it should be accompanied by a written agreement determining the purpose of a deposit. (A legal mortgage of a life policy is effected by a deed of assignment, the operative part of which includes a covenant by the borrower for the repayment of the principal and interest, and a statement regarding the assignment of policy subject to a promise for redemption.

To protect his own interest, a banker should get the mortgage registered. The policy should also be taken possession of so that a subsequent mortgagee may not obtain a prior right of assignment by giving an earlier notice and obtaining possession of the policy concerned. A well-drawn deed of mortgage always contains a clause relating to the power to sell the policy in the event of a default.

Fixed Deposit Receipt

A fixed deposit receipt is issued by banker for a deposit made for a specific period if, before the expiry of period, the customer urgently needs money, he may take a loan from the banker on the security of the fixed deposit receipt. The banker should take the following precautions while making an advance against a fixed deposit receipt:

(i) He may advance a loan against the fixed deposit receipt issued by his own bank, but not against the fixed deposit receipt issued by another bank, because in that case the other bank possesses a paramount lien on the receipt.

(ii) If a fixed deposit receipt is in joint names and the loan is being sought by one of the depositors authorizing the bank to sanction the loan against the receipt.

(iii) While receiving a fixed deposit receipt as security, the banker should have it signed by the depositor over a revenue stamp in the discharge of instrument so that the bank gets the authority by appropriating the amount of the fixed deposit towards the repayment of the loan.

(iv) The banker should not grant a loan to a minor against a fixed deposit receipt, even though the receipt is in the name of the minor.

Supply Bills

Banks are sometimes approached for advances against bill for good supplied to government departments and agencies. Businessman, who supply goods to these departments or agencies on the basis of previously submitted tenders, and contractors on partial or complete completion of contract, submit a bill for the amount of goods supplied or the contract work done in accordance with the terms and conditions of the contract. Such bills referred to as supply bills. These bills are passed for payment by the appropriate authority only after verification that the goods supplied confirm to the terms c f the contract. The procedure however, of checking and passing the bills takes a couple of sometimes even longer. During this period, the parties approach banks for advances against such supply bills.

Supply bills are not bills of exchange. They do not, therefore, enjoy the legal status of negotiable instruments. A supply bill, however, represents a debt arising out of a bonafide supply of goods, or contract work done. Such bills are endorsed for payment to the bank and have to be receipted on a revenue stamp. They are also accompanied by a separate letter of authority addressed to the concerned Government department or agency by the supplier or contractor to pay the amount directly to the bank.

In law, there can be valid equitable assignment of future debts, and such debts cannot be attached by another another creditor to the detriment of a prior creditor who may have advanced money on their security (Bharat Nidhi Ltd., vs. Takhtmal and another, 1969, 39, company case 114; also Hindustan Commercial Bank Ltd., vs. Union of India and others, AIR 1965, Allahabad 474).

Risk in giving Advances against supply bills

The banker incurs the following risks in granting loans against supply:

(i) The security available to a banker is by way of assignment of debts represented by supply bills it suffers from usual drawbacks of assignment of debts as security. There is always the possibility of a counter-claim or set-off against the debt.
(ii) The debtor, usually the government, might pay the amount direct to the creditor unless the assignment is registered with the debtor, and the debtor undertakes to pay the amount only to the assignee.
(iii) Generally speaking, the payment of such bills are made by the government departments after a long time because of procedural delays.
(iv) The amount may be reduced payment refused, if there is a default in observing the terms of contract by the supplier/contractor.

Precautions to be taken by the banker

The bank should take precautions to ensure that he does receive payment on the supply bills.

(i) Advances against supply bills should be granted only to honest suppliers/contractors, having a long experience in the business.
(ii) The banker should thoroughly scrutinize the terms of the contract between the supplier/contractor and the government.
(iii) The banker should ask the supplier/contractor to execute an irrevocable power of attorney in his favor, authorizing him to receive

the amount of the bill. The power of attorney should be filed with the department to which the supply bill is submitted.

(iv) The banker should ask the supplier/contractor to give an undertaking to repay any amount received by the later directly from the Government department in respect of the bills entrusted to the banker for collection.

Letters of Credit

A letter of credit is a document or order by a banker in one place, authorizing some other banker, acting his agent or correspondent, in another place, to honor the drafts or cheques of a person named in the document, up to the amount stated in the letter and charge the total amount of the drafts so honored or payments so made to the guarantor of the letter of credit. The particulars of all the drafts or cheques, drawn by the specified person against the credit, are required to be endorsed at the bank of the letter of credit so that it will be easy to find out how much of the credit allowed has been utilized, and how much is outstanding.

Kinds of letter of Credit

Letters of credit are of various kinds. They may divide into two divisions, viz.:

(i) **Personal credit letters or Travelers facility letters**: A letter by which a banker requests another, to whom the said letter is addressed, to hold a certain sum at the disposal of a third person who is the holder of that letter and to pay to him such amounts as he requires against either cheques on the banker giving this letter or on the banker to whom the letter is addressed but not exceeding in total the whole amount covered by the said letter. This letter is generally taken when a customer wants to visit and spend most of his time at one particular place and wants to obtain funds during that period. Such credits are known as encashment credits.

(ii) **Letters for Commercial credit**: These are of letters of credit used for the purpose of financing shipments of goods imported into, or exported from, a country or for the movement of produced or manufactured goods imported into, or exported from, a country or for the movement of produce or manufactured goods from one place to another in the country itself.

Personal letters of credit or Travelers letter of Credit

A banker giving such a letter of credit asks another banker to whom it is addressed to place a specific sum of money at the disposal of or to the credit of one in whose favor the letter is issued. This type of credit aims at facilitating travelers or others temporarily resident in another country by allowing them to draw cheques on the branch offices or agencies of the bank concerned for the purpose of obtaining such cash as they may require in the course of their travel in, or residence at those places. When this letter is addressed to more than one banker, it is known as a circular letter of credit and the bankers to whom it is addressed have to endorse on the letter the amount paid by each one of them. With a circular letter, a letter of indication or identification is also issued to a customer which contains a specimen of his signature.

Circular Notes

Sometimes, those letters of credit are accompanied by circular notes in the form of cheques the value of denomination of such sums as may be convenient to the holder. The letter of credit then virtually becomes a letter of indications or identification, stating the numbers and the amount up to which the circular notes are due, and containing a specimen signature of the holder. The holder has to keep the letters of credit or indication, as well as the circular notes in separate boxes while travelling, and gradually cash the notes by producing the letter of credit or indication is addressed.

Circular Cheques

Instead of circular notes with letters of indication as mentioned in the preceding paragraph, it is more common nowadays to issue circular cheques without the letter of indication. These circular cheques are issued by banks to their agents abroad, are bound in the book form, and are drawn in the currency of the country in which the payment is to be made.

Travelers' cheques

Travelers cheques are similar to circular cheques or circular notes but do not require a letter of identification. At the time issue, the holder is required to place his signature on all the cheques issued to him and to pay for these cheques. At the time of encashment, he is required to sign once again. This facilitates identification, for the second signature is checked to find out whether it corresponds with the original signature placed at the time of issue before payment is made.

Letters for Commercial Credit

This type of letter of credit is used to finance trading activities. The customer wishing to open such a credit approaches a banker with a request for a letter addressed to another person in a different city or country from whom he expects shipments of goods on credit. The amount of such credit settled with the banker after the later receives the requisite security to his satisfaction. The banker, by giving the said letter of credit, authorizes the other party, who is to make the shipment, to draw a bill of exchange on him up to the amount mentioned in the said letter, which the banker giving the letter agrees to accept, provided it is drawn strictly in accordance with the terms and stipulations covered by the letter of credit. It is usual to stipulate in the said letter that the credit has to be made use of within the period stated in the letter, usually six months. If the banker undertakes to accept the bills drawn in accordance with such a letter without conditions, the document is called an open or clean letter of credit. If, the other hand, the stipulation is that the documents of title to the goods covered by the bills drawn against shipments are to accompany the bills, the letter is called a documentary letter of credit.

Documents against acceptance and documents against payment

When documents are attached to a bill of exchange and are handed over to the drawee on his accepting the bill, the bill is called a D/A bill, i.e., documents against acceptance bill. If, on the other hand, the documents are only handed over or delivered not on acceptance, but the actual payment of the bill, the same is known as documents against payment bill (D/P bill). In the first case, the drawee has to be given credit during the interval that the is accepted and the rate at which the actually paid. In other case, no credit is given because the documents are only deliverable on payments. It may be noted that, in commercial credits, the bills generally drawn are D/A (documents against acceptance) bills.

The possessions of a bill of lading against acceptance would no doubt give a banker a good title to the goods. An agreement between him and his customer to the effect that bills of lading would be forwarded against acceptance would, on acceptance of bill, give to the banker against his customer an equitable claim against the bill of lading which is good even against the trustee in bankruptcy or an official assignee (Lutcher vs. Comptoir d'Escompe I.Q., B.D., 709). If is bill accepted on the condition that it will be payable on delivery of the bill of lading, the banker is not liable to pay unless and until the bill of lading is casually hand over. The banker is thus a security for his acceptance in the bill of lading (Ex-paete breet, L.R. 6, Ch. 838 at p. 84).

The law places on the banker who undertakes to negotiate a draft by his acceptance under a letter of credit granted by him the responsibility to properly protect the person on whose request he so acts, and that care is taken to ensure that all the conditions under which the said drafts are to be negotiated are fulfilled by the person to whom the said letter is addressed. The banker must also see to it that the person with whom he is dealing is a person to whom the letter has been issued. There was a case in which a bank negotiated a draft which was not accompanied by a policy of insurance in a proper form. It was held that the bank was liable because it committed a breach of its contract with the party at whose request the letter was issued. [Borthwick vs. Bank of New Zealand (1900) 6 Com. cases 1]. Of course, here, the limit of the bank's obligation was to see that the documents presented along with the bill of exchange were actually documents specified in the letter of credit. [Basee and Selve vs. Bank of Australia (1904), 20 T.L.R. 341].

Clean letter of Credit

No. 11571 National & Grindlays Bank Ltd.,

14 Park Street,

£ 1,00,000

To London

February 15,1976 Messrs. Prakash Wadhwani & Co. Ltd.,

Frere Road,

MumbaiDear Sir,

You are hear by authorized to draw drafts upon this bank at thirty days sight to the extend on all of £ 1,00,000 (Pounds One Hundred Thousand only), and we hereby engage with the drawers, endorsers, and bonafide holders of all drafts drawn under and in compliance with the terms of this credit, that the same shall be duly accepted payable in London, UK, on presentation in order; and that they shall be duly honoured on presentation in order at maturity.

The credit will remain in force for six months from this date. The particulars of all drafts drawn against it must be endorsed on the back thereof, and the bills must specify that they are drawn that under credit no. 11751 dated the fifteenth day of February, 2018.
Yours Faithfully,

For the National & Grindlays bank

(sd.) V. John

Manager

A confirming bank must not disburse moneys under a letter of credit except against documents strictly complying with the terms of the credit. Where a letter of credit is opened, the relationship between the instructing and the confirming banks is in the absence of a contract to the contrary that, of principal and agent. [Bank Melli Iran vs. Barclays Bank (1951) T.L.R. 1057].

Documentary Letter of credit

No. 305 Lloyds Bank Ltd.

$ 10000 57th Street, 6th Avenue,

New York,

July 5, 2018.

To

Messrs. Alrich & Co. Ltd.

Colaba,

Mumbai.

Dear Sir,

You are here by authorized to draw drafts upon this bank at thirty day's sight to the extent in all of $ 10000 (Dollars ten thousand only) or invoice cost of goods to be shipped to Messrs. Alexander & Company of New York. This credit expires, unless previously cancelled, six months from the date. All drafts against it must be drawn and fully advised to us before that date, accompanied by invoices and bill of lading issued to the order of the shipper and endorsed in blank, together with marine insurance policies.

Particulars of all drafts drawn under this credit must be endorsed on the back thereof, and the bills must specify that they are drawn under credit no. 305, dated July 5, 2018. We here by engage with the drawers, endorsers, and bonafide holders of the drafts under and in compliance with the term of this credit, that against surrender to this bank of the above-mentioned documents in order, the said drafts shall be duly accepted payable in New York, USA., on presentation in order; and that they shall be duly honored on presentation in order at maturity.

Yours faithfully,

For Lloyds Bank Ltd.,

(sd.) Samuel Smith

Manager

Recoverable and irrevocable letter of credit

In the case of revocable or unconfirmed letters of credit, a banker issuing them can cancel the authority at any time he chooses; but he will still be liable for bills negotiated before its cancellation. An irrevocable or confirmed letter of credit cannot be cancelled unless it has run its full course or unless its beneficiary agrees to such cancellation. The of a confirmed letter of credit "constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any dispute which there may be between the parties on the question whether the goods are up to contract or not. A vendor of goods selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price." [Malas & Aur. (Trading as Hamzeh Males & sons) vs. British Imex Industries Ltd., (1958) I All E.R. 262)].

In the case of Cape Asbesto Co. Ltd., vs. Lloyds Bank Ltd., (1921) W.N. 274, it was held that in the case of recoverable letters of credit, thought the baker was not any legal obligation to give notice before revoking, the practice of bankers in the usual course of business is to give such notice and that the said practice was the most prudent, reasonable and business-like practice. This means that though the bankers in the usual course do give notice as a matter of courtesy and as a matter of policy before they revoke a letter of credit, they are not bound to do so in law. That is the reason why justice Bailhache observed in the case cited above that "an unconfirmed credit is practically useless". This is subject to rule that as long as the credit happens to be in force and the documents are in order, the banker must be accept the bill; otherwise he would be liable to damages. [Urquhart Lindasy and Co., vs. Eastern bank (1922) I K.B. 318].

Distinction between Irrecoverable Letter of credit and Bank Guarantee

An irrevocable letter of credit also differs from a bank guarantee in state bank of India vs. The Economic Trading Co. S.A.A., and others (A.L.R. 1975, Calcutta 145), the Calcutta High Court observed that the important point of distinction was the autonomy of an irrecoverable letter of credit and the dependence of a bank guaranted on a contract between the beneficiary of the guarantee and a third party. Payment under an irrevocable letter of credit does not depend on the performance of obligations of the part of the seller except these which the letter of credit expressly imposes. In such cases the obligation is of the bank to the beneficiary and no third party comes into the picture. In the case of a bank guarantee by definition a third party is always on the scene. Unless there is some act of omission or commission on the part of the party, payment under a bank guarantee does not become due. In other words, a bank guarantee does not enjoy the autonomy of an irrevocable letter of credit. In case of a guarantee there is always the question of a contingency does not enjoy the autonomy of an irrevocable letter which of credit. In case of guarantee there is always the question of a contingency on the occurrence of which the guarantee becomes enforceable.

QUESTIONS:

1) Define secured loan.

2) State any two lending principles.

3) What are the disadvantages of cash credit?

4) Write note on overdraft.

5) Explain briefly Contract of guarantee.

6) What is pledge?

7) Distinguish between Pledge and Hypothecation.

8) What is Assignment?

9) Explain in detail types of letter of credit.

10) Explain in detail different types of collateral securities.

UNIT-IV

Agriculture Finance

India is predominantly an agriculture country. The agriculture sector is an important segment of the national economy because about 70 per cent of the people directly or indirectly depend on agriculture, for their livelihood, and because about 50 per cent of the total national income is derived from agricultural moreover, agricultural commodities comprise almost 80 per cent of the total consumer expenditure. Fluctuations in the levels of agriculture output directly affect the prices of consumer goods; and the general level of prices fluctuates with the rise and fall in agricultural prices. The purchasing power of a vast majority of people in India is thus linked up with fluctuation in the fortunes of agriculturists. Finance for agricultural purposes was generally provided by the cooperative banking system under the patronage of the state Governments and the Reserve Bank of India. It was only from 1955, when the Imperial Bank of India was converted into the State Bank of India, that commercial banks started financing for agricultural purposes.

some other developments which have led to a more active involvement of the banks in the field of agricultural finance are;

[i] Establishment of the Refinance Corporation for agriculture to provide refinancing facilities to cooperative, commercial and development banks for their agricultural advances;

[ii] The policy of the social control of banks imparted a new sense of direction to commercial banks which began to provide finance for agriculture purposes - something which they had not done before;

[iii] The Agriculture Finance Corporation was set up in 1968 to increase the commercial banks which began to provide finance for agriculture purposes -something which they had not done before;

[iii] The Agriculture Finance Corporation was set up in 1968 to increase the commercial banks' participation in agricultural financing

[iv] Fourteen major banks were nationalized in 1969 [six more were nationalised in 1980] which has led to a greater involment of commercial banks in the financing of agriculture under the direction of the Reserve Bank and the Central Government.

