324 - BANKING MANAGEMENT

SYLLABUS

Unit – I Introduction to Banking: Structure of Indian Banking System – Scheduled Commercial Banks, Foreign Banks, Commercial Banks, Payment Banks, Small Finance Banks. Types of Banking – Universal Banking, Wholesale Banking, Private Banking, Retail Banking; RBIMonetary Policy. Different Types of Accounts, Various Services Offered by Banks, Sources of Risk in Banks, Analysing Bank's Financial Statements.

Unit – II Uses of Bank Funds: Features of Bank Credit, Assessment of Credit Worthiness of Borrowers, Different Types of Loans, Priority Sector Lending, Sectoral Limits. Loan Pricing - Pricing of Fixed & Floating Rate Loans, Cost – Benefits. Securitisation, Syndication. NPAs: - Concept of Gross and Net NPAs, Causes, Recovery of NPAs. Asset Recovery Companies, Bad Bank.

Unit – III Regulation and Innovations in Banking System: Regulation of Banks, Basel Accords I, II, and III. Banking Innovations - Core Banking Solution, Digital Banks, Plastic Money, NEFT, RTGS, Mobile Banking, M Wallets, Net Banking, E-Rupee, Central Bank Digital Currency.

Unit – IV Non- Banking Finance Companies: Types, Operations, Microfinance Companies, Regulation.

Unit – V Credit Information Bureaus, Credit Scores, and Credit Repository of Large Clients. Account Aggregator. Credit Guarantee Options. Deposit Insurance - Supervisory College.

UNIT-1

INTRODUCTION TO BANKING

Banking is an industry that handles cash, credit, and other financial transactions. Banks provide a Safe place to Store extra cash and credit. They offer savings accounts, Certificates of Deposit, and checking accounts. Banks use these deposits to make loans. These loans include home mortgages, business loans, and car loans.

A Bank is a financial institution licensed to receive deposits and make loans. Two of the most common types of banks are commercial/retail and investment banks. Depending on type, a bank may also provide various financial services ranging from providing safe deposit boxes and currency exchange to retirement and wealth management.

Definition

Banking is defined as "Accepting of deposits of money from public for the purpose of Lending or Investment, repayable on demand or otherwise and withdrawable by cheque, draft, or otherwise"

Structure of Indian Banking System

Reserve Bank of India is the central bank of the country and regulates the banking system of India. The structure of the banking system of India can be broadly divided into scheduled banks, non-scheduled banks and development banks.

Banks that are included in the second schedule of the Reserve Bank of India Act, 1934 are considered to be scheduled banks.

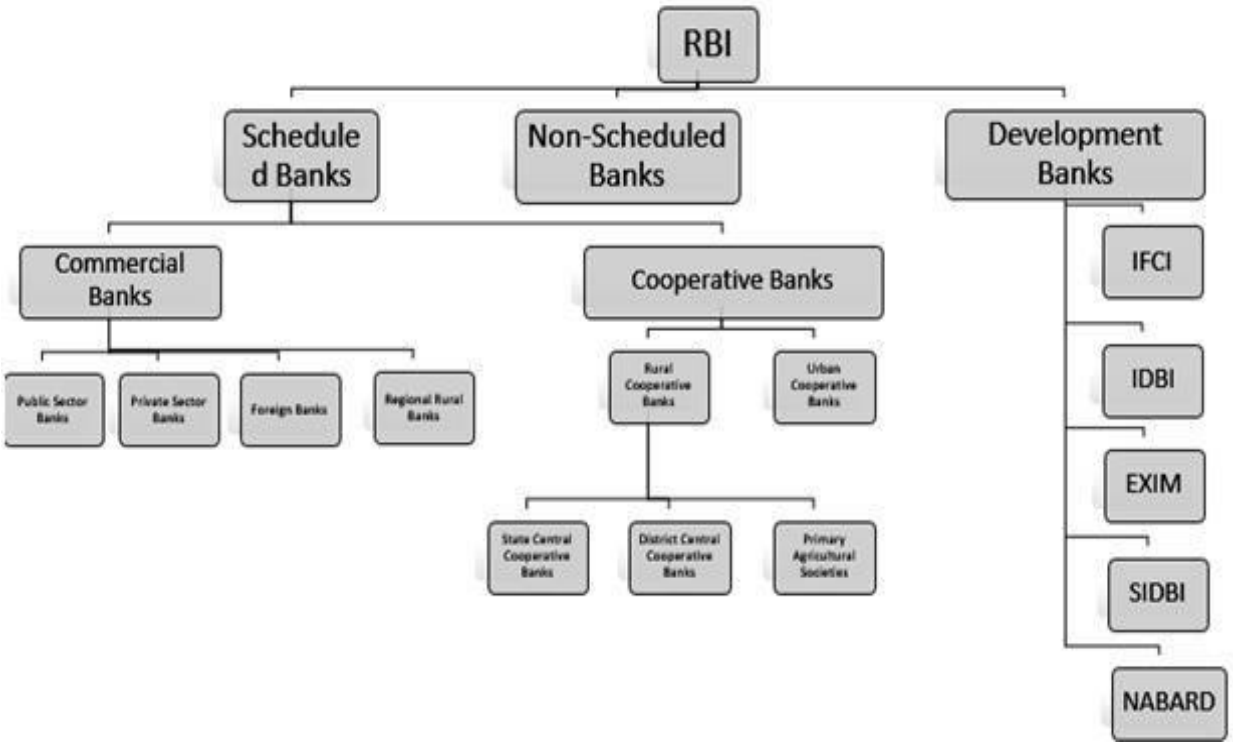
All scheduled banks enjoy the following facilities:

- Such a bank becomes eligible for debts/loans on bank rate from the RBI
- Such a bank automatically acquires the membership of a clearing house.

All banks which are not included in the second section of the Reserve Bank of India Act, 1934 are **Non-scheduled Banks**. They are not eligible to borrow from the RBI for normal banking purposes except for emergencies.

Scheduled banks are further divided into commercial and cooperative banks.

Scheduled, Non-Scheduled Banks and Development Banks:



Commercial Banks

The institutions that accept deposits from the general public and advance loans with the purpose of earning profits are known as **Commercial Banks**.

Commercial banks can be broadly divided into public sector, private sector, foreign banks and RRBs.

- In **Public Sector Banks** the majority stake is held by the government. After the recent amalgamation of smaller banks with larger banks, there are 12 public sector banks in India as of now. An example of Public Sector Bank is State Bank of India.
- **Private Sector Banks** are banks where the major stakes in the equity are owned by private stakeholders or business houses. A few major private sector banks in India are HDFC Bank, Kotak Mahindra Bank, ICICI Bank etc.
- A **Foreign Bank** is a bank that has its headquarters outside the country but runs its offices as a private entity at any other location outside the country. Such banks are under an obligation to operate under the regulations provided by the central bank of the country as well as the rule prescribed by the parent organization located outside India. An example of Foreign Bank in India is Citi Bank.

- **Regional Rural Banks** were established under the Regional Rural Banks Ordinance, 1975 with the aim of ensuring sufficient institutional credit for agriculture and other rural sectors. The area of operation of RRBs is limited to the area notified by the Government. RRBs are owned jointly by the Government of India, the State Government and Sponsor Banks. An example of RRB in India is Arunachal Pradesh Rural Bank.

Cooperative Banks

A **Cooperative Bank** is a financial entity that belongs to its members, who are also the owners as well as the customers of their bank. They provide their members with numerous banking and financial services. Cooperative banks are the primary supporters of agricultural activities, some small-scale industries and self-employed workers. An example of a Cooperative Bank in India is Mehsana Urban Co-operative Bank.

At the ground level, individuals come together to form a Credit Co-operative Society. The individuals in the society include an association of borrowers and non-borrowers residing in a particular locality and taking interest in the business affairs of one another. As membership is practically open to all inhabitants of a locality, people of different status are brought together into the common organization. All the societies in an area come together to form a Central Co-operative Banks.

Cooperative banks are further divided into two categories - urban and rural.

- Rural cooperative Banks are either short-term or long-term.
    - Short-term cooperative banks can be subdivided into State Co-operative Banks, District Central Co-operative Banks, Primary Agricultural Credit Societies.
    - Long-term banks are either State Cooperative Agriculture and Rural Development Banks (SCARDBs) or Primary Cooperative Agriculture and Rural Development Banks (PCARDBs).
- Urban Co-operative Banks (UCBs) refer to primary cooperative banks located in urban and semi-urban areas.

Development Banks

Financial institutions that provide long-term credit in order to support capital-intensive investments spread over a long period and yielding low rates of return with considerable social benefits are known as **Development Banks**. The major development banks in India are; Industrial Finance Corporation of India (IFCI Ltd), 1948, Industrial Development Bank of India' (IDBI) 1964, Export-Import Banks of India (EXIM) 1982, Small Industries Development Bank Of India (SIDBI) 1989, National Bank for Agriculture and Rural Development (NABARD) 1982.

The banking system of a country has the capability to heavily influence the development of a country's economy. It is also instrumental in the development of rural and suburban regions of a country as it provides capital for small businesses and helps them to grow their business. The organized financial system comprises Commercial Banks, Regional Rural Banks (RRBs), Urban Co-operative Banks (UCBs), Primary Agricultural Credit Societies (PACS) etc. caters to the financial service requirement of the people. The initiatives taken by the Reserve Bank and the Government of India in order to promote financial inclusion have considerably improved the access to the formal financial institutions. Thus, the banking system of a country is very significant not only for economic growth but also for promoting economic equality.

Scheduled Commercial Banks

The scheduled commercial banks are those banks which are included in the second schedule of RBI Act 1934 and which carry out the normal business of banking such as accepting deposits, giving out loans and other banking services. The major difference between Scheduled Commercial Banks and Scheduled Cooperative Banks is their holding pattern, since cooperatives are registered under the Cooperative Societies Act as cooperative credit institutions.
Scheduled Commercial Banks can be further divided into four groups:

- Public Sector Banks: This includes:
  - SBI & Associates
  - Nationalized Banks
  - Other Public Sector Banks
- Private Banks
- Foreign Banks
- Regional Rural Banks

Scheduled Commercial Banks (Public Sector)
At present, there are 27 Public Sector Banks in India including SBI (plus its 5 associates) and 19 nationalized banks. Further, there are two banks which have been categorized by RBI as "Other Public Sector Banks". IDBI and Bhartiya Mahila Bank come under this category.

Scheduled Commercial Banks (Private Banks)
In private sector banks, most of the capital is in private hands. There are two types of private sector banks in India viz. Old Private Sector Banks and New Private Sector Banks.

Foreign Banks
As of December 2014, there are 43 foreign banks from 26 countries operating as branches in India and 46 banks from 22 countries operating as representative offices in India. Most of the foreign banks in India are niche players. RBI policy towards presence of foreign banks in India is based upon two cardinal principles viz. reciprocity and single mode of presence. more details about regulation of Foreign Banks by RBI, click here

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Regional Rural Banks

Regional Rural Banks were started in 1970s due to the fact that even after nationalization, there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers. **Each RRB is** owned by three entities with their respective shares as follows:

- Central Government → 50%
- State government → 15%
- Sponsor bank → 35%

They are regulated by NABARD.

Foreign Banks

A foreign bank branch is a type of foreign bank that is obligated to follow the regulations of both the home and host countries. Because the foreign bank branch has loan limits based on the total bank capital, they can provide more loans than subsidiary banks. That is because the foreign bank branch, while possibly small in one market, is technically part of a larger bank. Hence, it enjoys the capital base of the larger entity.

Understanding Foreign Bank Branches

Banks often open a foreign branch to provide more services to their multinational corporate clients. However, operating a foreign bank branch may be considerably more complicated because of the dual banking regulations that the foreign branch needs to follow.

For example, suppose that Bank of America opens a foreign bank branch in Canada. The branch would be legally obligated to follow both Canadian and American banking regulations in many cases. In actual practice, foreign bank branches are sometimes exempted from specific rules in one country or the other.

With globalization and capital markets maturing, the administrative burden of multiple regulatory standards might be offset by other operational economies of scale. These may include global branding, marketing, and product offerings best served by a single entity with numerous local branches.

Advantages of Foreign Bank Branches

Foreign bank branches tend to be more effective in countries with high taxes and nations where it is easy for international firms to enter the market.

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According to an article in the Journal of Banking and Finance, banks are more likely to organize themselves as branches in nations that have higher corporate taxes. Depending on the country, a branch of a foreign bank may be able to avoid some of the high taxes faced by domestic firms.

Foreign bank branches are also more likely to operate where they face lower regulatory barriers to entry. When it is easy to enter the market, a bank does not need to spend money setting up a subsidiary in the country.

Disadvantages of Foreign Bank Branches

Foreign bank branches may face special difficulties during an economic or political crisis. Since they operate in that foreign country during a crisis, they will be negatively impacted by events there. At the very least, foreign bank branches stand to lose money. At worst, they might have to deal with a run on the bank branch with little support from the foreign government.

A government in crisis is more likely to use its limited resources to support domestic banks. Foreign banks might be left to bail out their own branches. This situation is different from a subsidiary bank, which is technically a domestic company in the foreign country. Subsidiary banks are also sometimes joint ventures with domestic banks, further increasing the chances that the local government will support them.

Commercial Banks

Commercial Bank

As per the commercial bank definition, it is a financial institution whose purpose is to accept deposits from people and provide loans and other facilities. Commercial banks provide basic services of banking to their customers and small to medium-sized businesses.

What is Commercial bank?

A commercial bank is a financial institution that provides services like loans, certificates of deposits, savings bank accounts bank overdrafts, etc. to its customers. These institutions make money by lending loans to individuals and earning interest on loans. Various types of loans given by a commercial bank are business loans, car loans, house loans, personal loans, and education loans.

They give out these loans from the money deposited by their customers in different types of accounts. They use the deposits as capital for providing loans. Commercial banks are essential

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for the economy of a country because they help in creating capital, credit as well as liquidity in

the market. These banks are generally physically located in cities but these days there are online banks are growing in numbers.

How commercial bank works?

Commercial banks offer basic services of banking to the public including individual customers as well as small and medium-sized businesses. Money is made by banks by charging for services and fees. The fees depend on the products given such as overdraft fees, fees for safe deposit boxes, late fees, etc. Various loans also consist of fees other than interest on loans.

Banks earn money by giving out loans and for that purpose they use funds from customer deposits. They charge higher interest rates on loans they give out and comparatively less rate of interest on the amount they get as deposits from their customers. For e.g., a bank may provide a 0.30 per cent rate of interest on savings account to its customers but charges a 4.8 per cent rate of interest annually for home loans.
Generally, commercial banks are situated in buildings where their customers come for using ATM machines and other banker window facilities. As internet technology has risen in recent years, most banks allow customers to do most services online. People can now make money transfers, deposits or make payments for bills online.

Importance of commercial banks

Commercial banks are essential for the economy because they create liquidity in the market and create capital besides providing their customers with essential services. Banks make sure liquidity in the market by lending out loans from the deposits of their customers.

What is commercial bank?

According to the commercial bank definition, it is a financial institution whose purpose is to accept deposits from customers and lend out loans.

What is commercial bank types?

Public sector banks, private sector banks, and regional rural banks are the types of commercial banks.

What is commercial bank functions?

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The basic functions are accepting deposits, lending out loans, transfer of money, and discounting bills of exchange.

Why are commercial banks important?

Commercial banks are important because they help in creating liquidity in the market.

Payment Bank

Definition: A payments bank is like any other bank, but operating on a smaller scale without involving any credit risk. In simple words, it can carry out most banking operations but can't advance loans or issue credit cards. It can accept demand deposits (up to Rs 1 lakh), offer remittance services, mobile payments/transfers/purchases and other banking services like ATM/debit cards, net banking and third party fund transfers.

Description: In September 2013, the Reserve Bank of India constituted a committee headed by Dr Nachiket Mor to study 'Comprehensive financial services for small businesses and low income households'. The objective of the committee was to propose measures for achieving financial inclusion and increased access to financial services.

The committee submitted its report to RBI in January 2014. One of the key suggestions of the committee was to introduce specialised banks or 'payments bank' to cater to the lower income groups and small businesses so that by January 1, 2016 each Indian resident can have a global bank account.

Why payments banks? The main objective of payments bank is to widen the spread of payment and financial services to small business, low-income households, migrant labour workforce in secured technology-driven environment.

With payments banks, RBI seeks to increase the penetration level of financial services to the remote areas of the country.

Existing prepaid payment instruments (PPI model) like Airtel Money does not give pay any interest on deposits.

Small Finance Banks

Small finance banks are those banks that operate in rural sections or sections of society that are excluded from the urban section. To help farmers, small business owners the small finance banks help Like all other banking organisations these types of banks i.e small finance banks also perform major tasks such as deposits and withdrawals.

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Small finance banks are registered under public limited companies under the Companies Act 2013. The main significance of small finance banks is to provide inclusion to underdeveloped areas. These banks provide provisions for saving vehicles to underserved or unserved sections of society.

These banks provide financing to the small business units in rural sections.

Who is Allowed to set up Small Finance Banks?

The functioning of small finance banks depends on if the resident individual has more than 10 years of banking experience. The companies registered, owned and controlled by residents will be eligible for setting up small finance banks. Small finance banks have the potential to make better opportunities unlike major banks because they solely focus on underserved people.
The promoters of small finance banks need to be eligible to be considered a part of small finance banks. RBI is usually the intelligent body behind reviewing the organisations, companies whole apply for being promoters of small finance banks.

Promoters' initial offering to the small finance banks should be at least 40% and gradually brought down throughout the years. The RBI needs to approve all the plans regarding the expansion of the small finance banks in the initial 5 years stage.

What is the Importance of Small Finance Banks?

Small finance banks have accepted deposits and lending money as their primary task. These banks can undertake activities like acting as distributors of various types of mutual funds and pension funds.

Importance of Small Finance Banks:

The small finance banks being an important part of the banking system have various important features that are mentioned below:

- The small finance banks have no restrictions on where they can operate
- They have open permission to operate in any desired location given they fall under proper proximity
- Small Finance Banks are just like any other commercial bank when it comes to risk management
- The company has to submit CRR and SLR like commercial banks
- The small finance banks should mainly focus on the important sectors like agriculture and small business
- The small business bank needs to have at least half of its loan portfolio as loans and advances to microfinance business
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List of Small Finance Banks

There are a total of 11 small finance banks that are recognised under RBI namely:

1. Au Small Finance Bank Limited
2. Capital Small Finance Bank Limited
3. Equitas Small Finance Bank Limited

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4. Suryoday Small Finance Bank Limited
5. Ujjivan Small Finance Bank Limited
6. Utkarsh Small Finance Bank Limited
7. ESAF Small Finance Bank Limited
8. Fincare Small Finance Bank Limited
9. Jana Small Finance Bank Limited
10. North East Small Finance Bank Limited
11. Shivalik Small Finance Bank Limited

Minimum Paid-Up Capital for Small Finance Bank

The RBI has assigned the minimum paid-up voting equity capital at ₹ 200 crores after changing it from ₹100 crores. The promoter of a small finance business can't hold voting equity shares for more than five years. If the promoter has an initial shareholder percentage above 40% then it is to be reduced to 40% within five years.

The small finance banks are to be listed if they achieve a net worth of ₹500 crores. The listing is supposed to happen within 3 years.

Minimum Capital for Small Finance Banks

The urban cooperative banks can function or convert themselves into a working small finance banks if they follow the guidelines mentioned by RBI to be a small finance bank. The net worth of these banks should be ₹100 crores and that is to be increased to ₹200 crore within 5 years. The small finance banks can offer up to only 15% of total capital funds as loans.

Conclusion

In the above article, it is mentioned in brief about the definition of small finance banks along with its significance and other information like who are allowed to be promoters and what amount of paid-up capital a small finance bank needs to have. The small finance banks have a huge role to play in regards to development in rural areas as these types of banks are the only mode of accessing incentives and schemes and other financial help when in need. The foreign shareholding of small finance banks is done under the guidance of Foreign Direct Investment (FDI). The small finance banks need to mention "small finance banks" in their names so they can be differentiated from other banks. They are looked after under the Reserve Bank of India Act, 1934 and the banking regulations Act 1949.

Types of Banking

Common types of banks prevalent in India include the following:

Scheduled and Non-Scheduled Banks

The banking sector is divided into scheduled and non-scheduled banks.

- Scheduled Banks are listed in the second schedule of the Reserve Bank of India (RBI) Act, 1934. The paid-up capital and collected funds of scheduled banks must be 5 Lakh and above. The RBI grants loans at the bank rate, and these banks are eligible to become

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clearing house members.

- Non-Scheduled Banks are banks not listed in the second schedule of the RBI Act, 1934. The paid-up capital and collected funds are less than INR 5 Lakh. Such banks need not borrow funds from the RBI.

Commercial Banks

Commercial banks can be scheduled or non-scheduled and are regulated under the Banking Regulation Act, 1949. These banks accept deposits and grant loans to the general public, businesses, and even the Government. Commercial types of banking systems are:

- **Public Sector Banks:** More than 75% of the total banking business in India comes under the public sector, also known as nationalised banks. The Indian Government and RBI are the major stakeholders in this sector.
- **Private Sector Banks:** Most stakeholders of Private Sector Banks are individual investors, not the RBI or Indian Government. Nevertheless, these banks must adhere to all the RBI regulations for their operations.
- **Foreign Banks:** Foreign Banks have their headquarters in a foreign country but operate as a private entity in India. They abide by the regulations of their home country and the country in which they operate.
- **Regional Rural Banks:** These scheduled commercial banks serve the economically weaker sections, such as marginal farmers, agricultural labourers, and small businesses. Operating at regional levels, RRBs offer banking facilities like debit cards, bank lockers, complimentary insurance etc.

Small Finance Banks

Licensed under section 22 of the Banking Regulation Act, 1949, these types of banking systems cater to sections of societies not usually served by large banks. They serve micro and cottage industries and small business units.

Payments Banks

RBI restricts these banks to offer deposit facilities only, with a deposit limit of INR 1 Lakh per customer. You can avail of debit cards and e-banking facilities.

Cooperative Banks

These banks are registered under the Cooperative Societies Act, 1912, and function on a no-profit no-loss basis. They offer banking services to entrepreneurs, small businesses, and industries.

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Universal Banking

A universal bank is nothing but a commercial bank with additional authority to act as an investment house and invest its money in non-allied companies. It is a system through which banks offer their regular, retail, and high net worth customers a bouquet of comprehensive financial services, including customised or tailored investment, retail, and commercial services.

Under universal banking, you get easy access to facilities like credit requirements, deposits, securities transactions, asset management, financial analysis, and underwriting services, among other things. Essentially, you get all the required financial services under one roof. This facility reduces your transaction costs and saves you precious time as well.

Types of Universal Banking Services

Universal Banking Services in India are broadly categorised into three types based on their functionality. They are as under:

1. **Investment banking services**

   Several public and private sector banks in India have started offering investment banking services. Such banks typically focus on providing services to various private investors and organisations. Also known as merchant banking, these banks generally offer their clients assistance with asset management, investment advisory services, raising capital, mergers and acquisitions, securities underwriting and securities trading, among other facilities. As is apparent, these functions of universal banking do not apply to everyday banking services.

2. **Wholesale banking services**

   Wholesale Banking Services are typically designed for businesses and corporate organisations, as opposed to individual bank customers. These services usually involve lending and borrowing funds on a large scale, compared to retail banking services that deal with comparatively smaller loan amounts for individual customers. Each transaction in wholesale banking is typically in the tunes of crores of rupees and multiple accounts. For instance, a customer of a wholesale bank may need pension fund accounts for its employees. Government organisations and multinational companies are typically customers who obtain wholesale banking services.

3. **Retail Banking Services**

   Retail banking is the most common type of universal banking service available globally. It is the type of banking that general bank customers and account holders are provided. Retail banking encapsulates the general banking facilities that include a wide variety of

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home, auto and personal loans and mortgage services. It also includes offering different

types of bank accounts – Salary, Current, Savings Accounts, and more. Banks provide safe deposit lockers, fixed and recurring deposits, credit and debit cards, and other such everyday banking services under retail banking.

Conclusion

With growing competition in the banking sector, most Indian banks are adopting a universal banking model to cater to the needs of their various clients. Universal banking enables banks to broaden their customer base. As a bank customer, you can enjoy an array of facilities under one umbrella, thanks to universal banking services.

RBI Monetary Policy

Monetary policy is the procedure by which the monetary authority of a nation, normally the central bank or currency board, controls either the expense of short-term borrowing or the cash supply, focusing on inflation or the loan fee to guarantee value strength and general trust in the currency. Further goals of monetary policy are:

- to contribute to the stability of the gross domestic product,
- to achieve and maintain low unemployment, and
- to maintain predictable exchange rates with other currencies.

In India, the monetary policy is developed by the Reserve Bank of India. Hence, it is also called the Monetary Policy of RBI.

Types of Monetary Policies

1. **Expansionary Monetary Policy**

If a country is facing a high unemployment rate especially during a crisis period such as a slowdown or a recession, the monetary authority of the country, which is usually the central bank of the country, can opt for an expansionary policy that is aimed at increasing economic growth and expanding economic activity.

As a part of expansionary monetary policy, the subsequent monetary authority often lowers the interest rates for consumers through various measures that make money-saving relatively unfavourable and promotes spending in the market. It leads to an increase in money supply in the market, with the hope of a boost in investment and consumer spending.

2. **Contractionary Monetary Policy**

Contractionary monetary policy is when a central bank uses the tools of monetary policy in order to fight inflation. Since inflation is a sign of an overheated economy, the bank must slow economic growth in order to control the situation. So, the contradictory monetary policy may result in slowing down economic growth and an increase in unemployment but is often required to control inflation.

- **Monetary Policy of RBI | Monetary Policy in India**

Developing the Monetary Policy in India is a prerogative of the Reserve Bank of India. Hence, it is also called the Monetary Policy of RBI. The RBI is vested with this responsibility under the RBI Act, 1934. The Monetary policy of RBI regulates the money supply, availability

of credit and interest rates. Let us look at the main goal of monetary policy and the monetary

policy instruments that the Reserve Bank of India uses to regulate the money supply to achieve the objectives of the economic plan.

- **Main Goal of Monetary Policy of RBI**

The primary goal of monetary policy of RBI is to maintain price stability keeping in mind the objectives laid out in the economic plan. Price stability is extremely important for attaining sustainable growth. To maintain price stability, inflation must be kept in check. RBI uses various monetary policy instruments to ensure that inflation is controlled. Let us look briefly at the monetary policy instruments used by the RBI.

- **Monetary Policy Instruments | Monetary Policy of RBI**

There are several direct and indirect monetary policy instruments that help in implementing the monetary policy in India. Let's discuss each one of them in brief:

- **Repo Rate:** Repo rate is the rate at which RBI lends short term loans (less than 90 days) to commercial banks.
- **Reverse Repo Rate:** Reverse repo is the rate at which the RBI keeps the extra deposit of all banks within itself.
- **Marginal Standing Facility (MSF):** It is the rate at which banks borrow overnight loans from RBI. It can be only up to 2% of the NTDL(Net Demand and Time Liabilities). It is always 1% or 100 basis points more than the repo rate.
- **Bank Rate:** It is the rate at which RBI offers long term loans (more than 90 days) to commercial banks.
- **Cash Reserve Ratio (CRR):** It is the ratio of the bank's total deposit that every bank has to keep with the RBI. It has to be in cash form only. RBI does not offer any interest on this reserve money. It can be between 0 to 15%. RBI announces the CRR in its monetary policy.
- **Statutory Liquidity Ratio (SLR):** It is the ratio of the bank's total deposit that a bank has to maintain with itself. It can either be in cash or in liquid assets including Gold, Foreign Currency, Government Bonds, etc. It can be between 0 to 40% as announced by the RBI in its monetary policy.
- **Open Market Operations(OMO):**It refers to the buying and selling of government securities between the RBI & banks.

Different Types of Accounts

Initially, there were only four types of bank accounts that were operating in India. These included the Current Account, Savings Account, Recurring Deposit Account and Fixed Deposit Account. But later with the advancement in the banking sector, various other types of bank accounts were introduced they are

1. Savings Account
2. Current Account
3. Recurring Deposit Account
4. Fixed Deposit Account
5. DEMAT Account

6. NRI Account

Savings Account

As the name suggests, the savings accounts can be opened by an individual or jointly by two people with an aim to save money.

The main benefit of opening a savings bank account is that the bank pays you interest for opening this type of account with them.

Given below are a few features of the Savings account:

- There is no limit to the number of times the account holder can deposit money in this account but there is a restriction on the number of times money can be withdrawn from this account.
- The rate of interest that an account holder get varies from 4% to 6% per annum
- There is no minimum balance that needs to be maintained for this type of an account
- The savings account holders can get an ATM/Debit/Rupay Card if they want to
- Savings bank account is further divided into two types: Basic Savings Bank Deposit Account (BSBDA) and the other one is Basic Saving Bank Deposit Accounts Small Scheme(BSBDS)
- The savings bank account is mostly eligible for students, pensioners and working professionals

Current Account

The second type of bank account is the current bank account. These accounts are not used for the purpose of savings.

Some important pointers related to the current bank account have been discussed below:

- This type of bank account is mostly opened by businessmen. Associations, Institutions, Companies, Religious Institutions and other business-related works, the current account can be opened
- There is no fixed number of times that money can either be deposited or withdrawn from such accounts
- Internet banking is available
- This type of bank account does not have any fixed maturity
- Overdraft facility is available for current bank accounts
- There is no interest that is paid on such accounts

Recurring Deposit Account

Recurring Deposit account or RD account is a form of account wherein the account holder needs to deposit a fixed amount every month until it reaches the fixed maturity date.

The features of the Recurring deposit account have been discussed below:

- Any individual or an Institution can open a recurring deposit account either separately or jointly
- Periodic or monthly instalments that need to be added can be as low as Rs.50/- or may vary from bank to bank
- The range of months for which an RD account can be opened varies from 6 months to 120 months
- The interest rate varies depending upon the bank you choose to open an account with
- Nomination facility is also available for RC accounts

- Passbook is issued for this type of bank account

- Premature withdrawal of the amount is permitted, provided a sum of amount is deducted as penalty

Fixed Deposit Account

FD or a fixed deposit account is another type of bank account that can be opened in any Public or Private sector bank.

The list of important things that need to be known with respect to the fixed deposit account has been mentioned below:

- It is a one time deposit and one time take away account. Under this type of account, the account holder needs to deposit a fixed amount of sum (as per their wish) for a fixed time period
- The amount deposited in FD account can only be withdrawn all at once and not in instalments
- Banks pay interest on the fixed deposit account
- The rate of interest depends upon the amount you deposit and for the time duration of the FD
- Full repayment of the amount is available before the maturity date of FD

DEMAT Account

Shares and securities which can be held in electronic format constitute the DEMAT account. The DEMAT account also stands for Dematerialized Account.

Given below the points that need to be known by a candidate regarding the DEMAT Account:

- There are only two depository organisations which manage this type of bank account in India. This includes: National Securities Depository Limited and Central Depository Services Limited
- This helps facilitate easy trade of bonds and shares
- Helps in conducting stress-free transaction of shares
- KYC is required for opening the DEMAT Account
- Transaction cost is reduced
- Traders can work from anywhere
- The transfer of securities can be done with reduced paperwork

NRI Account

To fulfil the bank requirements of a Non-Residential Indian or a Person of India Origin, the option of NRI account is available.

The NRI Accounts are further divided into three types:

1. **NRO (Non-Resident Ordinary Rupees) Account –** This shall allow you to transfer your foreign earnings easily to India. It can be opened in the form of an FD/RD/Current/Savings account. These accounts can be opened by an individual or jointly opened
2. **NRE (Non-Resident External Rupees) Account –** When an Indian citizen moves abroad to work there, his/her account needs to be converted into an NRE account. This account can be jointly opened with an Indian resident
3. **FCNR (Foreign Currency Non-Resident) Account –** This type of account can be opened to manage an international currency. It can only be in the form of Term deposit and can be withdrawn after the maturity period only.

Various Services Offered by Banks

Following are the few services which bank provides

- Advancements of loans
- Cheque payments
- Discounting on bills of exchange
- Collecting and paying the credit instruments
- Guarantee by banks
- Consultancy
- Credit cards
- Funds remittance
- Debit cards

Advancements of loans

Banka runs on the profit they make. They are into the business of making profits. So, to generate the profit they give loans to the public and private organizations.

Thus, in return, they get an interest paid to them which helps them in making a profit. Banks need to keep a minimum cash reserve with them.

So, after deducting this cash reserve, banks provide short, medium, and long-term loans to the people who are in need of it.

Cheque Payments

The person who holds an account in the bank is provided with the cheque pads.

Thus, the account holders draw cheque upon the bank when they are required to pay the money.

So after verifying formally, banks pay for the cheques and proceed with the official procedures.

Discounting on bills of exchange

This is another popular services of banks for lending the money. In this method, the person who holds the bill of exchange gets it discounted by the bank in exchange for a bill.

The creditor gives the payment to the debtor who accepts it and agrees that the amount shall be paid upon maturity. Once the marginal deductions are made the bank pays the value to the holder of the bill.

After that, when the bill is matured the banks get their payment from the person who has accepted the bill.

Collecting and paying the credit instruments

For modern purposes, there are a variety of instruments that are used as credit instruments. This includes promissory notes, bill of exchange, cheques, etc.

These instruments are dealt with by the banks. The banks are responsible for collecting and paying the different types of credit instruments.

These credit instruments are the representative of the customers.

Guarantee by Banks

In modern banking, customers are provided with the guarantee by the banks. This happens mostly when the customers have to deposit a large fund in courts or government offices for various reasons.

The banks itself acts as a guarantee for that person.

Consultancy

Modern banks expand their businesses and also provides consultancy services to its customers.

For this, they hire legal, financial, and market leaders and experts who can provide advice to customers regarding industry, income, trade, investment, etc.

Credit Cards

It is a service that allows the holders to make the purchase of the goods and services in exchange for a credit card.

It immediately pays off for the services and goods while the cardholder is required to pay back the amount over a period of time with a certain percentage of interest.

Funds Remittance

In this facility, banks provide the customers to transfer their funds from one account to another using cheque, drafts, etc.

Debit Cards

Debit cards withdraw the funds electronically from the cardholder accounts. To verify the transaction and keep it safe all the debit cards requires personal identification number (PIN).

