BANKING AND FINANCE

Banking is the backbone of commerce and industry. A ‘Bank’ is a comprehensive term for a number of institutions carrying on certain kinds of financial business, dealing in money. It buys and sells money in the same way as a trader buys goods for resale at a profit. Similarly banks buy money from depositors and sell i.e. lend it to the borrowers. Besides that banks also provide facilities for exchange and transmission of funds etc.

In India, the banking system is carried on both on indigenous as well as on western lines. Under indigenous system, a seth, mahajan, baniya or a sahukar acts as a banker. They have been catering to the credit requirements of people since time immemorial. Under western system, the Reserve Bank of India controls all the commercial banks, savings banks, co-operative banks, industrial banks, exchange banks, etc.

After independence, banking in India began to grow very rapidly because our country took to the path of planned economic growth. The State Bank of India was formed in 1955 to fulfill the financial needs of people. The Government of India nationalized the 20 large commercial banks to give a boost to the economy and thus speed up the rate of economic development. Nationalization of banks has changed the entire concept of banking industry in India. Banks now promote capital formation by encouraging people to deposit their surplus money with them so as to earn attractive rates of interest offered by them. They also facilitate industrial and commercial development by providing finance under attractive schemes.

TYPES OF BANKS:

The banks are classified as under:

1) Commercial banks
2) Saving banks
3) Land development banks
4) Cooperative banks
5) Industrial banks
6) Exchange banks
7) Mixed banks
8) Export Import Bank of India

1) Commercial banks:

A bank which accepts demand deposits and allows withdrawal of money by cheques or by any other means is a commercial bank. However, nowadays, a commercial bank performs many other functions, such as, providing finance for trade, industry and commerce, transferring money from one place to another etc.

Function or services of Commercial Banks:

i) **Services to depositors:** Banks provide a means for saving money, i.e. by accepting money on deposits or saving accounts on which a reasonable interest is paid. They provide the following facilities to their customers:

a) Collect the amount of cheques, demand drafts, bills of exchange, hundis, local and foreign bills on behalf of their depositors.
b) They offer discounting facilities in respect of local and foreign bills of their depositors.
c) They also pay insurance premium, subscription and taxes on behalf of their depositors, if so desired.

ii) **Sevices by way of loans:** The commercial banks lend money to their customers in the following way:
a) Overdraft
b) Cash credit
c) Loans
d) Discounting of bills

a) Overdraft: Under this scheme, a customer is allowed to draw cheques even if there is no balance amount standing to the credit of his account, i.e. permitting him to overdraw on his account. Banks, however, fix a limit for the customer beyond which there can be no further overdrawing. For example, a customer has Rs. 20,000 standings to his credit and he issues cheques for Rs. 50,000, he would be said to have overdrawn an amount of Rs. 30,000. The customer is required to pay interest at a specified rate on the amount of Rs. 30,000 on daily basis.

The overdraft facility is, however, allowed only against some security, but in some cases, the personal security of the customer may be adequate.

b) Cash credit: Under this scheme, a bank fixes a limit upto which a customer may borrow money from it against some security. The cash credit account of customer is operated on a regular basis. He borrows money when he needs it and he repays it when he is able to do so. An interest is charged by the bank on the outstanding amount in a cash credit account.

c) Loans: When a bank advances a certain sum to a customer against some security or mortgage, it is called a loan. The loan is not generally granted on long term basis.

d) Discounting of bills: Under this scheme, the banks encash their customer’s bill before they become due for payment. For this service the bank charges a nominal discount.

iii) Miscellaneous services: In addition to above services, a bank provides a number of other services, such as,

- It buys and sells shares/bonds/debentures on behalf of its customers.
- It accepts its customer’s valuable articles, such as jewellary, securities, shares, other important documents for safe keeping in its strong room meant for this purpose. A strong room provides a large number of cupboards of different sizes called lockers for safe keeping of belongings of customers.
- It collects interests/dividend on securities and shares belonging to its customers.
- It makes regular payment of subscription, insurance premium, taxes etc. on behalf of its customers.