Objectives of Agriculture Finance

Some of the important objectives of agriculture finance are;

i. To help increase agricultural production
ii. To help fill the existing credit gap in the field of agriculture;
iii. To provide adequate and timely credit for viable agriculture schemes
iv. To help achieve the national plan objectives, with special emphasis on the weaker sections;
v. To help in inculcating banking and saving habits among the rural people; and
vi. To assist cultivators in adopting improved methods of agriculture.

It may be mentioned here that the financing of agriculture is the most important part of rural credit in India. The following chart indicates the various institutional channels of rural credit in this country;
I National Bank for Agriculture and Rural Development.
II State co-operative Banks.
III Scheduled Commercial Banks.
IV Regional Rural Banks.
V State Cooperative Land Development Banks.

Indirect Finance

i. Credit for financing the distribution of fertilizers, pesticides and seeds
ii. Loans to the Electricity Board for the expenditure already incurred by them to provide low tension connections from step-down points individual farmers to enable them to energize their wells
iii. Loans to farmers through primary agricultural credit societies under the scheme introduced for the purpose.
iv. Finance under hire-purchase schemes for the purchase of agricultural machinery implements.
v. Loans for the construction and running of storage facilities [warehouses, godowns, silos and cold storages] in the producing areas. if the loans to cold storages are covered by a guarantee of the credit Guarantte Corporation, they should be classified under small-scale industrial advances.
vi. Advances to custom service units managed by individuals, institutions or

organizations which maintain a fleet, bulldozers, well-boring equipment, threshers, combines, etc., and undertake work from farmers on contract basis. if these advances are covered by a guarantee of the Credit corporation, they should be classified under small-scale industrial advances.

vii. Loans to individuals, institutions organisation which undertake spraying operations.

viii. Loans to corporative banks to enable them to relend to cooprative marketing societies [provided that a certificate from the state coporative Bank in the favor of such loans is produced].

ix. Loans to the cooperative banks of the producers for the examples , Aarey Milk colony Cooperative bank consisting of licensed cattle owners

x. Indirectly financing farmers through the corporative system [otherwise then by subscriptions to bond and debenture issues] provided that the certificate from the state Cooperative Bank in favor of such loan is produced .

xi. loans to agro -industries corporation

xii. loans to state-sponsored Agricultural credit corporations

xiii. Advances to the agriculture finance corporation ltd..,

xiv. The commerical banks also provided them finance through the primary agricultural credit socities [PACS] farmers service societies [FSS] and Large Sized Adivasi Multi-purpose societies [LAMP].

Direct Finance

i. Development loans [i.e; the type of loans eligible for refinance from the agricultural Refinance and Development Corporation] to traditional plantations, viz, coffee, tea, rubber and spices and short-term as well as development loans to other plantations, horiculture [including the growing of bananas, cashews, lemon, grass, oil etc.] and bee keeping

ii. Credit, secured or otherwise, provided directly to farmers to finance such production and development needs as are indicated in the following paragraphs.

iii. short-term loans raising crops [crop loans], advance up to R-5,000 TO farmers agianst pledge/hypothecation of agricultural produce for a period not excedding 3 months and medium and long-term loans for financing production and developments needs.

I. **Purchase of Agricultural inputs and Machinery**

a. purchase of agricultural inputs; Fertilisers, pesticides, insectisides, fungicides and weedicides and improved seeds, high-yielding variety seeds, manures, etc
b. purchase of agricultural implements; Iron ploughes, harrows hoses, land-levellers, bound formers, hand tools sprayers, dusters, hay-press, sugarcane crushers, threshers machines, etc.
c. purchase of farm machinery; Tractors, power-tillers, tractors accessories, namely, disc ploughs etc.
d. purchase of trucks, bullockcarts and other transport equipment, etc., to assist in the transport of agricultural inputs and farm products.
e. purchase of farm animals-cows, bullocks, buffaloes, poultry birds, pigs, bees, etc

II **Development of irrigation Potential**

This is achieved through;

a. the construction of shallow and deep tubewells, tanks, etc., and the purchase of drilling units;
b. The construction deepening and clearing of surface wells, boring wells; purchase of oil engines; and installation of electric motors and pumps;
c. The purchase and installation of turbine pumps; the construction of feild channels [open as well as underground];
d. the construction of lift irrigation projects;
e. the installation of the sprinkler irrigation system

III. **Reclamation and Land Development Schemes**

The bounding of farm lands, levelling of land, terracing conversion of dry paddy lands into wet irrigable paddy lands; the development of farm drainage; the reclamtion of saline lands and the prevention of salinisation; the reclamation of revine land; the purchase of bulldozers, etc.

IV. **Construction of farm Buildings and Structures**

Bullocks-sheds, implements-sheds, tractor and truck-shades, farm stores, etc.

V. **Construction and running of storage Facilities**

The construction and running of warehouses, godown, silos and cold storages

VII. **Payement of Irrigation Charges,** etc.

Charges for hired water from wells and tubeweels, canal water changes; the maintainace and unkeep of oil engines and electric ,motors; the payement labour charges, electricity charges, marketing charges, service charges to custom service units; the purchase of poultry food; the payment of development cases, etc.

VIII. **Development of Dairying and Animal Husbandry in all its aspects**

IX. **Development of Fisheries in all its aspects**

a. from fish-catching to exports;
b. financing of equipment necessary for deep-sea fishing;
c. Rehabilitation of tanks [fresh water fishing];
d. Fish breeding, etc

X. **Development of poultry and piggery in all its Aspects**

The erection of poultry houses and pig-houses, bee-keeping, etc.,

XI**. Miscellaneous**

the development and maintainance of stud farms, seri-culture, etc.,

fix keeping in viewthe losses suffered by him and his capacity to repay. such a borrower may be given furthur crop loan for the next agricultural oprations.

Types of agricultural finance

Agricultural credit may be provided in two ways;

i. Short-term credit or seasonal Credit; This type of credit provides the farmers with the working capital to meet the seasonal requirmentas. this type of credit is normally repayable in one year.
ii. Medium-term Credit; This credit povides the farmer with capital for the purchase of livestock, farm machinary etc., or of for undertaking improvements or land etc. This is normally repayable in more then two years.

The credit provided by commerical banks to the agricultural sector may be divided into two categories;

i. Direct Credit; This type of credit is provided to the farmers for the production and marketing of crops; and
ii. Indirect Credit; This type of credit is granted to cooprative credit

socities, marketing and processing socitiesw etc.

CROP LOANS:

According to reserve bank guidelines, the banker should proceed in the matter as follows;

i. Amount of loan; the banker should determine the amount of loan to besanctionad to a farmer on the basis of -

a. the area to be cultivated by him, and

b. the scale of finance for specific crops per hectarev.

The scale of finance includes all expanses to be incurred by farmers for raising crops including costs all inputs; cost of oprations\services and other charges. The scale of finance, once determined should be reviewed periodically and revised if the cost of cultivation increases.

ii Disbursement;short-term crops loans are generally divided int;

a. cash component to be disbursed in cash, and

b. kind component to be disburesed through the suppliers of seeds, fertilisers and pesticides

Margin money; In case of agriculture loans up to 10,000 [both short-term and long-term loans] banks should not take any margin.

Security; Banks are required to take security for agriculture loans as follows;

no collateral security by way of mortage of land/charge on land or third party gurantee should be taken for crops loans upto 10,000 and terms loans upto 10,000 where movable assests are created. only primary security by way of hypothecation of crops or movable assests should be taken. where there are geniue diffculities in the creation of mortage/charge on land wherever required banks can take third party gurantee or any other security.

Rates of Intrest; The reserve bank of India prescribed concessional rates of intrest on all advances granted by shceduled commerical banks and regional rular banks up to 2 lakh.

Intrest in payeble only at a time of repayment of prinicple. Intrest on current dues is not to be compounded.

iv. Conversion into term loans; Banks are primetted to convert a crop loan into a term loan if the borrower is unable to repay due to any natural calamities. his death or physical incapacity or any unusual circumstance beyond his control.

Repayment period of the converted crop loan should be fixed keeping in view the losses suffered by him and his capacity to repay. such a borrower may be given be further crop loan for the next agriculture operations.

DEVELOPMENT LOANS

These loans are given in the form of terms loans for the following purposes;

i. Minor irrigation sinking of new wells, installation of diesel/ electric pumpsets;
ii. Land improvement land reclamation soil conservation land leveling and shaping laying out of field
iii. Diversified purposes such as;
    a. purchase of tractors threshers farm machinery agro service centres
    b. dairy poultry sheep-breeding piggery fisheries
    c. Plantation and horticulture development.
    d. construction of god owns and silos
    e. Market yards development.
    f. Aerial spraying.
    g. forestry
    h. Setting up of gobar gas plants.
    i. purchase of work animals driven carts, and
    j. Seri culture and bee-keeping

Period

These loans should be repayable in 3 to 10 years, ending the purpose of the loan, the borrower capacity to repay other revelant factors

Security

Banks may take security for term loan as follows;

a. where the borrower creates movable assets out of loans; such assets may be hypothecated with the bank in case the loan amount is up to the cost of economic unit where applicable or 5,000, bank may also take a third party guarantee or mortgage of the land, as its own discretion.
b. Where movable assets are not created out of loans; banks should take only demand promissory note/loan agreement if the amount is up to 2,000 in other cases mortgage of land may also be taken at the description of bank. bank may take a simple declaration by the borrower that a charge has been created on the land in the favour of the bank. in those stars

where legislation by the borrower on hte lines suggested by the Talwar Committee has been passed

Margins

Banks are required to maintain margins as follows;

a. loans to cost of economic unit [where applicable] or 5,000 whichever is lower and loans up to r=5,000 to small marginal farmers and agricultural laborers-no margins if subsidy if t
b. For others,margin may vary between 15% and 25%depending uponthe purpose and amount of loan.

LENDING PROCEDURE

Banks should follow the following guidelines while granting direct agricultural advances:

1. **Time of Lending:** Agriculturist should be provided adequate quantity of credit at the right time. For this purpose banks should prepare a definite calendar of operations particularly for crop loans so that the applications for loans are collected and processed well in advance. Medium term credit may appropriately be disbursed in the off-season when the cultivators are not busy with their crops.
2. **Availability of Ground Water:** Banks should make their own arrangements to get information on ground water availability for grant of term loans for minor irrigation.
3. **Completion of Application Forms:** Banks staff should help the forms. For illiterate small and marginal farmers and landless labourers, banks should arrange for their photographs at their own cost.

Area Approach

Banks should adopt area approach which aim at intensive and close coverage of selected areas around a branch for meeting the total agricultural credit needs of borrowers and for ensuring effective supervision over the use of credit by borrowers. However, banks should also accept viable schemes received from places beyond their normal common areas, if they feel that they can service such loans effectively.

Application Form

Loan application forms must be made available in all regional languages. These forms are two parts. Form I contains basic data regarding the applicant and form II covers the different purposes for which the loans is required. In form II, the bank's supervisory staff will make recommendations on the loan proposal after making necessary enquiries from the applicant or by collecting information during their presanction visit to the applicant.

Appraisal Form

If the application for loan is for a large amount say 5,000 or more the bank staff may collect more details for assessing the economic viability of the proposal. for this purpose bank may evolve an appraisal form with brief check list of points to be verified in order to appraise the loan application. the form may include comments on-

i. the quantum and period of loan with reference to the life of the asset to be acquired.
ii. the possible improvement in income for deciding the repaying capacity of borrower, and
iii. other relevant details.

Repayment of loans

The repayment scheduled for both short- and medium-term loans should coincide with the time when the cultivator has sold his produce. Due dates for the repayment of the loans should be fixed accordingly.

GUIDELINES FOR RECOVERY OF AGRICULTURE

The Reserve Bank of India has emphasized the need of prompt recovery of direct agricultural advances and has suggested to the commercial banks to follow the following guidelines in this regard.

i. Credit provided by the bank should be related to production efforts. banks should give low priority for finnancing of agriculture under traditional methods of cultivation of for maintenance and replacement of existing assets.

ii. The scale of finance must be in consonance with scale of inputs and coast of assets vis- a-vis incremental income.

iii. The pre-lending appraisal system should be through and update to time-to-time.

iv. loans should be disbursed promptly and in time, as far as possible, in the form o f direct payment to suppliers. cash component of the loan should not be large.

v.To ensure that credit is used for productive purpose only periodical foll ow-up of the use of loan and condition of resultant produce is essential. bank should carefully monitor the loan disbursement and should remain in contact with the borrower.

vi. repayment schedule for loans should coincide with the time when the cultivator generally sells his produce and is in possession of funds. The repayment period should be a shorter one. It should be stipulated keeping in view the incremental income accruing to small farmer so that he may repay the loans within the prescribed period. a substantial portion of incremental income should be left with the borrower so as to enable him to meet his requirements of bare necessities in addition to repayment of loan installment and interest.

Vii. The borrower should be informed about the due date soon after the crop is harvested

Vii. Banks should appoint adequate and suitable field staff who would remain in touch with the borrowers and their agriculture operation supervise the use of credit and sort out problems. Block-wise recovery campaigns should be organised in association with the officers of the state government department

ix. If the poor recovery performance is due to old overdues, banks should monitor the progress of current dues and arrears separately.

x.In case of term loans the NABARD has indicated to banks the schedule of term loans repayment periods including the gestation periods to be given to small borrowers. banks should adhere strictly to such repayment periods in the sanction letter

ii. study group on state enactments having a bearing on lendings by commercial banks to agriculturists

Farmers can offer only land, a tangile asset, as a security for advances by commercial banks. but various state governments have enacted different laws relating to land tenure and tenancy reforms, ceiling on land holdings, agricultural debt relief , regulation of money leading. etc. these encatments have made it diffuclt for commerical banks to participate in agricultural financing. under the chairmanship of Shree R.K Talwar and expert group was therefore appointed by the reserve bank of India to examine the state laws having a bearing on the leadings by commercial banks to agriculturist. the group submited its report in 1970 recommending the enactment of a single lesgislation, in corporating the various amendments suggested by it to the different state laws, and prepared model bill to enable the state government to take expidicious action on this recomendation some of the important recommendations of the group are:

i. the cultivator, having no right or restricted rights of alienation [trnasfer] in their lands or interest therein, should be vested with right to alinate land or intrest in the land by them in favour of banks in order to obtain agriculture financ.

ii. The cultivators should receive the same concessions in the respect of stamp duty, registration fees and charge for non- encumbrance certificates as was given to borrowers from corporative socities.

iii. commercial banks should be exempted from the purview of money leading and debt relief legislation.

iv. Commercial banks should be exempted from legislation relating to ceiling on land, and should be permitted to acquire and hold land to facility recovery of loan.

v. to help in the timely recovery of loans by commercial banks, a state government should empower an official to issue order, which have the force of a civil court decree, for the payments of dews to commercial banks by sale of mortagaged or charged property.

vii. the general principal of priorty has between has institutional credit agencies in regard to the recovery of loans based on common security should be the same has in indicated in the transfer of property act,1882. this would ensure that the concept of first charge in favour of cooporatives does not adversly effect the commerical banks

viiii. all institutional credit agencies should have priority of charge vis-a-vis private agencies moreover, the agencies providing term loans for development proposes should have a priorty of charge over the agencies providing term loans for development proposes.

many state govermentas have indicated legislation on the lines of the models bill recoomended by the expert group, and this has made it poosible for commerical banks to undertake financing agriculture on a large-scale. sum state goverment have reduced the stamp duty payable by agriculturist on documents exicutate by them in favour of commerical banks. many other cities have been added to the list where an equitable mortage may be created. with this measures, sum of the legal hurdless in the way of commerical banks financing agriculture have been removed

iii. **Regional Rural Banks**

Development of the rural economy was accepted as an intergl aspect of the main strategy in the sixth five year plan. the case for the development of rural economy was urgent and pressing because it is the basis of the social stability and economic growth with distributive justice. the concept of rural development is wider then that of agricultural development. in the rural sector, the credit requirments of village artisans, craftsman and cottage industrial units have been niglected the most. the primary credit socities offer credit mostly to the agriculturist.

credit is the most important and probably the most scrace input in indian agriculture. rural people are always unable to exhibit their laten potential and face diffucilites in obtaining loans. it is generalyy believe that rural credit must be cheap so that even the poorest farmace and rural artisans may affort it.

though there has been commandable giography extention in the oprations of co-prativea agencies, commerical banks, the state bank of india and its subsidies and other financial institutions working in rural areas, a large part of rural india and many types of rural activities are still badly in need of finance and other assitance for their proper development. in order, therfore, that this financial institutions may be of greatr assitance to small and marginal farmers, rural artisans, small and retail traders, self-employed persones, agricultural laborers and other in remote areas, and inorder to identify their needs, the idea of regional rural banks was concived.

in its report in 1972, the banking commesion, which was constituted under the chairmanship of shri R.G. saraiya, recoomende the seeting of rural banks which would extended banking facilities to rural areas and thus revolutionise rural financial. according to the commesion, the banking entity in rural areas should be essentialy cooprotive in cherecter and provide a wider range of service then those which were provided by primary agricultural credit socities. On 1st july 1975 the ministary of finance govorment of india costituted a working group to examine indepth the question of the seeting up of few rural banks to crater to the credit needs of they rural people. the group submitted its report on 30 july 1975.