The other services of banks include online banking, home banking, ATM services, and many more.

Sources of Risk in Banks

"With great risks comes great reward," especially in banking. Banks are in the business of taking on financial risk to generate profit. However, the stakes are high, and the downside potential is huge. This includes legal repercussions, which have increased steadily since the 2008 financial crisis.

Banks have spent significant dollars on everything from regulatory compliance to litigation and compensation claims. Risk managers are feeling more pressure to build and maintain sustainable risk management frameworks that handle a wider, more comprehensive set of risk types.

Beyond traditional risks like credit, market, and liquidity risk, the impact of model risk and ESG risk is on the rise. Additionally, there's a whole host of nonfinancial risks, where the downside can be difficult to quantify. This blog lists nine common risk types that we come across when working risk clients at global banks.

Types of **financial risks:**

1. Credit Risk

Credit risk, one of the biggest financial risks in banking, occurs when borrowers or counterparties fail to meet their obligations. When calculating the involved credit risk, lenders need to foresee and predict the possibility of them making back the loan, principal, interest, and all.

2. Market Risk

Market risk is the risk of losing value on financial instruments on the back of adverse price moments driven by changes in equities, interest rates, credit spreads, commodities, and FX.

3. Liquidity Risk

Liquidity refers to a bank's ability to meet its collateral and cash obligations while avoiding major losses. Liquidity risk is the risk of incurring losses where certain commodity or investment cannot be traded without impacting its market price.

4. Model Risk

Model use at large banks is growing by more than 20% each year (IDC), which in turn leads to greater model risk. Banks must manage model accuracy to prevent significant financial losses when assumptions grow, models are misused, or other forms of malfunction occur.

5. Environmental, Social and Governance (ESG) Risk

Environmental, social, and governance events, from climate change to diversity and inclusion policies, can have material impact on the value of investments. Banks must proactively measure and manage these risks, integrating ESG data, scoring models, and climate models into the investment process and credit risk evaluations.

Types of non-financial risk:

6. Operational Risk

Operational risk is the risk of losses incurred by inadequate internal processes, people, and systems, or from external events.

7. Financial Crime

Money laundering, corruption, fraud are examples of financial crime, leading to economic benefits for individuals through illegal ways. Banks need to make sure they develop fool proof techniques to avoid the losses posed by financial crime.

Analyzing Banks Financial Statements

In India banks occupy a substantial portion of the overall stock market and hence, they probably form at least some part of the investment portfolios of equity investors. No matter whether an investor invests through mutual funds or directly in stocks, it is difficult for him/her to escape banks or financial firms. With credit penetration in India still remaining low, financial firms have a long runway for growth in the coming years. It translates into the growing popularity of banking and financial stocks.

However, analysing banks is very different as compared to analysing an FMCG or say an auto company because of the following reasons.

- The financial statements of banks can prove to be a black hole. Lots of numbers can lead to more confusion than any clear understanding.
- Unlike non-financial firms wherein metrics like gross margin, working-capital cycle, debt to equity, etc., are important criteria to consider, banks altogether have different metrics. To analyse a bank's financial statements, one needs to first have a clear understanding of these metrics.

In this story, we have discussed some of the most important metrics that investors need to know while researching a banking firm.

Capital adequacy ratio (CAR)

It is the measure of a bank's available capital divided by the loans (assessed in terms of their risk) given by the bank. CAR is used to protect depositors and promote the stability and efficiency of financial systems. It helps measure the financial strength or ability of the financial institution to meet its obligations by using its assets and capital. The higher the CAR, the better capitalised the bank is. In India, as per the RBI norms, Indian-scheduled commercial banks are required to

maintain a CAR of 9 per cent, while Indian public-sector banks are emphasised to maintain a CAR of 12 per cent.
Suppose, the CAR for an XYZ Bank stood at -2.8 per cent during certain quarter. This shows that XYZ Bank had no capital to be absorbed as losses from bad loans.

Gross and net non-performing assets

Non-performing assets (NPAs) indicate how much of a bank's loan book is in danger of not being repaid. A loan turns non-performing if the interest or instalment of the principal amount is not received for a period of 90 days. NPAs are further categorised as gross and net NPAs. Gross NPA includes both the principal and interest aspects of the loan, whereas net NPA is calculated mainly by subtracting the provisions made by the bank from the gross NPA.
`
Public-sector banks in recent years have been plagued by bad loan problems. State Bank of India, the largest public sector bank, recorded 11 per cent of its outstanding loans as NPA (Gross NPA) as of FY18.

Provision coverage ratio

In banking, it is a fact that some portions of loans will always turn bad. Banks, therefore, make provisioning for such bad loans by setting aside funds to a prescribed percentage of their bad assets. For example, if the PCR is 70 per cent for a particular category of bad loans, banks have set aside funds equivalent to 70 per cent of those bad assets out of their profits. A high PCR means that most asset-quality issues have been taken care of.
The PCR for troubled Yes Bank stood at just 43.1 per cent as of FY19, depicting that the bank had an asset-quality issue and it wasn't able to provide adequately for bad loans.

Return on assets

In the balance of banks, loans given out to borrowers are assets whereas depositors' money is a liability. Return on assets depicts how profitable the bank is relative to its total assets. It is calculated by dividing net profit by total assets. A high ROA relative to other banks can be on account of various factors, including substantial other income, aggressive lending practices, operational efficiency and other factors.

CASA ratio

It stands for current account saving account. CASA is the per cent of deposits held by banks in current and savings accounts. Banks pay low interests on such accounts. A high CASA ratio is positive for the bank, as it is able to reduce the total borrowing rate.

Net interest margin

As the name suggests, it is the difference between the interest income generated from borrowers and the amount of interest paid to depositors, relative to total deposits. It is a profitability ratio and similar to the gross margin of a normal company.
HDFC Bank on the back of its ability to raise capital at a low cost and good lending practices has one of the best net interest margins in the banking sector. HDFC Banks NIM consistently ranged around 4.3 per cent during the past few years till FY20.

Cost to income

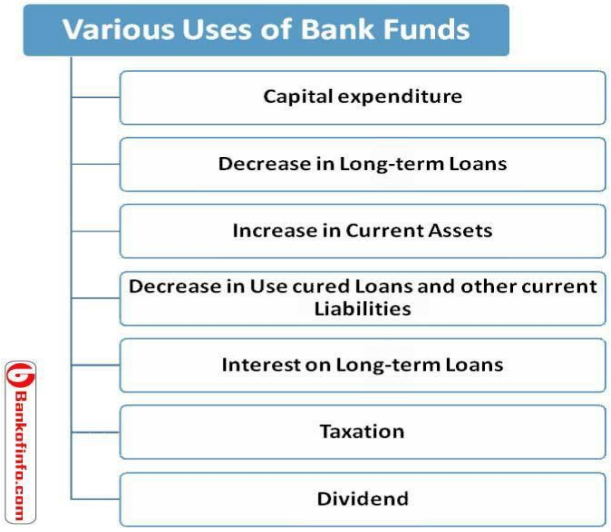
It is an important ratio to determine how efficiently a bank is being run. Cost to income is calculated by dividing operating expenses by the bank's operating income (interest income plus other income). There is an inverse relation between cost to income and the bank's profitability. The lower the cost-to-income ratio, the better the profitability is.
For HDFC Bank, the cost-to-income ratio has consistently decreased over the last few years and stood at 38.6 per cent as of FY20. On the other hand, SBI, which has an operating income of more than double that of HDFC Bank, is able to generate an operating profit only slightly higher than HDFC Bank, as its cost-to-income ratio stood at 52.5 per cent as of FY20. HDFC Bank is able to generate better profitability because of operational efficiency.

UNIT-2

USES OF BANK FUNDS

The utilization of funds may take the form of either a) an increase in assets both fixed current, or b) a decrease in liabilities. Let's know the various uses of bank funds.

Uses of bank funds



Capital expenditure

The amounts to be spent for acquiring additional fixed assets and for normal replacement and renewals are to be shown separately under the relevant periods.

Moreover, the total of the figures relating to the project shone against this item should be equal to the figure of the capital cost of the project as shown in the statement of the cost of the project.

The decrease in long-term loans

The long-term loans raised from financial institutions are repayable in installments as per the schedule of repayment agreed upon.

Similarly, payment for plants and machinery purchased on a deferred payment basis is to be made in an agreed manner. The installments of these payments should be shown under the respective years.

Increase in current assets

Estimates about the increase in the number of book debts, stock in trade, bills receivable and other current assets are to be shown under this head.

The level of these assets increases with an increase in the level of working capital raised through short–term borrowings.

The decrease in the use of cured loans and other current liabilities

The short-term borrowings are to be repaid, as per the terms agreed upon. The cash credit limits are fixed on a year-to-year basis and are usually renewed. The number of such loans should not be shown as repaid.

Interest on long-term loans

Interest payable on term loans (including the loan for which the application is being made) is to be shown against this item. The term loans are repayable in installments.

Hence, the amount of interest payable on the outstanding amount of loans goes on declining, as the installments are paid in subsequent years.

Taxation

As the concern starts earning profits, provision for taxation is to be taken into account. The concern may, however, take a few years time to earn profits.

Moreover, if the Government has granted any tax holiday for the concern for a certain period, no amount is payable as tax during that period.

Dividend

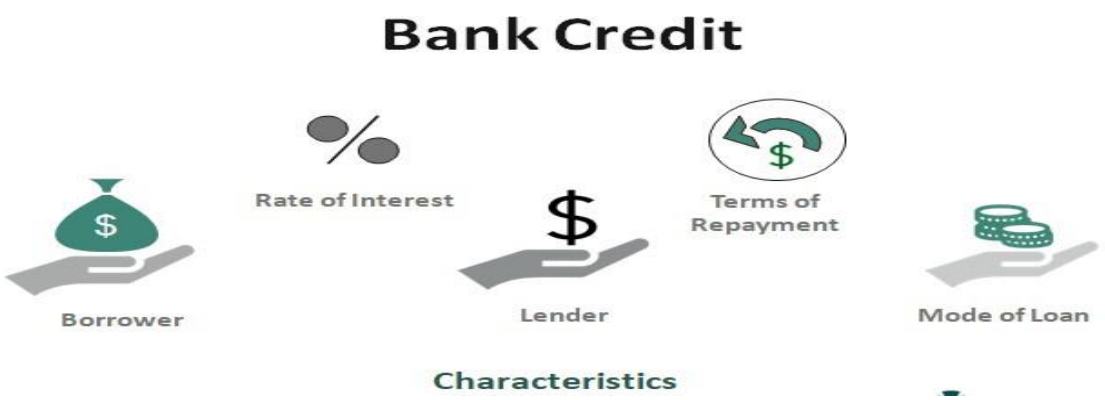
The amounts of dividends that are expected to be declared in future years out of the profits of the company are to be shown as cash outflow. Dividends are payable only when the company starts earning profits.

Moreover, a portion of the net profit is usually plowed back into the business itself to consolidate the financial position of the company and retain its funds within the business.

Here are the major uses of bank funds, there may be more uses of bank funds but these seven are the most common and important uses of bank funds.

Features of Bank Credit

The following are features of bank credit.



1. **Borrower:** Person who borrows money.
2. **Lender:** The person who lends money is usually the bank.
3. **Rate of Interest:** The interest rate can be fixed or floating rate of interest. The floating interest rate is based on benchmark rates like LIBOR or MIBOR.
4. **Terms of Repayment:** These are mentioned in the loan covenant and strictly adhere to avoid the prepayment penalty.
5. **Mode of Loan:** Normally given in cash but sometimes will be given in the form of raw material or fixed assets.

Purpose of Bank Credit

The following are the purpose of the loan.

- **Educational Loans:** These are given for pursuing higher education, repayment of which is due after completing education. Interest gets accumulated for the loan.
- **Housing Loans:** These are given to buy a home. The repayment of principal and interest is based on the EMI principal. House is collateral for such loans, and excessive documentation is required.
- **Vehicle Loans:** These are given to purchase vehicles like cars, tempo, two-wheeler, autos, and trucks. Normally assets are hypothecated to the Bank unless and until the final installment is paid. You often see "we banked …. Bank" written on the backside of cars. This indicates a loan is taken from "… Bank".
- **Vendor Financing:** This is an arrangement provided by the Bank to pay to vendors as per agreed credit terms, and in turn, the borrower will pay to the Bank after, say, 60 days or 90 days. The Bank charges an interest rate to the borrower for paying in advance to suppliers. The advantage of this is minimal documentation required by the Bank.
- **Letter of Credit Facility:** Like vendor financing but predominantly used while importing goods or making payments to overseas vendors. Terms of repayment and interest rate are mutually agreed upon between the parties.

Assessment Of Credit Worthiness Of Borrowers

Creditworthiness is an essential principle of business, signifying how deserving a customer is of getting credit. A customer is creditworthy if the company believes it can pay the debt on time. It is determined by multiple factors such as revenue, payment history, credit score, outstanding liabilities, etc.

The five Cs of creditworthiness

Businesses use multiple criteria to determine a customer's creditworthiness. The five Cs of credit is one of the most well-known techniques for evaluating creditworthiness. Understanding the **five Cs—character, capacity, capital, collateral, and conditions**—can assist in determining a customer's capability to repay the borrowed credit. Let's look at what each one signifies.

1. **Character**

Character assesses how dependable and trustworthy a customer is. To establish a customer's character, one must analyze their credibility and background. Credit history is one of the main factors to consider while evaluating a customer's character. It contains a detailed description of the customer's credit report and credit score. This data includes how long the customer has been in business, bankruptcies, whether they make timely payments, and more. Credit scores vary from 300 to 850, with higher scores indicating strong creditworthiness.

2. **Capacity**

Capacity refers to the ability of the customer to repay their debt. To evaluate the capacity of a customer, consider cash flow statements, business debt, and payment history. The Debt Service Coverage Ratio (DSCR) and Debt-to-Income ratio (DTI) help determine a company's cash flow and overall health. A DSCR of 1.25 or higher and a DTI ratio of 36% or lower is considered ideal.

3. **Capital**

Capital signifies the total funds and assets (both financial and non-financial) owned by a company. Before extending credit to a new customer, evaluate the worth of the customer's

business in terms of their investment in fixed assets and other instruments. Review the

customer's bank records and financial statements to get a clear picture of their capital. If these statements show a trend of strong capital growth, the customer is less risky and can be assigned a higher credit limit.

4. **Collateral**

Collaterals are assets that a customer commits to back a line of credit. These are fixed assets like inventories, corporate bonds, or real estate. Companies generally demand collateral as an assurance for extending credit. While working with a high-risk customer, always ask for collateral to limit the likelihood of bad debts.

5. **Conditions**

Conditions are terms established by a company in light of its policies or due to economic conditions or regulations prevalent in the customer's region of operations. Geographic location, industry type, currency fluctuations, and political environment are some of the factors that influence a company's payment terms and conditions. A customer with a stable geopolitical environment is more creditworthy since it faces lower economic risks.

Steps to check the creditworthiness of a new customer

Before granting credit, a company should assess the customer's competence to manage and repay outstanding debts. Collecting and analyzing information about the customer from credible sources to check creditworthiness can help you avoid the pitfalls of late payments or bad debt. Here is a step-by-step guide to determine the creditworthiness of a new customer:

Step 1: Collect relevant details to extend credit

Collecting relevant information about the client is the first step to assessing creditworthiness. The customers should fill out a business credit application form consisting of general business information, bank references, credit references, and more. These details would help to aggregate client data in one place for faster customer onboarding.

Step 2: Check credit reports

Analyzing credit reports is an ideal method to evaluate a customer's creditworthiness. A credit report contains information on the company and its financials, enabling you to generate credit scores. It depicts a company's capacity to pay by tracking its payment history and public records. Credit reports of a company are available for purchase from credit reporting agencies such as Experian, D&B, and Equifax.

Step 3: Assess financial reports

The financial report of a company provides insights into its cash position. Financial reports include the cash flow statement, income statement, and the balance sheet of the company. The financial health of a new customer should be examined thoroughly by reviewing their public financial statements.

Step 4: Evaluate the debt-to-income ratio

Analyze the DTI ratio of a customer to better understand their cash flow statement. DTI ratio indicates how much of a company's monthly income is spent on repaying debts. It helps determine the risk associated with the customer account. To calculate the DTI ratio, divide the company's monthly debt payments by gross monthly income.

A low DTI ratio indicates a healthy balance between debt and income, whereas a high DTI ratio shows that a client has more obligations than the monthly income.

Step 5: Conduct credit investigation

You must use multiple sources to conduct further investigations to evaluate the creditworthiness of a customer. These investigations should contain:

- Customer background and history
- Credit policies
- Accounts receivable aging report
- Economic and political climate analysis
- Future business probability

All these factors contribute to better decision-making and customer authentication.

Step 6: Perform credit analysis

After gathering all necessary information about the new customer, conduct a comprehensive account analysis. Evaluate trade references, scrutinize financial statements, and apply credit analysis to predict the probability of default. While performing credit analysis, the profitability ratio, leverage ratio, and liquidity ratio are some of the key financial metrics to consider.

Different Types of Loans

Loans can be utilised for various things in today's world. It can be used for funding a start-up to buying appliances for your newly purchased house. Let us talk about the different types of loans available in the market and their specific characteristics that make these loans useful to the customers.

Personal Loans:

Most banks offer personal loans to their customers and the money can be used for any expense like paying a bill or purchasing a new television. Generally, these loans are unsecured loans. The lender or the bank needs certain documents like proof of assets, proof on income, etc. before approving the personal loan amount. The borrower must have enough assets or income to repay the loan. In case of personal loans, the application is 1 or 2 pages in length. The borrower gets to know about the denial or approval of the loan within a couple of days.

You must remember that the rate of interest associated with these loans can be on the higher side. The tenure of these loans is not that long. So, if you borrow a big amount, it can be difficult for you to repay without planning your finances properly.

Personal loans can prove to be of great help when you wish to take a small amount loan and repay it as soon as possible.

Credit Card Loans:

When you are using a credit card, you must understand that you will have to repay for all the purchases you make at the end of the billing cycle. Credit cards are accepted almost everywhere, even when you are travelling abroad. As it is one of the most convenient ways to pay for the things you buy, it has become a popular loan type.

Home Loans:

When you wish to purchase a house, applying for a home loan can help you to a great extent. It provides you the financial support and helps you buy the house for yourself and your loved ones. These loan generally come with longer tenures (20 years to 30 years). The rates offered by some of the top banks in India with their home loans start at 8.30%. Your credit score is checked

before the loan request is approved by the lender. If you have a good credit score, there is a fair chance that you will be able to enjoy lower rates of interest with your home loan.
Home loans are primarily taken for buying new homes. However, these loan can also be used for home renovations, home extensions, purchasing land property, under-construction houses, etc.

Car Loans:

Buying a car can definitely shows a great sense of joy and happiness in you. A car will remain as your asset and it is going to be one of the biggest investments that you make. A car loan helps you to pave the path between your dream of owning a car and actually buying your car. Since credit reports are crucial for judging your eligibility towards any loan, it is good to have a high credit score when you apply for a car loan. The loan application will get approved easily and you might get a lower rate of interest associated with the loan.
Car loans are secured loans. If you fail to pay your instalments, the lender will take back your car and recover the outstanding debt.

Two-Wheeler Loans:

A two-wheeler is pretty essential in today's world. May it be going for a long ride or a busy road in a city – bikes and scooters help you to commute conveniently. A two-wheeler loan is easy to apply for. This amount you borrow under this loan type helps you to purchase a two-wheeler. But if you do not pay the instalments on time and clear your debt, the insurer will take your two-wheeler to recover the loan amount.

Small Business Loans:

Small Business Loans are loans that are provided to small scale and medium scale businesses to meet various business requirements. These loans can be used for a variety of purposes that help in growing the business. Some of these could include purchase of equipment, buying inventory, paying the salaries of employees, marketing expenses, paying off business debts, meeting administrative expenses, or even to open a new branch or take up a franchise.
The eligibility criteria for small business loans varies from lender to lender, but the common ones are the age of the business owner, the number of years the business has been operational, income tax returns, and statement of the previous year's turnover that has been audited by a Chartered Accountant (CA).

Payday Loans:

Payday loans are also called salary loans. These are unsecured short-term loans that require the customer to be employed with a steady income. They usually have high interest rates. This is based on the applicant's credit profile, age, and income. Documents required would be salary statements and other proof of income.

Cash Advances:

These loans are offered by credit card issuers and allow credit card users to withdraw cash from an ATM machine using the credit card. The amount of cash that can be withdrawn from a credit card in this way will depend on the credit limit available. The cash has to be paid back with interest, which is usually calculated from the day the cash has been withdrawn. There are also other fees associated with a cash advance, such as cash advance fees and ATM or bank fees.

Home Renovation Loan:

Home innovation loans are offered by most lenders. These can be availed to meet the expenses

related to renovation, repairs, or improvement of an existing residential property. Depending on

the lender, there is a lot of flexibility with what you can do with a home renovation loan. You can use it to buy products or pay for services. For example, you can use it to pay for the services of a contractor, architect, or interior decorator. You can also use it to buy furniture, furnishings, or household appliances such as a refrigerator, washing machine, air conditioner, etc. It can be used for painting, carpentry, or masonry work as well.

Agriculture Loan:

Agriculture loans are loans that are provided to farmers to meet the expenses of their day-to-day or general agricultural requirements. These loans can be short term or long term. They can be used for raising working capital for crop cultivation or to buy agricultural equipment.

Gold Loan:

A gold loan can be used to raise cash to meet emergency or planned financial requirements, such as business expansion, education, medical emergencies, agricultural expenses, etc. The loan against gold is a secured loan where gold is placed as security or collateral in return for a loan amount that corresponds to the per gram market value of gold on the day that the gold has been pledged. Any other metals, gems, or stones that are in the jewelry will not be calculated when determining the value of the gold loan.

Loan Against Credit Card:

Loan against credit card is like a personal loan that is taken against your credit card. These are usually pre-approved loans that do not require any additional documentation. Depending on the lender, this can be converted into a personal loan that is interest free within a certain period of time. After that, it will attract a certain percentage of interest. There is a processing fee associated with converting the credit limit that is pre-assigned into a loan.

Education Loan:

An education loan is availed specifically to finance educational requirements towards school or college. Depending on the lender, it will cover the basic fees of the course, the exam fees, accommodation fees, and other miscellaneous charges. The student is the borrower with any other close relative being the co-applicant, such as a parent, grandparent, spouse, or sibling. It can be availed for courses in India or abroad. It can be taken for a wide variety of 28ecognized courses which are either part time or full time. They cover vocational courses as well as undergraduate and postgraduate courses.

Consumer Durable Loan:

Consumer durable loans are loans that are availed to finance the purchase of consumer durables such as a electronic gadgets and household appliances. Depending on the lender, they can be used to buy anything from mobile phones to television sets. Loan amounts range from Rs.5,000 to Rs.5 lakh. There is no security deposit required usually. Some lenders offer 0% interest on consumer durable loans with instant approvals and minimal documentation required as well.

Loan Against the Insurance Schemes:

If your insurance scheme is eligible for a loan, you can avail the loan amount from your insurer. You may also use the investment for insurance as collateral. Generally, loans cannot be availed right from the commencement of the insurance policy. After 3 years into the scheme, you can apply for a loan against insurance.

Loan Against Fixed Deposits:

This is a type of loan where your fixed deposit is the collateral. For example, if you have a fixed deposit of Rs.10 lakh in the bank, you can avail a loan of up to Rs.8 lakh. However, the rate of interest associated with this kind of a loan is usually higher than the fixed deposit rate.

Loan Against Mutual Funds and Shares:

Certain lenders provide loan against your mutual fund value and share value. However, you will not be able to borrow huge amounts under this type of loans.

Priority Sector Lending and Sectoral Limits

Priority Sector Lending and Sectoral Limits

1. Priority Sector Lending (PSL)

Meaning and Definition

Priority Sector Lending refers to the lending provided by banks to certain important sectors of the economy that require adequate and timely financial assistance for their development. These sectors may not always receive sufficient credit under normal commercial lending practices. Therefore, the Reserve Bank of India (RBI) requires banks to provide a specified portion of their lending to identified priority sectors.

The main objective of Priority Sector Lending is to ensure that credit facilities reach weaker sections of society, small businesses, farmers and other economically important groups. It promotes inclusive economic growth and helps reduce inequalities in access to finance.

Example: A bank provides a crop loan to a small farmer, a business loan to a micro-enterprise, or an education loan to an eligible student. These loans may qualify as Priority Sector Lending if they satisfy the applicable RBI guidelines.

Objectives of Priority Sector Lending

1. Agricultural Development: To provide financial assistance to farmers for crop cultivation, irrigation, farm equipment and other eligible agricultural activities.
2. Support to Small Businesses: To help micro, small and medium enterprises (MSMEs) obtain funds for starting, operating and expanding their businesses.
3. Financial Inclusion: To extend banking credit to people and businesses that may have limited access to formal finance.
4. Employment Generation: To support small enterprises, self-employment and other activities that create job opportunities.
5. Development of Weaker Sections: To improve access to credit for eligible weaker sections of society.
6. Balanced Economic Development: To encourage the growth of different sectors and regions of the economy.
7. Reduction of Economic Inequality: To provide financial opportunities to groups that may otherwise find it difficult to obtain bank loans.

Major Categories of Priority Sector Lending

According to the RBI's Priority Sector Lending framework, the major categories include agriculture, MSMEs, export credit, education, housing, social infrastructure, renewable energy and others.

Master Direction

1. AgricultureBanks provide loans for crop cultivation, irrigation, farm machinery and eligible allied activities such as dairy farming, fisheries and poultry.

Example: A farmer obtains a crop loan to purchase seeds and fertilizers.

2. Micro, Small and Medium Enterprises (MSMEs)

Eligible loans help small businesses purchase machinery, buy raw materials, meet working capital requirements and expand their operations.

Example: A small tailoring unit borrows money to purchase additional sewing machines.

3. Export Credit

Eligible bank finance supports businesses involved in exporting goods and services, subject to applicable RBI conditions.

Example: A garment exporter receives finance to fulfil an overseas order.

4. Education

Eligible education loans help students meet expenses associated with higher education and approved courses.

Example: A student obtains an education loan for an MBA programme.

5. Housing

Certain housing loans qualify for priority sector classification when they meet the applicable conditions and limits.

Example: An eligible household receives a bank loan to purchase a modest residential house.

6. Social Infrastructure

Eligible finance supports specified facilities such as schools, healthcare facilities and sanitation projects in accordance with RBI guidelines.

Example: A bank finances an eligible healthcare facility in a rural area.

7. Renewable Energy

Eligible loans support specified renewable-energy projects and installations, including solar and other approved energy systems.

Example: A borrower obtains finance for an eligible solar power installation.

8. Others

This category covers other eligible activities specified in RBI directions, which may include certain loans to weaker sections and eligible self-help groups.

Example: An eligible self-help group obtains a bank loan for a small income-generating activity.

Banks must meet applicable priority-sector lending targets calculated with reference to the prescribed measure of bank credit. The target differs according to the category of bank. The RBI directions available in the cited source prescribe the following broad targets.

Category of bank	Overall priority-sector target
Domestic commercial banks (excluding RRBs and SFBs)	40%
Foreign banks with 20 or more branches	40%
Foreign banks with fewer than 20 branches	40%, subject to specific export-credit provisions
Regional Rural Banks (RRBs)	75%
Small Finance Banks (SFBs)	75%

Note: These are overall targets, not the percentage of every bank loan that must go to each individual category. Additional sub-targets and classification conditions apply. Refer to the latest RBI directions for regulatory use.

Advantages of Priority Sector Lending

- It improves access to institutional finance for farmers and small businesses.
- It encourages agricultural and rural development.
- It supports employment and self-employment opportunities.
- It promotes financial inclusion among underserved groups.
- It helps direct credit towards economically important activities.

- It supports more balanced economic development.

2. Sectoral Limits

Meaning and Definition

Sectoral limits refer to the restrictions or maximum exposure limits established by a bank for lending to particular industries, economic sectors or categories of borrowers. These limits help prevent a bank from concentrating too much of its lending in one sector.

Banks lend to different sectors, such as agriculture, real estate, infrastructure, manufacturing, services and trade. If a bank lends a very large amount to a single sector and that sector experiences financial difficulties, the bank may suffer substantial losses. Therefore, banks monitor their exposure to individual sectors and establish appropriate limits based on risk, capital, regulatory requirements and internal credit policies.

Example: Suppose a bank has total eligible lending exposure of ₹1,000 crore and establishes an internal exposure limit of ₹150 crore for a particular industry. The bank would monitor its lending to that industry to ensure that its exposure remains within the approved limit, subject to applicable regulations and the bank's policies.

The ₹150 crore limit in this example is illustrative, not an RBI-prescribed universal limit.

Objectives of Sectoral Limits

1. To Control Credit Risk: Sectoral limits help reduce the risk of excessive lending to industries that may experience financial difficulties.
2. To Avoid Concentration of Loans: They prevent the bank from depending too heavily on one industry or category of borrowers.
3. To Protect Depositors' Money: Proper control over lending exposure helps safeguard the funds entrusted to banks.
4. To Maintain Financial Stability: Limits help banks manage exposure to economic fluctuations and industry-specific problems.
5. To Improve Risk Management: Banks can identify, measure and monitor risks associated with different sectors.
6. To Diversify Lending: Sectoral limits encourage banks to distribute credit across different industries and activities.
7. To Support Sound Lending Decisions: They help banks establish lending policies that consider the risks and repayment capacity associated with each sector.

Factors Considered While Fixing Sectoral Limits

- Risk of the Sector: Banks assess the financial stability and risk profile of the industry.

- Demand for Credit: Lending limits may reflect the financing requirements of businesses in a sector.
- Repayment Capacity: Banks evaluate whether borrowers in the sector are likely to repay their loans.
- Economic Conditions: Inflation, interest rates, demand fluctuations and economic slowdowns can affect sectoral risk.
- Regulatory Requirements: Banks must comply with applicable RBI exposure norms and other regulatory requirements.
- Bank's Capital and Resources: The bank considers its capital position, available funds and overall risk-bearing capacity.
- Existing Exposure: The bank examines how much it has already lent to a particular sector before approving additional loans.

Example of Sectoral Limits

Consider the following illustrative lending distribution of a bank with total lending of ₹1,000 crore.

Sector	Illustrative lending limit	Existing lending
Agriculture	₹200 crore	₹160 crore
Manufacturing	₹250 crore	₹220 crore
Real estate	₹150 crore	₹130 crore
Infrastructure	₹250 crore	₹180 crore
Other sectors	₹150 crore	₹120 crore
Total	₹1,000 crore	₹810 crore

The bank monitors each sector's outstanding exposure against its approved limit. For example, if the real estate limit is ₹150 crore and existing lending is ₹130 crore, only ₹20 crore remains available under that illustrative limit, unless the bank revises the limit in accordance with its policies and applicable regulations.

Advantages of Sectoral Limits

1. They reduce excessive exposure to a single industry.
2. They help banks manage sector-specific credit risks.
3. They encourage diversification of lending.
4. They support better monitoring of loan portfolios.
5. They help banks prepare for economic downturns affecting particular industries.
6. They contribute to the stability and soundness of the banking system.

3. Difference Between Priority Sector Lending and Sectoral Limits

Basis	Priority Sector Lending	Sectoral Limits
Meaning	Lending directed towards specified priority sectors under RBI guidelines	Restrictions or exposure limits on lending to particular sectors

Main objective	To improve access to credit for identified sectors and eligible groups	To control risk and prevent excessive concentration
Nature	Prescribes lending targets and eligibility criteria	Establishes maximum or internal exposure boundaries
Regulatory role	Governed by RBI's PSL directions	Governed by applicable regulatory exposure norms and banks' risk policies
Examples	Eligible agriculture, MSME and education loans	Limits on a bank's exposure to real estate or infrastructure
Main benefit	Promotes financial inclusion and economic development	Promotes diversification and risk management

Important distinction: Priority Sector Lending encourages banks to provide a specified share of credit to eligible activities. Sectoral limits help banks control how much risk they take in individual sectors. They are related to lending policy, but they serve different purposes.

Loan Pricing

1. Meaning of Loan Pricing

Loan pricing refers to the process of determining the interest rate and other applicable charges that a bank imposes on a borrower for providing a loan. It is an important part of credit management because the bank must earn sufficient income to cover its cost of funds, operating expenses, credit risk and other costs while offering reasonable borrowing terms to customers.

Banks consider several factors while fixing loan interest rates, including the cost of obtaining funds, the borrower's creditworthiness, the loan amount, repayment period, security offered, market conditions and competition from other lenders.

Example: If a bank provides a business loan of ₹5,00,000 at an annual interest rate of 12%, the interest charged is part of the bank's income from the loan. The rate should be determined after considering the cost and risk associated with lending.

2. Objectives of Loan Pricing

1. To Earn Profit: Loan pricing enables banks to earn interest income and maintain profitability.
2. To Cover the Cost of Funds: Banks must recover the cost of deposits and other funds used to provide loans.
3. To Cover Operating Expenses: The interest and charges should contribute towards administrative, employee, technology and loan-processing expenses.
4. To Compensate for Credit Risk: Borrowers with a higher risk of default may attract a higher risk premium, subject to applicable regulations.
5. To Remain Competitive: Banks must consider prevailing market rates and the prices offered by competing financial institutions.
6. To Attract Creditworthy Borrowers: Reasonable and transparent pricing can help banks attract suitable customers.
7. To Maintain Financial Stability: Proper pricing helps banks manage risk and sustain lending operations.

3. Factors Affecting Loan Pricing

1. Cost of Funds

The cost of funds is the cost incurred by a bank to obtain money through deposits and other funding sources. A higher cost of funds may increase the pressure on the bank to charge higher lending rates

2. Creditworthiness of the Borrower

Banks assess the borrower's income, repayment history, financial position and credit score. A borrower with a strong repayment record may qualify for more favourable pricing than a borrower with a higher risk of default.

3. Loan Amount and Period

The amount borrowed and the repayment period influence the bank's exposure and administrative costs. Longer-term loans may also involve greater uncertainty about future interest rates and repayment conditions.

4. Security or Collateral

A secured loan is supported by assets such as property, deposits or machinery. The availability and value of suitable collateral may reduce the bank's potential loss if the borrower defaults.

5. Operating Costs

Banks incur expenses for processing applications, verifying documents, monitoring loans, collecting repayments and maintaining banking systems. These costs are considered in the overall pricing process.