- A bank undertakes credit transfer from one branch to another.
- It accepts and pays bills of exchange in respect of imported goods and also purchases bills of exchanges drawn by exporters on a foreign importer.
- It helps people going or planning to go abroad by arranging for them foreign exchange or providing traveller's cheques and letters of credit.
- It provides assistance and also advises the customers in regard to investment and other financial matters.

2) Saving banks:

In India, there are hardly any independent saving banks. The post office and commercial banks have a separate arrangements to deal with savings of people under 'Postal Saving Bank' and 'Saving Bank Section' respectively.

The main aim of a savings bank is to encourage the habit of thrift among people, so that they are able to save money for their various future needs. These banks introduce a number of attractive schemes so as to encourage people to save money. The savings bank have a one point programme, namely to mobilise people's savings and invest them in profitable business. The profit earned on that is utilized to pay interest on the savings of its customers. These banks do not undertake other functions usually performed by commercial banks.

3) Land development banks:

They are also known as Land Mortgage Banks. These banks have been set up to provide a long term credit to farmers at reasonable rates of interest. The recovery of loan is made in easy instalments spread over a number of years.

These banks were established in India before independence, but they have made rapid progress after independence. However, this progress is limited only to a few states, such as Tamil Nadu, Andhra Pradesh, Karnataka, Maharashtra and Gujarat.

4) Cooperative banks:

These banks are organized on the principle of cooperation. These banks collect their capital by selling shares to the public and by accepting deposits from their members and others. They also receive loans and grants from the Government and Central Cooperative Banks.

Cooperrative banks are organized on a three tier pattern:

a) Primary credit societies
b) District central cooperative banks
c) State cooperative banks

The primary credit societies are organized at the village level, central cooperative banks are organized at the district level and state cooperative banks are organized at the state level. These banks provide short term finance to farmers and small scale industrial units.

The primary credit societies provide loan to farmers. They get loans from district cooperative banks. The central cooperative banks perform all the functions of a commercial bank. Their capital consists of their own share capital, deposits received from members and others, and loans from state cooperative banks. The state cooperative banks have their headquarters in the capital of the respective state. They manage and ccotrol all district cooperative banks under them. The capital of state cooperative banks consists of their own share capital, loans from the Reserve Bank of India, deposits and loans received from its members and other individuals and institutions.

5) Industrial banks:

These banks provide medium and long term loans to industrial concerns. The Government of India has set up a number of specialized instituions which provide loans to industrial concerns. These are:

i) Industrial Finance Corporation of India
ii) Industrial Credit Investment
iii) National Small Scale Industrial Corporation
iv) Industrial development Bank of India

Similarly, state governments have also set up their own financial corporation to meet the credit requirements of industrial concerns in their respective states.

The institutions like Life Insurance Corporation and Unit Trust of India also provide term finance to industrial concerns.

6) Exchange banks:

These banks are mainly concerned with buying and selling of foreign exchange and for providing finance to the import and export trade. The main functions of these banks are as under:

a) They help to transfer foreign exchange arising out of international trade through bills of exchange. The transfer of foreign exchange is usually done by telegraphic transfer, under which a bank in one country instructs a bank in a foreign country to pay a specific amount of foreign currency to a particular person or firm.
b) They perform the hedging functions where exchange risks are involved. Normally it is done when conversion of one currency into another is subject ro fluctuation in value.
c) They also provide finance to domestic trade and perform several other functions associated with commercial banks.
d) They provide credit by discounting of bills of exchange, so as to enable the importer to take the possession of goods, sell them and be in a position to pay the bill on the due date. The bill of exchange is normally for a period of three months.

7) Mixed banks:

These banks represents a mixture of commercial and industrial banks. The aim of a commercial bank is to provide short-term finance, while an industrial bank provides long term finance to industrial concerns. As such, mixed banks provide the facility of both short term finance and long term finance to industrial concerns.

8) Export Import Bank of India:

The EXIM Bank of India was launched on 1st January, 1982 with the object of promoting finance and facilitating the export and import of goods and services to promote the country's international trade and commerce. The bank is wholly owned by the Government of India. The main functions of the bank are as under:

a) To act as a principal office for coordinating the activities of various institutions engaged in financing international trade.
b) To issue or participate in guarantees in association with commercial banks.
c) To give financing and rediscounting facilities to commercial banks.