Establishment

the goverment of india accepted the recommendations of the group and promulgated the Regional Rural Banks ordinance on 26th september 1975 for the establishment of regional rural banks.

This ordinance was replaced by the regional rural banks act of 1976 in terms of sub-section 1 of section 3 of thev act the central goverment may by a notification in the official gazette etablish a regional rural bank, if requested to do so by a sponsering bank.

Capital Structure

the authorised capital of each RRB shall be 1 crore which the central goverment may increase or decrease in consulation with the reserve bank of india and the sponsering bank, subject to a minium of 25 lakh the issued the capital of RRB shall be 25lakh of which 50 percent shall be subscribed by the central goverment 15percent by the concerned sate goverment and 35percent by the sponsering bank. There is a privision for an increases in issued capital the board of directors of the RRB after consulation with the reserve bank and the sponsering bank and with the prior approval of the central government. the sharesof a R R B shall be treated as approved securities for the purpose of the banking regulation act of 1949.

Sources of Funds

1. NABARD has a share capital of 100crore, contributed by the union Government and the Reserve Bank on a 50:50 basis.
2. For its long-term operations, NABARD will draw funds from the Government of India, the World Bank and other multilateral and bilateral agencies and the market.
3. Another source of long-term operations will be 'National Rular Chit Fund' that NABRAD will maintain and to which will be transferred the National Agricultural Credit (Long-term Operation) Fund of the Reserve Bank of India, with the further contributions to the fund every year.
4. For the purpose of converting short-term loans into medium term-loans, funds will be drawn from National Rular Credit (stabilization) Fund to which will be transferred the National Agricultural Credit (Stabilization)

Fund or the Reserve Bank of India with the further contribution made to it every year.

5. For its short-term operation, it will draw funds mainly from the Reserve Bank.
6. A ‘Research and Development Fund’ will be created and maintained through contributions from profits every year.

Functions

The functions of NABARD can be divided into three categories:

(1) Providing Credit facilities;
(2) Regulatory activities;
(3) Development activities;

1. Providing Credit Facilities

(A) It provides by way of refinance to the banks all kinds of production and investment credit to agriculture, small-scale industries, artisans, cottage of village industries, handicrafts and other allied economic activities in an integrated manner.

(b) It extends short-term credits, repayable over a maximum period of 18 months, to the State Cooperative Banks (SCBs) and the Regional Rular Banks (RRBs) and other Reserve Bank approved financial institutions for agriculture operations, marketing of crops, marketing and distributions of inputs required for and farm and rular development, bonafide commercial and trade transactions and production and marketing activities of artisans, small-scale industries, tiny rular crafts. There is provision to convent these short-term loans granted to state Cooperative Banks and Regional Rular Banks into medium-term loans for a maximum period of seven years under droughts conditions.

(c) It provides medium-term loans for a minimum term loans for a minimum period of 18 months and maximum of seven years to SCBs and RRBs.

(d) It provides long-term credit not exceeding 25 years, including the period of rescheduling to SCBs and RRBs.

(e) NABARD extends loans and advances to State Governments for periods not exceeding 20 years to enable them to subscribe directly or indirectly to the share capital of cooperative credit societies.

(f) It gives long-term loans directly to any institution approved by the Government of India.

(g) It contributes to the share capital or invest in securities or any institution concerned with agricultural and rular development.

2. Development Activities

It formulates design and aid, projects and programs to suit the requirements of agriculture and rular development. Such project will be aided from the research and Development Fund. It will also monitor and implement the various projects and evaluate them for insuring development of better projects.

3. Regulatory Activities

The Banking Regulation Act, 1949, empowers NABARD to undertake the inspection of RRBs and Cooperative Banks other than primary Cooperative Banks. Applications from these banks for opening new branches will be submitted to the Reserve Bank through NABARD, which will forward them with its comments.

Administration

NABARD is managed by full-time chairman and a separate managing director. It will have the following 16 regional offices under the control of regional managers- Hyderabad, Kolkata, Gauhati, Patna, New Delhi, Ahmadabad, Mumbai, Chandigarh, Jammu, Chennai, Trivandrum, Indore, Bangalore, Bhuvaneswar, Jaipur and Lucknow. But for operations on credit limits, Arunachal Pradesh, Assam, Manipur, Meghalaya, Nagaland, Tripura, West Bengal, Andaman and Nicobar, Island will be covered by the Kolkata office; Delhi, Himachal Pradesh, Jammu & Kashmir and Punjab by New Delhi office; Maharashtra, Goa and Madhya Pradesh by the Mumbai Office; and Tamil Nadu, Kerala and Pondicherry by the Chennai Office.

QUESTIONS:

1) Define agricultural loan.

2) What are the objectives of agricultural finance?

3) Explain the role of Regional Rural Banks.

4) Explain briefly crop loan.

5) State any six development loans available to agriculturist.

6) Explain in detail the functions of NABARD.

Foreign Exchange and Export Finance

Foreign exchange operations and trade financing in India are significantly different countries. Here, they are insulated from international markets by an elaborate system of foreign exchange and trade controls.

The term foreign exchange may be defined as a mean of payment of an instrument of short-term credits for various countries with the different monetary units, when looked at from the point of view of their purchase or sale against the national money, or that of their holding as reserves. It refers to foreign money which includes notes, cheques, bills of exchange, bank balances and deposits in foreign converted into that of another country.

Foreign Exchange Market

Foreign exchange transactions arise mainly from trade transactions among residents of different countries. The foreign exchange market is the clearing house through which the purchase and sale of foreign exchange are offset against each other. The main link between the buyers and sellers of foreign exchange in the foreign exchange market is the bank.

Methods of International Payments

Payment by one country to another country may be made in the following ways:

(i) **Telegraphic Transfer**: A telegraphic transfer (TT) is a method of transferring money by telegram, cable or telex issued by a bank in one centre to another in a foreign centre. It is the quickest method of transmitting funds. Transfers of large amounts of money between banks are generally by TT.

(ii) **Mail Transfer**: A mail transfer is an order in writing sent mail to pay cash to a third. On receipt of an MT order, the receiving bank issues to the beneficiary its own cheque or makes payment to the beneficiary's account with itself or with another bank. An MT is similar to cheque, but it is a neither transferable nor negotiable. The purchaser of an MT pays an cash in domestic currency immediately on its purchase; but the beneficiary receives the payment only after the arrival of the MT at the foreign centre.

(iii) Drafts and Cheques: a draft is a pay order issued by a bank on its own branch or some other bank abroad. It is payable on sight. The purchaser of a draft pays to issuing bank money in local currency. The funds in the foreign centre are available to him only after the presentation of the draft to the paying bank.

(iv) Bills of Exchange: A bill of exchange is an unconditional order in writing addressed by one person to another, requiring the person to whom it is addressed to pay certain sum on demand or within a determinable date.

Rate of Exchange

In simple words, the rate of exchange is the price of one currency in terms of another currency. It may be defined as the number of units of one currency that will be exchanged for one unit or a given number of units of another currency.

Mint parity under Gold or silver standard (up to 1914)

The rate of exchanged may be determined on the basis of the gold silver content in the currencies of two countries. If both the countries are on the gold standard or silver standard, this type of rate of exchange is known as mint parity. For example, if the currency of the country A has twice as much gold contents as the currency of country B, 2 units of currency B will be exchanged for 1 unit of currency A. In such a system, the rate of deviates from the mint parity only to the extent of the cost of shipping gold silver from one country to another, including insurance, handling charges etc. The gold export or import points are known as specie points. They represent the exchange rates, below and above which it is more economical to use gold in settlement of international debts. If the rates move above or below the gold points, gold is imported or exported between the countries, which immediately brings about the readjustment in the exchange rate within the gold points.

Purchasing power parity under paper Currency (1918-1944)

Under the paper currency systems prevailing in different countries of the world, it is not possible to determine the rate of exchange on the basis of mint parity because there is no intrinsic value of the currencies. The rate of exchange is determined on the basis of the "purchasing power parity theory", which was propounded by Prof. Gustav Cessel, a Swedesh economist, as an alternative method of arriving at comparison of the values of two currencies. According to this theory, the basis for determining the exchange rates between currencies on paper currency standard in their relative purchasing power. The purchasing power parity between two currencies is defined as that amount of the currency of one country which endows the holder with the same amount of purchasing power, that is, command over goods and services – as would a stated amount of the currency of the other country. For example, if $1 in USA buys good worth Rs 7 in India, the exchange rate of U.S. $ and Indian rupee in a free market would be $ 1 = Rs 7. This rate equalises the relative purchasing power of the dollar and rupee.

The purchasing power parity theory has been criticized on the following grounds:

(i) The price indicates of different countries do not reflect the true changes in the purchasing powers;
(ii) The period of the commodities included for the computation of the index numbers change over a period of time in different countries;
(iii) The base period exchange rate may not be an equilibrium rate for use as the base rate; and
(iv) Tariffs, quotas, exchange restriction, etc., may distort the demand and supply factors in both countries.

Bretton Woods System (1946-1971)

During world war II (1939-1971), foreign exchange transactions were suspended by all the countries, and there was complete Government control on economic and trade activities. After the war, an international conference was convened at Bretton Woods in July 1944 with a view to establish a system of stable exchange rates and an orderly adjustment process to balance the payment's disequilibrium. In accordance with the agreement reached at Bretton Woods, the International Monetary Fund (IMF) was established in 1946. The main purpose of the establishment of the IMF, is known as the Bretton Woods system. The main features of this system are:

(a) Member countries of the IMF fixed the parties of their currencies in terms of gold or US dollar.
(b) The pound sterling area countries, including India, fixed the parity of its currencies in terms of gold and the US dollar.
(c) The USA fixed the parity of the dollar in term of gold at $ 35 per ounce and undertook the obligation to convert the dollar balances, held by the central banks of different countries, freely into gold at the fixed rate, and thus maintain the stability of the price of the dollar in terms of gold.

(d) The exchange rates of the currencies were established in terms of the dollar by official intervention in the exchange market by the central banks of these countries.
(e) According to IMF rules, member countries are bound to maintain their exchange rates within a margin of one per cent above and one per cent below the fixed parity of their currencies.
(f) If there is a persistent and fundamental disequilibrium in the balance of payments position of a country, the declared parity of the currency of that country may be changed in consultation with IMF.

Floating Exchange Rates

The massive balance of payments deficits, dwindling gold holdings, increasing dollar liabilities and accelerating inflation forced the US Government in August 1971 to stop the conversion of dollar balances into gold or other assets. As a result, the Bretton Woods System, which worked for about 25 years, came to an end.

After a brief period of realignment of currencies under the Smithsonian Agreement in December, 1971, major countries of the world adopted floating exchange rates. This present system of exchange rate is mixture of:

(i) Limited floating rates; and
(ii) Pegged rates.

Limited Floating Rates

The currencies of the United States, Britain, Canada, Italy, Japan, Switzerland, etc., are floating independently in world markets. This floating is however, of a limited nature, because it is managed within certain limits, i.e., the monetary authorities intervene in the market to keep the rates within nationally desirable limits.

Some other countries – Belgium, Denmark, West Germany, France, Norway and Sweden – float their currencies jointly under an arrangement called snake in the tunnel. Under this arrangement, member countries maintained fixed rates between their currencies with a maximum margin of $2^{1}/_{2}$ per cent on either side of the parity in the official markets, while floating as a group against non-member currencies.

Pegged Rates

Many countries peg their rates either to a single intervention currency or to a composite group of currencies. The main intervention currencies are the dollar, pound, sterling and the French franc. For example:

(i) India, Pakistan, Bangladesh, Zambia, Guyana, Ireland, Mauritius and Sri Lanka have pegged their currencies to pound sterling;
(ii) Cameroon, Chad, congo, dahomy, Gabon, ivory coast, mali, niger, sengal and togo have linked their currencies to French franc;
(iii) Tanzania, Kenya, Uganda, Australia, Indonesia, Thailand and many latin American countries have pegged their currencies to the US dollar; Saudi Arabia, kuwait, Fiji and Qatar have linked their currencies to special drawing rights (SDRs).

The rates of the pegged currencies are maintained against the respective link currencies through official intervention in the domestic exchange market; but they float against their currencies in the international market together with the relative link currency. All the pegged currency countries avail themselves of the margin of $2^{1/}{}_{4}$ per cent permitted by the IMF since December 1971.

At present, the exchange markets of the world are highly unstable, and the rate movements are very high on day-to-day basis. The worldwide inflationary trends and the massive current account deficits created by the rapidly rising oil prices have added more uncertainties to the already complex exchange market conditions. It is likely, therefore, that an agreement on a reform of the international monetary system may be reached in the near future.

Exchange Rate of Indian Rupee

Under the Bretton Woods system, the par value of the Indian rupee was declared in terms of gold and the pound sterling was used as the intervention currency. The Reserve Bank of India maintained the par value of the rupee within the permitted margin of one per cent above and below the rate, and brought pound sterling, when there was an excess demand in the market, at fixed rates in order to keep the exchange rate of the rupee stable. When the rupee was devalued in June 1966, its par value was fixed at 0.118489 grams of one fine gold per Indian Rupee or Rs.7.50 per US dollar. The corresponding rupee-sterling rate was Rs. 18 per pound sterling.

After break down of Bretton Woods system in August 1971, when all the important countries switched over to floating rates , the pound sterling continued to be the intervention currency for the Indian rupee, and the rupee-dollar rate was kept stable. At the time of realignment of currencies in December 1971, the rupee was delinked from the US dollar and linked with pound sterling. India decided to maintained the exchange rate stable within the wider margin of 2.25 per cent on either side of the central (i.e., a total of 4.50 per cent margin). From June 1971 to September 1975, though the exchange rate of the rupee was kept stable in term of pound sterling, it fluctuated with pound sterling against all the other currencies. During this period the pound sterling effectively depreciated by 29 per cent, and the effective trade weighted depreciation of the rupee was as much as 18 per cent against all the other currencies.

As the pound sterling was continuously showing signs of weakness and the rupee had already depreciated significantly with the pound sterling, the rupee-sterling link was not considered favorable to India at the stage. On 25th September, 1975, therefore, the rupee was delinked from the pound sterling and linked with a basket of currencies. The market value of all the units of the various currencies included in the basket at the time of delinking the rupee from the pound sterling was equal to £ 5.4620, which is the mid-point between the Reserve Bank's buying and selling rate for the pound sterling. As in the past, the intervention currency continues to be pound sterling. Whenever there is a change in the market value of the units of various currencies by more than 2.25 per cent against the standerd unit of account, say, SRD, the rupee-sterling rate is altered suitably. The value of the rupee is maintained within a limit of 2.25 per cent on either side of the middle in rate term of the basket of currencies.

Quotations of Exchange Rate

The rate of exchange is the price of one currency expressed in terms of another currency. It is a rate at which the currency of one country is exchanged with currency of another country. Any one currency may be selected as the standard against which the other currency is valued. Exchange rate quotations are of two types:

(i) Direct quotations;
(ii) Indirect quotations.