6. Market Interest Rates

Changes in market interest rates, RBI policy rates and relevant lending benchmarks can influence the rates charged on loans, especially floating-rate loans.

7. Competition

Banks consider the interest rates and lending conditions offered by competing banks and financial institutions when designing their loan products.

8. Profit Margin and Business Strategy

Banks also consider their desired return, lending objectives and the type of customer or loan product. The final rate must comply with applicable RBI directions and the bank's approved pricing policy.

4. Pricing of Fixed Rate Loans

Meaning

A fixed-rate loan is a loan in which the interest rate remains unchanged for the agreed fixed-rate period. The borrower can plan repayments more easily because changes in general market interest rates do not directly change the contracted rate during that period.

Example: A borrower takes a loan at a fixed interest rate of 10% per annum. If market interest rates rise to 11%, the borrower's contracted rate remains 10% during the agreed fixed-rate period, subject to the loan contract.

Advantages of Fixed Rate Loans

- Predictable Repayments: Borrowers can plan their budgets more easily.
- Protection from Rate Increases: A rise in market interest rates does not automatically increase the contracted rate during the fixed-rate period.

- Financial Planning: Businesses can estimate borrowing costs when preparing budgets and investment plans.
- Certainty: The borrower has greater certainty about the applicable interest rate.

Disadvantages of Fixed Rate Loans

- Limited Benefit from Rate Reductions: If market rates fall, the borrower may continue paying the contracted fixed rate.
- Potentially Higher Initial Rate: Depending on market conditions, the fixed rate offered may be higher than the available floating rate.
- Contractual Restrictions: Changing or closing the loan early may involve conditions or charges where permitted by applicable rules and the loan agreement.

Example

A business borrows ₹2,00,000 at a fixed annual interest rate of 10%.

Simple interest for one year, assuming the full principal remains outstanding throughout the year:

₹2,00,000 × 10% = ₹20,000.

Therefore, the interest for that year is ₹20,000 under this simplified example. Actual interest on instalment-based loans is calculated according to the outstanding balance and the loan's repayment schedule.

5. Pricing of Floating Rate Loans

Meaning

A floating-rate loan is a loan whose interest rate can change during the loan period according to an agreed benchmark and applicable spread. When the benchmark changes, the interest rate payable by the borrower may increase or decrease according to the contract.

In India, the applicable RBI framework specifies how different categories of floating-rate loans are to be benchmarked. For example, qualifying floating-rate retail and MSME loans from banks are linked to prescribed external benchmarks.

Components of a Floating Interest Rate

A floating interest rate is generally expressed as:

Floating interest rate = Benchmark rate + Spread

- Benchmark rate: A reference rate used to determine changes in the lending rate.

- Spread: An additional margin determined under the lender's pricing policy, considering factors such as credit risk and other permitted components.

Example: Suppose a loan is linked to a benchmark of 6.5% with a spread of 2.5%.

Floating interest rate = 6.5% + 2.5% = 9% per annum.

If the benchmark later rises to 7%, the rate would become 9.5%, assuming the spread remains unchanged and the contractual reset rules apply.

Advantages of Floating Rate Loans

- Potential Benefit from Falling Rates: Borrowers may pay less interest when the applicable benchmark declines.
- Market Responsiveness: The rate can adjust to changes in the interest-rate environment.
- Potentially Lower Initial Cost: In some market conditions, the initial floating rate may be lower than a comparable fixed rate.
- Suitable for Some Long-Term Borrowers: Borrowers willing and able to manage changing repayments may prefer floating-rate arrangements.

Disadvantages of Floating Rate Loans

- Uncertain Borrowing Cost: The borrower cannot know the exact interest cost over the entire loan period.
- Risk of Higher Repayments: A rise in the benchmark can increase the interest rate.
- Budgeting Difficulties: Changes in repayments or loan tenure may complicate financial planning.
- Exposure to Market Conditions: The borrower's financial burden may increase when interest rates rise.

6. Difference Between Fixed and Floating Rate Loans

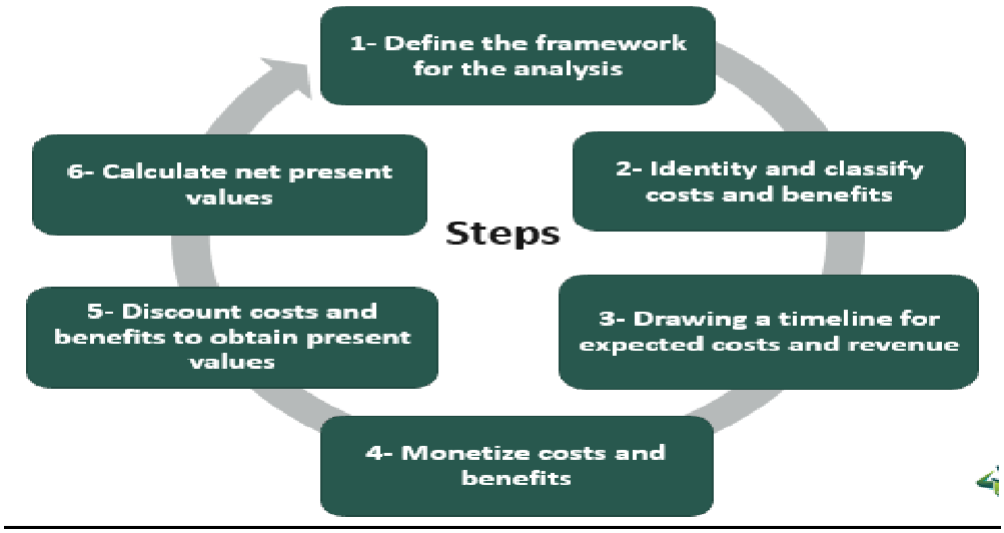
Basis	Fixed Rate Loan	Floating Rate Loan
Interest rate	Remains fixed for the agreed fixed-rate period	Changes according to the benchmark and contract
Repayment planning	Generally more predictable	Less predictable
Effect of rising market rates	Contracted rate generally remains unchanged during the fixed period	Interest rate may increase
Effect of falling market rates	Borrower may not benefit automatically	Borrower may benefit if the benchmark falls
Risk to borrower	Less exposure to market-rate changes during the fixed period	Greater exposure to changes in the benchmark
Suitable for	Borrowers who prefer certainty	Borrowers who can manage

		changing rates
Example	Loan at a contracted 10% fixed rate	Loan at benchmark rate + 2.5% spread

Cost Benefits

The cost-benefit analysis compares the costs and benefits of a project and then makes a decision on whether or not to proceed with the project. The project's costs and benefits are measured in monetary terms after adjusting for the time value of money, thus providing a true picture of the costs and benefits. Net Present Value and Benefit-Cost Ratio are the two most common methods of doing a cost-benefit analysis. The NPV model chooses the project with the highest NPV. The benefit-cost ratio model chooses the project with the highest benefit-cost ratio.

Cost-Benefit Analysis



We all know it's quite simple to make an investment decision when the benefits overshadow the costs, but only a few of us know the other key elements that go into the analysis. The steps to create a meaningful model are:
The steps to create a meaningful Cost-Benefit Analysis model are:

1. **Define the framework for the analysis.**
   Identify the state of affairs before and after the policy change or investment on a particular project. Analyze the cost of this status quo. We need to first measure the profit of taking up this investment option instead of doing nothing or being on ground zero. Sometimes the status quo is the most lucrative place to be in.
2. **Identity and classify costs and benefits.**
   It is essential to costs and benefits are classified in the following manner to ensure that you understand the effects of each cost and benefit.

   – Direct Costs (Intended Costs/Benefits)
   – Indirect Costs (Unintended Costs/Benefits),
   – Tangible (Easy To Measure And Quantify)/
   – Intangible (Hard To Identify And Measure), And
   – Real (Anything That Contributes To The Bottom Line Net-Benefits)/Transfer (Money Changing Hands)

3. **Drawing a timeline for expected costs and revenue.**
   When it comes to decision making, timing is the most crucial element. Mapping needs to be done when the costs and benefits will occur and how much they will pan out over a phase. It solves two major issues. Firstly, a defined timeline enables businesses to align

themselves with the expectations of all interested parties. Secondly, understanding the timeline allows them to plan for the impact that the cost and revenue will have on the operations. This empowers businesses to better manage things and take steps ahead of any contingencies.

4. **Monetize costs and benefits.**
   We must ensure to place all costs and all benefits in the same monetary unit.
5. **Discount costs and benefits to obtain present values.**
   It implies converting future costs and benefits into present value. It is also known as discounting the cash flows or benefits by a suitable discount rate. Every business tends to have a different discount rate.
6. **Calculate net present values.**
   It is done by subtracting costs from benefits. The investment proposition is considered efficient if a positive result is obtained. However, there are other factors to be considered, as well.

Principles of Cost-Benefit Analysis

- **Discounting the costs and benefits –** The benefits and costs of a project have to be expressed in terms of equivalent money of a particular time. It is not just due to the effect of inflation but because a dollar available now can be invested, and it earns interest for five years and would eventually be worth more than a dollar in five years.
- **Defining a particular study area –** The impact of a project should be defined for a particular study area. E.g., A city, region, state, nation, or the world. It's possible that the effects of a project may "net out" over one study area but not over a smaller one.
- The specification of the study area may be subjective, but it can impact the analysis to a significant extent.
- **Addressing uncertainties precisely –** Business decisions are clouded by uncertainties. It must disclose areas of uncertainty and discretely describe how each uncertainty, assumption, or ambiguity has been addressed.
- **Double counting of cost and benefits must be avoided –** Sometimes though each of the benefits or costs is seen as a distinct feature, they might be producing the same economic value, resulting in the dual counting of elements. Hence these need to be avoided.

Importance of Cost-Benefit analysis

- **Determining the feasibility of an opportunity:** Nobody wants to incur losses in business. When a massive sum of money is invested in a project or initiative, it should at least break even or recover the cost. To determine whether the project is in the positive zone, the costs and benefits are identified and discounted to present value to ascertain the viability.
- **To provide a basis for comparing projects:** With so many investment choices around, there has to be a basis for choosing the best alternative. Cost-benefit analysis is one the aptest to tools to pick through the available options. When one out of the two options seems more beneficial, the choice is simple. However, a problem arises when there are more than two alternatives to evaluate. This model helps businesses to rank the projects according to their order of merit and go for the most viable one.
- **Evaluating Opportunity Cost:** We know that the resources at our disposal are finite, but

investment opportunities are many. Cost-benefit analysis is a useful tool for comparing and selecting the best option. However, while choosing the most viable project, it is also imperative to be aware of the Opportunity Cost or the cost of the next best alternative foregone. It helps businesses to identify the benefits that could have arisen if the other option was chosen.

- **Performing Sensitivity Analysis for the various real-life scenarios:** Situations are not always the same, and the exact outcome cannot be predicted. The discount rate can be tested over a range. Sensitivity analysis can be instrumental in improving the credibility of a Cost-benefit analysis and is mainly used where there is ambiguity over the discount rate. The investigator may change the discount rate and the horizon value to test the sensitivity of the model.

Cost–Benefit Analysis of Loan Pricing

Meaning

Cost–benefit analysis of loan pricing is the process of comparing the costs incurred by a bank in providing a loan with the income and other benefits expected from that loan. It helps the bank determine whether the proposed interest rate and loan conditions are financially worthwhile.

The bank should not fix the interest rate solely to maximise income. It must also consider the borrower's repayment capacity, the probability of default, administrative expenses and the overall sustainability of the lending decision.

Costs Involved in Providing a Loan

1. Cost of Funds: The interest or other costs the bank incurs to obtain the money it lends.

2. Operating Cost: Expenses relating to loan processing, documentation, staff, technology, monitoring and collection.

3. Credit Risk Cost: The expected loss associated with the possibility that a borrower may fail to repay the loan.

4. Administrative and Legal Expenses: Costs associated with verifying documents, preparing agreements, registering security and enforcing repayment where necessary.

5. Capital and Liquidity Costs: The cost of maintaining the capital and liquidity required to support lending, as applicable under the bank's framework.

Benefits or Returns from Providing a Loan

1. Interest Income: Interest charged on the loan is the principal source of direct lending income.

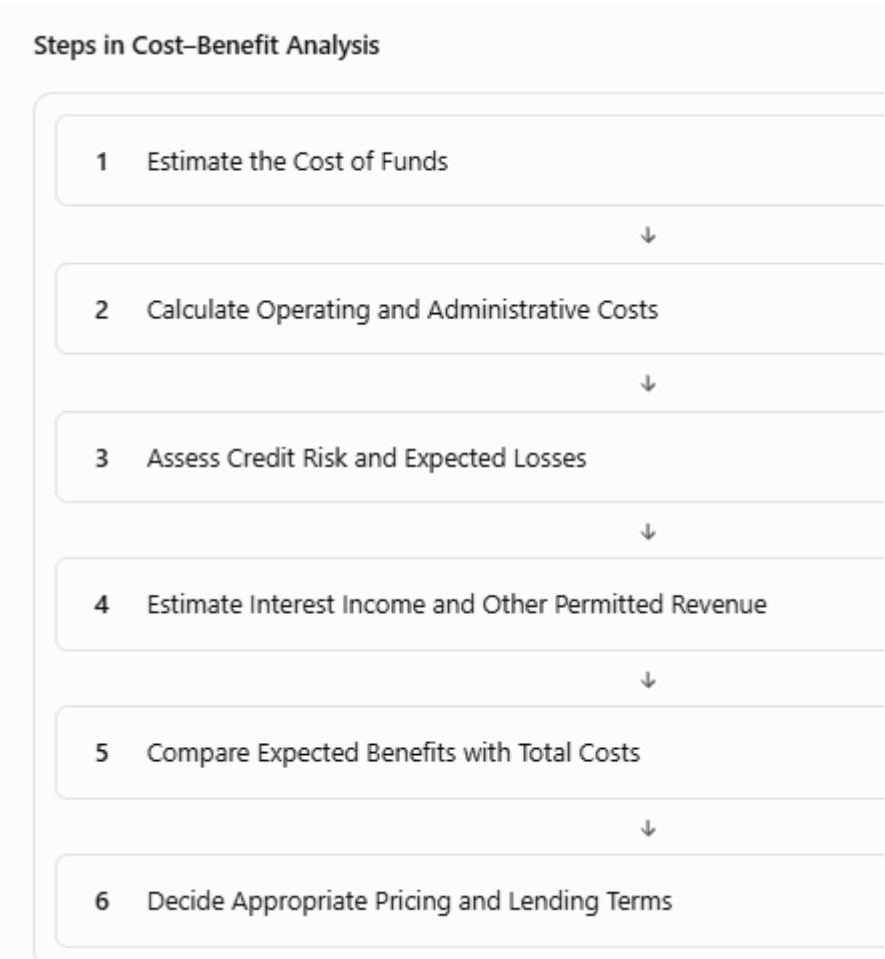
2. Processing and Other Permitted Fees: Banks may earn applicable fees for loan-related services, subject to disclosure and regulatory requirements.

3. Customer Relationship: A satisfactory lending relationship may lead to other legitimate banking business, such as deposits and payment services.

4. Business Growth: Appropriate loan pricing helps the bank expand its loan portfolio while maintaining acceptable risk and returns.

5. Developmental Benefits: Lending to eligible businesses, farmers and households can support economic activity, employment and financial inclusion.

Steps in Cost–Benefit Analysis



Suppose a bank provides a loan and estimates the following annual amounts.

Particulars	Amount
Expected interest income	₹30,000
Cost of funds	₹15,000
Operating and administrative costs	₹4,000
Expected credit loss	₹3,000
Total estimated costs	₹22,000
Estimated net contribution before other costs and taxes	₹8,000

Calculation:

Estimated net contribution = Expected interest income − Total estimated costs

= ₹30,000 − ₹22,000

= ₹8,000

In this simplified example, the loan generates an estimated contribution of ₹8,000 before other unlisted costs and taxes. The bank must also consider capital requirements, liquidity, the borrower's financial condition and whether the expected return is adequate for the risk involved.

Importance of Cost–Benefit Analysis

1. Helps Fix Appropriate Interest Rates: It enables the bank to set pricing that considers both expenses and expected returns.
2. Improves Profitability: It helps identify loans that may not generate adequate returns relative to their costs and risks.
3. Controls Credit Risk: It encourages banks to account for expected losses before approving loans.
4. Supports Better Decisions: Banks can compare different loan proposals and lending terms.
5. Promotes Responsible Lending: Pricing decisions can consider the borrower's repayment capacity instead of focusing only on income generation.
6. Improves Resource Utilisation: It helps banks allocate funds to loans that meet their risk and return requirements.

Securitisation

Cost–Benefit Analysis of Loan Pricing

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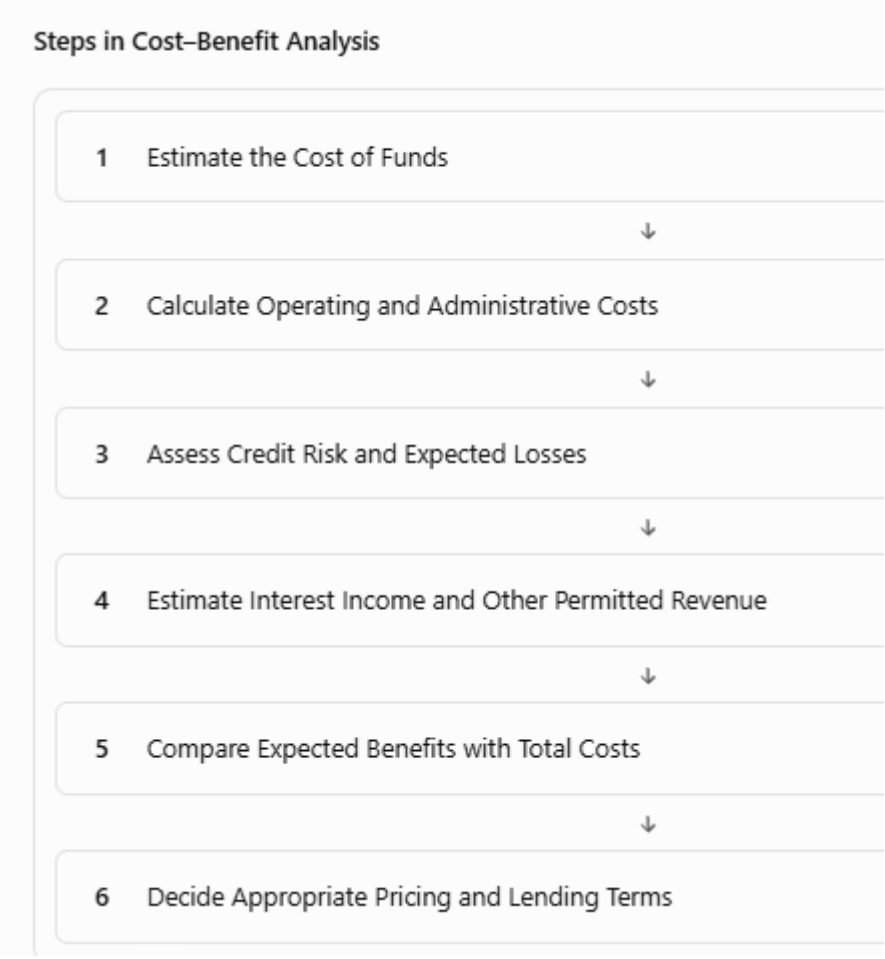
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Conclusion

Loan pricing is a key element of bank credit management. Fixed-rate loans offer greater certainty, while floating-rate loans adjust to changes in the relevant benchmark. Cost–benefit analysis helps banks evaluate whether the income from a loan is sufficient to cover its funding, operating and risk-related costs. Effective loan pricing supports profitability, responsible lending and the long-term stability of banks.

The next topic in Unit II is Securitisation. We'll cover its meaning, process, participants, advantages, disadvantages and a practical banking example, so it can be used as standalone exam material.

1. Meaning and Definition of Securitisation

Securitisation is a financial process in which a bank or financial institution combines a group of loans or other eligible financial assets and transfers them to a separate entity. That entity issues securities to investors, and the money collected from the underlying loans is used to make payments to those investors.

In simple words, securitisation converts a pool of eligible loans into marketable financial securities. It enables lenders to obtain funds from investors rather than waiting for all the loans to be repaid over time.

The assets used for securitisation may include eligible housing loans, vehicle loans and other loan receivables. The exact assets and transaction structure must satisfy applicable regulatory requirements.

Master Directions+1

Example: A bank has provided 1,000 home loans to different customers. Instead of waiting several years to collect all the repayments, the bank may transfer an eligible pool of these loans to a special purpose entity. The entity issues securities to investors. As borrowers repay their home loans, the cash flows are used to pay the investors according to the agreed terms.

2. Objectives of Securitisation

1. To Improve Liquidity: Securitisation helps banks convert eligible loan assets into funds that can be used for further lending.
2. To Mobilise Funds: It allows financial institutions to obtain funding from investors in the financial market.
3. To Support Further Lending: Funds received through securitisation may help banks provide additional loans to eligible borrowers.
4. To Distribute Credit Risk: Securitisation can transfer some credit risk to investors, depending on the structure of the transaction.
5. To Diversify Funding Sources: Banks can obtain funds through mechanisms other than deposits and conventional borrowing.
6. To Improve Asset Management: It helps financial institutions manage their balance sheets and funding requirements.

7. To Provide Investment Opportunities: It enables investors to invest in securities supported by cash flows from underlying financial assets.

3. Parties Involved in Securitisation

1. Originator: The bank or financial institution that originally provided the loans and transfers eligible assets for securitisation.

2. Special Purpose Entity (SPE): A separate entity established to hold the transferred assets and issue securities to investors. It is commonly called a Special Purpose Vehicle (SPV).

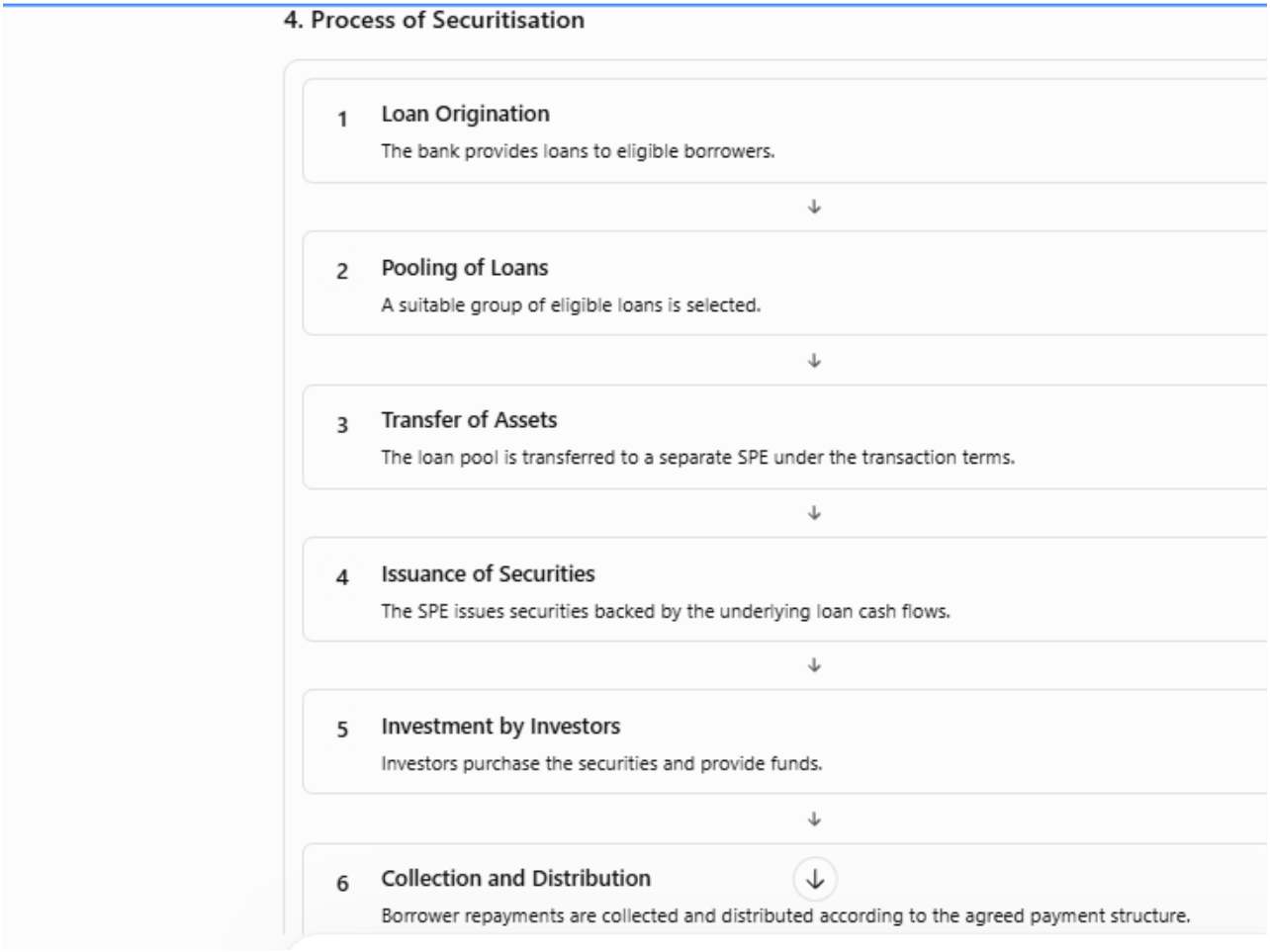
3. Investors: Individuals or institutions that purchase the securities issued by the SPE and receive payments according to the terms of the transaction.

4. Servicer: The institution responsible for collecting repayments from borrowers and performing related loan-servicing activities. The originator may continue to act as the servicer.

5. Credit Rating Agency: An agency that evaluates the credit risk of securities when a rating is sought or required.

6. Trustee: Where appointed, the trustee performs duties for investors or other parties as specified in the transaction documents.

4. Process of Securitisation



Explanation of the Process

Step 1: Loan Origination

The bank initially provides loans to customers, such as homebuyers or vehicle purchasers. These loans generate repayments over a period of time.

Step 2: Pooling of Loans

The bank identifies a group of eligible loans with suitable characteristics. The loans are grouped together to form a pool of financial assets.

Step 3: Transfer of Assets

The eligible loan pool is transferred to a separate entity under the applicable legal and regulatory framework. The transfer arrangements specify the rights and responsibilities of the parties.

Step 4: Issuance of Securities

The SPE issues securities backed by the cash flows generated by the underlying loans. These securities may have different risk levels and payment priorities.

Step 5: Investment by Investors

Investors purchase the securities and provide funds to the SPE. The originator receives payment for the transferred assets, subject to the transaction structure and costs.

Step 6: Collection and Distribution

Borrowers continue making repayments according to their loan agreements. The collected amounts are used to meet servicing expenses and make payments to investors in accordance with the securities' terms.

5. Types of Securitisation

1. Mortgage-Backed Securities (MBS)

Mortgage-backed securities are supported by cash flows generated from a pool of mortgage loans, such as eligible residential housing loans.

Example: Securities backed by repayments from a pool of home loans.

2. Asset-Backed Securities (ABS)

Asset-backed securities are supported by cash flows from eligible financial assets other than mortgage loans, such as vehicle loans or certain consumer loan receivables.

Example: Securities supported by repayments from a pool of vehicle loans.

3. Collateralised Loan Structures

Some securitisation arrangements use pools of loans and divide the securities into different classes, known as tranches, according to their payment priority and credit risk.

Example: One class of investors may receive payments before another class, subject to the transaction agreement.

Note: The availability and treatment of particular structures depend on the applicable regulatory framework.

6. Advantages of Securitisation

1. Improves Liquidity: Banks receive funds from transferring eligible assets rather than waiting for the entire loan period to end.
2. Supports Credit Expansion: The funds obtained may be used to provide new loans, subject to capital, liquidity and other requirements.
3. Diversifies Funding: Securitisation provides an alternative source of funding.
4. Distributes Risk: Depending on the structure, some credit risk may be transferred to investors.
5. Improves Financial Market Development: It creates investment opportunities based on the cash flows of financial assets.
6. Improves Balance-Sheet Management: It can help banks manage their assets, funding needs and exposure to particular risks.

7. Disadvantages of Securitisation

1. Complexity: Securitisation transactions can involve complicated legal documents, structures and cash-flow arrangements.
2. Credit Risk: If borrowers fail to repay their loans, investors may receive lower payments than expected.
3. Transaction Costs: Legal, administrative, rating, servicing and other expenses may reduce the financial benefits.
4. Information Asymmetry: Investors may not have the same detailed knowledge of borrowers as the original lender.
5. Market Risk: Changes in interest rates and market conditions can affect the value and demand for securities.
6. Potential for Poor Lending Standards: If lenders do not maintain sound credit assessment practices, securitisation may encourage excessive risk-taking.
7. Regulatory Requirements: Banks must comply with applicable requirements relating to eligible assets, transfers, disclosures, risk retention and other prudential matters.

8. Difference Between Traditional Lending and Securitisation

Basis	Traditional Lending	Securitisation
Basic process	The bank provides loans and holds them as assets.	Eligible loans are pooled and transferred through a securitisation structure.
Source of funds	Deposits, borrowings and other funding sources	Investors provide funds by purchasing securities.
Repayment	Borrowers repay the bank under loan agreements.	Borrowers repay the underlying loans; cash flows support payments to investors.
Liquidity	Funds are generally recovered over the loan repayment period.	The transfer may provide funds earlier to the originator.
Risk	The bank retains the loan risk unless it is otherwise transferred or mitigated.	Risk may be redistributed, depending on the structure and retained exposures.
Complexity	Usually involves a direct lender–borrower relationship.	Involves additional entities, documentation and securities.

9. Practical Example of Securitisation

Suppose ABC Bank has a pool of 500 eligible vehicle loans with an outstanding principal amount of ₹10 crore.

The bank transfers the eligible loan pool to an SPE. The SPE issues securities backed by the repayments from those loans, and investors purchase the securities for an agreed amount. The bank receives funds from the transaction, less applicable costs and adjustments.

Borrowers continue to repay their vehicle loans. The collections are then used to make payments to investors and meet other transaction expenses in accordance with the agreed structure.

The bank may use the funds received to support additional lending. However, the extent to which it transfers credit risk or removes assets from its balance sheet depends on the transaction's legal, accounting and regulatory treatment.

Conclusion

Securitisation is an important financial technique through which eligible loans are pooled and converted into marketable securities. It can improve liquidity, diversify funding sources and distribute credit risk. However, its success depends on sound lending standards, transparent documentation, proper risk assessment and compliance with applicable regulations.

The RBI's Securitisation of Standard Assets Directions, 2021, were updated in December 2022. Because regulatory directions can be amended or superseded, use the latest applicable RBI framework when including specific compliance requirements in the final notes.

Syndication of Loans

1. Meaning and Definition

Loan syndication is a process in which two or more banks or financial institutions jointly provide a large loan to a single borrower. The total loan amount is divided among the participating lenders, so that no single bank has to provide the entire amount or bear all the associated credit risk.

Loan syndication is generally used when a borrower requires a large amount of finance that may exceed the lending capacity, risk appetite or exposure limits of an individual bank.

Example: A company requires ₹500 crore to establish a manufacturing plant. Instead of one bank providing the entire amount, five banks may jointly provide the loan, with each bank contributing ₹100 crore.

2. Objectives of Loan Syndication

1. To Provide Large-Scale Finance: Loan syndication enables banks to meet the substantial financial requirements of large companies and infrastructure projects.
2. To Share Credit Risk: The participating banks share the risk associated with the borrower rather than one bank bearing the entire exposure.
3. To Improve Lending Capacity: Banks can participate in large financing arrangements without individually committing the full loan amount.
4. To Diversify Risk: Each bank can spread its lending across different borrowers and projects.
5. To Support Major Projects: Loan syndication facilitates finance for industries, infrastructure, power generation, transportation and other capital-intensive projects.
6. To Improve Resource Utilisation: Several financial institutions can combine their resources to finance a common borrower.
7. To Strengthen Cooperation Among Banks: It encourages financial institutions to cooperate in arranging and providing large loans.

3. Parties Involved in Loan Syndication

1. Borrower: The individual company or organisation that requires a large loan for business expansion, infrastructure development or another purpose.

2. Arranger or Lead Bank: The bank that organises the loan syndication, negotiates the major terms and coordinates with other participating lenders.

3. Participating Banks: The banks or financial institutions that contribute portions of the total loan amount and receive repayments according to their respective commitments.

4. Agent Bank: The bank appointed to perform administrative functions, such as coordinating loan disbursement, collecting repayments and communicating with participating lenders.

5. Legal and Financial Advisers: Professionals who may assist with documentation, financial evaluation, security arrangements and legal compliance.

Note: Depending on the transaction, the lead arranger and agent bank may be the same institution or different institutions.

4. Process of Loan Syndication

Step 1: Identification of Loan Requirement

A company identifies a requirement for a large amount of finance to establish a new project, expand production capacity or meet another major business need.

Step 2: Appointment of Lead Bank

The borrower approaches a suitable bank to arrange the financing. The lead bank evaluates the requirement and coordinates the syndication process.

Step 3: Credit Assessment

The lead bank examines the borrower's financial statements, credit history, expected cash flows, business prospects, security and ability to repay the loan.

Step 4: Formation of the Syndicate

The lead bank invites other banks and financial institutions to participate. Each institution evaluates the proposal before agreeing to contribute a portion of the loan.

Step 5: Agreement on Loan Terms

The participating lenders agree on the amount of finance, interest rate, repayment schedule, fees, collateral and other contractual conditions.

Step 6: Loan Disbursement

Once the required approvals and documentation are completed, the participating lenders provide their agreed shares of the loan. Disbursement may take place in stages depending on the loan agreement.

Step 7: Repayment and Monitoring

The borrower repays the loan according to the agreed schedule. The agent bank or designated institution coordinates repayment distribution and other administrative activities as specified in the agreement.

5. Types of Loan Syndication

1. Underwritten Deal

In an underwritten arrangement, the lead bank or arranging institution commits to providing the agreed total financing, subject to the contract. It then arranges participation by other lenders. If it cannot distribute the intended amount, it may have to retain the undistributed portion, depending on the terms.

2. Best-Efforts Syndication

In a best-efforts arrangement, the lead bank agrees to use reasonable efforts to arrange the required financing but does not necessarily guarantee that the entire amount will be raised.