FINANCIAL PLANNING:

Finance is the life blood of any business. For smooth functioning of a business enterprise, finance is required. Finance is defined as the provision of money at any time when the business requires it. The purpose of financial planning is to ensure that adequate funds are available to the business firm for its proper utilization and administration.

There are three main aspects of financial planning:

a) Estimating the amount of capital to be raised for smooth running of business.
b) Determining the form and the proportionate amount of securities to be raised.
c) Laying down effective policies for proper administration of financial plans.

The financial policies should cover the following points:

i) The total finance required for business.
ii) The proper utilization of funds.
iii) Controlling and handling the activities of financial collection and repayment.
iv) The determination of profit and its proper utilization.
v) Decision regarding the terms and conditions for the funds to be collected.
vi) The ways and means necessary for achieving targets of financial planning.

The success of an organization mainly depends on its sound financial policies which have the following essential characteristics:

- It should be flexible.
- It should be economical.
- It should provide for sufficient cash in hand.
- It should provide for maximum utilization of funds raised in business.
- It should not fail under any circumstances.

Types of Finance:

The financial requirements of a business are mainly of two types:

1) Fixed capital
2) Working capital

1) Fixed capital:

The fixed capital of a business is invested in permanent assets, such as, land and building, plant and machinery, furniture, fixtures etc. These assets are required in a business in order to carry on its activities. A business may meet its fixed capital requirements from a number of sources, such as,

i) Issue of shares
ii) Issue of debentures
iii) Ploughing back its own profits
iv) Public deposits
v) Loan from specialized institutions
vi) Term loans from banks etc.

2) Working capital:

The working capital is required by a business for the purchase of raw materials and for meeting day to day expenses such as wages, salaries, rents, taxes, interest etc. The working capital is also known as the revolving or circulating capital because it is invested, recovered and reinvested repeatedly during the life time of the business.

The working capital is of two types:

a) Permanent or fixed working capital
b) Variable working capital

a) Permanent or fixed working capital:

It is always necessary for a business to maintain a certain minimum level of stock of raw materials and finished goods and to pay regular expenses, such as wages, salaries, rent, interest etc. The permanent working capital is also needed immediately after the establishment of a new business.

b) Variable working capital:

The amount of variable working capital requirement depends on the particular purpose for which it is needed for the business. For example, if there is a sudden increase in the volume of business, further working capital is required to meet the demands of the business.

The working capital is raised from the following sources:

i) Issue of shares
ii) Issue of debentures

iii) Ploughing back its own profits
iv) Public deposits
v) Commercial banks
vi) Specialized financial institutions

Source of Finance:

Basically, there are two methods of raising capital for any business enterprise:

a) Owned capital
b) Loan capital

a) Owned capital:

It is contributed by the owner, i.e. sole proprietor, partners, shareholders etc. It remains invested in the business so long as the business continues to exist. The return of such capital is dependent on the availability of surplus capital to be distributed.

b) Loan capital:

It may be raised from individual banks or financial institutions. It involves periodical payments of interest at a fixed rate and repayment of loan capital after the expiry of the stipulated period. The loan capital is available only against mortgages or the pledge of the property of the borrower.

The source of finance can be classified into three parts on the basis of duration for which it is required by the business. These are:

i) Long term finance
ii) Medium term finance
iii) Short term finance

i) Long term finance:

It remains invested in the business for a considerable long term period, i.e. ten years or more. The long term finance is often invested in fixed assets, such as, land, building, plant, machinery etc. It may be raised through the following sources:

- Shares
- Debentures
- Ploughing back of profit
- Financial institutions

- **Shares:** In a small scale business, the whole of the capital required by the business is invested by the owner. But on a large scale business, the ownership shares are issued to the public. The capital required by the business is divided into a large number of equal parts and each part is considered as a share.