Direct quotations

In direct quotations, the exchange rate is expressed in variable units of the domestic currency for a fixed unit of a foreign currency. The domestic currency here refers to the centre from which the quotation emanated. For example, in the Bombay market quotations, the domestic currency is the Indian rupee.

Example:

Bombay Market Quotations

(a) Rs. 18.9678-18.9890 (per £)
(b) Rs. 7.1500-7.1550 (per $)

New York Market Quotations

(a) $ 2.3050-2.3060 (per £)
(b) $ 12.4550-12.4650 (per Rs. 100)

Indirect Quotations

In an indirect quotation, the exchange rate is expressed in variable units of the foreign currency per fixed unit (s) of the domestic currency.

Bombay Market Quotations

£ 5.555 – 5.65 (per Rs. 100)

$ 12.4550 – 12.4650 (per Rs. 100)

New York Market Quotations

French Fr. Frs. 4.81 – 4.91 (per US$ 1)

Rs 7.532-7.542 (per US $)

Two-way Quotations

Exchange rate quotations generally given in two ways – i.e., buying rate and the selling rate.

Buying Rate

The buying rate is the rate at which some dealers offer to buy foreign exchange.

Selling Rate

The selling rate is the rate at which some dealers offer to sell foreign exchange. But these rates are applicable to the banks which are members of the foreign exchange market. The other customers of foreign exchange buy or sell at the customer rates quoted by the banks. These are different from the market rates, though they are based on market quotations.

Forward exchanges

Foreign exchange transactions may be divided into two categories:

(i) Spot or ready transactions; and
(ii) Forward exchange or future transactions.

Spot or Ready Transactions

A spot or ready transaction is one in which the delivery of the foreign exchange takes place immediately after the deal is effected. In actual practice, however, the term spot delivery in international market refers to delivery after two clear working days. For a spot transaction entered into on 5th October, the delivery of the foreign exchange would be made on 8th October. In India, a spot transaction refers to a cash transaction or delivery of foreign exchange on the same day.

Forward Exchange or Future Transactions

A forward exchange contract is a transaction in which foreign exchange is bought or sold for delivery at a future date is prearranged exchange rate. The currency is exchanged between the buyer and seller on the date of maturity. In international markets, however the maturity date is two clear working days from the date of the contract plus the forward period. In India, the maturity date is calculated from the date of contract. For example, for a one-month forward contract entered into on 5th October, the maturity date will be 8th November. In India, the maturity date will be 5th November. The rate at which currencies are bought and sold is called the forward exchange rate or the forward rate, and is expressed in relation to the spot rate ruling at the time the forward rate is quoted.

There can be three possible relationships between the spot rate and the corresponding forward rate, namely:

(a) At par;

(b) At a premium; and
(c) At a discount.

The forward date is at par with the corresponding spot rate if the forward exchange is worth as much as the spot exchange. If the forward exchange is worth more than spot exchange, it is known to be at a premium. If the forward exchange is less than the corresponding spot exchange, it is said to be at a discount. The main advantage of the forward exchange is to protect import ande export traders against the risk of changes in exchange rates. There is often a time gap between the signing of a sale contract and the receipt of payment by exporters and of the actual remittance of payments by importers. During this period, the exchange rate may change, and cause a loss to traders.

In India, only banks and other institutions licensed for the purpose by the Reserve Bank of India can deal in foreign exchange. Foreign exchange market operations are conducted within the framework of the foreign exchange regulation of India and the rules and procedures laid down by the Foreign Exchange dealers Association of India (FEDAI). The FEDAI is an association of banks authorized to deal in foreign exchange. The latter's buying and selling rates, as well as their rates of commission, etc., are determined by the FEDAI in consultation with the Reserve Bank of India.

INTERNATIONAL LIQUIDITY

(Special Drawing Rights)

Definition

International Liquidity may be defined as the resources available to the monetary authorities of different countries for the settlement of net payments between national systems or currency areas with non-free exchange rates.

International Liquidity or international money or international reserve refers to all the resources available to the monetary authorities of a country which may facilitate the meeting of its balance of payment difficulties.

Functions

The main functions of international liquidity are:

1. To facilitate the settlement of international indebtedness, and

2. To act as a means of stabilizing, or controlling the external value of domestic currency through the intervention in the functioning of the normal foreign exchange mechanism.

Components

The principal components of international reserve till 1969 were the following:

1. Gold.
2. National currencies of some countries used as international money, e.g., in the last few decades US dollar and pounds sterling have been kept by many countries as foreign exchange reserves and they have been treated and accepted as near money assets.
3. Automatic drawings rights on reserves have not been found to be sufficient to meet the requirements of international indebtness. This is not new problem. First we will try to understand this problem of international liquidity.

The World Liquidity Problem

Growth of International Trade

Due to rapid growth in international trade in last few decades, the demand for acceptable means of international payments have been growing at a much faster rate than the development of possible international reserve assets to meet them. During 1950s world trade showed an annual growth rate of 8%, whereas the annual growth rate of reserves was 2.1% During 1960s growth of the world trade remained at 8%, the growth of reserves was 3.2%.

One of the most important factors responsible for the slow growth of international trade is the problem of the international liquidity.

The old gold standard cannot cope with the world liquidity problems. In fact, the current output of gold is barely enough to meet a fraction of the demand for world liquidity.

Some of the measures which may help to create more liquidity are:

(i) Raising of IMF Quotas

Raising of quotas of member countries of IMF would be safe and effective method for raising the world liquidity.

(ii) Swap Arrangements

swap arrangements are mutual arrangements between the central banks of two or more countries for the creation of necessary credit. Such arrangements have been tried from time-to-time and found satisfactory.

(iii) Special drawing rights (SDRs)
Another method to create large liquidity, through the the issue of special drawing rights to member countries of the IMF has proved quite successful.

Special Drawings Rights

An important factor responsible for the world liquidity problem is the emergence of developing economies in trade. The developed economies have large surplus production to be sold in international market.

The developing economies have in recent decades started taking active participation in international trade mainly as buyers of goods produced largely in developed economies. Such large purchases have became necessary for the economic development of these economies. But this increase in international trade can be successfully achieved and operated only if it is well supported by a liberal state of international liquidity. In simple words, this means that the exporting economies should be able to recover the value of their exports, and the importing economies should be sufficient means (reserves) to meet these liabilities.

Special Drawing Rights

“special drawing rights are reserve assets allocated by the international monetary fund so its members as a supplement to existing reserve assets (Gold, foreign exchange reserves, IMF loans, etc.)” special drawing rights (SDRs) scheme was introduced in January 1970, as a supplement to existing reserve assets.

Salient Features

The salient features of the special drawing right scheme as follows:

1. SDR is book entry (credit entry) in the name of the participating countries in the Special Drawing account of International Monetary Fund.
2. The scheme provides for the allocation to member countries of IMF, what are called Special drawing rights, created by an agreement amongst members as to the percentage of existing resources (quotas) with the IMF to be formed into SDRs.
3. The SDRs allocated and credited to a participant's account are owned by its for meeting deficits in its balance of payments only. Such a country can get an equivalent amount in the currency from other participating countries.
4. SDRs cannot be directly used for marking international settlements. They can be transferred only within the "special drawing account", to a designed participant for obtaining convertible foreign exchange which in turn can be used for settling international debts. In other words, the SDRs arrangement does not imply convertibility of SDRs into gold or any other form of international liquidity, because SDRs are not legal claims on any institution.
5. When any country wants to use its SDRs allocation, it requests the IMF to arrange conversion of its SDRs into foreign exchange. Some other countries are then designated by the IMF to accept the applicants SDRs and to provide specified currencies against transfer of SDRs to their account. There is no obligation on the part of a country which uses its SDRs allocation to restore its holdings or repay the obligations. However, it can restore its holdings by voluntarily purchasing SDRs from other countries.
6. All member countries of IMF are obliged to accepts SDRs up to the point at which its holdings are three times its allocation. It means at any particular movement, a country's reserve may include an amount of SDRs that can vary from zero to 300% of its cumulative allocation or more with the member's agreement. The drawings from the "General Account" of the IMF have to be repaid, but SDRs once allocated continue in permanent existence.
7. Due to SDR scheme, for the first time, the total stock of resrves and its rate of growth are determined independent of the availability of gold to be held as official reserve and the accumulation of balances in key currencies.

Mode of Allocation

All member countries of international monetary fund are participants in the SDR scheme. The fund allocates SDRs to participants in proportion to their quotas, i.e., a member whose quota was 5% of the total quotas of participants in SDR scheme would receive 5% of which allocation. The time and amount of allocations are based on recommendation of the managing director and are to be approved by the board of governors, voting with an 85% majority. The fund created SDR 9.5 billion over the three years 1970-72 which were allocated to 112 member countries. Total SDRs allocated up to now are as follows:

Date/year	Billion units of SDR allocation
1970-72	9.5
1979	4.0
1980	4.0
1981	4.0
	21.5

The total SDR allocations 21.5 billion units up to the end of 1981 constitutes 4.4 of the total world reserves, other than gold.

The IMF has the authority to extend the range of official holders beyond its member countries. The world bank, the international development association (IDA), bank for international settlement and six other financial institutions have been designated as “other holder” of SDRs. At the end of Dec.1981,SDR 16 billion were held by participants and SDRs 5 billion by Fund's General Reserve Accounts Up to 1991,India's Reserve Trauche position was of SDR 487 million in the fund. The country also purchased SDR 1.27 billion under the IMF financing facilitaties.

VALUATION OF SDR

Originally, the value of an SDR was expressed in terms of gold ,but they were not redeemable in gold.With the advent of floating exchange rates between the major currencies in early 1970s a new basis of valuation became necessary. With effect of 1st July 1974 ,the standard basket technique was adopted under which value of SDR was related to basket was simplified by replacing the 16 currencies with those of currencies,i.e.Dollar,Deutsch Mark,Japanese Yen,French Franc abd Pound Sterling.

Under basket technique , the SDR is valued as sum of fixed amounts of several currencies,To ensure maximum stability for exchange value of SDR , the criterion used for selection should be those most widely uswd international trade and payments. The weight each currency was given in the basket was intended to reflect its importance in trade as well as its importance in financial markets

IMPORTANCE AND USE OF SDR

The use of SDR as a unit of account outside the IMF has grown in importance in recent years. A growing number of international organizations use SDR as unit of account. Some 15 countries peg thier currency to SDR largely because of automatic element of portfolio diversification entailed by uts impetus to this use particularly because it is made it easier for banks to handle SDR denominated deposits time deposits denominated in SDRs are most important in terms of volume but there is a wide range of other instruments ranging from current accounts,Through certificates of deposit and floating rate notes,to 10 years syndicated credits however a clearing system for private SDR payments has not yet developed. Such a system would facilitate future growth in volume and type of SDR denominated financial instruments and might also encourage the use of SDR as a unit of invoicing commercial transactions. Current use of SDR for this purpose is minimal

RATE OF INTEREST

The interest rate on SDR was set 5% per annum on July 1st 1974 about half the combined market rate at the time.It was adjusted according to formula every 6 months.Experience showed that SDR rate,which workings of formula kepy about half of combined market ratewas too low,imparing the quality of SDR as a reserve asset.Consequently, between July 1976,and May 1981,the SDR interest rate was rised in steps to full combine market rate.

SDR AND DEVELOPING COUNTRIES

A majority of countries of world (3/4th of member of international monetary fund)Come in category of developing countries.These countries because of their larger needs of reserves for developmental purpose are getting some relief and benefit for SDR scheme. It has strengthened their capacity to mitigate abrupt fluctuations in thier export earnings and thus to meet on a continuous basis,their development oriented import requirements.It also helps these countries in their balance of payment difficulties.However the developing countries have a genuine case for receiving a large share of the SDRs and if there is a technical hitch in doing so,it is very essential that the whole basis for the allotment of quotas in IMF to different members countries should be revised.India has time and again,Stressed important of combining the creation of additional international liquidity with the provision of development finance, but it was never accepted by industrially developed countries.

EXPORT FINANCE

With rapid increase in foreign trade, the demand for financing both import and export of good has gone up. Like the financing of internal trade, foreign trade requires financing by banks. This is specialized service and calls for not only technical expertise but also worldwide connections trade,but since the last few decades, Indian banks have leading role in providing this service.They now finance exports by offering -

1)Packing Credit

2)Loan against duty drawbacks and subsidy

3)Advance against bills for collection

4)Credit for purchase of export bills

5) Post-shipment term finance

6)Guidance in exhange control formalities

7)Export promotion measures

8)Documentation - shipping documents, uniform custons etc.

Export finance includes pre shipment finance or post shipment finance or both.

PRE SHIPMENT FINANCE (PACKING CREDIT)

An exporter may need finance to purchase raw materials and equipment to manufacture goods which will later be exported to foreign country.Credit facilities required for this purposes are called packing credit or pre shipment finance, which is generally short term accommodation provided by banks.

POST SHIPMENT FINANCE

When exporter loads the goods on to a ship and secures a bill lading and insurance papers etc.

He seeks the help of a banker in realising payments from a foreign importer. In most cases,this will turn through bills of exchange. Also called drafts which are drawn by an exporter on importer in a foreign country. These bills may be of 2 types-

1) D/A - Documents against acceptance

2)D/P - Documents against payments

The bills are sent to the foreign importer (buyer) through a commercial bank. In a D/A bills,the documents of title to goods (bills of lading,insurance papers etc.)are given by the bank to the importer following acceptance of the bill drawn by the exporter. In the D/P bills, documents of title to goods are given by the bank of the importer on payment of the goods. This method of securing payment is common in cases where foreign buyer is not known to seller. When buyer is not so known and seller feels that there may be a risk in obtaining payment, the importer secure a letter of credit from a banker in his country. The bill of exchange drawn under a letter of credit may be negotiated with any banker or the banker name in such letter or credit. (By negotiation we mean negotiating banker pays to the drawer the value of bill on the assurance of opening banker. By the opening banker is meant banker who issues letter of credit at request of importer in favor of exporter on a bank in exporters country.)

It may be noted here that , there is a difference between the negotiation of a bill and purchase of an export bill. When the exporter knows the importer and the letter of credit is not thought necessary a bill of exchange is drawn by the exporter on importer and payment is secured against documents. The bill may be drawn at the sight or payable after a stipulated period. In the letter case, it is retained by the bank and the presented to the buyer for payment on the date of maturity. Such documentory bills are purchased by the banker. Normally, the exporter's bank gives immediate credit for these bills, and a discount or a fee or interest is charged by the bank for this service.

COLLECTIONS OF FOREIGN BILLS

The collection of a bill on behalf of a customer is done by a bank in the same way as it is in the case of home trade.Foreign bills are normally accepted for collection when the exporter is unable to negotiate then in the absence of letter of credit or the exporter is unable to sell them to a banker.

MEDIUM TERM FINANCE TO EXPORTERS

Bank also extend term loan facilities to exporters against a differed installments recievable from importers. The exporter normally furnishes to the financing bank the promissory notes executed by the importer or a guarantee from the importer's bank covering the default receivables.

Apart from the normal risk involved in various types of lending by banks, the financing of exports involves certain other risk which include those arising from the insolvency of the foreign buyer,exchange restrictions, currency regulations, import controls etc. Although in all such cases bank always look to exporter whom.it has financed,this may not always help him to recover his dues and the bank, therefore needs some protection. In the connection, the help established of the export risk insurance corporation limited, in 1956 was a welcome development from January 1964, the export risk insurance corporation was merged into export credit guarantee corporation. The services of corporation includes covering risk of insolvency and default, of war and civil commotion, of transfer of money, of import/export restrictions, of diversion of goods, and any other risk which is caused by factors beyond control of exporter or the buyer which arise from events occurring outside the exporter's country such as CIF risks and inability to recover by sales,expense incurred on markets surveys, publicity and other promotional measures for the development of particular markets etc.

INSURANCE POLICIES TO EXPORTERS

The export credit guarantee corporation issue the following standard insurance policies to the exporters :-

1) Shipments(Comprehensive risks)policy

2)Shipments (Political risk) policy

3) Contracts (Comprehensive risk)policy

4)Contracts (Political risk) policy

5)Packing credit insurance policy

The contracts(comprehensive risk) policy protects exporter from time he receives order until he receives payment against both political and commercial risks likewise, the shipment comprehensive risk policy covers both political and commercial risk from the dste of shipment till payment is received.Packing credit insurance policy covers pre-shipment risk on credit given against firm contract of sale.The policy covers risk of insolvency of the exporter or his protracted default in repaying the advance. Risk involved in export on consignment basis are also covered by an appropriate endorsement. In addition to covering risk and risk arising from events outside India,the corporation also covered additional risk arising out of of cancellation of current export license or impositions of restrictions. On export licence or on export of goods not provisionally subject to license tye corporation covers risk upto 80% in case of commercial risks and upto 85% risk in case of political risk. In case of every buyer, exporter has to get a credit limit fixed by exporters are required to cover shipments made by them to all the countries during a period of 12 months from the date of commencement of the policy, excluding shipments confirmed irrevocable letters of credit and those paid in advance.