3. Club Deal

A club deal is a financing arrangement in which a relatively small group of lenders jointly provides a loan. The lenders may negotiate the terms collectively, and the structure can be simpler than a large syndicated transaction.

6. Advantages of Loan Syndication

1. Large Amount of Finance: It enables borrowers to obtain funds for projects that require substantial investment.
2. Risk Sharing: Credit exposure is distributed among participating lenders according to their commitments.
3. Access to Multiple Lenders: Borrowers can obtain finance through a coordinated arrangement instead of negotiating separate loans with many banks.
4. Efficient Coordination: The lead bank coordinates the financing process and documentation.
5. Diversification for Banks: Participating banks can spread their lending across multiple borrowers and projects.
6. Support for Economic Development: Syndicated loans can finance infrastructure, industrial expansion and other major investments.
7. Flexible Financing Structures: The lenders and borrower can agree on suitable loan amounts, repayment periods and disbursement arrangements.

7. Disadvantages of Loan Syndication

1. Complex Documentation: Several lenders are involved, so the transaction may require extensive legal and financial documentation.
2. Longer Arrangement Time: Credit assessment and coordination among multiple institutions can delay approval.
3. Higher Transaction Costs: Arrangement fees, legal charges and administrative expenses may increase the cost of financing.
4. Coordination Difficulties: Participating lenders may have different risk appetites or preferences regarding loan terms.
5. Dependence on the Lead Bank: The process relies significantly on the lead bank's ability to coordinate lenders and manage documentation.
6. Borrower Credit Risk Remains: Syndication shares exposure among lenders but does not eliminate the risk that the borrower may default.
7. Complex Restructuring: If the borrower faces financial difficulties, obtaining agreement among several lenders may be complicated.

8. Example of Loan Syndication

Suppose ABC Infrastructure Ltd. requires ₹600 crore to construct a highway project.

Four banks agree to participate in the loan as follows:

Participating bank	Loan contribution
Bank A — Lead Bank	₹200 crore
Bank B	₹150 crore
Bank C	₹150 crore
Bank D	₹100 crore
Total syndicated loan	₹600 crore

In this example, Bank A coordinates the transaction, while Banks A, B, C and D contribute their agreed amounts.

The borrower receives the total financing according to the loan agreement and repays it under the agreed terms. Each bank bears the credit exposure associated with its own commitment, subject to the contractual arrangements.

9. Difference Between Loan Syndication and Securitisation

Basis	Loan Syndication	Securitisation
Meaning	Multiple lenders jointly provide a loan to a borrower.	Eligible financial assets are pooled and used to support securities issued to investors.
Main purpose	To provide large-scale financing	To obtain funding through the transfer or financing of eligible assets
Participants	Borrower, lead bank and participating lenders	Originator, special purpose entity, investors and other service providers
Basic structure	One loan with multiple lenders	A pool of assets supporting securities
Risk allocation	Loan exposure is shared among participating lenders	Risk may be transferred or redistributed, depending on the structure
Example	Four banks jointly finance a highway project.	Securities are issued against cash flows from a pool of eligible home loans.

Conclusion

Loan syndication is an important banking technique through which two or more financial institutions jointly finance a borrower requiring a large amount of credit. It enables banks to share credit exposure, combine financial resources and support major projects. However, successful syndication requires careful credit assessment, clear contractual terms and effective coordination among participating lenders.

Concept of Gross and Net NPA'S

NPA expands to non-performing assets (NPA). Reserve Bank of India defines NPA as any advance or loan that is overdue for more than 90 days. "An asset becomes non-performing when it ceases to generate income for the bank," said RBI in a circular form 2007. To be more attuned

to international practises, RBI implemented the 90 days overdue norm for identifying NPAs has been made applicable from the year ended March 31, 2004. Depending on how long the assets have been an NPA, there are different types of non-performing assets as well.

What is an asset for a bank?

Asset means anything that is owned. For banks, a loan is an asset because the interest we pay on these loans is one of the most significant sources of income for the bank. When customers, retail or corporates, are not able to pay the interest, the asset becomes 'non-performing' for the bank because it is not earning anything for the bank. Therefore RBI has defined NPAs as assets that stop generating income for them.

Categories of NPA

There are different types of non-performing assets depending on how long they remain in the NPA category.

a) Sub-Standard Assets

An asset is classified as a sub-standard asset if it remains as an NPA for a period less than or equal to 12 months.

b) Doubtful Assets

An asset is classified as a doubtful asset if it remained as an NPA for more than 12 months.

c) Loss Assets

An asset is considered as a loss asset when it is "uncollectible" or has such little value that its continuance as a bankable asset is not suggested. However, there may be some recovery value left in it as the asset has not been written off wholly or in parts.

NPA Provisioning

Keeping aside the technical definition, provisioning means an amount that the banks set aside from their profits or income in a particular quarter for non-performing assets; such assets that may turn into losses in the future. It is a method by which banks provide for bad assets and to maintain a healthy book of accounts.

Provisioning is done according to which category the asset belongs to. The categories have been mentioned in the above section. Not only the type of asset, but provisioning also depends on the type of bank. Like, Tier-I banks and Tier-II banks have different provisioning norms.

Concept of Gross and Net NPA'S

What is Gross Non-Performing Assets?

Gross non-performing assets is a term used by financial institutions to refer to the sum of all the unpaid loans which are classified as non-performing loans.

Credit institutions offer loans to their customers who fail to be honoured and within ninety days, financial institutions are obligated to classify them as non-performing assets because they are not receiving either principle or net payments.

What is Net Non-Performing Assets?

Net non-performing assets is a term used by credit institutions to refer to the sum of the non-performing loans less provision for bad and doubtful debts. Credit institutions tend to provide a precautionary amount to cover the unpaid debts.

Therefore, if one deducts provision for unpaid debts from the unpaid debts, the resulting amount refers to the net non-performing assets.

Difference between Gross NPA and Net NPA

1. **Meaning**

One of the main difference between gross non-performing assets and net non-performing assets arises from the meaning. Gross non-performing assets refer to the total amount of the debts that an organization has failed to collect or the people owing the organization has failed to honor their contractual obligations of paying both the principal and interest amount.

On the other hand, net-non performing loans is the amount that results after deducting provision for doubtful and unpaid debts from the sum of the loans defaulted. It is the actual loss that the organization incurs after loan defaults.

2. **Default Period**

Credit institutions offer a grace period after which an individual is required to start paying the loan and its associated interests. If the payment duration expires, the institution is obligated to write-off those debts which are not paid.

Non-performing loans are listed as default after ninety days which is internationally recognised. Any amount that is due after the ninety-day grace period is classified as a default. However, net-non performing asset does not have a grace period and is immediately calculated and classified as a net non-performing asset.

3. **Method of Calculation**

Gross non-performing loans are the sum of all the loans that have been defaulted by the individuals who have acquired loans from the financial institution. This means that all loans defaulted are added together to form gross non-performing assets.

$Gross\ NPA = (A_1 + A_2 + A_3 \ldots\ldots + A_n)/Gross\ Advances$

Where A_1 stands for loans given to person number one.

On the other hand, net non-performing assets are the amount that is realized after provision amount has been deducted from the gross non-performing assets.

Net NPA = (Total Gross NPA) – (Provision for Unpaid Debts)/Gross Advances

4. Actual Loss

The other difference between gross non-performing assets and net non-performing assets is what the organization refers to as the actual loss facing the company. Gross non-performing assets do not constitute the actual loss facing the organization.

Net non-performing assets constitute the actual loss experienced by the organization after debts have defaulted. Since the credit institution has already provided for unpaid loans, the provided amount is deducted from default amount which results in the actual loss experienced by the organization.

5. Causes of Gross NPA and net NPA

There are some significant factors that have been highlighted to be the extreme causes of gross non-performing assets include poor government policies, industrial sickness, natural calamities, willful defaults, and ineffective recovery tribunal among others.

Although net non-performing assets are principal products of gross non-performing assets, there is a significant difference in that the amount provided by the credit institution to cover for unpaid debts plays a vital role in determining the amount of net non-performing assets.

6. Effects of Gross NPA and Net NPA

Some of the significant causes of gross non-performing assets include the bad effect on the goodwill of the company and bad effect on the equity value of the organization.

A company with bad equity value experiences difficulties in attracting investors due to low return on investment and low share value of the company.

On the hand, net non-performing assets have significant impacts on profitability and liquidity of the company. Low liquidity means that the company does not have enough cash to meet its obligations when they fall due which means the company cannot afford to run the daily activities.

Difference between Gross NPA and Net NPA

GROSS NPA VERSUS NET NPA

Basis For Difference	Gross NPA	Net NPA
Meaning	Sum of loans Defaulted	Default Loans – Provision for Default
Default Period	Ninety Days	Immediately
Actual Loss	Not Actual Loss	It is the Actual Loss
Causes	Poor government policies, industrial sickness, natural calamities etc.	Low Provision for Unpaid Debts
Effects	Equity and Company Goodwill	Profitability and Liquidity

DifferenceBetween.net

Causes of NPA's

1. **Willful Defaults:-** The Indian Public Sector Banks are worst hit by these defaults. It is a default in repayment obligation.
Kingfisher Airlines Ltd. Is one among many of those willful defaulters. Other are Beta Napthol, Winsome Diamonds & Jewellery Ltd., Rank Industries Ltd., XL Energy Ltd. etc.
2. **Industrial Crisis:-** Industries depend on banks to fulfill their projects. If industry is in crisis, it is bound to hit the banking sector and their NPA will rise.
3. **Credit distribution Mis-management:-** Often ill-minded borrowers bribe bank officials to get loans with an intention of default.
4. **Lenient Lending Norms:-** One of the main reasons of rising NPAs is the lenient Lending Norms especially for corporate honchos where their financial status and credit rating is not analysed properly.

Recovery of NPA's

Recovery mechanism is a process of carrying out the recovery procedures and mechanisms required to restore the financial assets in the event of failure to repay by the borrower. An NPA as explained above is an asset that has ceased to generate income and returns which if not dealt with correctly and promptly can be detrimental to the bank and therefore the recovery of NPAs plays an important role to sustain the banking industry.

Mainly recovery is done through the following aspects:

1. **Lok Adalats**

   The Lok Adalat is one of the alternative dispute redressal mechanisms set up by the government. It is a forum where disputes or cases pending in the court of law or at pre-litigation stage are settled mutually. Lok Adalats have been given statutory status under the Legal Services Authorities Act, 1987. Under the said Act, the decision made by the Lok Adalats is deemed to be a decree of a civil court and is final and binding on all parties and no appeal against such an award lies before any court of law.

   If the parties are not satisfied with the award of the Lok Adalat though there is no provision for an appeal against such an award, however they can initiate litigation by approaching the appropriate court by filing a case by following the required procedure exercising their right to litigation. The jurisdiction of the Lok Adalats is in cases/disputes of less than 10 lakh rupees in value.

   The persons deciding the cases in the Lok Adalats are called the Members of the Lok Adalats and they have the role of statutory conciliators only and do not have any judicial role. Therefore, they can only persuade the parties to come to a conclusion for settling the dispute outside the court in the Lok Adalat and shall not pressurize or coerce any of the parties to compromise or settle cases or matters either directly or indirectly.

The Lok Adalat cannot decide the matter referred to it on its own but instead it is to be decided on the basis of the compromise or settlement between the parties. The members shall assist the parties in an independent and impartial manner in their attempt to reach amicable settlement of their dispute. Mobile Lok Adalats are also organized in various parts of the country which travel from one location to another to resolve disputes in order to facilitate the resolution of disputes through this mechanism.

As on 30.09.2015, more than 15.14 lakhs Lok Adalats have been organized in the country since its inception. More than 8.25 crore cases have been settled by this mechanism so far.[6]

2. Debt Recovery Tribunals (DRTs)

The Recovery of Debts Due to Banks and Financial Institutions Act,1993 (RDDBFI Act) made provisions for speedy redressal to lenders and borrowers through filing of Original Applications also known as OAs in the Debt Recovery Tribunals (DRTs) and appeals in Debts Recovery Appellate Tribunals (DRATs). Therefore, under the RDDBFI Act the DRTs and DRATs have been established to help provide for the need of speedy redressal for banks against NPAs.

The DRT also has the power to decide upon the applications filed against the secured creditors by the borrower or mortgager for the action taken by them under the Securitization Act. As of today, the government has established 39 DRTs and 5 DRATs, which are single Member Tribunals. The problem plaguing the DRTs like several other debt recovery mechanisms is that they are slow to work out on pending disputes as the process is very long which results in a high number of pending cases.

3. Sarfaesi Act

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 better known as the SARFAESI Act was formed after the considerations carried out by committees constituted by the government to examine the reforms and changes that are needed in the banking and legal systems for better functioning of the debt recovery mechanisms.

The main purpose of this Act is to provide speedy recovery of defaulted loans and help reduce the mounting stress on the banks due to the increase in NPAs. The act provides the banks and financial institutions with a mechanism to better recovery of assets by enabling them to take possession of securities and sell them to reduce the burden of the Non-Performing Asset.

The Act aims to achieve recovery of NPAs through three major ways which are the following:

i. **Securitization:**
The Section 7 of the SARFAESI Act gives an outlook of what exactly happens in securitization, it states that any securitization company or reconstruction company, may, after acquisition of any financial asset offer security receipts to qualified institutional buyers, (other than by offer to public) who are those who have expertise and sound knowledge to evaluate and make their investment in the Capital Markets, for subscription in accordance with the provisions of those Acts.

A securitization company or reconstruction company may raise funds from the qualified institutional buyers by formulating schemes for acquiring financial assets and shall keep and maintain separate and distinct accounts in respect of each such scheme for every financial asset acquired out of investments made by a qualified institutional buyer and ensure that realizations of such financial asset is held and applied towards redemption of investments and payment of returns assured on such investments under the relevant scheme. The main advantage of securitization is that it allows the institutions to raise finances by selling assets or income streams.

ii. **Asset Reconstruction:**

In Asset Reconstruction the Securitization companies or Reconstruction Companies buy the NPAs from the banks and take measures to recover the bad loans from the borrower by carrying certain functions according to the powers vested in them by the Act.

Section 9 of the SARFAESI Act gives measures for asset reconstruction such as:

a. The proper management of the business of the borrower;
b. Changing or taking over the management of the business of the borrower;
c. The sale or lease of a part or the whole of business of the borrower;
d. Rescheduling the payment of debts payable by the borrower;
e. Enforcement of security interest in accordance with the provisions of the SARFAESI Act;
f. Settlement of dues payable by the borrower;
g. Taking possession of secured assets in accordance with the provisions of

the SARFAESI Act.

Thus, Asset Reconstruction helps the banks reduce the burden of NPAs on banks as when a Securitization company or Reconstruction Company takes over the NPA the banks and financial institutions can get returns on the NPA which reduces the stress of bad loans on banks and other institutions.

iii. **Enforcement of Security Interests:**

The Section 13 of the SARFAESI Act makes provisions for enforcement of security interests it states that notwithstanding anything contained in section 69 or section 69A of the Transfer of Property Act, 1882 any security interest created in favour of any secured creditor may be enforced, without the intervention of court or tribunal, by such creditor in accordance with the provisions of this Act.

Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt or any instalment thereof, and his account in respect of such debt is classified by the secured creditor as non-performing asset, then, the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor may take recourse to one or more of the following measures to recover his secured debt, namely:

a. take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realizing the secured asset;
b. take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realizing the secured asset;
c. appoint any person (hereafter referred to as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor;
d. require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

The section 14 of the SARFAESI act is another provision to help the secured creditors, it states that chief metropolitan magistrate or district magistrate shall assist the secured creditor in taking possession of the secured asset.

The secured creditor can for the purpose of taking possession or control of

any secured asset make a request in writing to the Chief Metropolitan Magistrate or the District Magistrate within whose jurisdiction any such secured asset or other documents relating to the secured asset may be situated or found, to take possession of the said asset or documents and the Chief Metropolitan Magistrate or the District Magistrate shall on such request being made to him:

a. take possession of such asset and documents relating thereto; and
b. forward such assets and documents to the secured creditor.

The section goes further to state that for the purpose of securing compliance with the provisions the Chief Metropolitan Magistrate or the District Magistrate may take or cause to be taken such steps and use, or cause to be used, such force, as may, in his opinion, be necessary. It also states that no act of the Chief Metropolitan Magistrate or the District Magistrate done in pursuance of this section shall be called in question in any court or before any authority.

4. Insolvency And Bankruptcy Code (IBC)

Before the Insolvency and Bankruptcy Code, 2016 came into force there were multiple laws and institutions that were overlapping in jurisdiction and functioning which lead to a lot of confusion in dealing with the insolvency and bankruptcy proceedings against individuals and companies. There was no legal framework which provided an efficient procedure to help the debt recovery process in India which was hurting the banks and other financial institutions and affecting the flow of credit. To overcome these hurdles the government introduced the Insolvency and Bankruptcy Code Bill in 2015 which was then passed in 2016 and came into force.

There were first 4 forums which dealt with matters of insolvency and bankruptcy which were the High court, Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunal (DRT) and Company Law Board (CLB), upon the enforcement of the IBC the burden of these forums was reduced as now all the matters in relation to the code were to be filed in the National Company Law Tribunal (NCLT). The main purposes of the IBC is to provide speedy remedies for the banks against NPAs and also to reduce the burden of the long pending cases in courts.

The IBC has made a provision for the formation of the Insolvency and Bankruptcy Board of India which is responsible for implementation of the Code that consolidates and amends the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximization of the value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders. The IBC also makes provisions to make a formal Insolvency Resolution Process (IRP).

Asset Recovery Companies

Asset Recovery Companies (Asset Reconstruction Companies – ARCs)

1. Meaning and Definition

Asset Recovery Companies, commonly discussed in Indian Banking Management as Asset Reconstruction Companies (ARCs), are specialised financial institutions that acquire stressed financial assets, particularly non-performing loans, from banks and other eligible financial institutions. Their main objective is to recover the money due from defaulting borrowers and help improve the financial position of lending institutions.

When borrowers fail to repay loans according to the agreed terms, the loans may become Non-Performing Assets (NPAs). A large volume of NPAs can affect a bank's profitability, liquidity and ability to provide fresh loans. ARCs help banks address this problem by acquiring eligible stressed assets and undertaking recovery or restructuring measures.

In India, ARCs operate under the applicable provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and relevant Reserve Bank of India (RBI) regulations.

Example: Suppose a bank has a business loan of ₹10 crore that has become a non-performing asset. The bank may sell the eligible stressed loan to an ARC under an agreed arrangement. The ARC then undertakes appropriate recovery or restructuring measures to recover the outstanding dues.

2. Objectives of Asset Reconstruction Companies

1. To Recover Bad Loans: ARCs take steps to recover outstanding amounts from borrowers whose loans have become stressed or non-performing.
2. To Reduce NPAs of Banks: They help banks dispose of eligible stressed assets and focus on their regular banking activities.
3. To Improve Bank Liquidity: Selling stressed assets may provide funds to banks that can be used for other lending activities.
4. To Reconstruct Financial Assets: ARCs may restructure eligible borrower obligations or adopt other permitted resolution measures.
5. To Revive Viable Businesses: Where feasible, ARCs may support the revival of businesses facing financial difficulties.
6. To Improve Financial Discipline: Their recovery efforts encourage borrowers to meet their financial obligations.
7. To Strengthen the Banking System: Effective resolution of stressed assets helps improve the quality of banks' loan portfolios.

3. Functions of Asset Reconstruction Companies

1. Acquisition of Stressed Assets
ARCs acquire eligible stressed financial assets from banks and other permitted financial institutions under agreed terms. The acquisition price may differ from the outstanding loan amount.

2. Recovery of Outstanding Loans
They undertake recovery measures to collect the amounts due from defaulting borrowers, using legally permitted methods.

3. Restructuring of Loans
Where appropriate, an ARC may restructure a borrower's financial obligations according to the applicable rules and agreed terms. This may involve changes to repayment schedules or other aspects of the debt.

4. Enforcement of Security
Where legally permitted and the relevant conditions are satisfied, ARCs may enforce security interests over assets pledged or mortgaged against loans.

5. Management of Acquired Assets
ARCs assess the financial position of stressed borrowers and select suitable resolution strategies. These may include recovery, restructuring, settlement or other legally permitted measures.

6. Sale or Resolution of Acquired Assets
ARCs may resolve acquired financial assets through permitted mechanisms, depending on the borrower's circumstances and the applicable legal framework.

7. Issuance of Security Receipts
ARCs may use security receipts as part of eligible asset reconstruction transactions. These instruments represent interests in financial assets acquired or held through the applicable structure.

4. Process of Asset Reconstruction
1 Loan Becomes an NPA
A borrower fails to meet repayment obligations and the loan is classified according to applicable rules.

2 Assessment of Stressed Asset
The bank evaluates the loan, outstanding dues, collateral and recovery prospects.

3 Transfer to an ARC
The bank and ARC agree on the acquisition of the eligible stressed asset.

4 Recovery Strategy
The ARC selects an appropriate lawful recovery, restructuring or resolution approach.

5 Collection and Resolution
The ARC works to recover the dues or resolve the financial asset.

6 Distribution of Proceeds

Recovered funds are applied according to the transaction terms and applicable law.

5. Advantages of Asset Reconstruction Companies

1. Reduction in NPAs: ARCs provide banks with a mechanism for resolving eligible stressed loans.
2. Improved Liquidity: Banks may receive funds from selling stressed assets instead of waiting for prolonged recovery proceedings.
3. Better Focus on Core Banking: Banks can concentrate more on deposit-taking, lending and other banking services.
4. Specialised Recovery Expertise: ARCs focus on stressed-asset resolution and can develop specialised recovery capabilities.
5. Possibility of Business Revival: Viable businesses may receive restructuring or resolution support where appropriate.
6. Improved Credit Management: Effective resolution of stressed loans may improve the quality of bank asset portfolios.
7. Support for Financial Stability: Better management of stressed assets can contribute to the stability of the financial system.

6. Limitations of Asset Reconstruction Companies

1. Uncertain Recovery: ARCs may not recover the full amount owed by borrowers.
2. Valuation Difficulties: Determining the fair value of stressed loans and the assets securing them can be challenging.
3. Legal Delays: Court proceedings and disputes over collateral can delay recovery.
4. High Recovery Costs: Legal expenses, asset management and other recovery-related costs may reduce returns.
5. Difficult Borrower Conditions: Businesses may have limited assets or poor financial prospects, making recovery difficult.
6. Market Uncertainty: Changes in economic conditions can affect the value of acquired assets and the chances of recovery.
7. Regulatory Compliance: ARCs must comply with RBI directions, applicable laws and other requirements governing their activities.

7. Example of an Asset Reconstruction Company

Suppose XYZ Bank has provided a business loan of ₹10 crore to a manufacturing company. The company experiences financial difficulties and fails to repay the loan. The loan becomes an NPA under the applicable classification rules.

XYZ Bank agrees to sell the eligible stressed asset to an ARC for ₹4 crore, subject to the terms of the transaction.

The ARC then evaluates the borrower's business, outstanding dues and available security. It may pursue lawful recovery, negotiate an eligible settlement or restructure the debt if appropriate.

If the ARC eventually recovers ₹6 crore, that amount represents its gross recovery before deducting applicable costs and accounting for the transaction's funding and payment arrangements. The actual financial return depends on the acquisition price, expenses, recoveries and contractual obligations.

Note: The figures are illustrative. Selling a loan does not automatically mean that the bank recovers the entire original outstanding amount.

8. Examples of Asset Reconstruction Companies in India

Some examples of Indian ARCs include:

- Asset Reconstruction Company (India) Limited (ARCIL)
- National Asset Reconstruction Company Limited (NARCL)
- Edelweiss Asset Reconstruction Company Limited
- JM Financial Asset Reconstruction Company Limited
- India SME Asset Reconstruction Company Limited (ISARC)

These names are examples of organisations in India's asset reconstruction sector; current registration and regulatory status should be checked against RBI's latest records.

Reserve Bank of India+1

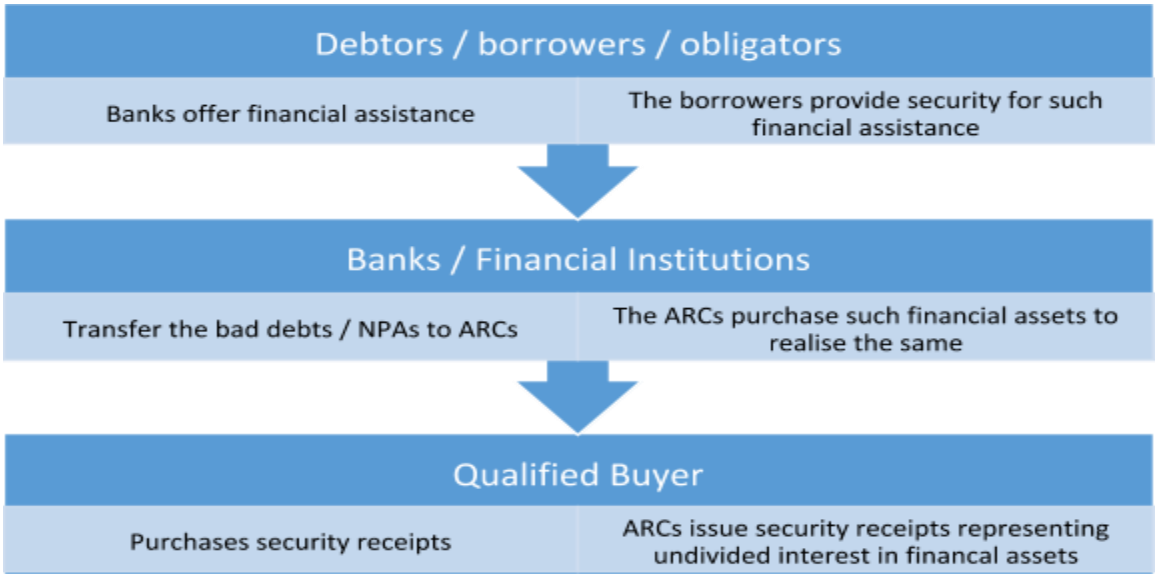
9. Difference Between a Bank and an ARC

Basis	Bank	Asset Reconstruction Company
Main purpose	Accepts deposits where authorised and provides loans and other banking services	Acquires and resolves eligible stressed financial assets
Main lending activity	Provides loans to individuals and businesses	Primarily focuses on asset reconstruction and securitisation activities permitted by law
Main source of income	Interest income and fees from banking services	Income or returns from permitted asset reconstruction and related activities
NPA management	Identifies, manages and attempts to recover its own NPAs	Acquires eligible stressed assets and pursues resolution or recovery
Customer focus	Depositors, borrowers and other banking customers	Banks, eligible financial institutions, investors and stressed borrowers
Regulation	Governed by applicable banking laws and RBI directions	Registered with and regulated by RBI under the applicable SARFAESI framework

Conclusion

Asset Reconstruction Companies play an important role in India's banking system by acquiring eligible stressed financial assets and undertaking recovery or restructuring measures. They help banks manage NPAs, improve asset quality and concentrate on regular banking operations. Their effectiveness depends on proper valuation, efficient recovery, sound governance and compliance with applicable regulations.

The working of the ARC can be summarized by the following diagram:



The business of asset reconstruction or securitisation may be commenced only after obtaining a registration certificate under Section 3 of the SARFAESI Act, 2002. The main requirement in this regard is that the 'net owned funds' as prescribed in the RBI Act should be Rs. 100 crore or more.

Bad Bank

A Bad Bank houses Bad loans or Non-Performing Assets (NPA). The idea of Bad Bank was implemented in countries like Sweden, Finland, France, Germany, Indonesia etc. Even with Bad Bank structure, the Non-Performing Assets (NPA) losses do not go away. It needs to be shared between investors, taxpayers of these banks in general and those of the bad bank.

The bad bank will manage Non-Performing Assets in suitable ways, some may be liquidated, others may be restructured, etc. In the meantime, it would work towards suitably disposing of the toxic assets. This concept has been successfully implemented in many western European countries post the 2007 financial crisis like Ireland, Sweden, France etc.

Recent Proposal of Bad Banks by Indian Banking Association (IBA)

Indian Banking Association (IBA) has submitted a proposal to both the Government and the Reserve Bank of India (RBI) to set up a 'Bad Bank.'

As per IBA estimates the 'Bad Bank' would require approximately Rs 10,000 crore of capital initially. The exact quantum of capital and amount of bad loans to be housed in the proposed 'Bad Bank' would only be finalised after discussions with the Government and Reserve Bank of India (RBI).

Bad Bank – Origin of Concept

The concept of a bad bank was pioneered at the Pittsburgh-headquartered Mellon Bank in 1988. Bad Bank would set up as a separate entity that would buy the Non-Performing Asset from other banks to free up their books for fresh lending. It is focused on the task of recovery.

A bank may accumulate a large portfolio of debts or other financial instruments which unexpectedly become at risk of partial or full default. A large volume of non-performing assets usually make it difficult for the bank to raise capital, for example through sales of bonds.

In these circumstances, the bank may wish to segregate its "good" assets from its "bad" assets through the creation of a bad bank.

How Does 'Bad Bank' Work?

1. Banks will be able to demarcate their assets into good assets and toxic or bad assets.
2. Good assets are ones in which loans are repaid as per schedule, and defaulted ones are classified as toxic assets or bad assets.
3. Toxic assets can be removed from Banks books and transferred to Bad Bank which has the sole purpose of aiding the recovery of risky assets.
4. Hence the banks will clean up and reduce their exposure to risky assets.
5. Bad Bank will absorb all the toxic assets of banks at a price below the book value of these loans.

What is the Need for a Bad Bank?

Investors would see large NPA's as a sign of Banks ill-health or financial weakness. If the NPA's are high, then the Bank loses its ability to borrow, lend or conduct business.

Bad Bank Structure – IBA Proposal

The 'Bad Bank' will be a 2 tiered structure.

Tier 1:

1. There will be an Asset Reconstruction Company (ARC) backed by the Government which would buy bad loans from banks and issue Security Receipts to the Banks.

2. As per RBI guidelines, ARC will hold Security Receipts of 15%.

3. Banks will get 15% of the cash and will hold 85% of Security Receipts. Hence it is called 15:85 structure.

Tier 2:

1. There will be an Asset Management Company (AMC).
2. AMC would be run by public and private bodies which includes banks as well.
3. Turnaround professionals.

Past Debates on Bad Banks

The idea of Bad Bank is not new. Currently, this is in the news due to the problem caused by COVID-19. Earlier the topic of Bad Bank was a matter of debate in the banking and finance circles when former Interim Finance Minister Piyush Goyal had put forward the idea when a committee headed by Sunil Mehta was formed to study the feasibility of National Asset Reconstruction Company. Even in 2017 Economic Survey had mooted the idea by suggesting the creation of Public Sector Asset Rehabilitation Agency (PARA). Even former RBI governor Raghuram Rajan had started a debate on Bad Banks in 2015 as a possible solution to the problems of Non Performing Assets.

UNIT-3
Regulation and Innovation in Banking System

The onset of the pandemic has caused an unpredicted increase in the demand among consumers for digital banking, including instant access to banking services, products, and information. In such circumstances, there can be no better time than the present to welcome the future of banking with digital bank, particularly when the world is stricken by the ever-increasing variants of the covid-19 virus and its ensuant plague that requires the restriction of free movement and avoidance of public spaces.

The growing use of technology has also led to tremendous changes in conventional ways of finance and keeping its eye on the advancement of digital technology around the globe. India has kept its pace with the rest of the world in technology innovation for digital inclusion in the financial sector.

The Reserve Bank of India (RBI), the primary regulator of the financial sector in India, has been conscious of the importance of technology-based innovations and its growing use in India. In 2019, the RBI issued its "Enabling framework for regulatory sandbox" guidelines. Under this, fintech companies – including startups, banks, financial institutions and any other company partnering with or providing support to financial services businesses – which also satisfy the eligibility criteria, are selected to test their products in the regulatory sandbox. This allows for the testing of new products, innovations and technologies in a live environment within specified parameters and timeframes under the aegis of the RBI.

Regulation of Banks

The financial system in India is regulated by independent regulatory bodies in different fields namely banking, capital market, insurance, commodity market, and pension funds. However, the Government of India plays an important role in influencing the regulatory framework of these institutions, at least to some extent.

Primarily, in India, the regulation of banks and financial institutions are governed by the Banking Regulation Act, 1949. It was passed as Banking Companies Act, 1949, and came into effect from March 16, 1949. Further, the name was changed to the Banking Regulation Act from March 1, 1966.

For a banking job aspirant, it is pertinent to know about the working and regulation of the financial institutions in India. From the examination viewpoint, objective questions can be asked regarding the Chairperson of regulatory bodies, the location of headquarters, year of establishment, etc.

Moreover, questions on the Banking Regulation Act and recent developments related to it can also be asked in Main and Interview.

Let us now briefly discuss the regulations of banks and financial institutions in detail:

Banking Regulation Act, 1949

Following are the important points regarding the Banking Regulation Act, 1949:

1. It regulates all banking institutions in India. Initially, it was applicable only to banking companies, but was amended in 1965 to bring the cooperative banks under its purview. Cooperative banks are formed and run by the state government, but the licensing and regulation are under the control of the RBI.
2. This Act gives the RBI the power to license banks, and have regulation over the shareholding; regulate the operations of banks; supervise the appointment of Board and management; lay down audit instructions; issue directives in the interest of public good; control moratorium, mergers, liquidations, and acquisitions; and impose penalties.

Important Banking Regulatory Bodies in India

Regulatory Body	Sector	Headquarters
Reserve Bank of India (RBI)	Banking & Finance	Mumbai
Securities & Exchange Board of India (SEBI)	Stock & Capital Market	Mumbai
Insurance Regulatory & Development Authority of India (IRDA)	Insurance	Hyderabad
Pension Fund Regulatory & Development Authority (PFRDA)	Pension	New Delhi
National Bank for Agriculture & Rural Development (NABARD)	Financing Rural Development	Mumbai
Small Industries Development Bank of India (SIDBI)	Financing Micro, Small & Medium Enterprises (MSMEs)	Lucknow

GATE Tirupati

National Housing Bank (NHB)	Financing Housing	New Delhi
Insolvency and Bankruptcy Board of India (IBBI)	Insolvency Proceedings	New Delhi

Let us now discuss some important regulatory bodies:

The Reserve Bank of India (RBI)

Established under the RBI Act, 1934, RBI is the central bank of India; and is vested with various responsibilities under the Banking Regulation Act, 1949. Following are some of its primary functions:

1. Issuance of banknotes
2. Banker to the government
3. Custodian of cash reserves of commercial banks
4. Custodian of foreign exchange reserves
5. Controller of credit
6. Lender of the last resort

Basel Accords I,II,and III

Basal accords are introduced by Basel Committee of Banking Supervision (BCBS), a committee of banking supervisory authorities that was incorporated by the central bank governors of the Group of Ten (G-10) countries in 1975. The main objective of this committee is to provide guidelines for banking regulations. BCBS has issued 3 accords named Basel 1, Basel 2 and Basel 3 so far with the intention of enhancing banking credibility by strengthening the banking supervision worldwide. The key difference between **Basel 1 2 and 3 is that Basel 1 is established to specify a minimum ratio of capital to risk-weighted assets for the banks whereas Basel 2 is established to introduce supervisory responsibilities and to further strengthen the minimum capital requirement and Basel 3 to promote the need for liquidity buffers (an additional layer of equity).**

What is Basel 1?

Basel 1 was released in July 1988 to provide a framework to address risk management from a bank's capital adequacy perspective. The principle concern here was the capital adequacy of banks. One of the main reasons for the same was the Latin American debt crisis during the early 1980s, where the committee realized that capital ratios of international banks are diminishing over time. A minimum ratio of capital to risk-weighted assets of 8% was stated to be implemented effective from 1992.

Basel 1 also specified the general provisions that can be included in the calculation of the minimum required capital.

E.g. The accord specified guidelines on how to recognize the effects of multilateral netting (an agreement between two or more banks to settle a number of transactions together as it is cost effective and time-saving as opposed to settling them individually) in April 1995.

GATE Tirupati

What is Basel 2?

The main objective of Basel 2 was to replace the minimum capital requirement with a need to conduct a supervisory review of the bank's capital adequacy. Basel 2 consist of 3 pillars. They are,

- Minimum capital requirements, which sought to develop and expand the standardised rules set out in the Basel 1
- Supervisory review of an institution's capital adequacy and internal assessment process
- Effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices

The new framework was designed with the intention of improving the way regulatory capital requirements reflect underlying risks and to better address the financial innovation that had occurred in recent years. The changes aimed at rewarding and encouraging continued improvements in risk measurement and control.

What is Basel 3?

The need for an update to Basel 2 was felt especially with the financial collapse of Lehman Brothers – a global financial services company which was declared bankrupt in September 2008. Pitfalls in corporate governance and risk management have led to the development of this accord which will be effective from 2019 onwards. The banking sector entered the financial crisis with too much leverage and inadequate liquidity buffers. Thus, the main objective of Basel 3 is to specify an additional layer of common equity (a capital conservation buffer) for banks. When breached, restricts payouts to help meet the minimum common equity requirement. Additionally, the following guidelines are also included in Basel 3.

- A countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts
- A leverage ratio – a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting
- Liquidity requirements – a minimum liquidity ratio, the Liquidity Coverage Ratio (LCR), intended to provide enough cash to cover funding needs over a 30-day period of stress; a longer-term ratio, the Net Stable Funding Ratio (NSFR), intended to address maturity mismatches over the entire balance sheet
- Additional proposals for systemically important banks, including requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution

Banking Innovations

Allowing a customer access to full banking services in real time, through any channel they choose is one of the results coming out of EU legislation known as the second Payment Services Directive (PSD2). Whether it's from an online terminal in a bank branch, an ATM, a voice call or online it allows customers the freedom of choice to access their accounts whenever and from wherever they choose.

Traditional banks are spending vast amounts of money to develop new systems and features so that they can keep up with the rapidly changing demands of their customers. As well, the institutions are looking for ways to streamline their own operations, improve performance and reduce overheads – any bank that fails to do this will quickly lose out in the face of competition both from traditional banks and from the new fintech players.

Completely 'digital only' financial institutions also provide customers with seamless access to the whole range of activity, even though these banks do not compete with traditional banks in regular business fields such as credit, overdrafts, mortgages and so on. They can generally offer several distinct advantages over brick-and-mortar banks in the form of reduced costs, user friendly interfaces, wider range of features and easy account openings.

Retail banking innovation 2023

Retail banking, also known as consumer banking or personal banking, refers to the banking services that are provided to individual consumers, as opposed to businesses or other organizations. Retail banking innovation refers to the development and implementation of new ideas, technologies, and approaches in the retail banking sector.

Some examples of retail banking innovation include:

1. Mobile banking: Many banks now offer mobile banking apps that allow customers to manage their accounts, make payments, and conduct other banking tasks using their smart phones.
2. Online banking: Many banks now offer online banking platforms that allow customers to manage their accounts and conduct other banking tasks using their computers or other devices.
3. Virtual assistants: Some banks are using artificial intelligence (AI) and chat bot technology to provide customers with personalized assistance and support through virtual assistants.
4. Contactless payment systems: Many banks now offer contactless payment systems, such as near field communication (NFC) and QR code scanners, that allow customers to make payments using their mobile devices or smart watches.
5. Personal financial management tools: Some banks are offering personal financial management tools that help customers track and manage their spending, create budgets, and achieve their financial goals.

Overall, the goal of retail banking innovation is to improve the customer experience and make banking more convenient, efficient, and secure for consumers

Digital banking innovation ideas 2023

There are many potential ideas for digital banking innovation, including:

1. Mobile banking apps that allow customers to manage their accounts, make payments, and transfer money on the go.
2. Integration with popular payment platforms such as Apple Pay, Google Pay, and PayPal.
3. Use of artificial intelligence and machine learning to improve customer service, such as through chat bots that can answer common questions and provide personalized recommendations.
4. Implementation of biometric authentication methods, such as facial recognition or fingerprint scanning, to improve security and make it easier for customers to access their accounts.
5. Offering investment and wealth management services, such as robo-advisors, to help customers grow their wealth.
6. Integration with wearable devices, such as smart watches, to enable customers to make payments and check their account balances directly from their wrists.

7. Implementing block chain technology to improve the security and efficiency of financial transactions.
8. Offering virtual reality or augmented reality experiences to enhance the customer experience and make banking more interactive and engaging.
9. Using data analytics to better understand customer needs and preferences, and to develop customized products and services.

Core Banking Solution (CBS)

1. Meaning and Definition of Core Banking Solution

A Core Banking Solution (CBS) is a computerised banking system that connects different branches of a bank through a centralised network, enabling customers to access banking services from any CBS-enabled branch, irrespective of where they originally opened their accounts.

Under the traditional banking system, many banking operations were performed separately at individual branches. This made it difficult for customers to access their accounts from other branches and sometimes resulted in delays in processing transactions. Core Banking Solution overcomes these limitations by integrating the bank's branches, customer accounts and major banking operations through a common system.

CBS allows banks to maintain customer account information centrally and process transactions through interconnected banking systems. It supports services such as deposits, withdrawals, fund transfers, loan processing, interest calculations and account statements.

Example: A customer opens a savings account at a bank branch in Tirupati. Later, the customer travels to Hyderabad and needs to withdraw money. If both branches are connected through CBS and the service is available, the customer can access the account at the Hyderabad branch without opening a new account there.

2. Objectives of Core Banking Solution

1. To Integrate Bank Branches: CBS connects different branches through a common banking network and information system.
2. To Provide Anywhere Banking: It enables customers to access eligible banking services from different CBS-enabled branches.
3. To Improve Transaction Speed: It reduces the need for separate manual processing at individual branches.
4. To Maintain Centralised Records: Customer accounts and transaction information can be managed through integrated banking databases.
5. To Improve Customer Service: It makes banking more convenient by reducing dependence on the branch where an account was opened.
6. To Reduce Manual Work: Computerised processing reduces repetitive paperwork and manual calculations.

7. To Improve Accuracy: Automated transaction processing helps reduce certain types of human error.
8. To Support Digital Banking: CBS provides an important technological foundation for services such as internet banking, mobile banking and electronic fund transfers.

3. Features of Core Banking Solution

1. Centralised Database

CBS enables a bank to maintain and access customer account information through an integrated database or coordinated centralised data systems. Authorised users can retrieve account details according to their permissions.

2. Anywhere Banking

Customers can access eligible banking services through different connected branches rather than being restricted to their home branch.

3. Real-Time Transaction Processing

Many CBS transactions are processed and reflected in account records promptly. The exact processing time depends on the transaction type, system design and applicable procedures.

4. Integrated Banking Operations

CBS connects important banking functions, including deposits, withdrawals, loans, interest calculations and account maintenance.

5. Customer Information Management

The system maintains customer details, account information and transaction records to support banking operations.

6. Automated Interest Calculation

CBS can calculate interest on eligible deposit and loan accounts according to the bank's configured rules and applicable terms.

7. Improved Reporting

The system helps banks generate account statements, transaction reports, operational reports and other records required for management and regulatory purposes.

8. Security and Access Control

CBS uses authentication, access permissions, transaction controls and audit records to help protect banking information. Its effectiveness depends on proper implementation and monitoring.

4. Components of Core Banking Solution

A Core Banking Solution generally consists of the following components.

Component	Explanation
Central banking database	Stores and manages account information and transaction records.
Banking application software	Processes deposits, withdrawals, loans, interest and other banking operations.
Network connectivity	Connects branches, ATMs and other authorised banking channels to relevant systems.
User interface	Allows bank employees and customers to interact with banking services.
Security system	Controls access, authenticates users and helps protect transactions.
Reporting system	Produces account statements, transaction summaries and management reports.
Backup and recovery system	Helps restore services and data after system failures or other disruptions.

5. Working Process of Core Banking Solution

Step 1: Customer Initiates a Transaction

The customer requests a service, such as withdrawing cash, depositing money, transferring funds or checking an account balance.

Step 2: Transaction Request Is Submitted

The request is entered into the banking system through an authorised branch terminal, ATM, internet banking platform or another supported channel.

Step 3: Customer Authentication

The system verifies the customer's identity using the applicable authentication method. It also checks the employee's or channel's permission to perform the requested operation.

Step 4: Central Banking System Processes the Request

The system checks relevant information, such as the account status, available balance, transaction limits and applicable banking rules.

Step 5: Account Records Are Updated

If the transaction is authorised and successfully completed, the relevant account records are updated. For example, a successful cash withdrawal reduces the customer's available account balance.

Step 6: Confirmation Is Provided

The customer receives a receipt, transaction reference or electronic notification, depending on the service and the bank's procedures.

6. Advantages of Core Banking Solution

Advantages to Customers

1. Convenience: Customers can access eligible banking services through different connected branches.
2. Time Saving: Automated processing reduces the need for certain manual procedures.
3. Easy Account Access: Customers can obtain account information and statements through supported channels.
4. Faster Service: Many routine transactions can be processed more efficiently.
5. Improved Fund Access: CBS supports integrated banking operations that make account access more flexible.
6. Better Service Availability: CBS helps banks provide services through multiple channels, subject to system availability.

Advantages to Banks

1. Operational Efficiency: CBS integrates banking activities and reduces duplication of work.
2. Centralised Management: Banks can monitor accounts and transactions across connected branches.
3. Improved Accuracy: Automated processing reduces certain manual calculation and data-entry errors.
4. Better Reporting: Integrated records support financial reporting and management decisions.
5. Reduced Paperwork: Many routine operations can be handled electronically.
6. Support for Expansion: A bank can connect additional branches and channels to its banking systems.
7. Improved Monitoring: Centralised transaction records can help banks monitor activities and identify unusual transactions.

7. Disadvantages of Core Banking Solution

1. High Initial Cost: Implementing CBS requires investment in software, hardware, networking and system integration.

2. Maintenance Expenses: Banks must regularly maintain, update and secure their systems.
3. Cybersecurity Risks: Connected banking systems may face threats such as phishing, malware and unauthorised access.
4. System Failure: A major technical problem can disrupt services across multiple branches or channels.
5. Dependence on Technology: Employees need appropriate technical knowledge, and customers may require support when digital services are difficult to use.
6. Data Privacy Concerns: Banks must protect sensitive customer information against unauthorised disclosure or misuse.
7. Training Requirements: Bank employees need training to use the system correctly and follow security procedures.

8. Example of Core Banking Solution in a Bank

Consider ABC Bank, which has branches in Tirupati, Chennai and Hyderabad.

Before implementing CBS, each branch may have maintained separate operational records, making cross-branch account access more difficult.

After implementing CBS:

- A customer opens a savings account at the Tirupati branch.
- The customer's account information is maintained in the bank's integrated system.
- The customer travels to Chennai and requests an eligible cash withdrawal.
- The Chennai branch accesses the customer's account through the connected banking system.
- The transaction is authorised and processed, and the account records are updated.
- The customer can later view the updated balance through a supported banking channel.

This example demonstrates how CBS integrates banking operations and enables customers to access eligible services across connected branches.

9. Difference Between Traditional Banking and Core Banking Solution

Basis	Traditional Branch-Based Processing	Core Banking Solution
Record management	Records may be maintained and processed separately at branches.	Account information and operations are integrated through connected systems.
Branch access	Services may depend more heavily on the home branch.	Eligible services can be accessed through other connected branches.
Transaction processing	More manual processing may be involved.	Many transactions are processed electronically.
Information access	Obtaining information from another branch may take additional time.	Authorised users can access integrated account information.

Paperwork	Greater dependence on physical records may exist.	Many records and processes are electronic.
Reporting	Consolidation of branch records may require additional work.	Integrated systems support consolidated reporting.
Technology dependence	Relatively lower dependence on integrated computer systems	High dependence on banking software, networks and supporting infrastructure

10. Difference Between CBS and Digital Banking

These two concepts are related, but they are not the same.

Basis	Core Banking Solution	Digital Banking
Meaning	Integrated system supporting a bank's core operations and account processing	Delivery of banking services through digital technologies and channels
Main purpose	To connect and manage banking operations and records	To enable customers to perform banking activities electronically
Main users	Bank employees, operational systems and supported banking channels	Customers and businesses using digital services
Examples	Centralised account processing, branch integration and account maintenance	Mobile banking, internet banking and digital payments
Relationship	Often provides the underlying systems used by digital channels	May use CBS to retrieve information and process transactions

Conclusion

Core Banking Solution is an important technological development in the banking industry. It connects bank branches through integrated systems, enables customers to access eligible services across branches, improves transaction processing and supports digital banking. Although CBS requires substantial investment and strong security controls, it helps banks improve operational efficiency, customer service and the management of banking information.

Digital Banking

Digital Banking is the automation of traditional banking services. Digital banking enables a bank's customers to access banking products and services via an electronic/online platform. Digital banking means to digitize all of the banking operations and substitute the bank's physical presence with an everlasting online presence, eliminating a consumer's need to visit a branch.

Benefits of Digital Banking

Advancing to a more technologically sophisticated way of doing things, it goes without saying that the benefits long outweigh the costs. Similarly, digital banking as a technological by-product aims to make life easier for the customers of a bank. Digital banking has the following benefits:

- Digital banking enables consumers to perform banking functions from the comfort of their homes, be it an elderly person who is tired of waiting in lines or a working-class professional who is caught up with work, or a regular person who does not want to visit the bank's branch to run a single errand. It also **offers convenience**.
- Elaborating on the convenience offered, digital banking lets a user carry out banking work around the clock, with **24*7 availability of access** to banking functions.
- One of the biggest drawbacks of traditional banking was the overly placed importance on paper. Banking has become **paperless** with the development of digital banking as a service. A user can log into their account at any point in time to monitor records.
- Digital banking allows a user to **set up automatic payments** for regular utility bills such as electricity, gas, phone, and credit cards. The customer no longer has to make a conscious effort of remembering the due dates. The customer can opt for alerts on upcoming payments and outstanding dues.
- Online shopping has become a cakewalk with payment channels becoming well-integrated with the online shopping portals. Internet banking has significantly contributed to **online payments**.
- Digital banking extending **services to remote areas** is seemingly a step toward holistic development. With smart phones at affordable prices and internet access in remote areas, the rural population can make the most out of digital banking services.
- Digital banking-enabled fund transfers **reduce the risk of counterfeit currency**.
- With the help of digital banking, a user can report and block misplaced credit cards at the click of a button. This benefit greatly **strengthens the privacy** and security available to a bank's customer.
- By promoting a cashless society, digital banking **restricts the circulation of black money** as the Government can keep a track of fund movements. In the long run, digital banking is expected to lower the minting demands of a currency.

Digital Banking products

If an individual has access to a stable internet connection and an internet-enabled smart device, digital banking has a lot to offer.

Digital Product services

Digital banking services	Utility
1. Obtain bank statements	View and download your bank statements for any specified period.
2. Transfer of Funds	With alternatives such as NEFT, RTGS, and IMPS available, the need to issue cheques and DDs has been eradicated.
3. Mobile banking	Mobile banking is digital banking through an application optimized for smartphones and tablets.
4. Cash withdrawals	ATMs facilitate cash withdrawals at any point in time. Moreover, ATMs are widely present in every locality.
5. Bill payments	Auto-debit feature for bill payments lets a user setup monthly debits in favor of regular utility payment.
6. Finance	Invest, raise loans, open fixed deposit accounts – all through digital banking. De-mat accounts can be linked to your bank accounts to provide a seamless flow of funds so you can invest promptly.
7. Manage cheques	Intervene in the cheque clearing process using digital banking to stop the cheque if the need arises.
8. Monitor transaction records	Banks send transaction alerts to the linked mobile number or email addresses. Transactions are updated almost as soon as executed. Digital banking also lets you monitor account balances or outstanding at the click of a button.

Types of Digital banking payments

- **Banking cards:** Cards are not only used to withdraw cash but also enable other forms of digital payment. Cards can be used for online transactions and on Point of Sale (PoS) machines. Prepaid cards can also be issued by the banks; such cards are not linked to the bank account but function through the money loaded onto them.
- **Unstructured Supplementary Service Data (USSD):** By dialing the number *99#, mobile transactions can be carried out without an application and internet connection. The number holds nationwide applicability and promotes greater financial inclusion on the ground level. The service lets the caller surf through an interactive voice menu and chooses the desired option on the mobile screen. The only catch is the mobile number of the caller should be the one linked to the particular bank account.
- **Aadhaar Enabled Payment System (AEPS):** AEPS lets the client initiate banking instructions following the successful verification of the Aadhaar number.
- **Unified Payments Interface (UPI):** UPI is the most trending form of digital banking presently. UPI makes use of a virtual payment address (VPA) so the user can transfer funds without entering bank account details or IFSC code. Another striking feature of UPI is that the applications let you consolidate all your bank accounts in one place. Funds can be transferred and received around the clock with no time restrictions. UPI-based apps in India are BHIM, PhonePe, and Google Pay. BHIM application, in addition to the transfer of funds to other virtual addresses and bank accounts, also lets the user transfer funds to another Aadhaar number. More importantly, UPI-based payments are free of cost.

- **Mobile Wallets:** Mobile wallets have eliminated the need to remember four-digit card pins or enter CVV details or carry loose cash. Mobile wallets store bank account and card credentials to easily add funds to the wallet and make payments to other merchants with similar applications. Popular mobile wallets are Paytm, Freecharge, Mobiwik, etc. Mobile wallets, however, generally have a limit on how much can be deposited in the wallet. A small fee may also be charged on depositing the funds from the mobile wallet back into the bank account.
- **PoS terminals:** Typically, PoS machines are portable devices that read a card to authorize and complete the payment. Supermarkets and gas stations opt for this method of payment. However, with digital banking thriving, PoS terminals have evolved into more than physical PoS devices. Virtual and Mobile PoS terminals have surfaced, which makes use of the mobile phone's NFC feature and web-based applications to initiate payment.
- **Internet and Mobile Banking:** Commonly known as e-banking, internet banking refers to obtaining certain banking services over the internet, such as fund transfers, and opening and closing accounts. Internet banking is a subset of digital banking because internet banking is only limited to core functions. Similarly, mobile banking is availing banking services through mobile-based applications.

Digital Banks

1. Meaning and Definition of Digital Banks

Digital banks are banks or banking institutions that provide banking services primarily through digital technologies, such as mobile applications, websites and electronic payment systems. Customers can use these services to perform banking transactions without having to visit a physical branch for every activity.

Digital banking enables customers to open or manage eligible accounts, transfer money, make payments, check balances, download statements and access other banking services electronically. It uses technologies such as internet connectivity, mobile devices, cloud infrastructure, data analytics and automated systems to make banking more convenient and efficient.

Example: A customer uses a banking app to check their account balance, transfer money to another person and pay electricity bills without visiting a bank branch.

Important distinction: The term digital banking is often used broadly for banking services delivered electronically. A digital bank may refer to a bank with a primarily digital operating model. In India, the expression should not automatically be taken to mean a separate, universally recognised banking licence category; the institution's actual regulatory status matters.

2. Objectives of Digital Banks

1. To Provide Convenient Banking: Digital banks enable customers to access banking services from home, offices or other locations using digital devices.

2. To Reduce Banking Time: Customers can complete many transactions without visiting a branch or waiting in queues.
3. To Promote Financial Inclusion: Digital channels can extend banking access to people in remote areas and underserved communities.
4. To Reduce Operating Costs: Digital processing can reduce paperwork and some costs associated with routine branch operations.
5. To Improve Transaction Efficiency: Automated systems help process payments, transfers and account requests efficiently.
6. To Enhance Customer Experience: Digital platforms provide convenient access to account information and services.
7. To Support Cashless Transactions: Digital banks support electronic payments and transfers, reducing the need for cash in many transactions.

3. Features of Digital Banks

1. Online Account Access: Customers can access account details, balances and transaction histories through supported digital channels.

2. Mobile Banking: Banking applications allow customers to transfer funds, make payments and perform other eligible transactions.

3. Internet Banking: Customers can access banking services through a bank's website using secure login credentials.

4. Electronic Fund Transfers: Digital banking supports electronic payment services such as NEFT, RTGS and IMPS, depending on the bank and service.

5. Digital Customer Onboarding: Eligible customers may open accounts or apply for banking products through digital processes, subject to identity verification and regulatory requirements.

6. Automated Banking Services: Automated systems can process routine transactions, generate statements and support customer service.

7. Digital Payments: Customers can make payments using supported methods such as UPI, cards and other electronic payment systems.

8. Security Mechanisms: Digital banking systems use authentication, transaction verification, monitoring and other security controls to protect customer accounts.

4. Types and Forms of Digital Banking

Digital banking can be delivered through several channels and operating models.

Type or form	Explanation	Example
Internet banking	Banking services provided through a website	Transferring funds through a bank's website
Mobile banking	Banking services accessed through a mobile application	Checking balances using a banking app
Digital payments	Electronic methods for transferring money or paying merchants	Paying a shopkeeper using UPI
Digital-only operating model	Banking services delivered predominantly through digital channels	An account managed mainly through an app and website
Digital Banking Unit (DBU)	A specialised physical banking unit equipped to provide digital banking services	A bank's self-service digital banking facility

Important: These are forms or delivery models of digital banking, not necessarily separate categories of banks recognised under Indian banking law.

5. Digital Banking Units (DBUs) in India

A Digital Banking Unit is a specialised physical banking facility established by an eligible bank to provide digital banking products and services. It combines digital infrastructure with self-service and assisted-service facilities.

The Reserve Bank of India introduced guidelines for establishing DBUs in April 2022. The objective was to expand access to digital banking, improve customer experience and promote financial inclusion.

Services provided by DBUs

- Opening eligible bank accounts through digital processes.
- Providing digital access to deposits and other banking products.
- Supporting digital loan applications and processing for eligible products.
- Facilitating digital payments and fund transfers.
- Helping customers use digital banking channels.
- Providing information and assistance related to selected banking services.

Example

A customer visits a DBU and uses a self-service terminal to access banking services. If assistance is needed, bank staff can guide the customer through the digital process. This combines physical assistance with electronic service delivery.

6. Advantages of Digital Banks

Advantages to Customers

1. Convenience: Banking services can be accessed from different locations.
2. Time Saving: Many transactions can be completed without visiting a branch.
3. Faster Payments: Supported electronic transfers and payments can be completed efficiently.
4. Easy Record Keeping: Digital statements and transaction histories help customers monitor their finances.
5. Greater Accessibility: Digital services can make banking easier for customers who have difficulty visiting branches.
6. Continuous Availability: Many digital services are available outside normal branch working hours, although maintenance and outages may affect availability.

Advantages to Banks

1. Reduced Paperwork: Electronic processing reduces reliance on physical documents for many routine transactions.
2. Operational Efficiency: Automation can improve transaction processing and routine service delivery.
3. Wider Customer Reach: Banks can serve customers across geographical areas through digital channels.
4. Lower Costs for Some Services: Digital processing may reduce the cost of handling routine transactions.
5. Improved Data Analysis: Transaction data can help banks understand customer needs and manage operations.
6. Better Service Integration: Digital channels can connect customers with payments, deposits, lending and other eligible services.

7. Disadvantages of Digital Banks

1. Cybersecurity Threats: Customers may face phishing, malware, identity theft and other online fraud risks.
2. Dependence on Internet Access: Customers need a suitable device and reliable connectivity for many digital services.
3. Digital Literacy Challenges: Some people may find banking applications and online processes difficult to use.
4. Technical Failures: Server problems, network disruptions or application errors may temporarily interrupt services.
5. Privacy Concerns: Personal and financial data must be protected against unauthorised access and misuse.
6. Limited Personal Interaction: Customers who need face-to-face guidance may prefer traditional branch services.
7. Digital Fraud: Customers may lose money if they disclose confidential credentials or approve fraudulent transactions.

8. Digital Banking in India: Examples

The following are examples of digital banking services and channels used in India.

YONO SBI

State Bank of India's digital platform provides access to eligible banking services and related features through digital channels.

HDFC Bank MobileBanking

Provides mobile access to eligible account services, transfers, payments and other banking facilities.

ICICI Bank iMobile

Provides access to supported banking transactions and payment facilities through a mobile platform.

These are examples of digital banking platforms operated by traditional banks. They should not automatically be classified as independent digital-only banks.

9. Difference Between Traditional Banking and Digital Banking

Basis	Traditional Banking	Digital Banking
Service delivery	Primarily through physical branches	Primarily through electronic channels
Customer presence	Often requires visiting a branch for certain services	Many services can be completed remotely
Working hours	Branch services follow specified working hours	Many digital services are available beyond branch hours
Documentation	May involve physical forms and documents	Many processes use electronic records and forms
Transaction processing	May involve manual steps and branch-based processing	Many transactions are automated
Operating costs	Physical branches involve premises and staffing costs	Digital channels may reduce some transaction costs but require technology investment
Personal interaction	Direct interaction with bank staff	Often self-service, with digital or remote assistance

10. Difference Between Digital Banks and Core Banking Solution

Basis	Digital Banks / Digital Banking	Core Banking Solution (CBS)
Meaning	Banking services delivered through digital channels or a digital-first	Integrated technology supporting a bank's core operations and account

	operating model	processing
Main purpose	To provide convenient electronic access to banking services	To connect and manage banking records and transactions
Customer interaction	Usually through apps, websites or other digital channels	Usually works behind the scenes and supports multiple banking channels
Examples	Mobile banking, internet banking and digital account services	Centralised account processing and connected branch operations
Relationship	May use CBS or other integrated banking systems	Often supports digital banking services

Conclusion

Digital banking has transformed the way banks provide services to customers. It improves convenience, supports faster transactions, reduces paperwork and expands access to banking services. However, cybersecurity, digital literacy, privacy and technology reliability remain important challenges. In India, digital banking platforms and Digital Banking Units contribute to the development of a more accessible and technology-enabled banking system.

Plastic Money

Money is an indispensable part of our lives. But where did the need for money arise from? You may recall learning about a barter system, in which commodities were traded for goods, followed by an age when gold and silver coins were introduced. As humanity progressed, we began to use paper notes and coins for commercial transactions. With time, we also used technology to pay for commodities.

The use of plastic money came through technology. Plastic money is your debit or credit card, although it can also refer to the wire transfers of funds from one bank to another. Let us get a more holistic idea of what plastic money is.

What do you mean by plastic money?

Cards are increasingly being used in place of actual cash. Plastic money refers to these cards. Debit and credit cards represent plastic money. Plastic money has made it easier for us to carry out transactions in our daily lives. It has replaced cash payments across the world and established itself as a necessary form of instant money. It has made it simpler for us to buy items with some of the **best credit cards** in the market, which we could not otherwise afford.

Benefits of plastic money

Plastic money comes with many benefits, including:

1. Cashless living

Plastic money has not only made our lives easier but has also alleviated the hassles that come with carrying currency. Some of the best credit cards allow us to move around the world without worrying about carrying cash.

2. Better security

One advantage of using credit or debit cards is the decrease in robberies and crimes. Hacking a card's PIN is difficult and necessitates the knowledge of certain procedures. As a result, credit and debit cardholders can be reasonably confident of the security of their funds.

3. Financial freedom

Credit cards allow a person to make a transaction and pay for it even when they do not have the funds. It is incredibly beneficial especially when you are short on cash. Credit cards also reduce the need to rely on others for financial assistance in an emergency. You can use the credit card to fund your requirement and later payback in instalments. Further, a credit card is easy to get. All you need to do is meet your bank's credit card eligibility criteria, and the card is yours.

4. Ease of doing transactions

Credit cards and debit cards can help make online payments, fund transfers, and other transactions with ease. It is incredibly simple to make payments with plastic money from any location. Furthermore, several online businesses provide discounts when paying using credit and debit cards.

5. Exciting deals and discounts

Every credit and debit card providers offers deals and discounts on shopping. They can help you save more and earn cashback on purchases.

6. Saving on travel

Travelling can be expensive without plastic money. Credit and debit cards provide lounge access and incredible deals on travel bookings. You cannot enjoy the same benefits while using cash, making plastic money a must if you are travelling.

Drawbacks of plastic money

Plastic money also has some downsides, such as:

1. Does not work everywhere

There may be certain venues and stores where only cash is accepted. For example, buying products from a small merchant or buying vegetables or newspapers.

2. Can land you in debt

If a person is not careful with plastic money, they can often overstep their spending limit and spend more than they can repay. This can land them in debt.

If you are in the market for credit and debit cards and want to transition from cash to plastic money, look no further than IDFC FIRST Bank. You will receive unsurmountable benefits if you use cards from IDFC FIRST Bank. From unlimited lounge access to huge discounts, the world is

your playing field with IDFC FIRST Bank. So, wait no more; get your card from IDFC FIRST Bank today! Use our mobile banking apps to unlock the benefits of our manifold cards.

National Electronic Funds Transfer (NEFT)

The National Electronic Fund Transfer (NEFT) is a payment platform which is used nationwide by many banks. This allows the easy and hassle-free transfer of money from one bank account to another bank account. With the world slowly shifting to online banking, the concept of NEFT has become very popular in the country and is an easy way of transferring funds. It eliminates the need to visit the bank to transfer funds, as you can transfer funds while at home.

NEFT - Transaction Timings

Fund transfer through NEFT service can be used any time and, on any day, of the year. NEFT services are conducted every 30 minutes throughout the day in batches and processed by 9:30 am for any transaction made prior to this time.

How to make an NEFT transfer

The procedure for National Electronic Funds Transfer (NEFT) is mentioned below:

Step 1: First login to your net banking account. If you do not have a net banking account then register for it on the website of your bank.

Step 2: Add the beneficiary as a payee. To do so, you have to enter the following details about the beneficiary in the 'Add New Payee' section:

- Account Number.
- Name.
- IFSC Code.
- Account Type.

Step 3: Once the payee is added, choose NEFT as mode of Fund Transfer.

Step 4: Select the account you wish to transfer money from, the payee, enter the amount that you wish to transfer, and add remarks (optional).

Step 5: Click on submit.

Benefits of Using NEFT for Fund Transfer

NEFT offers a lot of benefits. Let's look into a few of these:

- The system allows the one-way cross-border transfer of funds from India to Nepal. This is under the Indo-Nepal Remittance Facility Scheme.
- With NEFT, you can easily transfer funds from one bank account of any branch to another account.
- It avoids the need for a physical instrument to transfer funds.
- There is no need for any physical presence of parties.
- NEFT is easy, simple and efficient.
- Money can be transferred via NEFT on holidays and weekends as well.
- You can initiate internet banking from any location.
- The confirmation of a transaction will be received via email and SMS notifications
- The real-time transactions of NEFT give assurance to both parties.

Real Time Gross Settlement RTGS

Real-Time Gross Settlement (RTGS) is a fund transfer method via which money is sent immediately without any delays. RTGS is typically meant for larger value transactions and the

minimum amount that can be sent via this mode is Rs.2 lakh.

You can use the net banking or mobile banking facility to transfer money via RTGS. You need the bank details of the individual to transfer money via this mode. Transfers can be scheduled in advance as well.

The following information is required for an RTGS transaction:

- The amount that needs to be transferred.
- Name of the payee/beneficiary as in the bank account,
- IFSC code of the payee/beneficiary.
- Account number of the payee/beneficiary.
- Name of beneficiary bank and bank branch.

Money can be sent using RTGS through net banking. To initiate such a transaction, it is important to collect some details from the payee such as account number, bank name, **IFSC code**, and account holder name. Another interesting feature of this wire transfer method is that transactions can be scheduled in advance.

The following information is required for an RTGS transaction:

- The amount that needs to be transferred in rupees
- Name of the payee/beneficiary as in the bank account
- IFSC code of the payee/beneficiary
- Account number of the payee/beneficiary
- Name of beneficiary bank and bank branch

RTGS Fund Transfer Process(Stepwise)

The step-by-step procedure to transfer funds via RTGS is mentioned below:

Step 1: Log in to your respective bank's internet banking account by entering your username and password.

Step 2: Go to the home page and click on the Funds Transfer option.

Step 3: Proceed to choose RTGS, key in beneficiary/payee details such as account number, IFSC code, etc.

Step 4: Review all details and then submit. The funds will be credited immediately to the payee's account.

Features and Benefits of RTGS Transactions

The main features and benefits of RTGS transactions are mentioned below:

- Realtime online fund transfer
- Used for high value transactions
- Safe and secure
- Reliable and backed by the RBI
- Immediate clearing
- Funds credited on a one-on-one basis
- Transactions executed on an individual and gross basis

Mobile Banking

M-banking refers to the use of the internet and mobile technology to bring financial services to customers. Customers use m-banking through a USSD, SMS, or mobile app to access banking services. As a result, it has eliminated the customers' need to visit the bank branch for every other financial necessity.

Busy lifestyle and, more recently, the COVID pandemic have forced people to opt for mobile banking. Round-the-clock banking services at the fingertips provide customers with an

easy, quick, and hassle-free experience. At the same time, banks also benefit from a reduction in operating costs due to savings in time and resources.

Though beneficial, m-banking is exposed to security threats like hacking that raise safety concerns among customers. In order to secure transactions, banks keep updating the security features of their m-banking app regularly. In addition, they also use a virtual private network (VPN), biometric login, and two-step OTP-based verification to ensure safety of customers.

To access m-banking, customers must download the bank's m-banking app from the app store. Then, proceed to create an online account to register for the same. It involves answering some questions, selecting a username and password, and setting up security preferences. After that, set an MPIN to be used every time a transaction is made.

Once the bank verifies the credentials, the customer becomes the registered user and can perform all the financial transactions using the mobile app. It includes shopping online, paying utility bills, making account information inquiries, transferring funds, using forex-related services, and booking tickets.

History

Let us discuss the m-banking history to know its origin. The earliest form of m-banking was performed using SMS in the 1990s. However, with the introduction of the mobile web and smartphones with wireless access protocol (WAP) in 1999, banks in Europe started offering m-banking platforms to their account holders.

Until 2010, banks were utilizing the mobile web and SMS to offer banking services on the customer's mobile. But after 2010, the advent of the following factors revolutionized the m-banking completely:

- Development of iOS by Apple and Android by Google for smartphones
- Emergence of web-based technologies (WBT) like CSS3, HTML 5, and JavaScript

WBT enabled the launch of web-based and mobile-based applications for banks on Android and Apple devices. As a result, banks started incorporating advanced features in their apps to attract customers. The enhanced functionality of apps with easy accessibility worked as bait for the customers. Thus, over the years, these m-banking apps emerged as the new normal globally.

Types of Mobile Banking Services

M-banking allows banks to offer a range of financial services to customers. From accessing account information to utilizing transaction, investment, loan, and support services, m-banking has assumed all roles traditionally requiring the help of a bank representative.

1 – Account Information

The account holders can:

- Extract the details related to accounts like bank statements
- Enable or disable SMS alerts of transactions
- Manage the fixed deposits and recurring deposits
- Know the loan details and statements
- Get debit card details
- Obtain credit card statements
- Understand and invest in insurance details
- Perform investment in securities

2 – Transaction

Customers can transfer funds between self-operated accounts, make payments to third-party bank account holders, and undertake utility bill payments, premium payments, and loan repayment using the mobile-based application. Moreover, many banking apps also integrate online shopping for the ease of customers laced with offers, cash backs, and rewards upon using these services.

3 – Investments

Many banks offer the facility of managing the investments like deposits, insurance, and equities from their m-banking interface embedded in the app.

4 – Loans

Banks provide the window of loans management to their customers. Customers can check the status of their loans, pay their EMIs, and even avail small digital loans using the app-based mobile utility.

5 – Customer Support

All banks provide a dedicated menu in their m-banking app to submit requests for services like cheque book, debit & credit card, and loan applications. The account holders can also check their ATM card and credit card reward points from the banking app.

6 – Content services

Several banks serve their customers with various loyalty programs, online shopping discounts, recharge offers, and other finance-related news through m-banking.

7 – Consumer Complaints

Customers can lodge complaints about any forgery or invalid transaction from their accounts using the app.

Mobile Banking Features

M-banking has features that ensure customers can access their accounts and carry out financial transactions on the go. Some key features of m-banking are:

1 – Accessibility

M-banking offers 24-hour access to all customers. Customers can log in to their app and view and track their account balances anytime. Besides, they can engage in fund transfers even during bank holidays.

2 – Security

The banks recognize the importance of providing a secure environment to customers for transactions based on the banking app. Hence, m-banking asks for SMS access, location access, biometric access, and application password from the customers to ensure their privacy and security.

3 – Transferability

Transferring funds from one bank account to another is the most basic m-banking activity. All the banking app-based transfers are now secured using two-step verification via app password and OTP-based transactions. The two-step verification is applicable in fund transfers, utility bill payments, and online shopping for the safety and convenience of customers.

4 – Investment Management

Many big banks offer the facility of securities trading through their banking app. It makes it easier for the customers to trade hassle-free. Also, m-banking enables customers to track their deposits and other investments from the convenience of their homes.

5 – Digital Payments

At present, all m-banking apps have a QR code reader for payment at merchant locations. So the customer has to point at the QR code of the merchant at their shops and pay the price of the goods using the account details from the QR code.

6 – Customer Service

M-banking provides personalized service to customers through live chat, phone, notifications, etc. This helps customers to get the required assistance without visiting the bank directly.

M-banking Advantages and Disadvantages

Like every other technology, m-banking can be advantageous as well as disadvantageous to customers. Therefore, one must know its pros and cons to stay safe.

Advantages

- Offers 24-hour accessibility to banking
- Saves time
- Provides a convenient way of making fund transfers and payments
- Enables easy tracking and monitoring of bank accounts
- Facilitates quick reporting of any illegal transaction or fraudulent activity
- Allows swift redressal of consumer complaints
- Increase request processing speed
- Makes online shopping possible
- Allows trouble-free management of investments
- Sends notification of bill or loan payments
- Encourages customers to stay indoors during a pandemic
- Eliminates the need to carry cash all the time
- Reduces chances of theft

Disadvantages

- Causes inconvenience for less tech-savvy account holders
- Removes human touch from banking
- Raises security concerns and online fraud
- Results in delays or losses in transactions due to mistakes
- Gives rise to comprehension issues due to the complex app interface
- Makes follow up on fraud reports difficult
- Delays service requests in case of internet issues

M WALLETS

Customers use mobile wallets to make in-store payments, and it is a convenient payment method compared to paying with cash or carrying physical credit cards. Mobile wallets are accepted as a method of payment in stores that are listed with mobile service providers.

The most popular mobile wallets include Google Pay, Apple Pay, and Samsung Pay. The wallets are integrated into mobile devices, or users can download the application from app stores.

Understanding Mobile Wallets

The information stored in a mobile wallet is encrypted, making it difficult for cybercriminals to execute fraudulent activities with them. While physical credit and debit cards can be stolen or duplicated, mobile wallets are difficult to steal since they come with encrypted keys that may not reveal any useful information.

Once a customer installs a mobile wallet on their mobile device, they are required to provide their credit card details, reward cards, and coupons. The information is then linked to an accepted personal identification format, such as a key or a scannable QR code.

When a customer makes an in-store payment, the mobile app uses near-field communication (NFC) technology to communicate between devices. The NFC uses a QR code, key, or another personal identification format to process the payment at the payment terminal. The action is triggered when the user taps or waves the NPC-enabled device at the merchant's point-of-service terminal.

Types of Mobile Wallets

The following are the main types of mobile wallets:

1. Open wallets

An open wallet is used directly by a bank or through a third party. Open wallets allow customers to use the funds in the mobile wallet for making payments for transactions or withdrawing the funds deposited to the account in cash. An example of an open mobile wallet is PayPal, which allows users to make payments for in-store and online purchases and still withdraw the funds in cash.

2. Closed wallets

Closed wallets are linked to specific merchants, and users can only use the funds to make payments for transactions initiated with the specific merchant. Users cannot use the money to make payments for transactions with other merchants and third-party service providers or withdraw the funds in cash. An example of a closed wallet is Amazon Pay.

3. Semi-closed wallets

Semi-closed mobile wallets allow users to use the funds in the wallet to make payments for transactions with multiple merchants, as long as there is an existing contract between the merchant and the mobile wallet company. Users can also withdraw the funds into a bank account. However, semi-closed wallets do not allow users to withdraw funds in cash.

How to Use a Mobile Wallet

After choosing your preferred mobile wallet, it is easy to set it up and use it to make payments. Start by downloading the mobile app in the app store onto your smartphone, tablet, or other compatible devices. Then, launch the app, and start adding the information you want to add to your wallet – credit cards, debit cards, coupons, reward cards, etc.

While it is possible to load information for multiple cards onto the wallets, only one card will be selected as the default payment option to be used to make payments. If a user wants to use a different card to make the transaction, they must change the default card before making the payment.

When making an in-store purchase, find merchants that accept your chosen payment gateway. Usually, merchants that accept mobile wallet payments can be identified through a contactless payment indicator (usually a sideways Wi-Fi symbol).
When making a payment, users are required to tap or wave their device to the NFC-enabled terminal. After making the payment, a message is sent to the merchant regarding the payment. The merchant must honor the message alert for the payment to be transferred from the consumer's account to the merchant's account.

Benefits of Mobile Wallets

1. Secured access

One of the benefits of a mobile wallet is its secured access. Before making a payment, the user is required to unlock the mobile device using a password or fingerprint. The app also requires users to type a passcode, use their fingerprint, or use the face scan to unlock the mobile wallet.
In the case of theft, it will be impossible for anyone to use the mobile device to make a payment without providing the required security credentials. It makes mobile wallets more secure than carrying physical credit cards and cash, which can easily be compromised.

2. Accessible and convenient

Mobile wallets are also quickly accessible and convenient, making it easier for users to make payments. They are preferred by consumers who want more convenience in paying for in-store purchases, instead of carrying physical wallets and cash to stores. Once credit card information is added to the mobile wallet, users can use the funds to pay bills and make purchases on the go.

Net Banking

Net-banking, also known as internet banking, is an electronic system managed by banks which enables customers to access financial as well as non-financial banking products online. Earlier, customers had to visit the banks even for a small service. However, after the arrival of internet banking, almost all the services and products can be accessed online. From fund transfer to requesting demand draft, net-banking facilities, and all banking essentials. It is not just convenient but also a secure method of banking.

How does Net Banking Work

To benefit from net-banking, customers are required to register for internet banking at the bank.

- Individuals having a savings account or current account at any bank can register for internet banking
- For net-banking to work properly, you need a personal computer, laptop or mobile, and good internet connection
- After registering, a unique customer ID and password are issued by the bank using which one can log-in to the net-banking portal

Features of Net Banking

Given below are some of the key features of Net Banking:

- A secure and convenient method of banking
- Password-protected banking system
- Easy access to financial and non-financial banking products/services
- Access your bank account anytime anywhere
- Track and manage bank balance, last transactions, statements, etc.

- Transfer funds online via NEFT, RTGS, IMPS anytime

- Process bill payments quickly
- Keep a track of payments, personal loans, home loans, business loans, credit cards, savings account, etc.
- Channelize or cancel automatic payments

How to Register for Net Banking

Most of the banks open an internet banking account for the customers as and when they apply for a new bank account. If you do not have an internet banking account already,

- You can submit the Internet Banking Application Form at your home branch along with required documents such as a copy of your bank passbook, Aadhaar card, etc.
- The bank will verify all the information and then issue a customer ID and password for internet banking
- The net-banking application form can be downloaded from your bank's official website
- After receiving the credentials, you can log-in and access net-banking

How to Register for Net Banking Online

Besides offline registration, which involves the submission of the application form at the bank, users can register for net-banking online from the respective bank's official website. However, it should be noted that not all banks offer online registration for internet banking services.

Step 1: Visit your bank's official net-banking website

Step 2: Click on the 'login' button under personal/retail banking option

Step 3: On the next screen, click on the 'New User? Register Here' option

Step 4: If you have already obtained the customer ID and password from the bank, enter and proceed to login. Otherwise, click 'Next'

Step 5: Now, you will be required to fill a 'Self Registration Form'. Enter details such as account number, registered mobile number, email address, branch code, CIF number, debit card details, etc. After that, click on 'Submit'

Step 6: Authenticate your registration using a one-time password sent to your registered mobile number

Step 7: On the next screen, your temporary customer ID and password will be displayed

Step 8: Log-in using your temporary credentials. You need to create a new log-in password after logging in for the first time

Note: *Login and transaction password should be changed every 2 months to safeguard the net-banking account.*

Steps for Net Banking Login

After successful registration, you can follow the given steps to log into your net banking account-

1. Visit your bank's official net-banking website. (Make sure the URL of the website starts with 'https://'. This means that the URL is secure)
2. If you are a retail user, choose 'Personal Log-in'. If you are a corporate user, choose 'Corporate Log-in'
3. Now, on the next screen, enter your customer ID and password
4. Enter Captcha and click on 'Login'
5. Your Net Banking dashboard will be displayed on the next screen

Types of Fund Transfers available on Net Banking

Net-banking allows the transfer of funds from one account to another through three different ways- NEFT, RTGS and IMPS. Let us understand these three methods in details-

NEFT

National Electronic Fund Transfer (NEFT) is one of the most commonly used payment methods which enables one-to-one fund transfer. It is a time-restricted process at the bank, but available 24×7 on the net-banking portals. Generally, it takes about 30 minutes for the funds to be successfully transferred via NEFT. However, the time can even stretch to 2-3 hours.

RTGS

Real-Time Gross Settlement (RTGS) refers to a continuous settlement of funds individually on an order-by-order basis. This implies that the RTGS system ensures that the beneficiary's account is credited with the funds immediately. Transactions via RTGS are monitored by the RBI which suggests that successful transfers are irrevocable. This method is used to transfer a minimum of Rs.2 lakh. Just like NEFT, RTGS is also a time-restricted service at the bank, but accessible 24×7 via net-banking.

IMPS

Immediate Payment System (IMPS) also deals in the real-time transfer of funds. It is most commonly used to transfer funds instantly within banks across India via mobile, internet and ATM. One can transfer funds via IMPS just with the mobile number of the beneficiary.

E Rupee

Simply put, the retail e-rupee – or the Central Bank Digital Currency-retail (CBDC-R) – is a **digital version of cash**. It is legal tender issued by the central bank, but in electronic form. The e-rupee will be issued in the same denominations as currently available banknotes and coins. Users can transact via a digital wallet offered by their banks.

How is it different from UPI?

One of the motivations behind launching a digital currency is to reduce settlement risk in the system. In the case of UPI transactions, the transfer of money involves a settlement process, where you place a request with your bank and the funds are then deducted from your account and transferred to the beneficiary's account.

But with e-rupee transfers, there is no intermediary. It is literally the electronic equivalent of handing cash over to another person. The money is never 'in transit'; nor is there any need for inter-bank settlement.

The e-rupees are simply transferred from one wallet to another and the funds become the property of the receiving party: this is the concept of 'settlement finality'.

What does it mean for users?

We could be looking at a **whole new era of reach and convenience** in digital payments. Transferring funds will be the literal equivalent of handing cash over. The process will be instantaneous. The RBI has even mentioned an 'offline' feature, which means that transactions can occur even without a mobile network. This could have serious implications for remote areas, where the penetration of digital payments has suffered.

A digital currency would reduce the dependence on cash and help reduce fraud in digital transactions. Further, the government could use the e-rupee to improve the mechanism of

directly transferring funds to beneficiaries of schemes.

One feature of physical cash transactions is **anonymity**: there is no digital trail. While the idea of anonymity while transacting in 'digital' rupees may sound infeasible, the RBI has suggested that "reasonable anonymity for small value transactions" could be a "desirable option for CBDC-R." This means that you could, potentially, transfer funds without leaving any record. However, such anonymous transactions will likely be capped at a certain value.

Another point to note is that e-rupees will likely not bear any interest, with the RBI arguing that it would be "logical" to offer CBDCs without interest since physical cash does not carry any interest either.

How do we start using the e-rupee?

For now, the trial will only cover selected consumers and businesses in a closed user group, with only certain cities and banks involved. When the e-rupee is rolled out, users will be able to download an app – for example, Yes Bank has launched its digital rupee app – from their banks and transact in digital rupees.

Why was the e-rupee introduced?

The RBI, in its concept document, mentioned a few principal motivations: 1. Reducing the cost associated with physical cash management (printing, storage, transportation etc.), 2. Increasing the adoption of digital payments, 3. Supporting financial inclusion (especially via the offline feature in remote parts of the country with poor connectivity) and 4. Providing Indians a safe digital currency without any of the risks associated with crypto currency.

The future

The e-rupee could have a transformative effect, deepening and widening the reach of digital payments in India. It could herald a new era of ease and convenience in digital payments in the country's farthest corners. It is important, though, to note that the e-rupee is intended by the RBI to "complement, rather than replace, current forms of money".

Central Bank Digital Currency

The Reserve Bank of India (RBI) has roped in at least five lenders including State Bank of India, ICICI Bank, IDFC First Bank and HDFC Bank to work on the retail pilot project of the central bank digital currency (CBDC), The central bank commenced the pilot project of India's very own digital currency —Digital Rupee — for the wholesale segment from November 1, 2022. "The use case for this pilot is settlement of secondary market transactions in government securities," the regulator mentioned in a notification on October 31, 2022. The RBI has identified nine banks including State Bank of India, Bank of Baroda, Union Bank of India, HDFC Bank, ICICI Bank, Kotak Mahindra Bank, YES Bank, IDFC First Bank and HSBC

Features of Digital Rupee

1) CBDC is a sovereign currency issued by central banks in alignment with their monetary policy.

2) It appears as a liability on the central bank's balance sheet.

3) It must be accepted as a medium of payment, legal tender, and a safe store of value by all citizens, enterprises, and government agencies.

4) CBDC is freely convertible against commercial bank money and cash.

5) CBDC is a fungible legal tender for which holders need not have a bank account.

6) CBDC is expected to lower the cost of issuance of money and transactions.

Types of CBDC that could be introduced

The Central Bank Digital Currency can be classified into two types — general purpose or retail (CBDC-R) and wholesale (CBDC-W). Retail CBDC can be used by all including the private sector, non-financial consumers, and businesses. Wholesale CBDC is designed for restricted access to select financial institutions.

While retail CBDC is an electronic version of cash primarily meant for retail transactions, the wholesale CBDC is designed for the settlement of interbank transfers and related wholesale transactions.
"It is believed that retail CBDC can provide access to safe money for payment and settlement as it is a direct liability of the central bank. Wholesale CBDC has the potential to transform settlement systems for financial transactions and make them more efficient and secure. Going by the potential offered by each of them, there may be merit in introducing both CBDC-W and CBDC-R,"

UNIT-4

Non-Banking Finance Companies

Non-Banking Financial Company (NBFCs) may be defined as a company registered under the Companies Act, 1956 and under the provisions of section 45-IA of the Reserve Bank of India Act, 1934. NBFCs provides banking services without meeting the legal definition of a bank such as holding a banking license.

Section 45-I of the Reserve Bank of India Act, 1934 defines ''non-banking financial company'' as–

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Following are the business in which NBFCs are engaged:

- Loans and advances
- Acquisition of shares/stocks/bonds/debentures/securities issued by the government or local authority or other securities of like marketable nature,
- Leasing
- Hire-purchase
- Insurance business,
- Chit business

But does not include any institution whose principal business is that of agricultural activity or any industrial activity or sale, purchase or construction of immovable property.

Classification of NBFCs based on the nature of its business

Depending upon the nature of the business NBFCs registered under RBI are divided into four categories depending upon its nature of business:

• hire-purchase company;
• equipment leasing company;
• loan company;
• investment company;
• infrastructure finance company

Types of Non-Banking Financial Companies

Types of Non-Banking Financial Companies (NBFCs)

1. Meaning of NBFC

A Non-Banking Financial Company (NBFC) is a financial institution that provides financial services such as loans, advances, asset financing, investment services and other specialised financial activities, but does not operate as a bank in the full legal sense.

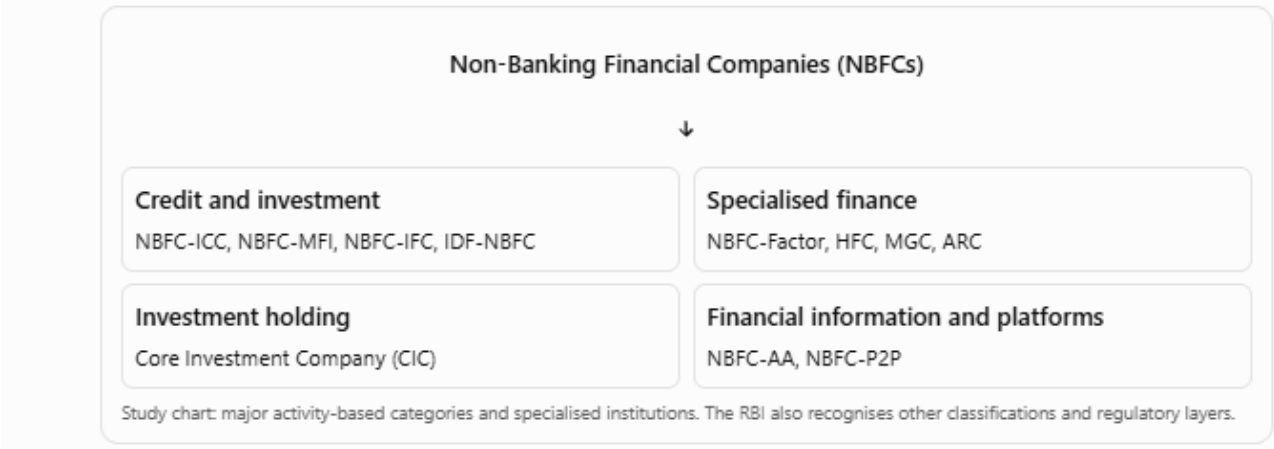
NBFCs play an important role in the Indian financial system by providing finance to individuals, businesses, small enterprises and infrastructure projects. They complement banks by serving customers and sectors whose financial requirements may not always be met by traditional banking institutions.

For example, a person who wants to purchase a two-wheeler may obtain a loan from an NBFC, while a small business may approach an NBFC for working capital or machinery finance.

NBFCs in India are regulated by the Reserve Bank of India (RBI), subject to the applicable laws and regulatory arrangements. They are different from banks because they generally cannot accept demand deposits or issue cheques drawn on themselves like banks. NBFC deposits, where permitted, are also not covered by the DICGC deposit insurance applicable to eligible bank deposits.

2. Classification of NBFCs

NBFCs can be classified according to the financial activities they perform. The important categories for study are given below.



Study chart: major activity-based categories and specialised institutions. The RBI also recognises other classifications and regulatory layers.

The following types are explained in detail.

3. Types of NBFCs

1. Investment and Credit Company (NBFC-ICC)

An Investment and Credit Company is an NBFC whose principal activities include providing loans and advances for productive or economic activities and investing in securities.

These companies provide finance to individuals, traders, small businesses and industries. They may also finance the purchase of vehicles, equipment and other assets.

Example: A finance company provides a loan to a small manufacturing unit to purchase machinery. Another company may provide a personal loan to an individual for meeting personal expenses.

Importance: NBFC-ICCs help individuals and businesses obtain credit for consumption, investment and business expansion.

Note: Asset finance companies, loan companies and investment companies were historically listed as separate categories. Their functions are now broadly covered within the consolidated NBFC-ICC classification, subject to applicable RBI rules.

2. Infrastructure Finance Company (NBFC-IFC)

An Infrastructure Finance Company is an NBFC that mainly provides finance for infrastructure projects. Such projects require substantial investment and generally take several years to complete.

Infrastructure financing supports the development of roads, highways, ports, power projects, telecommunications facilities and other infrastructure.

Example: An infrastructure finance company provides a long-term loan to an eligible company developing a highway or power-generation project.

Importance: These companies help mobilise funds for large projects that contribute to economic development and employment generation.

3. Infrastructure Debt Fund (IDF-NBFC)

An Infrastructure Debt Fund is a specialised NBFC designed to facilitate the flow of long-term debt into eligible infrastructure projects. Its financing activities are subject to specific RBI conditions.

Infrastructure projects often require long-term funds because their construction and revenue-generating periods may extend over several years. Infrastructure debt funds help provide suitable long-term financing arrangements.

Example: An IDF-NBFC refinances an eligible infrastructure project after it has commenced commercial operations and satisfies the applicable requirements.

Importance: It supports long-term infrastructure financing and helps improve the availability of funds for eligible projects.

Difference: An NBFC-IFC primarily provides infrastructure finance, whereas an IDF-NBFC has a specialised role in facilitating long-term debt for eligible infrastructure projects.

4. Core Investment Company (CIC)

A Core Investment Company is a specialised company that primarily holds investments in shares, preference shares, debt or loans of companies within the same group, subject to the applicable RBI definition and conditions.

Unlike a regular lending company, its main purpose is to hold and manage investments in group companies rather than to provide loans directly to the general public as its principal business.

Example: A business group owns companies engaged in manufacturing, logistics and technology. A Core Investment Company within that group holds investments in these companies.

Importance: CICs facilitate the ownership and management of investments within a corporate group. Certain CICs are subject to RBI registration and regulatory requirements based on their size, funding and other conditions.

5. Microfinance Institution (NBFC-MFI)

A Microfinance Institution classified as an NBFC-MFI provides small loans to eligible low-income households and economically disadvantaged groups. Microfinance is intended to improve access to formal credit for people who may have limited access to conventional banking finance.

These loans may support small businesses, self-employment, agricultural allied activities and other permitted income-generating purposes.

Example: A woman running a small tailoring business obtains a microfinance loan to purchase a sewing machine and additional materials.

Importance:

- Encourages self-employment and small-scale entrepreneurship.
- Improves access to formal credit for low-income households.
- Supports women's economic participation.
- Helps finance small income-generating activities.

An NBFC-MFI is subject to specific RBI requirements, including the applicable definition and qualifying conditions for microfinance loans.

6. Factoring Company (NBFC-Factor)

A Factoring Company provides finance by purchasing or acquiring eligible business receivables, or by extending loans against receivables in accordance with applicable regulations.

A receivable is money that a business expects to receive from a customer for goods supplied or services rendered. Sometimes, a business cannot wait until the customer pays the invoice. Factoring helps the business obtain funds earlier.

Example: A supplier sells goods worth ₹5 lakh to a retailer and allows payment after 60 days. The supplier approaches a factoring company and receives an agreed amount against the eligible invoice before the retailer makes payment.

Importance:

- Improves the working capital position of businesses.
- Helps businesses meet immediate operating expenses.
- Reduces the waiting period for receiving invoice payments.
- Supports small and medium-sized enterprises in managing cash flow.

7. Mortgage Guarantee Company (MGC)

A Mortgage Guarantee Company provides mortgage guarantees to eligible lenders against specified losses arising from a borrower's failure to repay a qualifying housing loan, according to the terms of the guarantee.

It does not simply function as an ordinary home-loan provider. Its specialised role is to provide a guarantee that can help manage the credit risk associated with housing finance.

Example: A lender provides a qualifying housing loan and obtains a mortgage guarantee from an eligible MGC. If the borrower defaults and the conditions of the guarantee are met, the company may be liable for the covered loss under the guarantee agreement.

Importance: Mortgage guarantees can help lenders manage housing-loan risks and support the development of housing finance.

8. Account Aggregator (NBFC-AA)

An Account Aggregator is an RBI-regulated entity that facilitates the secure sharing of a customer's financial information between permitted financial institutions, based on the customer's consent.

It does not primarily provide loans or invest customer funds. Instead, it enables financial information to be shared in a consolidated and organised manner through the applicable consent-based framework.

Example: A customer applying for a loan may consent to sharing eligible financial information from multiple accounts with a lender through an Account Aggregator. This may help the lender assess the customer's financial position.

Importance:

- Makes financial information sharing more convenient.
- Reduces dependence on manually collecting multiple documents.
- Can help financial institutions assess credit applications more efficiently.
- Gives customers a consent-based mechanism for sharing eligible financial data.

9. Peer-to-Peer Lending Platform (NBFC-P2P)

A Peer-to-Peer Lending Platform is an online platform that brings eligible lenders and borrowers together. It facilitates the lending process without functioning as a conventional bank that accepts deposits and lends those deposits.

The platform helps match lenders who wish to lend money with borrowers seeking funds. Its activities are subject to specific RBI regulations.

Example: A borrower seeks a personal loan through a registered P2P platform. The platform facilitates a match with eligible lenders who agree to provide funds under the applicable terms.

Importance:

- Provides an alternative channel for connecting lenders and borrowers.
- Uses digital platforms to facilitate lending.
- May expand access to credit for eligible borrowers.
- Offers lenders an additional avenue for lending, subject to credit risk.

Important distinction: A P2P platform facilitates lending; it does not guarantee that every borrower will repay or that every lender will earn a return.

10. Housing Finance Company (HFC)

A Housing Finance Company primarily provides finance for housing-related purposes, subject to the applicable regulatory definition. Its lending may support the purchase, construction, reconstruction, renovation or repair of residential properties.

Housing finance is a specialised area because home purchases often involve large loans and long repayment periods.

Example: A family approaches a housing finance company for a loan to purchase an apartment. The company evaluates the family's income, repayment capacity, property documents and other relevant factors.

Importance:

- Supports home ownership.
- Provides finance for residential construction and improvement.
- Helps individuals meet long-term housing requirements.
- Contributes to the development of the housing sector.

Housing Finance Companies are regulated by the RBI under the applicable framework.

11. Non-Operative Financial Holding Company (NOFHC)

A Non-Operative Financial Holding Company is a specialised holding-company structure associated with promoters or promoter groups setting up a new bank under the applicable RBI framework.

It holds eligible financial-services entities under a prescribed structure rather than functioning as an ordinary public-facing lending company.

Example: Under an approved banking arrangement, a promoter group uses a holding-company structure to hold its bank and other permitted financial-services entities.

Importance: It supports an appropriate ownership structure and separation of financial businesses under applicable regulatory conditions.

12. Asset Reconstruction Company (ARC)

An Asset Reconstruction Company is a specialised financial institution registered with the RBI to undertake asset reconstruction and related permitted activities under the applicable law.

It generally acquires eligible stressed financial assets from lenders and works towards recovery or resolution through legally permitted methods.

Example: A lender transfers an eligible stressed loan asset to an ARC. The ARC then pursues recovery or restructuring using the mechanisms permitted under law.

Importance:

- Helps lenders manage stressed assets.
- Supports recovery of eligible overdue loans.
- Can improve the management of non-performing financial assets.
- Contributes to the resolution of distressed credit.

An ARC is a specialised RBI-regulated financial institution governed by a specific legal and regulatory framework; it should not be confused with an ordinary loan company.

4. Summary table of NBFC types

Type	Main activity	Simple example
NBFC-ICC	Lending and investment	Loan for machinery
NBFC-IFC	Infrastructure finance	Highway project loan
IDF-NBFC	Long-term debt for eligible infrastructure projects	Refinancing an eligible operating project
CIC	Investment in group companies	Holding shares in group businesses
NBFC-MFI	Small loans to eligible low-income borrowers	Loan for a tailoring business
NBFC-Factor	Finance against business receivables	Early finance against an invoice
MGC	Mortgage guarantees	Guarantee supporting an eligible housing loan
NBFC-AA	Consent-based financial information sharing	Sharing financial data for a loan application
NBFC-P2P	Online platform connecting lenders and borrowers	Platform-facilitated personal loan
HFC	Housing finance	Home purchase loan
NOFHC	Prescribed holding structure for setting up a bank	Holding eligible financial entities
ARC	Asset reconstruction and recovery	Acquisition and resolution of eligible stressed assets

The table summarises the principal functions of each category. The RBI's detailed definitions, registration conditions and regulatory requirements determine how a company is classified.

5. Conclusion

Non-Banking Financial Companies are important components of India's financial system. They provide credit, investment, infrastructure finance, microfinance, housing finance and specialised financial services. Different types of NBFCs serve different financial needs: some focus on lending, some support long-term infrastructure projects, and others facilitate factoring, financial information sharing or recovery of stressed assets.

Thus, NBFCs complement the banking sector by expanding the availability of financial services and supporting individuals, businesses and economic development.

Operations of Non-Banking Finance Companies

Operations of Non-Banking Financial Companies (NBFCs)

1. Introduction

Non-Banking Financial Companies (NBFCs) are financial institutions that provide services such as loans, advances, asset financing, investment and other specialised financial activities. They play an

important role in providing credit to individuals, small businesses, industries and infrastructure projects.

The operations of an NBFC involve obtaining funds through permitted sources, assessing the financial requirements of customers, providing loans or other financial services, collecting repayments, managing risks and complying with regulatory requirements prescribed by the Reserve Bank of India (RBI).

Unlike banks, NBFCs generally cannot accept demand deposits or issue cheques drawn on themselves. Not all NBFCs are permitted to accept public deposits.

2. Major operations of NBFCs

1. Raising funds

An NBFC requires funds to conduct its financial activities. Depending on its category and regulatory permissions, it may obtain funds through bank borrowings, loans from financial institutions, debentures, commercial paper, other permitted market instruments and its own capital.

Some eligible NBFCs may also accept public deposits after satisfying the applicable RBI requirements. However, public deposits are not available as a funding source to every NBFC.

Example: An NBFC raises funds through borrowings from a bank and uses the funds to provide vehicle loans to eligible customers.

2. Assessment of creditworthiness

Before providing a loan, an NBFC evaluates the borrower's ability and willingness to repay the amount. This process is known as credit assessment.

The company may examine the applicant's income, employment or business stability, existing debts, repayment history, credit information and other relevant documents. Where applicable, it may also assess collateral offered by the borrower.

Example: Before granting a business loan, an NBFC examines the business's sales, cash flow, financial statements and existing liabilities.

3. Providing loans and advances

Lending is one of the major activities of many NBFCs. They provide finance to individuals and businesses according to their business model and regulatory permissions.

Common lending activities include:

- Personal loans
- Vehicle loans
- Business loans
- Loans for machinery and equipment
- Housing finance through eligible housing finance companies
- Microfinance loans through eligible NBFC-MFIs

Example: A small business obtains a loan from an NBFC to purchase machinery and increase its production capacity.

4. Asset financing and leasing

Some NBFCs specialise in financing physical assets used for personal or business purposes. These may include cars, commercial vehicles, tractors, generators and industrial equipment.

In asset financing, the customer receives finance to purchase an asset and repays the amount according to the loan agreement. Under leasing arrangements, the use of an asset is provided under the terms of a lease agreement.

Example: An NBFC finances the purchase of a tractor by a farmer or an eligible commercial vehicle by a transport operator.

5. Disbursement of loans

After the loan application is assessed and approved, the NBFC completes the required documentation and disburses the loan according to the agreed terms.

The amount may be transferred to the borrower's bank account or paid directly to the seller, depending on the purpose of the loan and the agreement.

Example: After approving a machinery loan, an NBFC transfers the approved amount to the equipment supplier.

6. Collection of repayments

NBFCs collect the principal and interest from borrowers according to the repayment schedule. Repayments may be collected through electronic transfers, authorised payment arrangements and other permitted channels.

The company maintains repayment records and follows up on overdue instalments. Effective collection helps the NBFC maintain liquidity and continue providing finance to other customers.

Example: A customer repays a vehicle loan through monthly instalments over the agreed loan period.

7. Investment activities

Certain NBFCs invest in eligible financial assets and securities according to their permitted business activities. Investment-related operations may include holding eligible securities, managing investments in group companies or undertaking other authorised activities.

The nature of these activities depends on the NBFC's classification and applicable regulatory requirements.

Example: A Core Investment Company holds investments in companies belonging to the same corporate group, subject to the applicable RBI rules.

8. Risk management

NBFCs face risks such as credit risk, liquidity risk, interest-rate risk, operational risk and fraud risk. They need suitable systems to identify, assess, monitor and control these risks.

Credit risk arises when borrowers fail to repay loans. Liquidity risk arises when the company cannot meet its financial obligations when due. Operational risk may result from system failures, errors or fraud.

Example: An NBFC reduces credit risk by checking a borrower's repayment capacity before sanctioning a loan and monitoring repayments afterwards.

9. Maintenance of accounts and financial reporting

NBFCs maintain accounting records of loans, borrowings, interest income, expenses, investments, repayments and overdue accounts.

They prepare financial statements and submit the reports and returns required by the applicable regulatory framework. Proper accounting and reporting help assess the financial position and performance of the company.

Example: An NBFC records loan disbursements and repayments, calculates outstanding balances and prepares its financial statements.

3. RBI regulations governing NBFC operations

NBFCs must comply with the regulations applicable to their category, size, activities and funding arrangements.

A. Registration and authorisation

An NBFC conducting activities that require RBI registration must obtain the appropriate registration and comply with applicable conditions. Registration does not automatically authorise the company to accept public deposits.

B. Restrictions on public deposits

Only eligible NBFCs specifically authorised to accept public deposits may do so, subject to the applicable RBI directions.

Under the RBI's public-deposit framework:

- NBFCs cannot accept public deposits repayable on demand.
- Permitted deposits generally have a maturity of at least 12 months and no more than 60 months.
- Applicable limits, investment-grade credit-rating requirements and other conditions must be satisfied.
- NBFC public deposits are not covered by the DICGC deposit insurance available to eligible bank deposits.
- The RBI does not guarantee repayment of deposits accepted by an NBFC.

These rules should not be applied indiscriminately to every NBFC; the requirements depend on the entity and its authorisation.

C. Maintenance of financial soundness

NBFCs must follow the applicable prudential requirements, which may include capital adequacy, income recognition, asset classification, provisioning and exposure limits. These requirements help ensure that the company manages its lending and financial risks responsibly.

D. Customer protection and fair practices

NBFCs must comply with the customer-protection and conduct requirements applicable to them. These may cover transparent disclosure of loan terms, interest rates and charges, appropriate recovery practices, grievance redressal and other prescribed obligations.

4. Flowchart of NBFC operations

1. Raising Funds

Capital and permitted sources of finance

2. Loan Application

Receive customer requirements and documents

3. Credit Assessment

Evaluate repayment capacity and risk

4. Loan Approval and Disbursement

Approve and release funds under agreed terms

5. Repayment Collection

Collect instalments and monitor overdue amounts

6. Accounting and Compliance

Maintain records, manage risk and submit required reports

5. Practical example of NBFC operations

Consider an NBFC that provides loans to small businesses.

A local furniture manufacturer requires ₹5 lakh to purchase additional machinery. The manufacturer submits a loan application with business and financial documents. The NBFC evaluates the business's cash flow, existing liabilities and repayment capacity.

After the application is approved, the NBFC disburses the loan according to the agreed terms. The manufacturer repays the loan in monthly instalments, including the applicable interest. The NBFC records the repayments, monitors the outstanding balance and follows up if an instalment becomes overdue.

Through these activities, the NBFC provides finance to the business while managing its own credit risk and complying with applicable regulations.

6. Conclusion

The operations of NBFCs include raising funds through permitted sources, assessing borrowers, providing loans, financing assets, collecting repayments, managing financial risks and maintaining proper accounts and regulatory reports. RBI regulations help ensure financial stability, responsible lending and customer protection. By providing specialised financial services, NBFCs complement the banking system and support individuals, businesses and economic development.

Micro Finance Companies

Microfinance companies, as the name suggests, are financial institutions that provide finances to low-income groups, where the finance requirement is lesser as compared to other sectors of the society. These sectors generally do not have access to traditional financial institutions such as banks and other financial institutions.

Need for Microfinance Companies

In India, there are many institutions like banks that grant loans to finance businesses. So why do we need microfinance companies? The need arises as it serves the following purposes:

- It provides financial assistance to enterprises that cannot place collateral
- It encourages women entrepreneurship
- It provides startups with much-needed support
- It offers assistance even for nominal amounts which generally are funded as hand loans
- It formalizes the process of lending and hence brings about discipline in borrowing by low-income groups. This prevents over-borrowing and reduces complications arising out of high future debts.

Formation of Microfinance Companies

Ideally, only a Non-Banking Finance Company (NBFC) is authorized by the Reserve Bank of India to conduct financial business. However, certain exemptions are provided by RBI to particular businesses to perform financial activities up to a specified limit. Therefore, a microfinance company registration can happen in the following two ways:

- Non-Banking Finance Companies (NBFC) duly registered with RBI
- Section 8 companies (companies formed under Section 8 of the Companies Act 2013)

Microfinance Company Registration as an NBFC

Given the differences in the two models for forming a microfinance company, the registration process also varies considerably. The following are the steps involved in the registration of a microfinance company through an NBFC:

- **Register a company:** To be registered as an NBFC microfinance company, the first step is to form a private or a public company. To form a private company, at least 2 members and a capital of Rs 1 lakh is required. To form a public company, at least 7 members are required.
- **Raise capital:** The subsequent step is to raise the required minimum net owned funds of Rs 5 crore. For the northeastern region the requirement is of Rs 2 crore.
- **Deposit the capital:** On collection of capital, the next step is to deposit the capital in a bank as a fixed deposit and obtain a 'No lien' certificate for the same.
- **Apply for license:** Finally, the NBFC must fill an online application for the license and submit it along with all the certified documents. A hard copy of the application and license must also be submitted at the regional office of Reserve Bank of India. The documents that must be available with the NBFC at the time of filing are:
    - Memorandum of Association and Articles of Association
    - Incorporation certificate of the company

- Board resolution copy

- Copy of Auditor's report of receipt of fixed deposit receipt
- Banker's Certificate of No Lien stating the net owned fund
- Banker's report about the company
- Recent credit report of the directors
- Net worth certificate of the directors
- Education/professional qualification proof of the director
- KYC and income proof of the director
- Proof of work experience in the financial sector
- Structure plan of the organization

Microfinance Company Registration as a Section 8 Company

The other option is to register a company as a Section 8 company. The procedure to be followed for the same is as follows:

- **Apply for Digital Signature Certificate (DSC) and Director Identification Number (DIN):** To form a company, the first process is to apply for a DSC and DIN. The DSC is essential for authorizing the e-forms.
- **Apply for name approval:** The next step is to apply for name approval in Form INC-1. The name must suggest that it is registered as a Section 8 company. So it must have the words sanstha, foundation or micro credit.
- **File Memorandum of Association (MOA) and Articles of Association (AOA):** Post the name approval; the company must draft the MOA and AOA and file it along with necessary documents.
- **File all relevant documents:** The last step is to file all relevant documents along with the incorporation certificate, and Form INC -12 to obtain a license. The primary basic documents required for registering a company under both the models are:
  - PAN Card copy of all directors/promoters
  - Documents for identity proof
  - Documents for address proof
  - Photograph of all directors/promoters
  - Proof of ownership of registered office or rental agreement for the same
  - NOC from the owner
  - Applicable stamp duty as mandated by the state
  - Any other documents as required

Regulation of Micro Finance Companies

REGULATION OF MICROFINANCE COMPANIES

1. Meaning of Regulation

Regulation refers to the rules, guidelines and procedures established by the government or a regulatory authority to control and supervise the activities of financial institutions. The main purpose of regulation is to maintain financial stability, protect customers and ensure that financial institutions operate in a fair and responsible manner.

Microfinance institutions provide small loans and other financial services to low-income households and economically weaker sections. Since these institutions deal with financially vulnerable customers, proper regulation is necessary to prevent unfair lending practices, excessive interest charges and financial mismanagement.

In India, the Reserve Bank of India (RBI) regulates NBFC-Microfinance Institutions (NBFC-MFIs) and other regulated entities that provide microfinance loans.

2. Types of Regulation

Financial institutions are generally subject to two major types of regulation. They are:

1. Prudential Regulation
2. Non-Prudential Regulation

A. Prudential Regulation

Prudential regulation refers to the rules and requirements designed to maintain the financial soundness and stability of financial institutions. It ensures that microfinance institutions have sufficient financial resources to continue their operations and meet their financial obligations.

The main objective of prudential regulation is to prevent financial failure and reduce risks in the financial system. Regulatory authorities supervise institutions and prescribe requirements relating to capital, financial reserves, loan-loss provisions and financial reporting.

Examples:

- Capital Adequacy: Microfinance institutions must maintain the prescribed level of capital to absorb possible financial losses.
- Reserve Requirements: Applicable financial institutions must maintain prescribed reserves or liquid assets.
- Loan-Loss Provisions: Institutions must make provisions for loans that may not be recovered from borrowers.

- Financial Reporting: Institutions must prepare and submit financial statements and regulatory reports.
- Risk Management: Institutions must identify, measure and control credit, operational and other financial risks.

Example: Suppose a microfinance institution provides loans to 10,000 low-income borrowers. Some borrowers may fail to repay their loans. Prudential regulations require the institution to maintain adequate capital and make provisions for possible loan losses so that its financial position remains stable.

B. Non-Prudential Regulation

Non-prudential regulation refers to rules that control the business practices and day-to-day activities of financial institutions. Its main objective is to protect customers and ensure fair treatment of borrowers.

Unlike prudential regulation, which mainly focuses on the financial strength of an institution, non-prudential regulation focuses on how the institution conducts its business and deals with customers.

Examples:

- Fair Lending Practices: Microfinance institutions must follow fair lending procedures and avoid exploiting borrowers.
- Transparency in Interest Rates: Institutions should clearly communicate interest rates, fees and other charges to customers.
- Prevention of Fraud: Institutions must establish procedures to prevent fraud, misrepresentation and financial crimes.
- Customer Protection: Borrowers must be protected against unfair recovery practices and misleading information.
- Loan Documentation: Loan terms, repayment schedules and other important conditions must be properly communicated to borrowers.
- Grievance Redressal: Customers should have a mechanism to register complaints and obtain solutions.

Example: If a microfinance institution provides a loan of ₹30,000 to a woman running a small tailoring business, it must clearly explain the interest rate, instalment amount, repayment period and other charges before providing the loan.

3. Difference Between Prudential and Non-Prudential Regulation

Basis	Prudential Regulation	Non-Prudential Regulation
Meaning	Rules relating to financial soundness and stability.	Rules relating to business practices and customer protection.
Main	To maintain financial stability.	To ensure fair and transparent operations.

objective		
Focus	Financial strength of the institution.	Conduct of the institution towards customers.
Major areas	Capital, reserves, provisions and risk management.	Interest-rate disclosure, fair lending and customer protection.
Beneficiaries	Institution, depositors and financial system.	Mainly borrowers and customers.
Example	Maintaining adequate capital.	Explaining loan charges clearly to borrowers.

4. Benefits of Regulation

Regulation provides several benefits to microfinance institutions, borrowers and the financial system.

1. Ensures Financial Soundness: Regulation helps microfinance institutions maintain adequate capital, reserves and financial resources. This reduces the possibility of financial failure and helps institutions continue their operations.

2. Protects Borrowers: Regulations protect borrowers from unfair lending practices, excessive charges, misleading information and improper recovery methods. This is particularly important because microfinance customers generally belong to low-income groups.

3. Creates Public Confidence: Proper regulation increases the confidence of customers in microfinance institutions. When people believe that financial institutions are properly supervised, they are more willing to use their financial services.

4. Prevents Financial Mismanagement: Regulatory requirements relating to accounting, auditing, loan documentation and risk management help prevent misuse of funds and financial irregularities.

5. Controls Unfair Lending Practices: Regulation encourages transparent lending procedures and responsible lending. It helps prevent exploitation of borrowers through hidden charges and unreasonable loan conditions.

6. Encourages Development of the Microfinance Industry: A proper regulatory framework creates a disciplined financial environment. It encourages responsible institutions to expand their services and reach more people who do not have easy access to traditional banking.

7. Reduces Financial Risks: Regulations relating to capital adequacy, loan-loss provisions and risk management help institutions identify and manage possible financial losses.

5. Costs of Regulation

Although regulation provides several advantages, it also creates certain costs and difficulties for microfinance institutions.

1. Cost of Supervision: Regulatory authorities must regularly inspect and monitor microfinance institutions. Maintaining supervision systems, conducting inspections and checking financial records involves additional expenses.

2. Increased Administrative Expenses: Microfinance institutions must maintain proper records, prepare reports, conduct audits and follow regulatory procedures. These activities require additional employees, technology and administrative resources.

3. Control of Interest Rates: Regulatory authorities may prescribe rules relating to interest rates and charges. Such restrictions can protect borrowers from excessive interest rates. However, microfinance institutions generally provide small loans to customers in remote areas, where operating costs are relatively high. If lending rates do not adequately cover these costs, the institution may face difficulties in maintaining its operations.

4. Capital Requirements: Regulatory authorities may prescribe minimum capital requirements for financial institutions. These requirements improve financial stability, but they may make it difficult for new or small microfinance institutions to enter the market.

5. Limited Expansion: Compliance with regulatory requirements may increase the cost of establishing branches and extending services to rural and remote areas. As a result, some institutions may find it difficult to expand their operations.

6. Higher Cost of Borrowing: When regulatory and administrative expenses increase, institutions may experience higher operating costs. These costs may indirectly affect borrowers through service charges or lending costs, subject to applicable regulations.

6. Regulation of Microfinance Institutions in India – RBI Framework

In India, the Reserve Bank of India plays an important role in regulating microfinance activities carried out by regulated financial institutions.

The RBI issued the Regulatory Framework for Microfinance Loans Directions, 2022, which established common rules for microfinance lending by regulated entities. The RBI also issued separate NBFC-MFI Directions, 2025, providing a specific regulatory framework for NBFC-MFIs.

Important regulatory aspects include:

1. Household Income Assessment: Regulated lenders must assess the household income of borrowers before providing microfinance loans.

2. Repayment Capacity: The total monthly repayment obligations of a household towards loans should generally not exceed 50% of its monthly household income. This includes both microfinance and non-microfinance loans for low-income households covered by the framework.

Reserve Bank of India

3. Transparency in Lending: Lenders must communicate important loan details, including interest rates and repayment obligations, clearly to borrowers.

4. Responsible Lending: Financial institutions should assess the repayment capacity of borrowers and avoid excessive indebtedness.

5. Customer Protection: Regulated entities must follow fair practices and provide suitable mechanisms for handling customer complaints.

6. Regulatory Supervision: NBFC-MFIs must comply with applicable RBI requirements relating to registration, governance, financial soundness and reporting.

7. Qualifying Assets: From June 2025, RBI revised the qualifying asset requirement for NBFC-MFIs to a minimum of 60% of total assets after deducting intangible assets.

Reserve Bank of India

7. Example of Regulation in Practice

Suppose a woman in a rural area wants to obtain a loan of ₹40,000 to start a small tailoring business.

Before providing the loan, the microfinance institution assesses her household income and existing loan commitments. It checks whether she can repay the proposed instalments without facing excessive financial pressure.

The institution explains the interest rate, repayment schedule and other charges. It provides the loan after completing the required procedures.

If the borrower faces a problem, she can approach the institution's grievance redressal mechanism.

This example shows how regulation promotes responsible lending, financial discipline and customer protection.

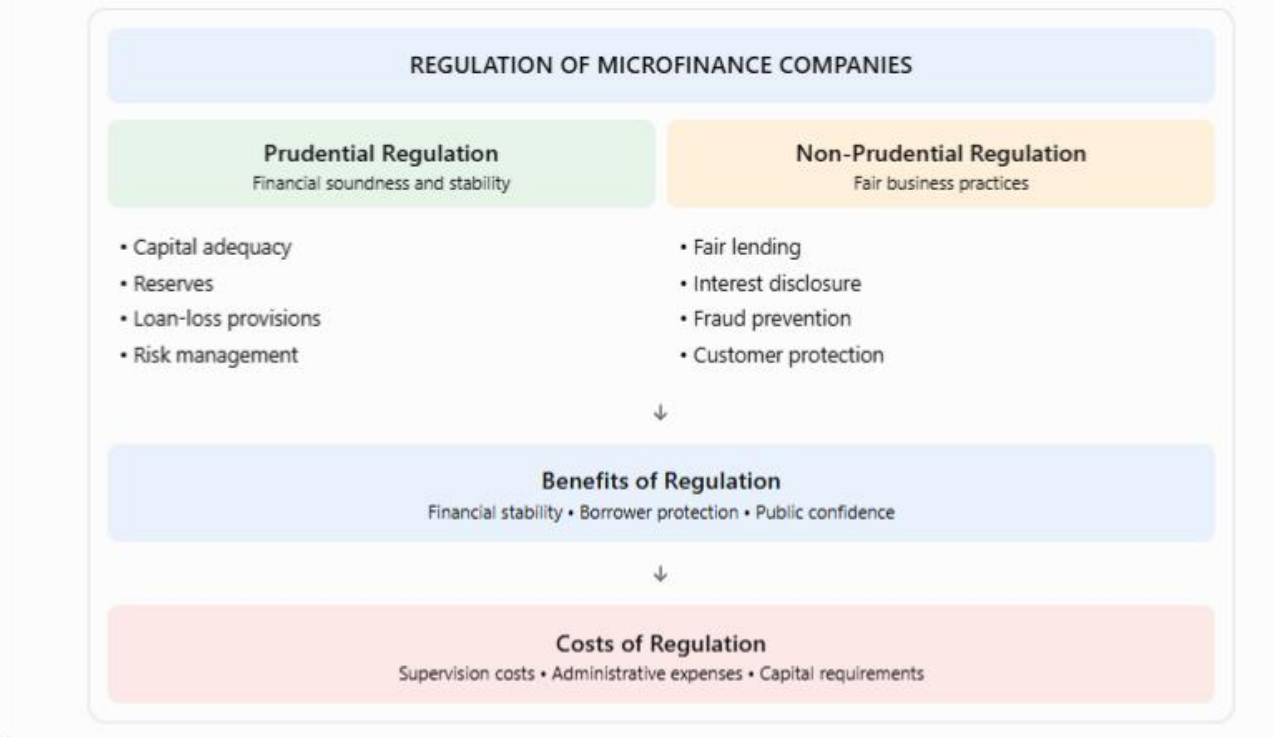
8. Conclusion

Regulation plays an important role in the development and stability of the microfinance industry. Prudential regulation maintains the financial strength of institutions, whereas non-prudential

regulation ensures fair business practices and protects borrowers. Although regulation involves additional costs and administrative responsibilities, it helps create a transparent, responsible and reliable microfinance system.

Representative Chart: Regulation of Microfinance Companies

REGULATION OF MICROFINANCE COMPANIES



UNIT-5

Credit Information Bureaus

Credit Information Bureau (India) Limited (CIBIL) is a credit bureau or credit information company, engaged in maintaining the records of all the credit-related activities of companies as well as individuals, including credit cards and loans.

The registered member banks and several other financial institutions periodically submit their information to CIBIL. Based on the information and records provided by these institutions, CIBIL issues Credit Information Report (CIR) and credit score to applicants and financial institutions.

CIBIL is a credit information database and does partake in any kind of lending decisions. It provides data to the banks and other lenders to quickly and efficiently filter the loan applications which they receive in the course of their business.

Product offerings by CIBIL

CIBIL offers three products viz. credit score, a credit report for individuals and credit report for companies:

Credit score

A credit score refers to a 3 digit numeric value that represents the creditworthiness of an individual. The creditworthiness ranges between 300 to 900 with 900 being the highest and 300 being the least. This score is computed with the help of the credit history of an individual.

Banks and most financial institutions prefer extending credit to an individual whose score is 750 and more. Individuals with good credit scores are less likely to default on their loan payments.

Credit report

The credit report contains the credit information that CIBIL fetches from various financial institutions. This detailed report contains information about an individual's history of borrowing and repayment routine, including defaults and delays.

The important parts of this report are credit Score, individual's personal information, employment details, contact information and account details.

Credit report for companies

Credit report for companies constitutes details about a company's credit history. The several segments in a company credit report speak about potential lenders, existing credit which the company has, any pending lawsuits and outstanding amount.

A good credit report is essential for approval of any loans, whereas a bad report could damage/reduce the chances of the loan being granted to the company.

Factors influencing a CIBIL score

Repayment History

Your CIBIL score would tell the loan providers if you are capable of dealing with the debt burden and whether you can repay the loan obligation. A repayment history with EMI defaults or late payments could negatively affect your credit score.

Credit Utilisation Ratio

This is another key factor that could impact your CIBIL score. Credit utilization ratio refers to the total amount of credit that you use against the total amount of credit that you've been authorized.

Financial experts suggest that individuals should try and keep the credit utilization ratio in the range of 25-30 % for maintaining a good CIBIL score report.

Excess Personal Loans/Credit Cards

Credit cards and personal loans both are unsecured loans. Too many credit cards and a high amount of personal loans with no secured loans such as an auto loan or home loan could have a negative impact on your CIBIL score.

So, if you have a balance of both the secured as well as unsecured loans, it might lead to a positive impact on the CIBIL score.

New Accounts

An increase in the number of credit cards and loans sanctioned to you imply a rise in your debt burden. In case numerous credit cards and loans are sanctioned over a short time period, your credit score would be negatively affected.

Building and preserving a good CIBIL score isn't rocket science, however, people tend to mess up their credit usage which does substantial harm to CIBIL scores. If you're mindful of your own physical health and do everything for keeping yourself healthy, maintain a financial discipline and you would find that your financial health is healthy too.

Credit Scores

A credit score is a number representative of an individual's financial and credit standing and ability to obtain financial assistance from lenders. Lenders use the credit score to assess a prospective borrower's qualification for a loan and the specific terms of the loan. Essentially, it is used to determine the borrower's ability to pay back the borrowed amount in due time. The credit score assessment is provided by a consumer credit reporting agency such as Equifax or TransUnion.

Who Uses Credit Scores?

Any organization that lends money as a source of business uses credit scores to assess the eligibility of a borrower. Such organizations specifically include banks, credit card companies, fintech-based lenders, insurance companies, landlords, government agencies, and mortgage companies.

It can be any individual or organization that seeks to lend someone money or enter into a contract that will require another party to pay them back in a predetermined time.

What is a Good Credit Score?

A credit score ranges from 300 to 850. The higher your credit score, the better your standing as a borrower is. A respectable credit score is above **670**.

How to Improve your Credit Score

1. Pay your bills on time

Paying off what is due on time consistently will establish your credibility as a borrower. Building your credit history takes time and steadily paying off what you owe in a timely manner is considered one of the biggest indicators of your creditworthiness.

For lenders, past behavioral patterns are considered key indicators of the future. Therefore, proving to lenders that you are capable of paying back on time helps improve your credit score.

2. Reduce your overall loan amounts

Proactively paying off more than what is due will ultimately help you showcase yourself as a credible borrower, who not only pays back, but who does so ahead of the due date. Doing that can also decrease any interest payments on borrowed funds.

For example, if you have the means to prepay your mortgage, then by doing so, you are coming across as a credible borrower and your credit score will improve.

3. Manage credit cards effectively:

Credit cards, if used diligently, are an excellent way to improve your credit score. Ideally, you should not spend more than 35% of your credit limit. Following this practice will help keep your total debt amount in check and also help ensure that you are able to easily pay back financing extended to you. Lenders specifically look at how much of your available credit you have actually borrowed. Again, to rate higher with lenders, it's a good idea to access no more than 35% of your available credit at any given time. So, for example, if you have a credit card with a $5,000 line of credit, you shouldn't allow your outstanding balance for that card to get above $1,700-$1,800.

4. Do not buy what you can't afford

As a golden rule, do not purchase things that you can't immediately pay off. While buying things on credit is convenient, if there is something you cannot afford immediately with the funds available to you, it is generally better to look in the other direction.

Maintaining financial health is all about making the correct decisions for yourself in the broad scheme of things and not indulging in impulse purchases that you may regret later.

Credit Repository of Large Clients

RBI has constituted a Central Repository of Information on Large Credits (CRILC) to collect, store, and publish data on all borrowers' credit exposures. Banks/Financial Institutions are expected to report findings to CRILC. Banks will have to provide credit information to CRILC about their borrowers with an aggregate fund-based and non-fund based exposure of and over Rs.5 Crores (Rs.50 million). Banks should also report the SMA status of their borrowers to the Central Repository of Information on Large Credits. As a way to impart knowledge about credit discipline, mainly regarding reduction in NPA level in banks, banks have been suggested to refer the information provided in CRILC instead of limiting the due carefulness to looking for NOC (No Objection Certificate) from the bank with whom the customer is availing credit facilities as per the presented declaration. The CRILC was built in 2014 precisely to help financial institutions and banks to assess their non-performing assets (NPAs) and also share this information with other institutions. The idea behind the creation of the CRILC was for financial institutions to notify the status of their stressed borrowers and submit the information to a central database of the Reserve Bank of India. There are also guidelines to separate borrowers as SMAs (Special Mention Accounts) of different levels to assess their probability of going delinquent. In January 2016, RBI imposed a fine of Rs.1 crore on the State Bank of Travancore (SBT) for violating some guidelines regarding the Central Repository of Information on Large Credits.

Account Aggregator

An Account Aggregator (AA) is a type of RBI regulated entity (with an NBFC-AA license) that helps an individual securely and digitally access and share information from one financial institution they have an account with to any other regulated financial institution in the AA network. Data cannot be shared without the consent of the individual. There will be many Account Aggregators an individual can choose between. Account Aggregator replaces the long terms and conditions form of 'blank cheque' acceptance with a granular, step by step permission and control for each use of your data.

The Account Aggregator system can make lending and wealth management a lot faster and cheaper.

Eight banks that have joined AA network

The individual's bank just needs to join the Account Aggregator network. Eight banks already have are- Axis, ICICI, HDFC, IndusInd Bank, State Bank of India, Kotak Mahindra Bank, IDFC First Bank, and Federal Bank.

How will the new Account Aggregator network improve an average person's financial life?

India's financial system involves many hassles for consumers today -- sharing physical signed and scanned copies of bank statements, running around to notarise or stamp documents, or having to share your personal username and password to give your financial history to a third party. The Account Aggregator network would replace all these with a simple, mobile-based, simple, and safe digital data access & sharing process. This will create opportunities for new kinds of services -- eg new types of loans.

Account aggregators that have received approval

Some of the account aggregators that have received approval from the RBI include CAMSFinServ, Cookiejar Technologies Pvt Ltd, FinSec AA Solutions Pvt Ltd and NSEL Asset Data Ltd, among others.

Can a consumer decide they don't want to share data?

Yes. Registering with an AA is fully voluntary for consumers. If the bank the consumer is using has joined the network, a person can choose to register on an AA, choose which accounts they want to link, and share their data from one of their accounts for some specific purpose to a new lender or financial institution at the stage of giving 'consent' via one of the Account Aggregators. A customer can reject the consent to share a request at any time. If a consumer has accepted to share data in a recurring manner over a period (eg during a loan period), it can also be revoked at any time later as well by the consumer.

How can a customer get registered with an AA?

You can register with an AA through their app or website. AA will provide a handle (like username) that can be used during the consent process.

Today, four apps are available for download (Finvu, OneMoney, CAMS Finserv, and NADL) with operational licenses to be AAs. Three more have received in-principle approval from RBI (PhonePe, Yodlee, and Perfios) and maybe launching apps soon.

CA Tirupati

Credit Guarantee Options

CREDIT GUARANTEE OPTIONS

1. Meaning of Credit Guarantee

A Credit Guarantee is a financial arrangement in which a third party provides assurance to a lending institution that a specified portion of a loan will be repaid if the borrower fails to repay it.

Credit guarantee schemes are generally established by governments or specialised institutions to encourage banks and financial institutions to provide loans to small businesses and entrepreneurs who may not have sufficient collateral security.

Small and Medium Enterprises (SMEs) often face difficulties in obtaining loans because they may not possess sufficient assets, financial records or credit history. Credit guarantee schemes help overcome this problem by sharing a portion of the credit risk with the lending institution.

Example: Suppose a small manufacturing business requires a bank loan of ₹10 lakh but does not have sufficient property to offer as security. Under an eligible credit guarantee scheme, a guarantee institution may cover a specified percentage of the lender's eligible loss if the borrower defaults. This encourages the bank to consider lending without requiring additional collateral, subject to its credit assessment and scheme conditions.

2. Meaning of Credit Guarantee Scheme (CGS)

A Credit Guarantee Scheme (CGS) is a programme designed to provide credit risk protection to banks and other lending institutions for loans granted to eligible businesses.

Under this scheme, a guarantee institution agrees to compensate the lender for a specified portion of the eligible loss if the borrower defaults. In return, the lender pays a guarantee fee according to the scheme's rules.

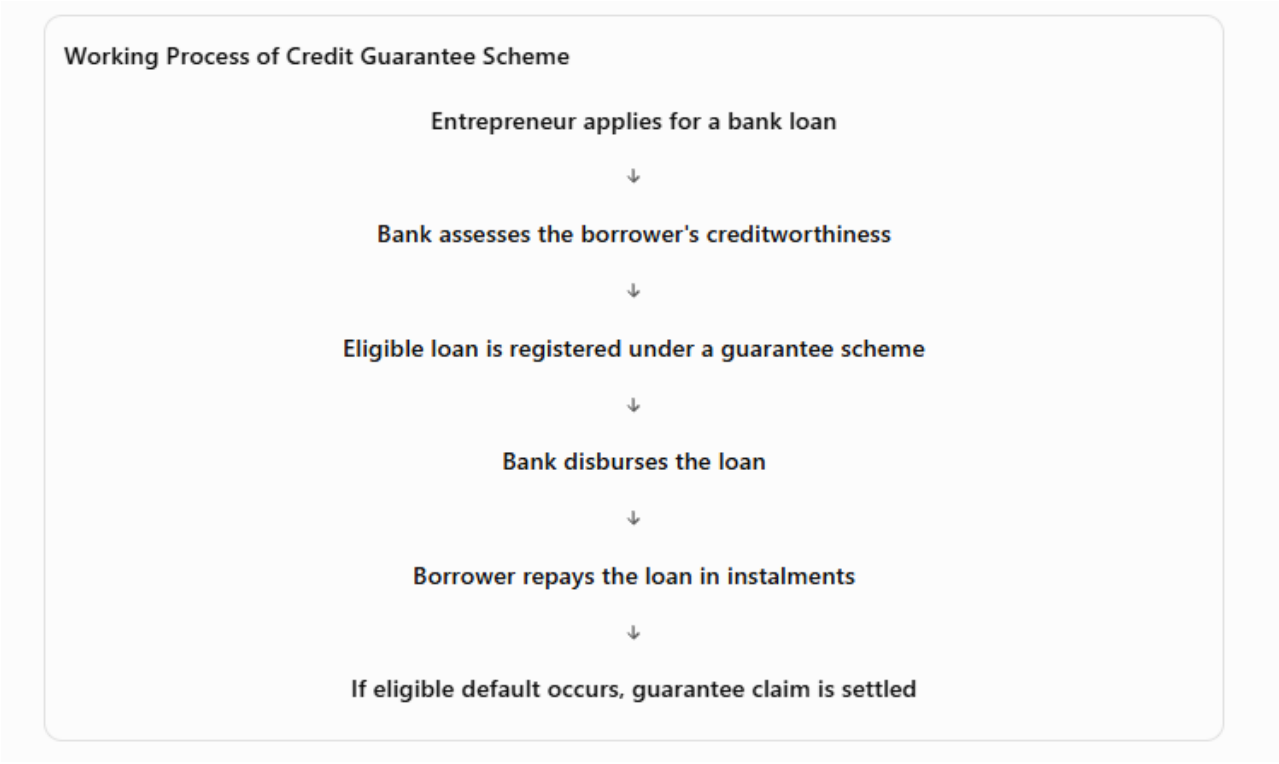
The main objective is to improve the availability of institutional credit to small businesses, especially those that cannot provide adequate collateral security.

3. How Does a Credit Guarantee Scheme Work?

The credit guarantee process generally involves the following steps:

1. Loan Application: An entrepreneur approaches a bank or financial institution for a business loan.
2. Credit Assessment: The bank examines the business proposal, repayment capacity, financial position and creditworthiness of the borrower.
3. Guarantee Scheme Selection: If the loan is eligible, the lender identifies an appropriate credit guarantee scheme.

4. Guarantee Registration: The lending institution submits the required application to the guarantee institution and pays the applicable guarantee fee.
5. Loan Disbursement: After completing the required procedures, the bank provides the loan to the entrepreneur.
6. Loan Repayment: The borrower repays the loan according to the agreed repayment schedule.
7. Claim Settlement: If the borrower defaults and the scheme's claim conditions are satisfied, the guarantee institution compensates the lender for the eligible guaranteed portion.



4. Important Principles of Credit Guarantee Schemes

The existing material identifies 16 principles developed to help governments establish, operate and evaluate public credit guarantee schemes for SMEs. These principles are grouped into four major areas.

A. Legal and Regulatory Framework

A legal and regulatory framework provides the foundation for establishing and operating a credit guarantee scheme. It defines the legal status, funding arrangements, ownership structure and supervisory responsibilities of the scheme.

1. Establish the CGS as an Independent Legal Entity

A credit guarantee scheme should be established as an independent legal entity. This gives the scheme a separate legal identity and allows it to manage its operations, enter into agreements and fulfil its financial obligations independently.

2. Provide Adequate Funding and Keep Sources Transparent

The scheme should have sufficient financial resources to meet its guarantee commitments. The sources of funds, government contributions and other financial support should be clearly disclosed to maintain transparency.

3. Promote Mixed Ownership and Treat Minority Shareholders Fairly

The ownership structure may include government, financial institutions and other eligible stakeholders. The rights and interests of minority shareholders should be protected to ensure fairness and balanced participation.

4. Supervise the CGS Independently and Effectively

The credit guarantee scheme should be supervised by an independent regulatory or supervisory authority. Effective supervision ensures that the scheme follows legal requirements, maintains financial discipline and operates responsibly.

B. Corporate Governance and Risk Management

Corporate governance and risk management ensure that the credit guarantee scheme is managed efficiently and that financial risks are properly controlled.

5. Clearly Define the CGS Mandate

The objectives and responsibilities of the scheme should be clearly defined. It should specify which businesses, lenders and credit facilities are eligible for guarantee support.

6. Set a Sound Corporate Governance Structure with an Independent Board of Directors

The scheme should have a proper management structure and an independent board of directors. The board is responsible for major policy decisions, monitoring performance and ensuring accountability.

7. Design a Sound Internal Control Framework to Safeguard Operational Integrity

The scheme should establish internal control procedures to prevent fraud, errors and misuse of funds. Proper documentation, auditing and approval procedures help maintain operational discipline.

8. Adopt an Effective and Comprehensive Enterprise Risk Management Framework

The scheme should identify, assess and control different types of risks, such as credit risk, operational risk and financial risk. Proper risk management helps the scheme remain financially sustainable.

C. Operational Framework

The operational framework explains how a credit guarantee scheme functions in practice. It includes eligibility conditions, guarantee coverage, pricing and claim settlement procedures.

9. Clearly Define Eligibility and Qualification Criteria for SMEs, Lenders and Credit Instruments

The scheme should clearly specify which businesses can receive guarantee support, which financial institutions can participate and which types of loans are eligible. This prevents confusion and ensures that benefits reach the intended beneficiaries.

10. Ensure the Guarantee Delivery Approach Balances Outreach, Additionality and Financial Sustainability

The scheme should reach a large number of eligible businesses while ensuring that it supports borrowers who may otherwise struggle to obtain credit. At the same time, it must maintain sufficient financial resources to continue its operations.

11. Issue Partial Guarantees That Comply with Prudential Regulation and Provide Capital Relief to Lenders

Credit guarantee schemes generally provide partial rather than complete protection to lenders. This ensures that banks continue to assess borrowers carefully and maintain responsibility for lending decisions.

12. Set a Transparent and Consistent Risk-Based Pricing Policy

The guarantee fee should be determined according to the risk associated with the borrower and the credit facility. The pricing system should be transparent, consistent and fair.

13. Design an Efficient, Clearly Documented and Transparent Claim Management Process

The scheme should establish clear procedures for submitting, examining and settling guarantee claims. Proper documentation and timely claim settlement help maintain the confidence of participating lenders.

D. Monitoring and Evaluation

Monitoring and evaluation help determine whether a credit guarantee scheme is achieving its objectives and maintaining financial sustainability.

14. Set Rigorous Financial Reporting Requirements and Externally Audit Financial Statements

The scheme should prepare accurate financial reports and conduct regular external audits. This helps ensure accountability and proper utilisation of funds.

15. Publicly Disclose Non-Financial Information Periodically

Important information such as the number of guarantees issued, beneficiary details, business categories supported and operational performance should be disclosed periodically.

16. Systematically Evaluate the CGS' Performance and Publicly Disclose the Findings

The scheme should regularly evaluate its performance by examining its financial position, guarantee claims, impact on lending and support provided to small businesses. The findings should be made available to the public.

5. Credit Guarantee Scheme in India – CGTMSE

In India, an important example of a credit guarantee arrangement is the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE).

CGTMSE was established jointly by the Government of India and the Small Industries Development Bank of India (SIDBI) to improve the availability of institutional credit to Micro and Small Enterprises (MSEs).

Its main objective is to encourage banks and other eligible financial institutions to provide loans to micro and small businesses without insisting on collateral security or third-party guarantees, subject to scheme conditions.

Important features of CGTMSE:

1. Collateral-Free Credit Support: It encourages eligible lenders to provide credit to eligible MSEs without requiring collateral security or third-party guarantees.
2. Support to Entrepreneurs: It helps new and existing micro and small enterprises, including first-generation entrepreneurs, obtain institutional finance.
3. Partial Credit Guarantee: CGTMSE covers a specified percentage of the lender's eligible loss. The percentage depends on the category of borrower and the applicable scheme conditions.

4. Participating Lending Institutions: Banks and other eligible lending institutions participate in the scheme.
5. Guarantee Fee: An applicable annual guarantee fee is paid for obtaining guarantee coverage.
6. Risk Sharing: It reduces the lender's exposure to credit risk, although the lender continues to be responsible for assessing the viability of the business.

Updated information: From 1 April 2025, the maximum eligible credit facility under the main CGTMSE scheme was increased to ₹10 crore per borrower. The actual guarantee coverage varies according to the applicable category and scheme rules.

Example: Suppose a small food-processing unit requires a bank loan of ₹8 lakh to purchase machinery. The entrepreneur does not have sufficient property to offer as collateral. The bank assesses the business proposal and, if the loan qualifies, registers it under CGTMSE. The guarantee provides the bank with partial protection against eligible losses if the borrower defaults. The entrepreneur remains responsible for repaying the full loan.

Remember: CGTMSE does not directly provide loans to entrepreneurs. The borrower applies to a participating bank or lending institution, and the lender obtains guarantee coverage under the scheme. It is not a loan waiver or subsidy.

6. Advantages of Credit Guarantee Schemes

1. Improves Access to Finance: Credit guarantee schemes help small businesses obtain loans even when they do not possess sufficient collateral security.

2. Encourages Entrepreneurship: These schemes support new entrepreneurs and encourage individuals to establish small businesses and self-employment activities.

3. Reduces Risk to Lenders: The guarantee institution shares a portion of the eligible credit loss with the lending institution, reducing its exposure to risk.

4. Promotes MSME Development: Small businesses can obtain finance for purchasing machinery, expanding production, purchasing raw materials and meeting working capital requirements.

5. Supports Employment Generation: Increased access to finance helps small enterprises establish and expand their operations, creating employment opportunities.

6. Promotes Financial Inclusion: Credit guarantee schemes help extend formal banking services to underserved businesses and entrepreneurs.

7. Encourages Bank Lending: By sharing credit risk, these schemes encourage financial institutions to consider eligible borrowers who may otherwise find it difficult to obtain loans.

7. Limitations of Credit Guarantee Schemes

1. Possibility of Loan Defaults: Even with guarantee coverage, borrowers may fail to repay loans, resulting in claims on the guarantee fund.

2. Financial Burden on Guarantee Institutions: If the number of defaults increases, the guarantee institution may face pressure on its financial resources.

3. Additional Administrative Procedures: Registration, documentation, verification and claim settlement may involve additional procedures for lenders.

4. Moral Hazard: If lenders depend excessively on guarantee protection, they may become less careful in evaluating loan applications. Partial guarantees and proper monitoring help reduce this problem.

5. Limited Awareness: Many small entrepreneurs may not know about available credit guarantee schemes and their benefits.

8. Conclusion

Credit guarantee schemes play an important role in improving the availability of finance to small and medium enterprises. They reduce the credit risk faced by lending institutions and encourage banks to provide loans to businesses that may not have sufficient collateral security. Proper legal arrangements, corporate governance, risk management, operational procedures and performance evaluation are essential for the success of these schemes.

Representative Chart: Four Areas of Credit Guarantee Principles

CREDIT GUARANTEE SCHEME (CGS)

16 Principles

A. Legal and Regulatory Framework

1. Independent legal entity
2. Adequate funding
3. Mixed ownership
4. Independent supervision

B. Corporate Governance and Risk Management

5. Clear mandate
6. Independent board
7. Internal controls
8. Risk management

C. Operational Framework

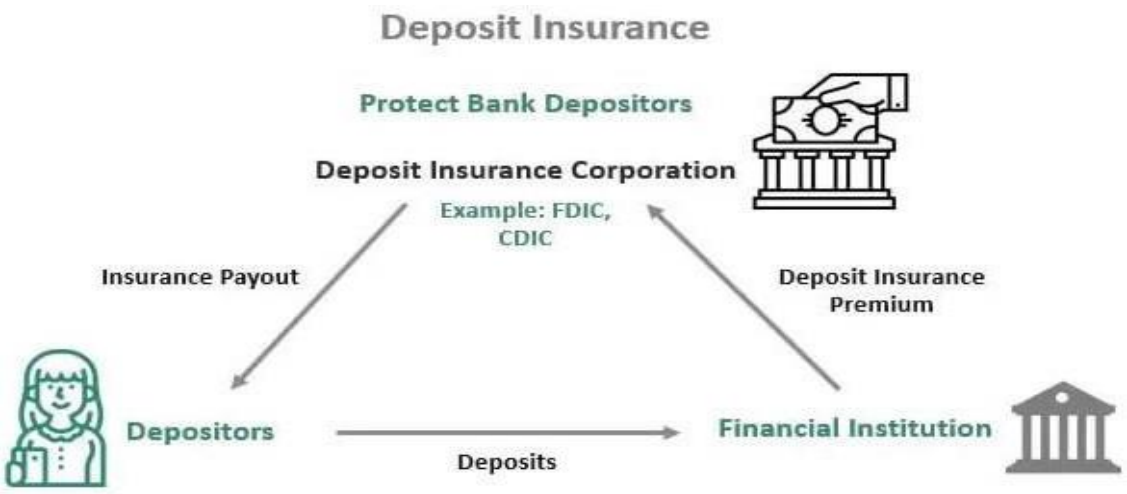
9. Eligibility criteria
10. Guarantee delivery
11. Partial guarantees
12. Risk-based pricing
13. Claim management

D. Monitoring and Evaluation

14. Financial reporting
15. Public disclosure
16. Performance evaluation

DEPOSIT INSURANCE

1) Deposit insurance is a type of insurance that protects depositors against loss in the event of a bank failure. It was first launched in the United States during the 1930s Great Depression to shield bank depositors from loss.



2. Meaning of Deposit Insurance

Deposit insurance is a financial protection system that safeguards bank depositors against the loss of their deposits when an insured bank fails, closes or becomes unable to repay its depositors.

Under this system, a specialised institution provides insurance protection up to a specified limit. It gives confidence to depositors that their money is protected to a certain extent, even if the bank faces financial difficulties.

In India, deposit insurance is provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC), which is a wholly owned subsidiary of the Reserve Bank of India (RBI). It operates under the Deposit Insurance and Credit Guarantee Corporation Act, 1961.

3. Objectives of Deposit Insurance

1. Protection of Depositors: The main objective is to protect depositors from losing their savings when an insured bank fails.

2. Maintaining Public Confidence: Deposit insurance creates confidence among people and encourages them to keep their savings in banks.

3. Promoting Financial Stability: It helps maintain stability in the banking system by reducing panic among depositors.

4. Preventing Bank Runs: It reduces the possibility of a large number of depositors withdrawing their money simultaneously due to fear of bank failure.

5. Encouraging Banking Habits: It motivates individuals to save their money through banking institutions rather than keeping large amounts of cash at home.

6. Supporting the Banking System: It acts as an important part of the financial safety net and helps maintain trust in the banking sector.

4. Deposit Insurance in India – DICGC

The Deposit Insurance and Credit Guarantee Corporation (DICGC) provides insurance protection to eligible bank depositors in India. It was established to strengthen the banking system and protect the interests of depositors.

DICGC collects insurance premiums from insured banks and uses the insurance fund to settle eligible claims when an insured bank fails or faces specified resolution situations.

Important features of DICGC:

1. Established Institution: DICGC is a wholly owned subsidiary of the Reserve Bank of India.

2. Legal Framework: It functions under the Deposit Insurance and Credit Guarantee Corporation Act, 1961.

3. Insurance Coverage: It provides deposit insurance up to ₹5 lakh per depositor per bank, including both principal and interest.

4. Insured Banks: It covers commercial banks, including foreign bank branches operating in India, regional rural banks, local area banks and eligible cooperative banks.

5. Compulsory Membership: Banks covered by the scheme cannot voluntarily withdraw from DICGC insurance.

6. Premium Payment: The insured banks pay the insurance premium to DICGC. Depositors do not directly pay this premium.

7. Depositor Protection: It protects eligible deposits when an insured bank is liquidated or placed under specified RBI restrictions, subject to applicable conditions.

5. Types of Deposits Covered Under DICGC

DICGC provides insurance protection to different types of eligible bank deposits.

1. Savings Bank Deposits: Money deposited in savings accounts maintained by individuals and other eligible customers.

2. Fixed Deposits: Money deposited for a fixed period at an agreed rate of interest.

3. Current Account Deposits: Balances maintained in current accounts by businesses, companies and individuals.

4. Recurring Deposits: Deposits made regularly, usually every month, for a specified period.

Deposits not covered under DICGC insurance:

- Deposits of foreign governments.
- Deposits of Central and State Governments.
- Inter-bank deposits.
- Deposits received outside India.
- Deposits specifically exempted under the applicable provisions.

Deposits raised by NBFCs, mutual funds, shares, bonds and cryptocurrencies are also not covered by DICGC's bank deposit insurance scheme.

6. Maximum Deposit Insurance Coverage

Under the DICGC scheme, each depositor is insured up to a maximum of ₹5,00,000 (Five Lakh Rupees) per bank, including both the principal amount and accrued interest.

The insurance limit is calculated by combining eligible deposits held by the same depositor in the same right and capacity in the same bank.

Important points:

1. The maximum insurance coverage is ₹5 lakh per depositor per bank.
2. Both principal and accrued interest are included within the ₹5 lakh limit.
3. Savings, current, fixed and recurring deposits are added together when held in the same right and capacity.
4. Deposits maintained in different branches of the same bank are combined.
5. Deposits held in two different insured banks receive separate insurance coverage.
6. Deposits held in different capacities, such as an individual account and a joint account, may be treated separately according to DICGC rules.

Example:

Suppose Mr. Ravi has the following deposits in different branches of the same bank:

Type of deposit	Amount
Savings Account	₹1,00,000
Fixed Deposit	₹3,00,000
Recurring Deposit	₹1,50,000
Total deposits	₹5,50,000

Although Mr. Ravi has deposited ₹5,50,000, the maximum amount insured by DICGC is ₹5,00,000. Therefore, the insurance protection is limited to ₹5 lakh.

If Mr. Ravi maintains eligible deposits of ₹5,50,000 in each of two different insured banks, the insurance limit is calculated separately for each bank.

7. How Does Deposit Insurance Work?

Deposit insurance works through a system in which insured banks pay premiums to DICGC, and DICGC provides insurance protection to eligible depositors.

The process can be explained through the following steps:

Step 1: Registration of Banks

Eligible banks are registered with DICGC under the deposit insurance scheme.

Step 2: Payment of Insurance Premium

Insured banks pay the prescribed insurance premium to DICGC. The premium is used to maintain the deposit insurance fund.

Step 3: Deposits by Customers

Customers deposit their money in savings accounts, current accounts, fixed deposits and recurring deposits maintained with insured banks.

Step 4: Bank Failure or Specified Restriction

If an insured bank goes into liquidation or is placed under specified RBI restrictions that prevent depositors from accessing their money, the insurance provisions become applicable.

Step 5: Preparation of Depositor Claims

The authorised liquidator or the bank, depending on the situation, prepares and submits the required depositor-wise claim information.

Step 6: Verification and Payment

DICGC verifies the claims and arranges payment of the eligible insured amount, subject to the maximum insurance limit and applicable procedures.

Step 7: Payment to Depositors

Eligible depositors receive the insured amount through the prescribed process.

8. Advantages of Deposit Insurance

1. Protection of Small Depositors: Deposit insurance protects small depositors from losing their entire savings when an insured bank fails.

2. Increases Public Confidence: People feel more secure about depositing their money in banks because a portion of their deposits is insured.

3. Prevents Bank Runs: It reduces panic withdrawals by assuring depositors that eligible deposits are protected up to the prescribed limit.

4. Promotes Financial Stability: It contributes to the stability of the banking system and reduces the possibility of financial disturbances.

5. Encourages Savings: People are encouraged to save money through banking institutions rather than keeping cash at home.

6. Strengthens the Banking System: It improves public trust in banking institutions and supports the smooth functioning of the financial system.

7. Supports Economic Development: Increased confidence in banks encourages savings and helps banks mobilise funds for lending and investment.

9. Disadvantages of Deposit Insurance

1. Moral Hazard: Banks may be encouraged to take excessive risks because depositors are protected up to the insurance limit. This problem can arise if banks do not maintain proper risk management.

2. Reduced Depositor Monitoring: Depositors may pay less attention to the financial condition and risk-taking activities of banks because their eligible deposits are insured.

3. Financial Burden on Banks: Banks must pay insurance premiums to DICGC, which increases their operating expenses.

4. Limited Insurance Coverage: The maximum insurance limit is ₹5 lakh per depositor per bank. Deposits exceeding this limit may not be fully protected.

5. Possibility of Mismanagement: If banking institutions take excessive risks, deposit insurance alone cannot prevent financial failure.

6. Dependence on Regulatory Supervision: Deposit insurance cannot independently guarantee the safety of the banking system. Effective supervision and regulation by authorities are also necessary.

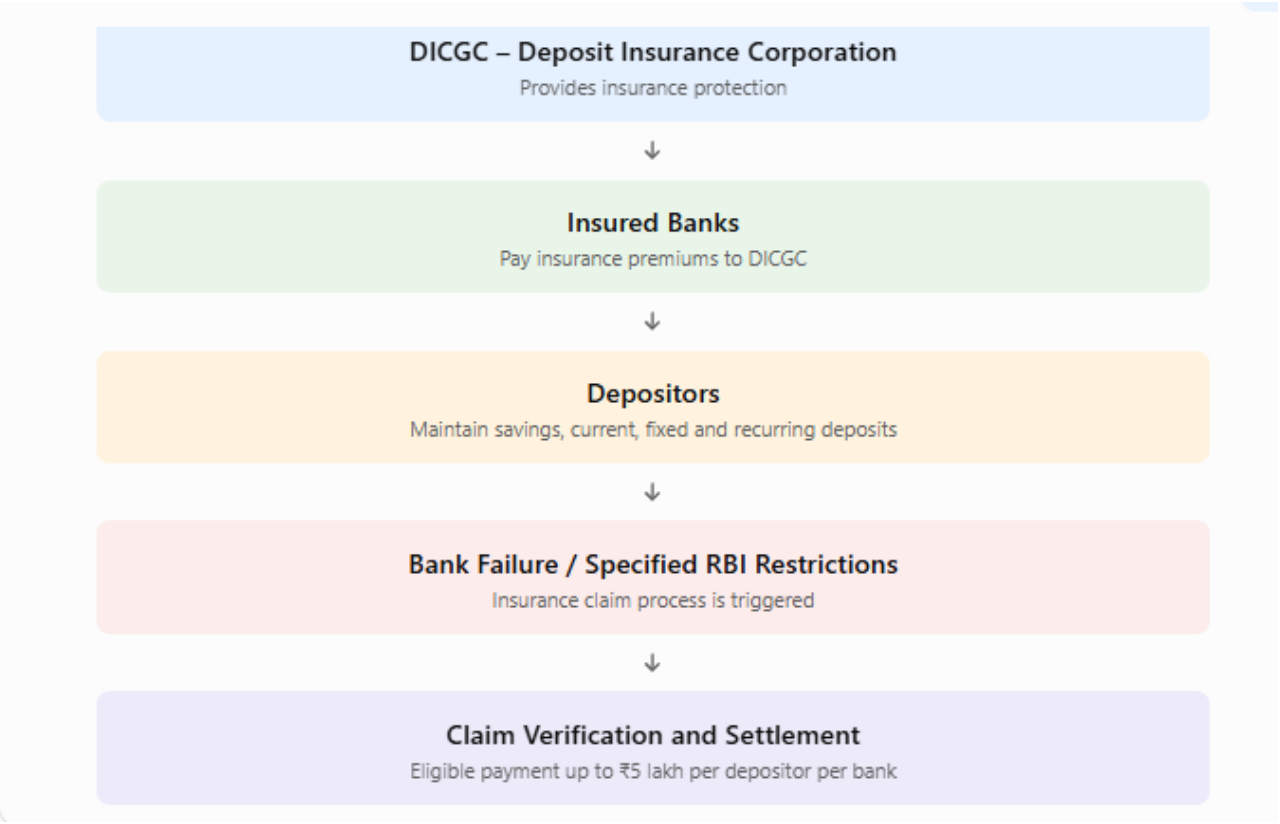
10. Difference Between Deposit Insurance and Credit Guarantee

Although both concepts are associated with financial protection, they serve different purposes.

Basis	Deposit Insurance	Credit Guarantee
Meaning	Protects eligible bank depositors against loss	Protects lenders against a portion of credit losses

Beneficiary	Bank depositors	Banks and other eligible lending institutions
Main purpose	Protect depositors' savings	Encourage lending by reducing credit risk
Situation	Bank failure or specified resolution situations	Borrower defaults on a guaranteed loan
Example	DICGC	CGTMSE

11. Representative Chart – Working of Deposit Insurance



12. Conclusion

Deposit insurance is an important mechanism for protecting bank depositors and maintaining public confidence in the banking system. In India, DICGC plays a significant role by providing insurance coverage up to ₹5 lakh per depositor per bank, including principal and interest. It helps reduce the fear of losing savings due to bank failure and contributes to financial stability.

Official reference: DICGC – A Guide to Deposit Insurance and DICGC – Frequently Asked Questions.

Supervisory College

Meaning of Supervisory College

A Supervisory College is a permanent but flexible arrangement in which banking regulatory and supervisory authorities from different countries come together to exchange information, coordinate activities and supervise an international banking group.

It mainly involves the cooperation between the home-country supervisor and host-country supervisors of a bank that operates in more than one country.

For example, if an Indian bank establishes branches or subsidiaries in the United Kingdom, Singapore and other countries, the banking regulators of those countries may cooperate with the bank's home supervisor to understand its overall financial position, risks and operations.

The Basel Committee on Banking Supervision recognises supervisory colleges as an important mechanism for improving the supervision of internationally active banks.

Bank for International Settlements+1

Meaning of Home Supervisor and Host Supervisor

Home Supervisor:

The home supervisor is the regulatory authority responsible for supervising the parent bank or banking group on a consolidated basis. It examines the overall financial position, activities, risks and performance of the banking group.

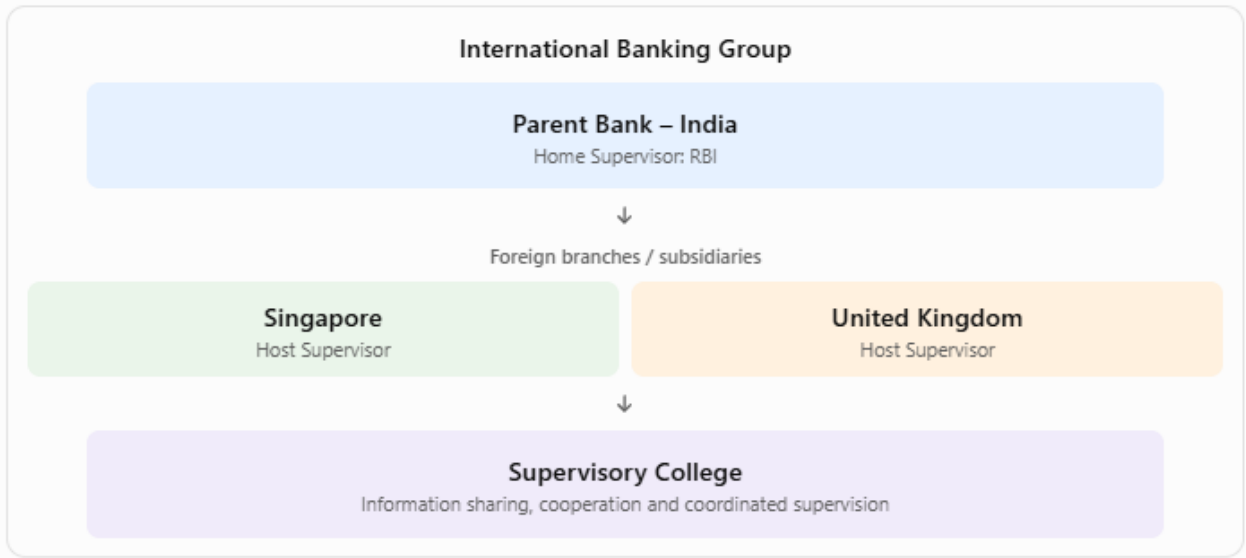
Host Supervisor:

The host supervisor is the regulatory authority responsible for supervising the foreign branches or subsidiaries of an international bank operating within its country. It monitors the activities and financial condition of the bank's local operations.

Example:

Suppose ABC Bank is headquartered in India and operates branches in Singapore and the United Kingdom.

- RBI acts as the home-country banking supervisor for the Indian bank.
- The banking regulatory authorities in Singapore and the United Kingdom act as host supervisors for the bank's operations in their respective countries.



Note: This is an illustrative example of home-host supervision, not a description of a particular bank's actual supervisory college.

Objectives of Supervisory College

1. Effective Supervision: The main objective is to improve the supervision of banks that operate in multiple countries. It helps regulatory authorities understand the overall activities of international banks.

2. Information Sharing: It provides a platform for home and host supervisors to exchange important information about the bank's financial condition, risks and operations.

3. Understanding Risk Profile: It helps supervisors understand the overall risk profile and vulnerabilities of an international banking group.

4. Coordination Among Regulators: It improves coordination between regulatory authorities from different countries and avoids gaps in supervision.

5. Financial Stability: It supports the stability of the banking system by identifying potential financial problems at an early stage.

6. Crisis Management: It helps supervisors communicate and cooperate during financial emergencies and prepare suitable responses to banking crises.

7. Consistent Supervision: It encourages a coordinated approach to supervising different branches and subsidiaries of the same banking group.

Functions of Supervisory College

1. Exchange of Financial Information

Supervisory colleges facilitate the exchange of information relating to the financial position of international banks. This includes financial statements, capital adequacy, liquidity position and other important financial details.

2. Assessment of Banking Risks

They help supervisors understand different risks faced by international banks, such as credit risk, market risk, operational risk and liquidity risk. This information supports better supervisory assessment.

3. Coordination of Supervisory Activities

Supervisory colleges help different regulatory authorities coordinate their supervisory activities. They may plan joint assessments, discuss important findings and coordinate examination activities wherever appropriate.

4. Monitoring International Banking Operations

They help supervisors understand the activities of foreign branches and subsidiaries and examine how the operations of one country may affect the overall banking group.

5. Crisis Preparedness

Supervisory colleges support the preparation of crisis management plans. They facilitate communication among supervisors during periods of financial stress and help authorities understand possible risks to the banking group.

6. Communication Among Regulators

They provide a structured platform for regular communication through meetings, video conferences, telephone discussions, emails and secure online communication systems.

Information Shared in Supervisory Colleges

Supervisory colleges exchange different types of information to understand the financial condition and risk exposure of international banks.

Information shared	Explanation
Supervisory risk	Information about the risks identified by regulatory authorities

assessments	
Stress-test results	Results showing how banks may perform under difficult economic conditions
Crisis preparedness plans	Plans prepared to handle financial emergencies
Capital position	Information about the bank's capital strength and capital requirements
Liquidity position	Information about the availability of funds to meet financial obligations
Strategic plans	Future business plans and expansion strategies of the banking group
Regulatory developments	Changes in banking regulations and financial policies in different countries

These details help supervisors develop a better understanding of the bank's overall risk profile and financial condition.

Structure and Organisation of Supervisory College

A supervisory college generally includes the following participants:

1. Home Supervisor: The regulatory authority responsible for supervising the parent bank and the overall banking group.

2. Host Supervisors: Regulatory authorities responsible for supervising foreign branches and subsidiaries operating in their respective countries.

3. Supervisory Representatives: Officials and experts who participate in meetings, discussions and information-sharing activities.

4. Bank Representatives: Representatives of the international banking group may participate in relevant discussions and provide information when required.

5. Communication Mechanism: Supervisors use meetings, video conferences, emails and secure websites to exchange information.

The structure of each supervisory college may differ depending on the size, complexity, international operations and risk profile of the banking group.

Importance of Supervisory College

1. Improves International Cooperation: It develops better relationships among banking regulators from different countries.

2. Reduces Information Gaps: It helps supervisors obtain information about the activities of foreign branches and subsidiaries.

3. Strengthens Risk Management: It helps identify financial risks and weaknesses in international banking operations.

4. Supports Better Decisions: Information shared among supervisors helps them make informed supervisory decisions within their respective legal responsibilities.

5. Improves Crisis Response: It provides a communication framework for handling financial emergencies.

6. Protects Financial Stability: It supports the stability of the international banking system by encouraging effective supervision.

7. Avoids Duplication of Work: Coordination helps supervisory authorities plan their activities more efficiently and reduce unnecessary duplication.

Advantages of Supervisory College

- Promotes cooperation between international banking regulators.
- Improves information sharing and communication.
- Helps identify risks in international banking operations.
- Strengthens consolidated supervision of banking groups.
- Supports preparation for financial crises.
- Encourages consistent supervisory approaches.
- Improves understanding of international banking activities.

Limitations of Supervisory College

1. Differences in Regulations: Different countries follow different banking laws and regulatory requirements, which may create difficulties in coordination.

2. Confidentiality Issues: Sharing confidential banking information between countries may involve legal restrictions and confidentiality concerns.

3. Communication Problems: Differences in language, time zones and communication systems may affect the smooth exchange of information.

4. Coordination Difficulties: Supervisory authorities may have different priorities and approaches towards banking supervision.

5. Limited Decision-Making Power: A supervisory college generally acts as a platform for cooperation and discussion rather than as a single decision-making authority. Individual regulators retain their legal responsibilities.

6. Complex International Operations: Supervising large banking groups with several branches and subsidiaries can be difficult because of their size and complexity.

Practical Example of Supervisory College

Suppose ABC International Bank is headquartered in India and operates branches in Singapore, the United Kingdom and Dubai.

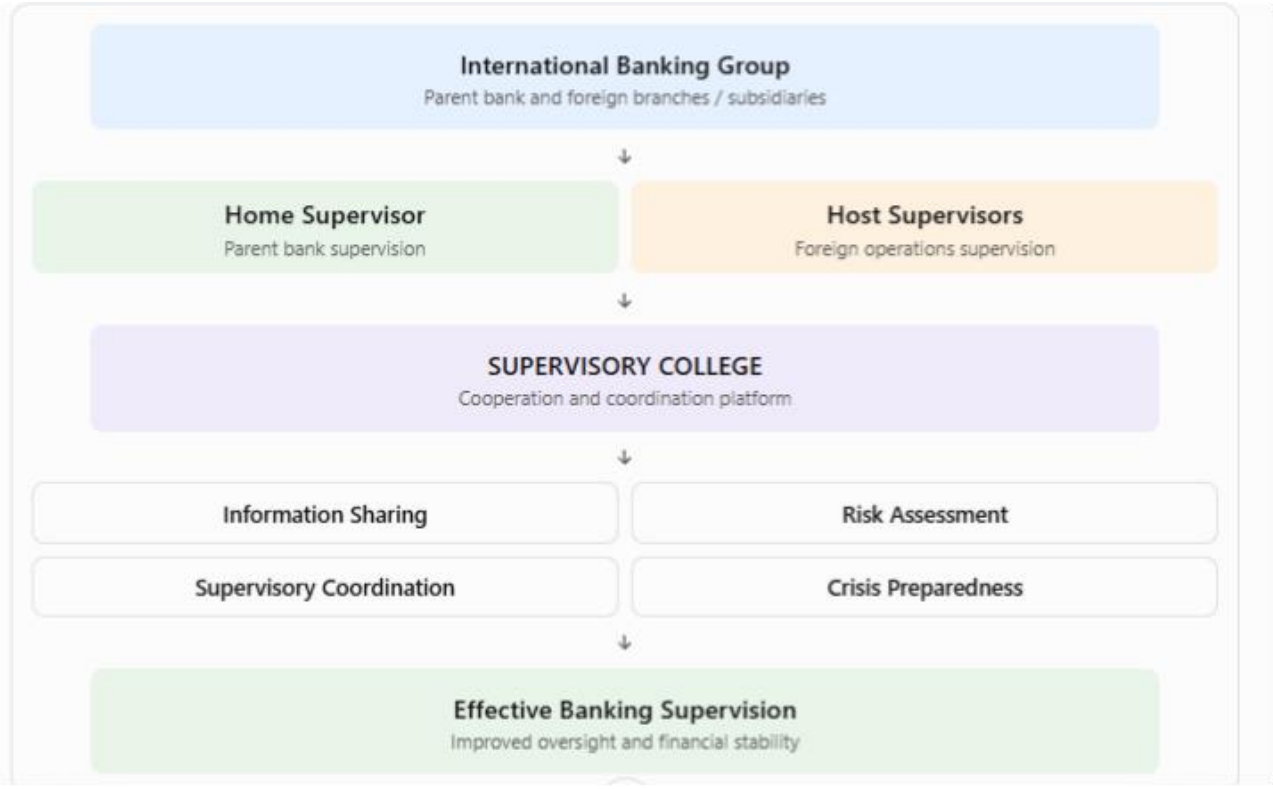
The bank provides loans, accepts deposits and offers financial services in all these countries. A financial problem in one country may affect the entire banking group.

To supervise the bank effectively:

1. RBI, as the home supervisor, monitors the overall banking group.
2. The regulatory authorities in Singapore, the United Kingdom and Dubai monitor the bank's local operations.
3. These authorities exchange information about the bank's financial position, capital, liquidity and risk exposure.
4. They discuss the results of stress tests and possible financial problems.
5. They coordinate supervisory activities and prepare for possible financial emergencies.

Through this arrangement, the regulatory authorities can develop a better understanding of the bank's overall operations and improve its supervision.

Representative Chart – Working of Supervisory College



Conclusion

A supervisory college is an important mechanism for improving the supervision of international banking groups. It brings together home and host supervisors to exchange information, assess risks, coordinate supervisory activities and prepare for financial emergencies. It strengthens cooperation among regulatory authorities and supports the stability of the international banking system.