  Shares are of two types:

  I) Preference shares

II) Ordinary shares

I) Preference shares:

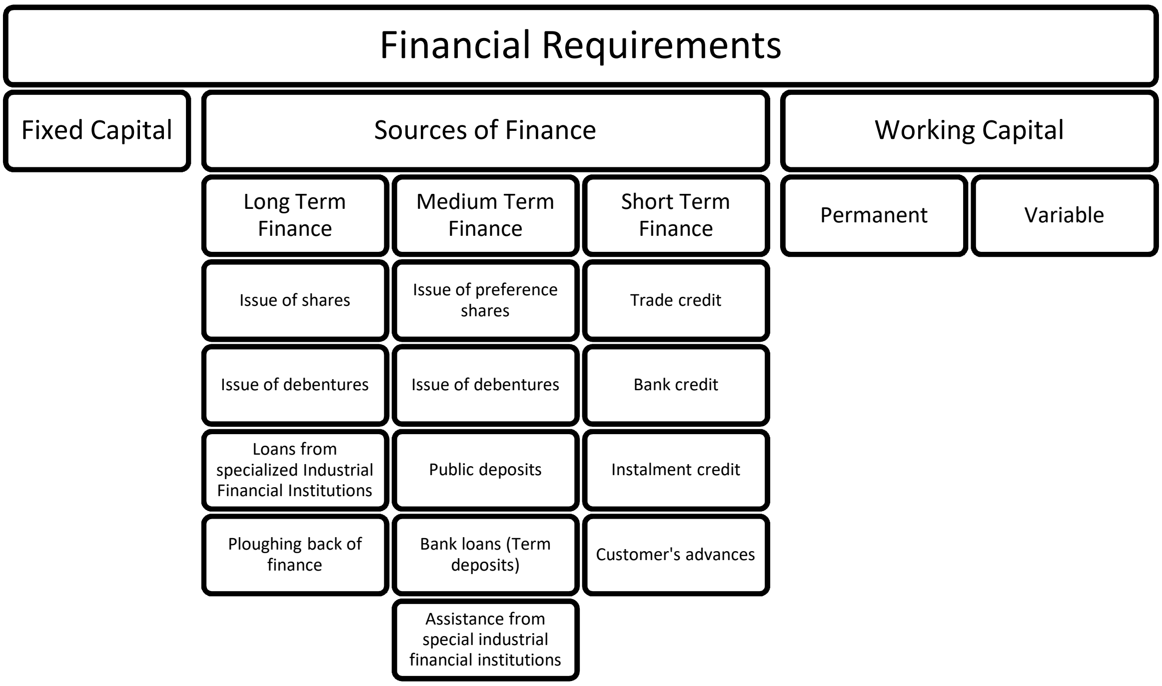
Preference shares are those which carry a preference both regarding dividend and the return of the capital. These shares are preferred by those people who do not like to risk their capital completely and yet want an income which is higher than that if invested in some other schemes. The preference share holders get a fixed dividend from the profits and the remaining profit is divided among the ordinary shareholders. The preference shareholders get a fixed dividend in case of winding up of the organization.

II) Ordinary shares:

These are also known as 'Equity shares'. The ordinary shareholders are the real owners of the organization because the company shareholders are the real owners of the organization because the company is controlled by them. These shareholders have voting rights to elect the directors of the company. The dividend on these shares is paid after the dividend on the preference shares has been paid. These shareholders have a risk because they get their claim only after the clearance of all other claims. These shareholders are generally paid a higher rate of dividend. The rate of dividend on such shares depends upon the amount of profits available and the policy of the directors the company in this regard.

- **Debntures:** A debenture is a document or certificate issued by the company acknowledging loan and also gives an undertaking to repay the specified borrowed sum along with interest to the debenture-holder on a prescribed date. The debenture holders are the creditors and not shareholders. They carry no voting rights. An interest on a debenture is payable periodically until the debenture matures. A debenture carries a fixed rate of interest.
- **Ploughing back of profits:** It means to re-invest the profit in the business. The profit earned by the business organization is not distributed or only partially distributed among the ordinary shareholders or partners. The money which is saved in this manner is re-invested in the business. This fund is generally known as 'Reserve Fund'.