The benefits of these policies may also be assigned by exporters in favor of their banks. Such assignments can be of - a) individual bills

b)exports to 1 country

c)whole policy.

The letter of authorisation signed by exporter is an authority to the insurer to pay direct to the bank.

The addition to 5 types of policies refere to above,the export credir guarantee corporation also issue the following policies:-

1) Manufacturer's credit insurance policy

2)Market development and market survey policies

Some other functions of corporation include supply of status information about customers in other county. The ESGC is a member of the berne union as association of credit inssurers in different countries and able to exchange credit information with insurers in other countries

FINANCIAL GUARANTEES TO BANKERS

The export credit guarantee corporation now issues, besides insurance policies, the following 5 types of financial guarantees direct to banks:-

1) Post shipment export credit guarantee

2)export finance guarantee

3)export production finance guarantee

4)export performance guarantee

5)packing credit guarantee

i) Thr post shipment export credit guarantee is issued to bank to indemnify them to the extend of 66.5% of any loss from purchase, discount or negotiation of export bill arising from the continued default or insolvency of an exporter. An enhancement in the risk covered to 90% was made in 1968 in respect of this guarantee covering advances to exporters of engineering and metallurgical products who secure large export order involving medium term and long term payments.

ii) Th export finance guarantee enables the exporter to obtain pre shipment finance on the domestic value of its goods.The guarantee enabled bank to offer, on a selective basis, decounting basis to the 125% of the value stated in shipping documents, with a bank advance guaranteed by the corporation. The indemnity to bank is to the extend of 75% of the loss incurred in case of loans insolvency or default.

iii) The export production finance guarantee seeks to enable to make available preshipment credit to cover the value of goods + the element of incentives accruable under various export promotion schemes.

iv) Export performance guarantee are in the nature of counter guarantee to the performance foreign buyers

v) Packing credit guarantee enables an exporter to obtain from his bank pre shipment finance for the purpose of purchasing, processing and packing goods required to be sent to export market. This guarantee is issued to bank and the corporation incemnifies them upto 66 and 2/3 % during 1968, the corporation increased to risk coverage under this guarantee to 90% in respect to the exporters of small scale units.

DIRECT FINANCE FOR EXPORTS BY INDUSTRIAL DEVELOPMENT BANK OF INDIA

Export from India have increased at rapid rate in last few years. It was therefore, felt that commercial bank might not be themselves be able to willing to carry the whole risk and provide the entire term finance and guarantee required by exporters. The industrial development bank of India therefore, introduced a new scheme from December 6th 1968, term of which a bank, in appropriate cases, enters into participation arrangements with eligible commercial bank with a view to providing term finance and guarantee facilities to industrial concerns both in publuv and private sectors, which export capital and engineering goods and services on deferred payment basis. The Scheme provides for export credits both during pre shipment and post shipment stages for periods over 6 months and for export performance guarantee on behalf of exporters all licensed scheduled bank in India which are authorized dealers in foreign exchange are eligible for participation under this Scheme. Normally the industrial development banks of India will change on its portion of the export credit, a rate of 5.5%, while the participating bank will charge its own rate on its portion upto 7% the ceiling rate currently prescribed by the reserved bank of India.

REFERENCE OF EXPORT CREDIT BY IDBI

The industrial development Bank of India took over the business of the refinance corporation on September 1, 1964 under provisions of the industrial development bank of India act. It has been since been operating a Scheme for refinancing medium export credit granted by commercial banks their advances in respect rof exports of capital and engineering goods. The eligibility for refinance covers all credits granted to those exporters in public and private sectors who are manufacturers,firms are also covered by this scheme. Refinance is granted in respect of credits normally repayable after 6 months but before 5 years , maximum period may be extended up to 7 years in deserving cases and upto 10 years in exceptionally deserving cases. The IDBI charges a uniform rate of 4.5 % and banks are required to charge exporters not more than 6%.

REFINANCE OF EXPORT CREDIT BY RESERVE BANK

The reserve bank of India had as early as June 1968 taken action in regard to the provision of forward cover in respect of long term export contracts so as to minimize the risk of currency depreciation by providing rollover facilities, and enabling the authorized deslers to offer such a cover to exporters. The authorized dealers may in turn obtain forward cover from the reserve bank in respect of their Stirling transactions. Similarly the reserve Bank already exempted packing credit advances and post shipment credit from the competition of the norm fixed in respect of a) the credit deposit ratio and b) unsecured andvances and guarantees by banks it has introduced following schemes in regard to export finance:

1)Export bill credit scheme : The export bill credit scheme was introduced in March 1963. Under this scheme the reserve bank grants advances to scheduled banks against their promissory notes payable on demand upon their declaration of holdings of eligible usance export bills drawn in foreign currencies or Indian Rupees and purchased or negotiated by them.

2) Pre-shipment credit scheme: Under this scheme which was introduced from 1st february, 1969, the reserve bank makes advances to scheduled banks against their promissory notes, together with a declaration to the effect that they have granted pre- shipment loans to exporters.

3) Export credit (interest subsidy) scheme: The export credit (interest subsidy) scheme was introduced on march 3, 1968, with the objective of reducing the cost of credit to exporters. Banks providing finance to exporters are given a subsidy of 1.5 per cent on the total outstanding, provided that they charge interest from the exporters within the ceiling prescribed by the reserve bank.

DOCUMENTARY CREDITS AND THE BANKER

Commercial transactions involving movement of goods from one country to another can be called the beginning of international trade. Importers and exporters are 2 essential parties engaged in any business between 2 countries. But unlike the domestic market there are many peculiar problems affecting the smooth conduct of foreign trade engagements. A few of them can be listed as problems of payment in terms of foreign currency , language, geographical separation by long distance, rules and regulations regarding import and export, political and commercial stability, problems in settling disputes between buyers and sellers and so many others. These are serious obstacles which frustrates any commercial activity also while the psychology of seller is to hang on to the goods till he gets paid the buyer will observe utmost care not to part with the money till he receives the correct consignment under the contract of course , such a stubborn situation doesn't encourage any business. It creates stalemate in the dynamic commercial world of interdependence and mutual benefit. In this context the role of banks in vital. Banks undertake to accomodate both buyers and sellers through the documentary credit operation which effectively means a reliable, Fructuous intermediation so that exporters and importers get exactly what they want. Documentary credit is brilliant discovery which acts as nucleus around which all international commercial transactions revolve and bear positive results.

The revised edition of uniform customs and practice for documentary credits (UCPDC) has come into effect from october 1, 1984. This new document (publication no. 400 of international chamber of commerce) has 55 articles which replaced the previous UCPDC of 47 articles. General provisions and definitions are discussed in articles 1 to 6, forms and notification of credits come under articles 22 to 42(this is the section which has the maximum number of 21 articles out of 55 in UCPDC), miscellaneous provisions are mentioned in articles 43 to 53 and transferrable credits by articles 54 and 55.

Article 3 of UCPDC says that credits by their nature are separate transactions from the sales or other contract on which they may be based and banks are in no way concerned with or bound by such contract even if any reference whatsoever to such a contract is include in the credit. India is a country which has subscribed ti adhere to the UCPDC as promulgated by the ICC and authorised dealers who are handlinf foreign trade in india are under absolut control of RBI. Authorized dealers in india are concerned with sale contracts in the context of foreign transactions whrerver it is applicable and a sale contract constitutes a basic document which should be made available to the banker. Banks insist on sale contracts which are legally enforceable, which are xontracts not subject to any approval and which are not attached with any contingent conditions. Such documents or contracts are held as securities by the banks where advance of many is involved.

Sale contract is the founding instrument which can be treated as prime contract. From this prime contract originate 3 essential subsidiary contracts and some miscellaneous contracts. 1st subsidiary contract is a transport contract i.e., a contract of carriage. Under this a transport document evidencing consignment in transit has to be produced namely a bill of lading, or s combined transport document, or an airway bill etc. , which are covered by articles 22 to 24 in general and articles 25-34 in particular in UCPDC. 2nd subsidiary contract is an insurance contract which calls for an insurance policy to be submitted(Articles 35-40). The 3rd subsidiary contract is the financial contract. On the basis of the terms recorded in the prime contract it is decided whether a DC will be opened or not. By virtue of the financial contract a documentary credit is opened which is a contract of agreement between the buyer (Opener) and buyer's banker (Issuing bank) favouring the seller (Exporter)

The exporter draws a bill of exchange for the value on the importer, the prime contract paves the way for bringing out the instrument of documentary which asures the exporter payment and ensures prompt delivery of the specified goods for the importers miscellaneous contracts under the sale of contract deals with submission of miscellaneous documents such a commercial invoice (Article 41) Certificate of weight, Certificate of Origin, Laboratory certificate, etc. (Article 42).

Article 4 of UCPDC states that in credit operation all parties concerned deal in documents and not in goods, services and/or other performances to which the documents may relate here it is to be understood by all parties concerned with credit that the application and protection available under UCPDC is extended only to those genuine documents handled by thr banker and not for any document

Articles 7-10 are concerned with different forms of credits such as revocable, irrevocable and confirmed irrevocable credits.Revocable credits are cheap but not favoured by sellers owinng to the inherent characteristics of the credit. Irrevocable credits are safe and cost incured is reasonable while confirmed irrevocable credits are costlier but safer. The utility of irrevocable credits are more in comparison to other credits.

Article 11 states that all credits must clearly indicate whether they are available by sighy payment by deferred payment by acceptance or by negotiation. Although these four types of transactions are there in India, negotiation credits are maximum in use.

UCPDC have stipulated different types of general credits such as revocable, irrevocable , confirmed irrevocable and transferable credits, yet it is significantly silent on such special credits like red clause revolving and back ro back credits.It is very pertinent to note that article 54 and 55 of UCPDC deal with transferable credits in details while about back to back credits its there absolutely no reference at all. This speciality makes it interesting to study about transferable and back ro back credits.

Generally, all the documentary credits are opened by buyer in favour of the seller. But in some situations the seller is not the actual producer of goods to br exported. The beneficiary is intermediary who purchases from one or more suppliers. In such case to avoid additional transactions by buying required things from third parties and supplying the same to the buyer known very clearly that the beneficiary is not the actual supplier of goods. Beneficiary under s transferable credit can be a person, a firm , a company an export house or a trading house. Transferable credits are also opened where such sellers who cannot get a documentary credit opened in their favour of such sellers who sre mot exporters of goods. But established exporters can easily arrange for credits whic will indirectly such suppliers.

In back to back credits the beneficiary receives a letter of credit in his favor but he is not producer of goods and doesn't wish to get a transferable credit as he does not want to feed any hint to the buyer regarding the procurement of goods from others for subsequent supplies. The notable future of a back to back credit is that unlike other credits in this case the beneficiary of the credit request advising bank to open another letter of credit in favour of its suppliers on the strenght of the first credit as security for the credits subsequently opened. Back to back credits are notcovered by UCPDC, may be because this is a 2nd credit transaction arranged by the seller through his bank in his country in favour of his suppliers. This transaction is also considered as a domestic credit arrangement between the bank and its customer. The advantage for the seller is that the supplier of goods will not know about the ultimate buyer it is also a point to note the comparing to volume of transactions accounted to other kinds of documentary credits operation by transferrable credit are less and back to back credits are still less.

Abu dhabi - Dinar

Aden-dollar

Afghanistan-afghani

Albania-Lek

Algeria-Dinar

Angolo-Esxudo

Argentina-Peso

Australia-Dollar

Austria-Schilling

Bahamas-Dollar

Bangladesh-Taka

Bahrain-Dinar

Belgium-Franc

Bolivia-Peso

Brazil-New Cruzero

Brunei-Dollar

Burma-Kyat

Canada-Dollar

Central African Republic-Franc

Chile-Escudo

China-Yuan

Columbia-Peso

Costa Rica-Colon

Cuba-Peso

Czechoslovakia-Crown

Denmark-Krone

Dubai-Riyal

Ecuador-Sucre

Egypt-Pound

El Salvador-Colon

Fiji islands-dollar

Finland-Markka

France-Franc

Germany-Deutsche Mark

Ghana-New Cedi

Greece-Drachma

Honga kong-Dollar

Hungary-Forint

Iceland-Krona

India-Rupee

Indonesia-Rupiah

Iran-Rial

Iraq-Dinar

Ireland-Pound

Israel-Pound

Italy-Lira

Jamaica-Dollar

Japan-Yen

Jordan-Dinar

Korea(south)-Won

Kuwait-Dinar

Liberia-US dollar

Libya-Pound

Malaysia-Dollar

Mexico-Peso

Monaco-Franc

Nepal-Rupee

Netherlands-Guilder

New Guinea- Dollar

New Zealand-Dollar

Nigeria-Pound

Norway-Krone

Pakistan-Rupee

Panama-Balboa

Peru-Sol

Philippines-Peso

Poland-Zloty

Portugal-Escudo

Romania-Leu

Russia-Rouble

Saudi Arabia-Riyal

Singapore-Dollar

South Africa-Rand

Spain-Peseta

Sri Lanka-Rupee

Sudan-Pound

Sweden-Krona

Switzerland-Franc

Syria-Pound

Thailand-Baht

Turkey-Pound

United Arab Emirates-Dirham

United Kingdom-Pound

Uruguay-Peso

Vatican City-Lira

Vietnam-Piaster

Zairc-Zaire

Zambia-Kwacha

QUESTION:

1) What is foreign exchange?

UNIT- V

FEE BASED BANKING SERVICES

Banks earn their income in two parts. One type of income is generated by undertaking risk i.e. by lending their deposits. This is called interest income and forms the major portion of any bank's earnings. However, **banks can also generate earnings from other sources wherein they do not have to lend money or collect interest. Such sources are called fee based banking services** and form an important part of any banks profit and loss statement. In this article we will list down the various sources from which banks can generate non interest i.e. fee based income.

1. **Cards**

Credit cards and debit cards have been new addition to the banks portfolios. However, in a short span of time, these services have started accounting for large sums in any bank's non interest earnings. There are a variety of fees charged by these cards. There are some fees like joining fees and annual fees. Then there are charges such as interest on overdue balance, over limit fees, service taxes etc. All these charges were not a part of any banks earnings a few years earlier. Besides every time a credit or debit card is used, banks that have issued such cards are paid fees by the merchant.

The introduction of credit cards has created this new addition to the bottom line of the bank's income statement.

2. **Commissions**

Banks have also started providing other services like selling insurance and mutual funds to their customers. Since banks have an intimate relationship with the customer, they are in a position to estimate their net worth and advise them regarding insurance as well as investment needs accordingly. Hence, insurance companies and mutual fund companies collaborate with banks to provide a one stop shop to the customers. Banks charge commissions to market these services to their customers. Over a period of time, commissions from bancassurance have started accounting for significant percentages of non interest incomes.

3. **Capital Market Advisory**

Banks often assist corporations in their debt issues in the bond market. They understand the macro-economic conditions very well given their vast experience with capital markets. Hence, they can advise corporations regarding the quantum of debt to be issued, the interest rate at which it needs to be issued as well as the time when issuing such debt would make selling it easier.

Banks usually do not underwrite these debt issues. Instead, they simply charge a flat fee for the advise that they provide and the expertise that they bring to the table.

4. **Demand Drafts and Pay Orders**

Demand drafts are different from negotiable instruments like cheques. When a bank issues a demand draft, it is no longer the customer's credibility which is at stake. Unlike cheques, demand drafts are issued by banks and therefore are paid and settled by banks on their own account. The bank is therefore providing a kind of guarantee to the party accepting the demand draft. For all practical purposes, a demand draft can be considered to be as good as cash because it is not subject to realization from the customer's account. A demand draft will always be paid unless the bank issuing it has gone bankrupt! Therefore banks charge a fee to provide a demand draft. This fees also forms a part of their non interest income.

5. **Guarantees**

Banks also provide the service of providing guarantees for a given fee. This service is used to bridge the trust gap between two parties. For instance, party A wants an advance payment whereas party B is willing to pay only after the work is completed. Neither party is willing to trust the other party. In such a case party B can deposit the funds with a bank and the bank can issue a guarantee to party A. Since the bank guarantee becomes a binding commitment made by a credible financial institution, party A can be rest assured that they will be paid once the work is completed as decided. The bank charges a fee for providing such a service. Bank guarantees are often used between first time trade partners. As trade is conducted often, counterparties become comfortable granting credit to each other and the need for bank guarantees is significantly reduced.

6. Account Related Fees

Banks also charge a wide variety of fees in order to maintain their customer's accounts. For instance when customers request checkbooks or additional debit cards, they are charged a fee. Besides, banks also charge penalties if the deposits maintained fall below a certain limit. They also charge fees if there are more than a certain number of withdrawals made within a given time period. Some form of payments made via bank accounts also result in fees being charged to the account.

7. Lockers

Lastly, banks also provide locker services to their customers. This was what the business of banking was originally about and most banks offer this service till date. Customers can store their valuables in the safe vaults of the bank and benefit from the extensive security that the bank has arranged for. The bank cannot access the valuables stored in these vaults and in most cases does not have any information regarding the content of the vaults. The bank merely provides a safe place for storage and charges a fee for the same. Earlier this fee used to form a significant part of non interest income of any bank. However, over time the usage of lockers has reduced drastically and other more profitable fee based businesses have emerged for banks.

Non interest component signify relatively risk free earning for the bank. Therefore banks which have consistently been able to generate stable and high noninterest income are valued highly by stock market investors.

FEE BASED BANKING SERVICES OF ONE OF THE FINANCIAL INSTITUTION AS A GUIDE

Fee Based Services	
1. Lockers	Locker rates vary for different branches, hence customers are requested to get in touch with respective branch
2. Debit Cards	Rs.99 p.a. (W.e.f. Sept 1, 2014 Rs.150 p.a. For Gramin locations - Rs.99 p.a.
3. Drafts	
3a. Demand Drafts	
Issue	Rs.50 per D.D. up to Rs.10,000; Rs.3 per thousand rupees or part thereof for DD of more than Rs.10,000, subject to a minimum of Rs.75 and maximum of Rs. 15,000
For Senior Citizen, Student & Rural locations	For amounts upto Rs.10,000 - Rs.40, For amounts above Rs.10,000 till Rs.50,000 - Rs.60, For amounts above Rs.50,000 - Rs.3 per thousand rupees or part thereof (maximum of Rs.15,000)
Issue - By deposit of cash	Rs.4 per thousand rupees or part thereof, subject to a minimum of Rs.100 and maximum of Rs. 15000
Duplicate/Revalidation/Cancellation	For Instrument value upto Rs.200 – Nil. For Instrument value above Rs.200 - Rs.100
3b. Pay Order	
Issue	Rs.50 for PO of up to Rs.10,000, For PO above Rs.10,000 Rs.2.50 per thousand rupees or part thereof, subject to a minimum of Rs.75 and maximum of Rs.15000
For Senior Citizen, Student & Rural locations	For amounts upto Rs.10,000– Rs.40, For amounts above Rs.10,000 till Rs.50,000 – Rs.60, For amounts above Rs.50,000 – Rs.2.50 per thousand rupees or part thereof (maximum of Rs.15,000)
Issue - By deposit of cash	Rs.150 per PO for amounts up to Rs.50,000, For PO above Rs. 50,000 Rs.4 per thousand rupees or part thereof, subject to a minimum of Rs.150 and maximum of Rs.15000
Duplicate/Revalidation/Cancellation	For Instrument value upto Rs.200 – Nil. For Instrument value above Rs.200 - Rs.100
4. Outstation cheque collection	
Through ICICI Bank	Upto Rs. 5,000 – Rs. 25 per instrument. Rs. 5,001 to Rs. 10,000 – Rs. 50 per instrument. Rs. 10,001 to Rs. 1 lakh – Rs 100 per instrument. Above Rs. 1 lakh - Rs. 200 per instrument
Through Non-ICICI banks	Upto Rs. 5,000 – Rs. 25 per instrument. Rs. 5,001 to Rs. 10,000 – Rs. 50 per instrument. Rs. 10,001 to Rs. 1 lakh – Rs 100 per instrument. Above Rs. 1 lakh - Rs. 200 per instrument

Fee Based Services	
1. Lockers	Locker rates vary for different branches, hence customers are requested to get in touch with respective branch
Speed clearing charges	Upto Rs 1 Lakh Nil; above Rs 1 Lakh Rs 150/- per instrument
5. NEFT Money Transfer	
Inward	Nil
Outward	Upto Rs.10,000 – Rs. 2.50 per transaction. Rs.10.001 to Rs.1 lakh – Rs. 5 per transaction. Above Rs. 1 lakh to Rs. 2 lakhs – Rs.15 per transaction. Above Rs. 2 lakhs – Rs.25 per transaction.
6. RTGS Money Transfer	
Inward	Nil
Outward	Rs. 2 lakhs to Rs.5 lakhs – Rs. 25 per transaction. Rs. 5 lakhs and above – Rs. 50 per transaction
7. Cheque return charges	
Local	
Inward	Rs.350 for one cheque return per month; Thereafter, Rs.750 per return in the same month for financial reasons. Rs.50 for non-financial reasons except for signature verification
Outward	Rs.100 for every cheque return for financial reasons.
Outstation	
Inward	Nil
Outward	Rs.150 plus other bank charges at actuals per cheque.
8. Cheque Book Issue	Nil for 20 payable-at-par cheque leaves in a quarter;Rs. 20 for every additional cheque book of 10 leaves
9. No Dues Certificate	Nil

UNIT-VI

ELECTRONIC BANKING

Meaning of E-Banking:

Online banking also known as internet banking, e-banking, or virtual banking, is an electronic payment system that enables customer of a bank or other financial institution to conduct a range of financial transactions through the website of the financial institution.

To access financial institution online banking facility, a customer with internet access would need to register with the institution for the services, and set up password and other credentials for customer verification.

Characteristics of E-Banking

1. E-banking is essentially performance of banking operations through electronic means or tools.
2. E-banking is the provision of banking products and services by banks through the extensive use of information technology, without direct resource to the bank by customers.
3. Provision of round the clock (i.e. 24 hours) access to banking facilities in a convenient feature of e-banking.
4. E-banking is the conduct of banking operations globally. In other word e-banking is anywhere banking.

Benefits of E-Banking:

E-banking offers number of benefits to Banks as well as Customers.

Benefits of E-banking to Banks

1. **Better Brand image:** Banks which offer e-banking services are regarded as leaders in technology implementation. Therefore they enjoy better brand image.
2. **Satisfies large number of customers:** E-banking ensures large number of customer, thereby contributing high rate of retention of existing customers of a bank.
3. **Attracts new customers:** E-banking attracts ne customers to a bank dye to availability of innovative banking facilities provided.
4. **Offers different services:** There is scope for offering different services under e-banking (e.g. fund transfers, payment of bill, stop payments, etc.)
5. **Reduced cost of operations:** E-banking contributes to the profitability of the bank through reduced cost of operation for banking services.
6. **Transfer fund between accounts:** E-banking (i.e. Phone banking) enables banks to pay certain fees of operation for banking service.

7. **Better controlled of banking risk:** Risk Of banking can be monitored and controlled by e-banking by establishing centralised database.

Benefits of E- Banking to Customers:

1. Bank customers can enjoy innovative banking products and services at a reduced cost.
2. Time saving Facilities, are made available to customers, round the clock without physical interaction of the customers with the bank.
3. Faster, easier and continuous access to banking information is made available to customers.
4. Facilitates better cash management to customers.
5. Allows customers to handle variety of banking transactions.
6. E- Banking inculcates a sense of financial discipline by recording each and every transaction.

Drawbacks of E-Banking

1. Initial cost of installation and operation is high.
2. Lack of skilled labour.
3. Security threats from unauthorised access, hackers, virus etc.
4. Risk of loss of breach of security is very high. Therefore banks have to install protection programs, hardware and software.
5. Risk of obsolescence.
6. It is difficult to adopt modern technology at multiple branches for banks having vast networks.
7. Fear of technology and psychological factors have made customers acceptance of e-banking poor in India.
8. Legal framework to support e-banking is still being questioned.
9. Sometimes customers find it difficult to log on.
10. Technical setup required to use the facility need not be always perfect.

Forms of E-Banking

1. Internet banking or net banking: Internet banking refers to provision of banking services by a bank to its customers through its websites.

2. Mobile banking: Mobile banking refers to conduct of banking operations on mobile .In other words, mobile banking means banking operations are done through mobile phones while a person is on the move.
3. Telephone banking or phone banking: Telephone banking refers to the delivery of banking and financial services to customer of a bank through the medium of telephone. In other words telephone banking is form of e-banking under which a customer can obtain necessary information by dialling a telephone number specified in advance.
4. Home banking: Use of personal computer at home for conducting the banking operations with his/her bank is called home banking.

AUTOMATED TELLER MACHINES (ATMS)

An automated teller machine is popularly called the cash machine or any time cash machine. It is an electronic machine installed by a commercial bank and operated by its customers, to withdraw money or make financial transactions.

In other words an ATM (Automated Teller Machine) is a telecommunication device that allows customers to directly use secure method of communication to access their bank accounts or make cash withdrawals.

Features of ATMs

1. ATM can be installed at any place where large number of people may be present.
2. ATM is any where banking facility provided to bank customers. They can transact banking business at ATMs which are installed at various convenient places.
3. ATMs provide banking services to customers round the clock.
4. ATMS are user friendly.

Advantages of ATMs to Customers

1. ATM permits cash withdrawals by customers from their bank accounts.
2. ATM permits cash deposit by customers into their bank account
3. ATM enables the customers to make enquiry about their bank balance.
4. ATM facilities request by customers for their statement of account.
5. ATM card holder can have access to cash and bank services at any location regardless of where they have maintained their accounts.
6. There is privacy in all transactions.
7. ATM permits change of personal identification number (PIN).
8. ATM facilitates request by customers for cheque books.
9. ATM facilitates transfer of funds, from one account to another in the same branch or in different branches of the bank.

10. ATM facilitates bill payments.
11. ATM facilities are available at any time, day or night (24 X 7) for 365 days a year.

Disadvantages of ATMs

1. Initial cost of installation of ATMs is very high.
2. ATM system demands literacy on the path of the user that is the customer.
3. ATM system requires computerisation of all bank branches.
4. There are certain restrictions on the ATM facilities for example more than specified amount of money in a day cannot be withdrawn from the ATM.

CREDITCARD

A credit card is an instrument which provides instant facility to its holder to purchase goods or services from business establishments enrolled as members of the credit card system. Credit cards are popularly known as plastic money as they are usually made of plastic.

Features of Credit Card

Some of the key features of a Credit Card are as follows:

1. It offers short term, zero-interest loan for every purchase.
2. It helps in building the cardholders credit history.
3. It offers various features, such as reward points, gift coupons', vouchers, cash back and extra discount on purchase.
4. Credit cards offer specified credit limit for purchase and cash withdrawals.
5. Some common charges on credit card include joining fee, annual fee, late payment charge, duplicate statement fee, cash withdrawal, service tax, cheque return charge, foreign currency transactions and over limit fee.
6. Credit card can be used at home and automated teller machine or other places during travel.
7. A credit card identifies its owner as the one who is entitled to purchase goods and services without the use of cash.

Advantages of credit card system

1. Credit card makes shopping very convenient as there is no need to carry cash or issue cheque.
2. Credit cards enable the card holder to avail of credit facilities sanctioned by the issuing bank.
3. Credit cards extend rollover credit facility, whereby the credit rolls over for reuse once the previous amount is repaid.

4. Credit cards provide a safe means of conducting financial transactions as it voids the risk of theft of cash.
5. Credit card facilitates easy record keeping.
6. Credit cards such as Visa cards and Master cards have wide acceptability by merchant establishments.

Disadvantages of Credit Card to Card Holders

1. Credit card holders are burden withy service charges, annual fee, membership fee and high interest for late payment.
2. Credit cards tempt the card holder to purchase goods and services beyond his means.
3. It is waste of money if the credit cards is not utilise.
4. It will drag the user into financial problems if payment of credit card is not done properly.
5. The method used to recover the outstanding dues on the credit card by recovery agents may cause mental agony to the user.

DEBIT CARD

Debit card is also a small plastic card used for making payment. It has a unique number mapped out with the account holder's bank account.

ELECTRONIC FUND TRANSFER (EFT)

Electronic fund transfer is a popular electronic payment method, to transfer money from one bank account to another.

QUESTION BANK

1. What is E-banking?
2. Explain the characteristics of e-banking.
3. Explain the benefits of e-banking to banks.
4. Explain the benefits of e-banking to customers.
5. Mention the drawbacks of e-banking.
6. Explain the forms of e-banking.
7. What is the full form of ATM.?
8. What is ATM and mention the features of it.
9. Mention the advantages of e-banking
10. Mention the disadvantages of e-banking
11. Write a short note on credit card.

12. Mention the advantages of credit card.
13. Mention the disadvantages of credit card.
14. What is mobile banking, mention the steps in it.
15. Write a short note on debit card.
16. What is RTGS?
17. What is NEFT?
18. State the difference between RTGS and NEFT.

FILL IN THE BANKS

1. The conduct of business through the internet where goods and services are exchanged and payments are made is known as ________.
   (E-banking, e-commerce, e-business, e-mail)
2. Use of computer at home to conduct banking operation with bank is called as _________.
   (Home banking, mobile banking, internet banking ,phone banking)
3. The instrument which provides instant credit facility to its holders to purchase goods and services from business establishment is known as _________
   (Credit card, visitor's card, customers' card, business card)
4. The electronic payment method , to transfer money from one bank to another bank where amounts exceeds rs.2,00,000 is called as ___________.
   (NEFT, RTGS, mobile banking, ECS)
5. The electronic payment method , to transfer money from one bank to another bank where amounts is less than rs.2,00,000 is called as ___________.
   (NEFT, RTGS, mobile banking, ECS)

UNIT-VII
Financial Markets

Financial markets refer to institutional arrangements for dealing in financial assets, or securities. In other words, financial markets refer to credit markets for meeting the long term and short-term credit needs of individuals, firms and corporate enterprises. In short, financial markets are Markets or arrangements for the creation and exchange (i.e. buying and selling) of financial assets or securities.

Objectives and Functions of Financial Markets:

- Financial markets facilitate the creation of credit.
- They provide liquidity to financial assets. That is, investors can readily sell their financial assets through the mechanism of financial markets.
- They promote mobilisation of savings, and their transformation into productive investments. They facilitate the process of balanced economic growth.
- They cater to the various credit needs of business people.
- They play a pivotal role in allocating resources in an economy.
- They facilitate price discovery, i.e., help in establishing the prices of financial assets or securities in the initial public issues.
- They considerably reduce the cost of transacting, i.e., buying and selling, of securities.

Classification on of Financial Markets:

Financial markets are broadly classified into two categories. They are:

1. Organised Market
2. Unorganised Market

Organised Market:

Organised market or organised financial market is the financial market where there are high degree of institutionalisation and instrumentalisation and standardised rules and regulations governing financial dealings, and which is subject to strict control by the Reserve Bank of India and other regulating bodies.

Unorganised Market:

Unorganised market or unorganised financial market refers to a financial market where there are a number of indigenous bankers, money lenders, private finance companies, chit funds, etc. who lend money to the public whose dealings are inadequate and not standardised and whose activities are not controlled by the Reserve Bank of India.

It may be noted that the Reserve Bank of India has taken a number of steps to bring the unorganised financial market under the fold of the organised sector. But its efforts have not yielded significant results.

Again, on the basis of credit requirements for short-term and long-term purposes, financial markets can be divided into two types. They are:

(1) Money Market

(2) Capital Market

QUESTIONs

- Write a note on financial markets.
- What are organised and unorganised markets?
- What are the functions of financial markets?

Money Market

Meaning of Money Market:

The term 'Money Market' does not refer to any particular place or office where money is bought (i.e., borrowed) and sold (i.e., lent). It refers to an activity, i.e., the borrowing and lending of short-term funds against short-term credit instruments (i.e., near money instruments), such as treasury bills, bills of exchange, bankers' acceptances, short-terms, Government securities, etc. It is the collective name given to all the financial institution in an economy which handle the purchase, sale and transfer of short-term credit instruments. In short, it is the entire mechanism (i.e., machinery) for borrowing and lending of short-term funds.

This is clear from the definitions of money market given by G.Growther and madden and Naddler.

According to G.Growther, "Money market is the collective name given to the various firms and institutions that deal in the various grades of near money".

In the words of Madden and Naddler, "Money market is a mechanism through which a large part of financial transactions of a particular country are cleared".

Characteristics of Money Market:

Money market has certain characteristics. The chief characteristics of money market are:

- Money market is concerned with the borrowing and lending of short-term funds 0nly
- For the borrowing and lending of funds, it is not necessary that the borrower and the lender should meet each other face to face at a particular place. They can carry on negotiations and effect their financial transactions through telephone, telegram, mail or any other means of communication.
- Near-money, i.e., short-term credit instruments, such as bills of exchange, treasury bills, etc. are also dealt with in a money market.
- A money market is not a single homogeneous market. It is composed of several specialized sub-markets, such as call market, treasury bill market, commercial bill market, discount market, collateral loan market, etc.
- As in any other market, in the money market also, there is a price for the money borrowed and lent. That price is called interest.
- There are a large number of borrowers and lenders in the money market.
- A large volume of short-term funds is traded in money market.
- Money market is the source of working capital finance. It (i.e., money market) is the major source of working capital finance.
- There are various instruments of money market. They are call money (i.e., inter-bank loans), treasury bills of the Government, trade bills of commercial enterprises commercial papers (promissory notes issued by reputed companies), certificates of deposit issued by commercial banks, etc.
- The dealers in money market are lenders (i.e., the suppliers of short-term funds) like the
  central bank, the commercial banks, discount houses, bill brokers, insurance companies financial corporations and business houses, and borrowers of short-term funds, such as the Government, semi-Government institutions, commercial banks, industrial and business concerns, stock exchange dealers, farmers and private individuals.

Importance and Functions of Money Market:

Money market performs a variety of functions in the credit structure of a country. they are:

- It provides an outlet to commercial banks for the employment of their short-term funds. The commercial banks employ their short-term funds in the call market, bill market and the collateral loan market.
- It offers a channel to non-banking financial institutions, such as insurance companies, financial houses, etc. for the investment of their short-term funds.
- It plays a very important role in the financing of trade and commerce. Both inland and international trade are, usually, financed through the system of discounting of bills in the discount market. The bill brokers, acceptance houses, the discount houses in England and the commercial banks all over the world play a very important role in the financing of trade and commerce.
- It provides short-term funds to industrialists to meet their requirements of working capital. Commercial banks and even non-banking financial institutions play a very important role in this respect.
- It helps the Government to raise the necessary short-term'furids through the issue of treasury bills or short-term bonds.
- The development of a capital market is dependent on the money market. The short-term rates of interest prevailing in the money market determine the long-term rates of interest prevailing in the capital market, and thereby, influence the capital market.
- It serves as the medium through which the central bank of a country can exercise its control over the creation of credit. Generally, the various credit control measures of the central bank produce their impact first on the money market, and, through the money market, on other sections of the economy.
- The various sub-markets, and the short-term rates of interests that prevail in the money market serve as a good barometer (i.e., indicator) of the monetary and banking conditions in the country.This information is a valuable guide to the central bank in determining its credit policies.

Essentials for the Development of Money Markets in a Country:
The essentials for the development of a money market in a country are:

() **Highly Organised Banking System:**

For the development of money market, there should be an highly organised banking system. This is because the commercial banks are the nerve centers of the money market, and they are the principal suppliers of short-term funds in the money market. The commercial banks also serve as a vital link between the central bank and the various segments of the money market.

(ii) **Presence of Central Bank:**

The presence of a central bank is an essential requirement for the development of money market. The central bank acts, as a bankers' bank and banker to the Government. It guides and regulates the money market.

(iii) **Availability of Proper Credit Instruments:**

For the development of money market, there should be the continous availability of proper credit instruments like bills of exchange, treasury bills, etc. There should be a number of dealers to deal in the credit instruments.

(iv)Existence of Sub-markets:

The existence of large number of sub-markets is an essential requirement of the development of money market.

(v) **Existence of Sub-Markets:**

The existence of a large number of sub-markets is an essential requirement for the development of money market.

(vi) **Ample Resources**

For the development of money market, there should be the availability of sufficient funds in the various sub-markets.

(vii) **International Attraction**:

A well-developed market should attract international borrowers and lenders. That is borrowers and lenders from foreign countries should participate in the money market for its development.

(viii) **Stock Exchanges** :

The presence of well-developed stock exchanges also is an essential requirement for the development of money market.

INDIAN MONEY MARKET

Characteristics of Indian Money Market:

The main characteristics of Indian Money Market are:

1. The Indian Money market consists of two sectors, viz., (1) the organised or the modem sector and (2) the unorganised or the indigenous sector.

The modern sector includes the Reserve Bank of India, the State Bank of India and its subsidiaries, the nationalised banks, the private scheduled and the non-scheduled banks and the foreign exchange banks. This sector also includes the co-operative credit institution and the non-banking financial institutions, such as the Life Insurance Corporation of India, the Unit Trust of India and the various finance corporations. In this sector, there are also financial intermediaries, such as the call loan brokers, the general finance brokers and the stock brokers.

The indigenous sector includes the indigenous bankers and the money lenders.

2. There is very little contact between the modern sector and the indigenous sector. There is absolutely no contact between the Reserve Bank of India and the indigenous bankers and the money lenders. Again, indigenous bankers do not have regular dealings with commercial banks. It is only occasionally when they are hard pressed for money that some indigenous bankers either discount their hundis or take loans against their demand promissory notes from some commercial banks. These financial facilities from the commercial banks are available not to all the indigenous bankers, but only to those whose names are on the approved lists of the commercial banks.

3. As there is very little contact and co-ordination between the organised sector and the indigenous sector, there is a wide disparity in the interest rates prevailing in these two sectors.

4. The Reserve Bank of India has more or less complete control over the organised sector. It has full control over the public sector and the private sector commercial banks. It has enough control over the foreign exchange banks after the passing of the Banking Regulation Act of 1949. It has control even over the co-operative banks after the enactment of the Banking Laws (Application to Co-operative Societies) Act of 1965. But it has no control over the indigenous bankers and the money lenders even today.

There is the absence of a well-developed commercial bill market in the country. Despite markets made by the Reserve Bank of India during the past several years, a well developed market is not present in the country.

Some of the important features of the Indian Money Market is the seasonal nature of the demand for money. There is enough and even excess demand for money only during the busy cultural season extending from November to June for financing the movement of cultural produce from the producers to the consumers. There is considerable decline in demand for money during the slack season extending from July to October.

Composition of Indian Money Market:
Indian money market consists of several components, sectors or sub-markets, each specializing in a particular type of lending.
The important sectors or sub-markets of the money market are:

(A)Call Money Market: Call Money Market is an important component of Indian money market. Money market specialises in call loans, which are sometimes called loans at call and short notice.

The call loans are the extreme form of short-term loans. The call loans are granted for might use or for 24 hours or for a maximum of 14 days. These loans can be recalled on and or at the shortest possible notice. It is for this reason that these loans are called **loans and short notice or money at call and short notice. .**

Collateral securities are not insisted in the case of call loans. interest on call loans varies from day to day, and even from hour to hour, and also from are to centre. The interest on call loans is very sensitive to changes in demand for and of call loans.

(B)Bill Market or Discount Market:

Bill market or discount market specialises in discounting commercial bills arising out of genuine trade transactions and also the treasury bills of the Government. Generally, short-term commercial bills of 90 days and treasury bills of 90days are dealt with in this market.

The main suppliers of finance in this market are commercial banks, and the main borrowers of finance in this market are traders.

It may be noted that, in India, the bill market or discount market is under-developed in spite of the many steps taken by the Reserve Bank of India to develop this market.

It may also be noted that, in India, besides the commercial banks, the Discount and Finance House of India Ltd., established in 1988, also undertakes the function of discounting of bills.

(C) Acceptance Market:

Acceptance market specialises in the acceptance of bills of exchange on behalf of customers. In India, in the acceptance market, cornmercial banks accept bills of exchange on
behalf of customers. In India, in the acceptance market, both inland bills of exchange and foreign bills of exchange are-accepted. But, usually, foreign bills of exchanges are accepted in this market.

(D) **Collateral Loan Market**:

Collateral loan market specialises in the granting of short-term loans against collated securities. Such loans are, usually, given by commercial banks to stock exchange deals brokers and business houses against stock exchange securities, goods, documents of goods, etc. These loans are usually given in the form of overdraft and cash credit.

Constituents of the Indian Money Market: The important constituents or institutions of the Indian Money Market are:

Reserve Bank of India:

The Reserve Bank of India was formed on 1st April, 1935. It is the central bank country. It dccupies an important place in the Indian Money Market. It has direct and contact with the various institutions in the organised sector of our money market unfortunately, it has no connection with the unorganised or indigenous sector. As such, it effective control only over the organised sector, and not over the indigenous sector.

State Bank of India:

The State Bank of India was formed on 1st July, 1955 after the nationalisation of the Im Bank of India. It is the biggest commercial bank in the country. It occupies an impo position in the Indian Money Market. It receives all types of deposits from the publiO" provides short-term loans to merchants and manufacturers. Of late, it has been laying emp on providing finance to co-operative institutions, farmers and small industries. It undertakes foreign exchange business.

Subsidiaries of the State Bank of India:

Today, there are seven subsidiary banks of the State Bank of India. They are (1) The Bank of Bikaner and Jaipur, (2) The State Bank of Hyderabad, (3) The State Bank of Mysore The State Bank of Fatale, (4) The State Bank of Saurashtra, (6) The State Bank of Travanc and (7) The State Bank of Indore. These banks are also commercial banks. They receive van types of deposits and provide short-term loans to trade and industry.

Nationalised Banks:

Nationalised banks are commercial banks. They occupy an important position in the Money Market. With more than 40,000 branches, they control about 60% of the total depo in the country. They provide short-term funds to industries, traders, farmers and others. of them do foreign exchange business also.

Private Sector Banks:

The banks in the private sector are of two types. They are (i) Scheduled Banks and (ii) Scheduled Banks. Scheduled banks are those which are included in the second schedule the Reserve Bank of India Act. Non-scheduled banks are those which are not included in second schedule. They are also commercial banks. They occupy an important place in Indian Money Market. They control about 5% of the total deposits in the country. They grant short-term loans to traders, industrialists and farmers.

Foreign Exchange Banks:

There are 34 foreign exchange banks in the country today. These are foreign banks undertaking India's foreign exchange business through their branches in India. They finance mainly the import and export trade in India. They also finance the internal trade of the country They perform even ordinary commercial banking business, such as acceptance of deposits.

Cooperative Credit Institutions:

Co-operative credit institutions are institutions which are concerned with the provision agricultural finance. There are three types of co-operative credit institutions in the country. They are (1) Primary Credit Socieities at village level, (2) Central Co-operative Banks at district level and (3) State Co-operative Banks at state level. All these institutions provide only short-term finance. The state co-operative banks provide short-term finance to the central co-operative banks. The central co-operative banks provide short-term funds to primary credit societies. The primary credit societies provide short-term loans to farmers. The co-operative credit institutions also occupy an important position in the India's Money Market. Today, they finance about 35% of the needs of agriculturists in India.

Indigenous Bankers and Money Lenders:

Indigenous bankers and money lenders are in the indigenous sector of the Indian Money Market. They are unorganised. They do not have any connections with the Reserve Bank of India. They do not have much contact even with the commercial banks or other institions in the organised sector of the money market. As such, they are not under the control of the Reserve Bank of India. Though they are not properly organised, they play a very prominent role in rural finance. They meet more than 50% of the financial requirements of the rural people. They provide short-term loans to farmers, artisans and other people in rural areas.

Credit Instruments used in the Indian Money Market:

The important credit instruments used in the Indian Money market are:

1. Trade Bills
2. Treasury Bills

3. Short-term Government Bonds
4. Hundis

Trade Bills: Trade bills are bills of exchange arising out of genuine trade transactions. They may be inland or foreign bills. They can be discounted with commercial banks. They are also !discountable with the Reserve Bank of India. Unfortunately, trade bills are not very popular in the Indian Money Market.

Treasury Bills:Treasury bills are promissory notes of 90 days' duration issued by the Government for raising short-term funds. Commercial banks and others invest their funds on these bills. They are discountable with any commercial bank. They can be rediscounted with the Reserve Bank of India. They have become very important in India on account of the lack of popularity of trade bills.

Short-term Government Bonds: Short-term Government bonds are bonds issued by the Government for periods of 5 years or less than 5 years. They provide a source of short-term funds to the Government and a channel of investment to commercial banks. These bonds have become very popular in the Inian Money Market in recent years.

Hundis:

Hundis are the chief credit instruments used in the indigenous sector of the Indian Money Market. They are nothing but inland bills of exchange drawn in regional languages. They act not only as a means of payment, but also as means of transfer of funds from one place to another.

Indian money market suffers from many defects. The main defects are:

1.Absence of co-ordination and co-operation between the organised and unorganised sectors:

There is no co-ordination and co-operation between the organised and the unorganised sectors of the money market. At times, there is even severe competition between the sectors, especially between the commercial banks and the indigenous bankers. Such a competition is extremely harmful to the economic progress of the country.

2. Competition among the Members of the Individual Sectors: There is competition not only between the organised sector and the unorgnised sectors but also among the members of the individual sectors. For instance, in the organised sector, the foreign exchange banks and the commercial banks consider themseleves as rivals. Similarly, in the unorganised sector, there is severe competition among the indigenous bankers. This harmful competition is not in the interests of the banking system of the country.

3. No All-India Money Market: There is no all-India money market as such. The Indian Money market is split into local markets. The money markets in big cities like Mumbai, Kolkata, Chennai, etc. have no contact with the money markets in the smaller towns. However, in recent years, the Mumbai Money Market has developed considerably. It has grown to such a state that at present it is a centre for the short-term funds of not only Mumbai but also other parts of India.: In fact, today, the Mumbai Money Market has become synonymous with the Indian Money Market.

4. **Lack of Uniformity in the Interest Rates:** One of the serious defects of the Indian Money Market is the existence of a wide diversity in the interest rates. For instance, the interest rates prevailing in the organised sector diffet, widely from those prevailing in the unorganised sector on account of lack of co-ordination between the two. Similarly, the interest rates current in the different sub-markets differ from one another on account of the absence of integration between them. .

5. Seasonal Financial Stringency: Another important drawback of the Indian money market is the stringency of funds during to busy agricultural season extending from November to June. During this season, there is increase in the demand for loans from traders and businessmen for financing the movement agricultural produce from the producing areas to the commercial centres. But the supply of funds during this season does not increase in the same proportion as the demand increases. With the result, there is shortage of funds.

6. Lack of Adequate Banking Facilities: Banking facilities available in the country are not adequate. No doubt, the State Bank of nationalised banks and the private sector banks have expanded banking facilities even in semi-urban and rural areas through their branch expansion programmes. Yet, the facilities available in the country, especially in the rural areas are not sufficient for the country.

7. Shortage of Funds in the Money Market: The Indian Money Market is having permanent shortage of funds. The funds available in money market are not sufficient to meet the needs of trade, industry and agriculture. The storage of funds is due to the fact that the rural savings are not mobilised because of the non-existance of banks in the rural areas. Further, the saving capacity of the people is also low on account of their low per capita income.

8. Lack of Control over indigenous Bankers: Indigenous bankers occupy an important place in the Indian Money Market, as they finance major portion of the requirements of trade, small-scale industries and agriculturists. Such It important sector of our money market is not subject to control by the Reserve

Bank of India. No doubt, the Reserve Bank of India has made many attempts to bring the indigenous sector under its control. But its efforts ended in a failure because of the non-co-operative attitude of genous bankers.

9. Shortage of Financial Instruments: In the Indian Money Market, there is lack of adequate and continuous supply of credit instruments, such as trade bills, treasury bills and short-term Government Securities.

10. Isolation: Indian Money Market is isolated from foreign money markets. There is hardly any movement of funds from foreign money markets to the Indian Money Market on account of exchange control restrictions on capital movements.

11. Absence of Well-developed Bill Market:
The existence of a well-developed bill market is indispensable for the efficient functioning of the credit system of a country. It is essential even for linking up the various credit agencies ultimately to the central bank. But such a bill market is not present in India. Till 1951, there was no bill market at all in India. It is only in January, 1952, that the Reserve Bank of India introduced some sort of bill market. But it was not a real bill market, as there was no rediscounting of bills by the Reserve Bank, but only granting of loans against time bills of 3 months.

The causes responsible for the absence of a real bill market in India are:

(a) As most of the business transactions are conducted in terms of cash, there is shortage of bills of exchange.

(b) Businessmen prefer cash credits and overdrafts to discounting of bills of exchange.

(c) On account f the lack of uniformity in the drawing of hundis between different parts of the country, discounting of hundis is not popular with commercial banks

(d) The preference of commercial banks for borrowing against the security of bills rather than rediscounting of bills with the Reserve Bank of India is also responsible for the non-development of bill market.

(e)The absence of specialised agencies like bill brokers, acceptance houses and discounting houses is also responsible for the non-development of bill market in the county.

(f)The discounting of foreign bills of exchange by foreign exchange banks in foreign countries has also stood in the way of development of bill market in the country.

(g)The heavy stamp duties on bills of exchange is also responsible for the non-development of bill market.

Suggestions for the Elimination of the Drawbacks of the Indian Money Market: **. Some of the important suggestions are as follows:**

1. **Imposition of Control on the Indigenous Sector:**

As the indigenous sector constitutes an important sector of the money market, some sort of control should be exercised by the Reserve Bank on the indigenous sector. No doubt, the various efforts made by the Reserve Bank of India in this direction have failed. This doesn't mean that the task of bringing the indigenous sector under the control of the Reserve Bank should be given up. It only indicates that fresh efforts should be made by the Reserve Bank in this direction.

2. **Standardisation of Hundis**:

As stated earlier, the hundis present in the Indian money market are drawn in regional languages. Further, there are wide variations in their forms and styles of writing. So,steps should be taken to standardise the hundis as regards the language and the form.

3. **Development of Bill Market**:

The proper development of money market in any country is not possible without an organised bill market. So, an organised bill market should be developed in India. The Reserve Bank of India should play a significant role in the establishment of a real bill market. It should provide greater re-discounting facilities to the commercial banks to develop bill market in the country. Again, specialised agencies, such as acceptance houses and discount houses also should be promoted.

4.**Expansion of Remittance Facilities:**

For bringing about uniformity in the interest rates in different centres of the country, there should be movement of funds from one place to another. For the movement of funds from place to place, the Reserve Bank of India should provide more and more remittance facilities not only to the commercial banks, but also to the indigenous bankers.

5. **Expansion of Clearing Houses**:

For the development of the money market, a large number of efficient clearing houses are necessary. But the number of clearing houses operating in India at present is limited. Further, their operational system is also defective. So, steps should be taken not only to increase the number of clearing houses, but also to improve their working.

6. **Expansion of Warehousing Facilities in Rural Areas:**

For the development of the money market, it is necessary to establish a large number of licenced warehouses or godowns, particularly in rural areas.

With the establishment of godowns in rural areas, farmers will be able to keep their surplus produce in the godowns and obtain receipts. Against these warehouse receipts, they can obtain loans from the banks and meet their requirements.

Elimination of Disparity in Interest Rates:

For the development of the money market, the wide disparity in interest rates found in the different sections of the money market and in the different sections of the country should be eliminated. Of late, the Reserve Bank of India has reduced the difference in the interest rates which existed in the different sub-markets, in the different centres and at different times through, remittance of funds and through proper monetary and credit policy. But the disparity in interest rates between the organised sector and the unorganised sector still exists. So, steps should be taken by the Reserve Bank to remove this disparity also.

Removal of Seasonal Monetary Stringency:

It has already been stated that the Indian Money Market is characterised by seasonal stringency of money during the busy season. It is necessary that this seasonal stringency should be removed for the efficient functioning of the Indian Money Market. It is gratifying to that, in recent years, the Reserve Bank of India has been able to reduce considerably the seaaonal stringency of funds through open market purchases of securities and greater re-discounting facilities to commercial banks.

Recent Developments in Indian Money Market :

Money developments have taken place in the Indian money market in recent years and have greatly contributed to the recent developments in the Indian money market. There is integration in between the unorganised money market and organised money market, which is quite necessary for the development of money market.

The control of the Reserve Bank of India. has increased not only on the organised financial market but also on the unorganised money market.

The extension of commercial banking to rural areas is also a recent development favourable for the growth of Indian money market.

Another recent development in the Indian money market is the participation of non-banking financial institutions and development banks like th General Insurance Corporation India, IDBI, NABARD, etc. as lenders.

The emergence of new instruments of credit like certificates of deposits, commercial papers, etc., is also a recent development in the Indian money market.

QUESTIONS:

1. Explain the meaning and characteristics of money market. „
2. Explain the importance and functions of money market.
3. Explain the essentials for the development of money market in a country.
4. State the characteristics of Indian money market.
5. Explain the credit instruments used in the Indian money market.
6. State the defects of the Indian money market.
7. Explain the suggestions for the elimination of the drawbacks of the Indian money market.
8. Explain the recent trends in the Indian money market.

CAPITAL MARKET -

Meaning of Capital Market:

The term 'capital market' is used by some in a broad sense to refer to the market for long-term funds as well as short-term funds. For instance, H.T.Parekh states, "By market, I mean market for all the financial instruments, short-term and long term, also commercial, industrial and Government paper". When capital market is used in such a broad sense, it (i.e., capital market) covers money market also.

However, capital market is, generally, used to refer to the market for long-term funds. So, capital market refers to the market for long-term loanable funds as distinct from money market, which refers to the market for short-term funds. In other words market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. In short, it refers to an organised mechanism for the effective transction of long term funds from the investing. parties, i.e., individual and institutional industrial and commercial undertakings.

Features of Capital Market: Capital market has certain characteristic features. They are:

- Capital market deals in long-term and medium-term funds.
- It is concerned with the transfer of long-term and medium-term funds from invsting parties to industrial and commercial enterprises.
- Ownership securities like equity shares and preference shares and crediors securities like debentures and bonds are dealt in the capital market.
- Capital market is composed of new securities market (i.e., primary capital market, stock market (i.e., secondary capital market) and special financial institutions.

- The dealers in the capital market are the industrial and commercial enterprises, and the investors like individuals and institutional investors. Capital market makes long-term funds available, i.e., makes funds available for investment and fixed assets.
- Capital market arranges large amount of funds.

Differences between Capital Market and Money Market:

There are some differences between capital market and money market. differences are:

- Capital market deals in long-term and medium-term funds, i.e., funds for periods varying between 1 year to 5 years (i.e., for medium-term) or for periods varying from 5 years to 20 years (i.e., long-term). But money market deals in short-term funds (i.e., for periods upto 1 year);
- Capital market arranges large amount of funds. But money market arranges amount of funds
- Capital market makes funds available for fixed capital, i.e., for investment in fixed as on the other hand, money market makes funds available for working capital.
- Capital market has limited and selected market, whereas money market has widely distributed market.
- The rate of interest in the capital market is, generally, low. But the rate of interests money market is, generally, high.
- Capital market deals with long-term securities like equity shares, preference shares, debentures and bonds. On the other hand, money market deals with short-term credit instruments, such as trade bills (i.e., bills of exchange), treasury bills, commercial papers, certificates of deposits, etc.

- In capital market, investment banks like special financial corporations, investment trust mutual funds, etc. are the leading financial institutions, whereas in money market, commercial banks are the principal financial institutions.
- Capital market acts as a link between investing parties and industrial and commercial enterprises. But money market acts as a link between the depositors and the borrowers.
- Each single capital market investment is of small amount. For instance, each share is, generally, of the value of Rs. 10. On the other hand, each single money market instruments generally, of large amount. For example, each CD (Certificate of Deposit) or CP (commercial Paper) is normally of the value of Rs. 25 lakhs.
- Capital market instruments have secondary market. But money market instruments, generally, do not have secondary market.

- In the capital market, generally, transactions take place at a formal place, e.g., stock exchange, whereas in the money market, transactions normally take place over phone, arid there is no formal place for the transactions.

No doubt, these two markets differ in many respects. But they are closely related to each other. First, the capital market is dependent upon the money market for funds. Secondly, the long term rates of interest that prevail in the capital market depend upon the short-term rates of interest which prevail in the money market. Thirdly, some of the, financial institutions like insurance companies and even commercial banks deal in both the markets.

Objectives and Functions of Capital Market:

Capital market has number of objectives, and performs a number of functions. They are:

- Capital market facilitates large-scale nation-wide mobilisation of savings and financial resources.
- Capital market facilitates acceleration of capital formation.
- Capital market helps in procuring foreign capital for the quicker economic development of a country.
- Capital market ensures effective allocation of the mobilised financial resources among projects which yield highest returns or which contribute to balanced economic development.
- It ensures ready and continuous market for long-term funds.

Importance of Capital Market:

Capital market plays an important role in the industrial and economic development of a country. Its importance is as follows:

- An organised and well-developed capital market ensures best possible co-ordination between the flow of savings and the flow of investment.
- It directs the flow of savings into most profitable channels, and thereby, ensures the optimum utilisation of financial resources.
- Capital market is a hand-maid to industry
- It makes available to industry sufficient amount of long-term capital at a reasonable rate of interest.
- It also helps industries in securing foreign capital to promote industrial and economic development in the country.
- It provides profitable investment opportunities to the small savers and investors.

CAPITAL MARKET IN INDIA

Classification of Capital Market or Types of Capital Market in India:

On the basis of the structure or status of the market, the capital market in India is classified Into two types, viz., (a) organised capital market and (b) unorganised capital market.

On the basis of industrial securities, the capital market is classified into two types viz., (a) primary capital market and (b) secondary capital market.

(a**) Primary Capital Market or new issues market:**

Meaning of Primary Capital Market: Primary capital market is the market in which funds are raised by industrial and commercial enterprises from investors through the issue of shares, debentures and, That means, this market is concerned with new issues only.

Features of Primary Capital Market:

Primary capital market has certain special features. Those features are:

- Primary capital market is concerned with long-term funds or capital.
- In the primary capital market, securities are sold for the first time.
- In the primary capital market, securities are issued by industrial and commercial companies directly to investors.
- Primary capital market promotes capital formation directly.
- The funds raised in the primary capital market are utilised by the issuing companies for investment on fixed capital, i.e., fixed assets.
- Primary capital market does not cover long-term loans from financial institutions,.

(b) Secondary Capital Market or Stock Exchange Market:

Meaning of Secondary Market:

Secondary market is the market which facilitates the transfer of ownership (purchase and sale) of second-hand or existing securities between investors. Secondary market is also known as stock exchange market, because the purchase and sale of existing securities between investors are made through stock exchanges. By facilitating purchase and sale of existing securities, secondary market provides liquidity to existing securities:

Features of Secondary Capital Market or Stock Market: Secondary capital market has certain characteristic features. Those features are:

- Secondary market is not the place of origin of the securities.
- Secondary market deals in previously issued securities (i.e., existing securities).

- In the secondary market, securities are not directly issued by a company to the investors; Securities are sold by an existing investor to another investor.
- In the secondary market, the securities are bought and sold by investors through brokers.
- Secondary market does not directly contribute to capital formation.
- Secondary market provides liquidity to securities, and thereby, increases the marketability of securities.

Differences between Primary Capital Market or New Issues Market and Secondary Capital Market or Stock Market:

There are some differences between primary capital market and secondary capital market. They are:

- New issues of securities are dealt in primary market, whereas existing securities (i.e., securities issued earlier) are dealt in secondary market.
- In primary market, securities are exchanged between companies and investors. But in secondary market, securities are exchanged between investors.
- Primary market promotes capital formation directly, whereas secondary market promotes capital formation only indirectly.
- In the primary market, securities are only bought by the investors from companies, and they are not sold. On the other hand, in the secondary market, securities are bought and sold.
- The prices of securities dealt in the primary market are determined by the management of issuing companies. But the prices of securities dealt in the secondary market are determined by the demand for and the supply of securities.
- In the primary market, securities are issued to investors for the first time, whereas in 'the secondary market, securities can be bought and sold any number of times.

Components of Capital Market in India:

The main components of capital market in India are (i) New Issue Market, (ii) Stock market (iii) Financial Institutions, (v) Mutual Funds and (v) Venture Capital Companies.

The New issue Market refers to the primary market where new securities (i.e., shares and debentures that have not been previously issued) are offered. Both new companies as well as existng companies can raise long-term capital in the new issue market:

The new issue market facilitates the transfer of funds from the willing investors, individuals institutions to the entrepreneurs setting up new enterprises or undertaking modernisation expansion programmes.

The new issue market also channelises the savings of individuals institutions into investments on industrial and commercial enterprises.

The new issue market is of much importance for the industrial and economic development of country, as it directs the flow of savings of the people into long-term investments.

The new issue market in India is not as highly developed as the new issue market in developed countries like the U.S.A. and U.K., Germany, etc. But, certainly, there has been a 'growth in the new issue market in India after 1990.

Stock Market:

Stock market is the secondary market where existing securities (i.e., shares and debentures 'already issued by companies) are traded. In short, stock market is the organised mechanism for the purchase and sale of existing securities.

In India, stock market is fairly well-developed in recent years. Today, there are 23 recognised stock exchanges in India. Besides, there are the Over-the-Counter Exchange of India, and the National Stock Exchange of India.

3.**Special Financial Institutions**:

Special financial institutions are one of the important constituents of the capital market in India.

Special financial institutions are the most active constituent of the Indian capital market. The special financial institutions provide medium-term and long-term finance on easy terms to big industrial and commercial undertakings.

They play an important role in the promotion of new coporate bodies and in the expansion and development of existing corporate bodies.

There are a number of special financial institutions in India. The important special financial institutions in India are:

1. The Industrial Finance Corporation of India (IFCI).
2. The Industrial Credit and Investment Corporation of India (ICICI)
3. The Refinance Corporation of India (R.F.I.)
4. State Financial Corporations (SFCs)
5. National Industrial Development Corporation (N.I.D.C).
6. National Small Industries Corporation (N.S.I.C).
7. Industrial Development Bank of India
8. National Industrial Reconstruction Corporation of India (N.I.R.C).
9. The Credit Guarantee Corporation of India (C.G.C.I.).
10. State Financial Development Corporations (S.F.D.Cs)
11. State Industrial Development Corporations (S.I.D.Cs)
12. Life Insurance Corporation of India.
13. Unit Trust of India.
14. Mutual Funds.
15. Venture Capital Companies

Again, capital market may be classified into '(1). Industrial Securities Market
(2) Government Securities Market and (3) Long-term Loan Market.

Industrial Securities Market: Industrial securities market is the market for industrial securities, such as equity shares, preference shares and debentures or bonds of industrial companies. In other words, it market where industrial companies raise long-term capital by issuing shares and debentures.

Government Securities Market: Government securities market is the market where long-term Government securities are traded. In this market, long-term securities of the central Government, state Government semi-Government authorities like city corporations, port trusts, improvement trusts, public sector undertakings. etc. are traded.

Long-term Loan Market: Long-term loan market is the market where development banks and commercial supply term loans (i.e., medium and long-term loans) to corporate borrowers.

Recent Developments in Indian Capital Market:

A number of developments have taken place in the Indian capital market with the launching of financial reforms since 1991. Some of the important developments are:

- Granting of statutory powers to the Securities and Exchange Board of India (SEBI) in 1992 to regulate the various constituents of the capital market.
- The emergence of the Over-the-Counter Exchange of India in 1992, permitting smaller companies to raise fund in the stock market.
- Development of a number of private sector mutual funds in 1993 to mobilise funds hi investment.
- Registration of foreign institutional investors by SEBI in 1993.
- Development of the National Stock Exchange of India in 1994 for online scripless trading in India.
- Commencement of Private Placement of Issues with foreign institutional investors in 1994.
- 6.banking, mutual funds, leasing and hire purchase companies, venture capital companies, etc. in the Indian capital market.

QUESTIONS

1. What is capital market
2. Distinguish between money market and capital market.
3. Explain the functions of capital market.
4. Distinguish between primary capital and secodary capital market.
5. Explain the componets of the capital makrket in india.
6. What are the charaterstics of Capital Market.
7. Explain the objectives and importance of Capital Market.