Chart Showing Various Sources of Finance and Type of Financial Requirements



- **Financial Institutions:** There are various financial institutions which have been set up by the center and state governments to provide long-term and medium-term finance to industrial concerns. These institutions charge a fixed low rate of interest.
  The various financial institutions are:

  a) **Industrial Finance Corporation of India (IFCI):** It was established in July 1948, with the objective of rendering financial assistance to industrial concerns (Public limited companies and cooperative societies) for a period not exceeding 25 years.

  b) **Industrial Development Bank of India (IDBI):** It was established in July 1964, with the aim to coordinate, regulate and supervise the activities of other financial institutions such as, IFCI, ICICI, UTI, LIC, and commercial banks. It also provides direct financial assistance to industrial concerns by providing loan on long term basis.

  c) **Industrial Credit and Investment Corporation of India (ICICI):** It was established in January 1955 to provide medium and long-term financial assistance to industrial units in the private sector.

  d) **Industrial Reconstruction Bank of India (IRBI):** It was established on 20th March, 1985 with an aim to nurse the sick industrial units by providing soft term loan to them.

  e) **National Small Industrial Corporation (NSIC):** It was established in February 1955 as a private limited company with the main object to promote and protect the small industries by providing to them financial assistance for the purchase of machinery and equipment.

  f) **State Financial Corporations:** These were established under the State Financial Corporation Act 1951. The main objective was to provide financial assistance in the form of loans and advances and direct subscription of shares, stocks, debentures and bonds.

  g) **State Industrial Development Corporations (SIDCs):** A number of state governments have established their own industrial development corporations to accelerate the growth of industries in their respective states. They grant loans and advances to the industries. They also subscribe to the shares and debentures of industrial concerns.

h) **Unit Trust of India (UTI):** It was established in 1964. The basic objectives of UTI is:
   - ➔ To stimulate and pool together the savings of people belonging to middle and low income groups.
   - ➔ To enable the investors to share the benefits of investment in the overgrowing number of industrial concerns in the country.

ii) **Medium term finance:**

It remains invested in the business for a period between 3 to 10 years. Medium term finance is generally used to implement expansion, extension or modernization programmes of a business. It may be raised through preference shares, debentures, term loans from banks, financial institutions (already discussed in the long term finance) and public deposits.

- **Public deposits:** The undertaking which intends to raise public deposits approaches the public through an advertisement in the press. The advertisement highlights the achievement of the company and its future plans and invites investors to deposit their saving with it. Generally, money is borrowed for 1 to 3 years and the rate of interest on borrowed sum depends upon the length of period of deposit. The interest is paid periodically or at maturity alongwith the amount of deposit.
- **Mortgages:** It is a secured loan borrowed from a bank, insurance company or any other similar agencies. The loan is sanctioned against mortgages or pledge of the property of the company. The same is returned back on payment of loan within the agreed time.

iii) **Short term finance:** It is raised for a period of less than two years. The short term finance is used to meet seasonal or current expenditure, such as purchases of raw material, payment of wages and other recurring expenditures. The following are the main sources of credit raising finance for short term:
   - Trade credit
   - Bank credit
   - Instalment credit
   - Customers advances

- **Trade credit:** The credit is granted by the manufacturers and wholesalers to the retailers to help them the sale of goods. The usual duration of such credit is 30 to 90 days. It is granted to the company without any security. The credit is granted only on the basis of goodwill and financial standing of the borrower. No interest is charged for this. Only the price charged is slightly higher than the cash price.
- **Bank credit:** Commercial banks generally provide loans for short periods. They provide term loan, overdraft, cash credit and advance in the form of a loan against securities. In order to get a loan from a bank, either the merchandise is placed in the custody of the bank or collateral securities are kept in the custody of the bank.

- **Instalment credit:** This is commonly called ‘Consumer credit’, as it is generally used by retailers for selling consumers articles like refrigerators, washing machines, television sets, fans etc. on easy instalments. These instalments include interest on unpaid sum and are suitably spread so as to enable the borrowing firm to meet them out of its current cash flow.
- **Customers advances:** Sometimes a firm meets its short term financial requirements through customer’s advances. Such advances represent a part of the price and carry no interest. The period of such credit will depend upon the time taken to deliver the goods.

STUDY QUESTIONS: