UNIT – 1 : Introduction to Banking and Finance

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 business loans, and car loans.
- Banking can be defined as the business activity of accepting and safeguarding money owned by other individuals and entities, and then lending out this money in order to earn a profit.

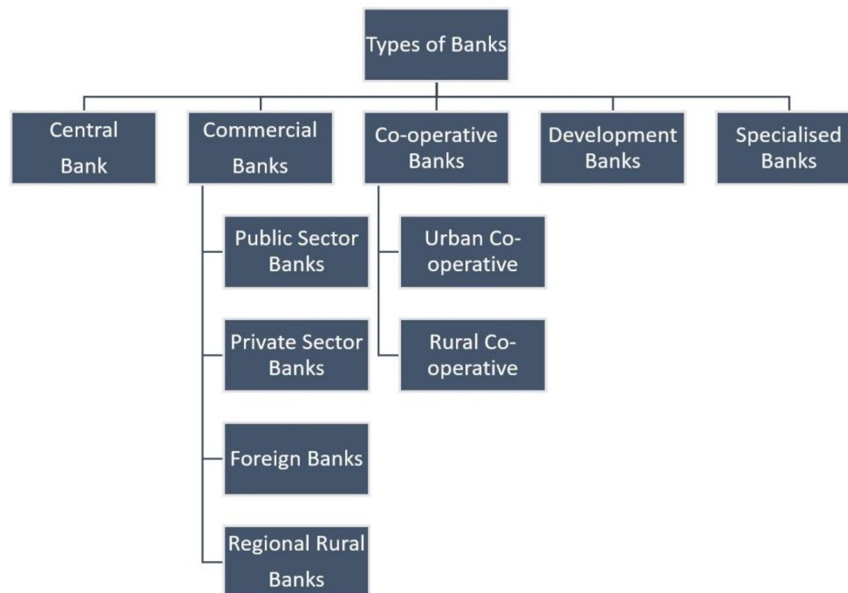
Definition of Bank: A Bank is a financial institution licensed to receive deposits and make loans.

Definition of Finance: Finance is a system that involves the exchange of funds between the borrowers and the lenders. It operates at various levels from firms to national to global levels.

Types of banks

Based on their functions, there are different types of banks operating in India as follows:

1. Central Bank
2. Commercial Banks
3. Cooperative Banks
4. Regional Rural Banks (RRB)
5. Specialized Banks
6. Payments Banks



First Types of Banks- Central Bank

A central bank is an independent agency that is mandated by the government to supervise the nation's money supply and monetary policy. In India, the Reserve Bank of India has severed as central bank. Each country has a central bank that oversees all other banks in that country.

Second Types of Banks- Commercial Banks

Commercial banks are governed by the Banking Regulation Act of 1949, and their business style is profit-oriented. They serve all segments, from rural to urban.Their principal duty is to receive deposits and make loans to individuals, businesses, and governments.

Commercial banks are further subdivided into public-sector banks, private-sector banks, and foreign banks.

a) **Public Sector Banks**
Public sector banks are defined as the government bank of the nation who owns the majority stakes (more than 50%). In India Public sector banks make up more than 75% of the nation's overall banking industry. Some Public sector banks in India are: State Bank of India (SBI), Bank of India, Punjab National Bank, Indian Bank etc.

b) **Private Sector Banks**
Private sector banks are those in which a private organization, an individual, or a group of people owns a significant stake or stock. Aside from the shareholding structure, both public and private sector banks provide the same range of services. Some of examples of these types of banks in India are: H.D.F.C. Bank, IDBI Bank, I.C.I.C.I. Bank , YES Bank, Axis Bank, Kotak Mahindra Bank

c) **Foreign Banks**
This type of bank includes private banks with headquarters in foreign nations and branches in our country. These banks must follow regulations of both their home nation and the country in which they operate. Foreign banks that operate in India include: Standard Chartered Bank, Deutsche Bank, HSBC Bank, Bank of America, Citibank.

Third Types of Banks- Cooperative Banks

Cooperative banks are governed by an elected managing committee and are recognized under the Cooperative Societies Act of 1912. Cooperative banks' duty is to provide financial resources to the rural people. In metropolitan regions, cooperative banks serve small enterprises, industries, and self-employment. In rural areas, they mostly fund agricultural industries such as farming, livestock.

Forth Types of Bank- Regional Rural Banks (RRB)

Regional rural banks (RRBs) are special commercial banks that offer reduced interest rates on loans to the agricultural and rural sections of the economy. This type of bank was founded to provide loans to the most vulnerable members of society, such as marginal farmers, small companies, and agricultural laborers.

Fifth Types of Banks- Specialized Banks

Specialized banks are founded to serve a certain industry or sector. It may specialize in export and import, or it may offer financial services to specialized businesses. In India, the following types of banks are in operation:

A. **NABARD** (National Bank for Agricultural and Rural Development) – To obtain financial support for rural, handicraft, village, and agricultural development.
B. **SIDBI** (Small Industries Development Bank of India) – This type of bank provides loans for a small-scale company or enterprise.
C. **EXIM Bank** – EXIM Bank stands for Export and Import Bank. To obtain loans or other financial aid from foreign countries when exporting or importing commodities.

Sixth Types of Banks- Payments Banks

Payments banks are a recently developed type of banking that was conceptualized by the Reserve Bank of India. Internet banking, mobile banking, and debit card facility are all services provided by payment banks. However, there are several limitations to this form of bank. Payment bank account holders can only deposit up to Rs.2,00,000/- and cannot apply for loans or credit cards with this account. These types of banks in India are listed below: Paytm Payments Bank, Airtel Payments Bank, India Post Payments Bank (IPPB), Jio Payments Bank

Functions of banks

Functions of the commercial banks have been divided into:

(1) Primary Functions (Accepting Deposits, Advancing-Loans)

(2) Secondary Functions (Agency Functions, General Utility Services)

(3)Electronic Banking Services (ATM, RTGS)

(1) Primary Functions

Banks have two primary functions-accepting deposits and advancing loans.

(A) Accepting Deposits: The bank accepts the deposits from public. People deposit their money as per their convenience and capability in the following accounts:

i. **Fixed Deposit (FD) or Time Deposit Account**: Money is deposited in this account for a fixed period. The depositor gets a fixed deposit receipt. The receipt contains the name of the depositor, the amount deposited, the rate of interest and the period for which the deposit is made. This receipt is not transferable. If the depositor needs this money before the completion of the deposit time period, then bank refunds this money to him after charging some discount.

The money deposited in this account earns maximum interest. The longer the period of deposit, the higher will be the rate of interest on deposit. The reason for it is that banks can use this money for a longer period. Money deposited in this account is also known as the Time Liability of the Bank.

ii. **Current or Demand Deposit Account**: In this account, a depositor can deposit money any number of time and can withdraw it as and when he requires it. In this account, generally business class deposits the money. Generally, the bank does not pay any interest on this deposit. If the total amount deposited is less than the minimum amount required, then the bank can charge some service charges. Money is withdrawn from this account by cheque. Money deposited in this account is known as the Demand Liability of the Bank.

iii. **Savings Account**: This account is to encourage the small savings. The bank pays interest on this account which is less than that of fixed deposit account. Money deposited in this account is known as Demand Liability of the Bank.

iv. **Recurring Deposit (RD) Account**: In this type of account, a depositor deposits a fixed amount of money for a fixed period. The money is deposited on monthly basis. This money cannot be withdrawn before the expiry of a fixed term except in certain conditions. The amount of interest which is received on the money deposited in this account is re-deposited along with the principle. This account attracts higher interest in comparison to other accounts like the Fixed Deposit Account. Money deposited in this account is known as Time Liability of the Bank.

(B) Advancing-Loans: Another main function of a bank is to advance loans to people. A bank receives money through deposits. A certain part of this money is transferred to the cash reserve and the balance is used by the banks for advancing loans. These banks generally provide loans for productive works and while doing so, they demand a proper security. The amount of loan is generally lower than the value of security. The banks advance loans of the following types:

i. **Cash Credit:** Under this, a borrower is allowed to withdraw a specific amount on the basis of a specific security. The borrower withdraws the money and deposits it within this specific limit only. The bank charges interest only on the money withdrawn.

ii. **Overdraft:** The customer, who maintains a current account with the bank, take permission from the bank to withdraw more amount than deposited in his account. The extra money withdrawn is called Overdraft. This facility is available to trustworthy customers for a small period. For instance, if in an individual's account Rs.10,000 is deposited and the bank has allowed him to issue a cheque upto Rs.12,000, then Rs.2,000 is an overdraft facility.

iii. **Demand Loan:** These loans are provided by the banks against the security of Fixed Deposit Receipt (FDR), Govt. Securities, Life Insurance Policies etc. These loans are called demand loans because the bank can demand them at any time.

iv. **Term Loan:** These loans are provided by the banks to their customers for a fixed period to purchase machinery, truck, scooter, house etc. The borrowers repay these loans in monthly/quarterly/half yearly/annual installments.

v. **Discounting of Bill of Exchange:** This is another method of providing advances by the banks. Under this, a bank gives money to its customers on the security of a Bill of Exchange before the expiry of the bill in case a customer needs it. After charging discount for the remaining period of the bill, the bank makes immediate payment against the bill. The bank charges interest from them as per the market rate and realizes its money on the completion of the period of the Bill of Exchange.

(2) Secondary Functions

Besides the primary functions, banks perform various secondary functions also such as agency functions and general utility functions.

(A) Agency Functions: A bank performs various agency functions for its customers:

i. **Collection and Payment of Various Items**: A bank collects cheque, rent, interest, etc. on behalf of its customers and pays taxes, insurance premium etc. as per their instructions.
ii. **Purchase and Sale of Securities:** A bank performs the function of selling and purchasing securities on behalf of its customers.
iii. **Trustee and Executor**: As per the instruction of their customers, banks perform the function of a trustee and an exececutor for their assets
iv. **Letter of Reference**: Banks provide information of financial conditions of their customers to traders of the same or other countries. In the same manner, banks collect the same information: about traders of the same or other countries for their customers.
v. **Bank Draft:** A bank draft is a financial instrument with the help of which money can be remitted from one place to another. Anyone can obtain a bank draft after depositing the money in the bank. The bank charges some commission in lieu of issuing a bank draft. The amount of commission varies from bank to bank. A bank may issue bank draft even free of cost depending on the customer's relation with the bank.
vi. **Banker's Cheque :** A banker's cheque is almost like a bank draft. It refers to that bank draft which is payable within the town. It can be termed as local bank draft. Banks issue pay order for local purpose and issue bank draft for outstations.

(B) General Utility Services: Commercial banks perform the type of functions which are helpful to general public. These functions are as follows:

i. **Locker Facilities**: Banks provide locker facilities to its customers where customers keep the gold and silver jewellery and other important papers safely. The annual rent for the use of the lockers is very low.
ii. **Traveller's Cheques**: Banks provide the facility of traveller's cheque to their customers who are travelling. With this facility, the customer need not carry cash with him and he can travel freely.

iii. **Business Information and Statistics**: As the banks are aware of the economic condition they can advise their customers on financial matters by collecting business information and statistics.

(3) Electronic Banking Services/E-Banking:

Using computer and Internet in the functioning of the banks is called electronic banking. Because of these services the customers do not need to go to the bank every time. The chief electronic services are the following:

i. **Automated Teller Machine (ATM):** ATM is an automatic machine with the help of which money can be withdrawn or deposited by inserting the card and entering your Personal Identification Number (PIN). This machines operates for all the 24 hours. This has reduced the work of an employee (teller) by more than half. The ATM is getting popular everyday.
ii. **Debit Card:** A Debit Card is issued to a customer in lieu of his money deposited in the bank. The customer can make immediate payment of goods purchased or services obtained on the basis of his debit card. Through this medium the money is transferred from the account of the purchaser to the account of the seller. With the help of the debit card money can also be withdrawn from the ATM.
iii. **Credit Card**: A bank issues a credit card to those of its customers who enjoy good reputation. It is not necessary that a customer should have money in the bank in order to get a credit card. This is a sort of overdraft facility.
iv. **Tele-banking:** Under this facility, a customer can get information about the balance in his account or information about the latest transactions on the telephone.
v. **National Electronic Funds Transfer (NEFT):**It refers to a nationwide system that facilitates individuals, firms and companies to electronically transfer funds from any bank branch to any individual, firm or company having an account with any other bank branch in the country. NEFT settles transactions in batches. The settlement takes place at a particular point of time. All transactions are held till that time. Any transaction initiated after a designated settlement time could have to wait till the next designated settlement time.
vi. **Real Time Gross Settlement (RTGS**): It refers to a funds transfer system where transfer of funds takes place from one bank to another on a 'Real Time' and on 'Gross' basis. Settlement in 'Real Time' means payment transaction is not subjected to any waiting period. The transactions are settled as soon as they are processed. 'Gross' settlement means the transaction is settled on one-to-one basis without bunching or netting with any other transaction. This is the fastest possible money transfer system through the banking channel.

Financial institution

A financial institution is an institution that provides financial services for its clients or members.

- Any institution that collects money and puts it into assets such as stocks, bonds, bank deposits, or loans is called a financial institution.
- There are **two types** of financial institutions :

1. Depository institutions and

2. Non-depository institutions.

1. Depository institutions pay you interest on your deposits and use the deposits to make loans. Examples: 1. Banks 2. Credit unions 3. Trust companies.
2. Those government or private institutions that serve as an intermediary between savers and borrowers, but do not accept time deposits, are known as non-depository institutions.
   Such institutions fund their lending activities either by selling securities or insurance policies to the public.
   Examples: 1. Insurance companies 2. Pension funds 3. Mutual fund companies

Many financial institutions provide both depository and non-depository services.

Functions of financial institutions

1) **Regulate monetary supply**
   The financial institution helps to regulate the economy's money supply. These institutions control inflation and also maintain stability in the money supply. Financial institutions are taking part in buying and selling the securities of the government which helps to regulate liquidity.
2) **Insurance services**
   The insurance companies also come under financial institutions as they provide money through investments to the insurer. Insurance companies provide insurance for vehicles, stocks, assets, marine, etc. Insurance companies also offer coverage for life insurance and health insurance. These insurance companies offer their hand in mobilizing savings and investing in productive investments.
3) **Investment consultation**
   Nowadays many investment options are carried out worldwide. A company/individual must choose wisely for investing in a specific investment option that suits their interest. Many investors may not be aware of various investment options. Every financial institution has investment consulting services to help their clients to adopt the best option available in the financial markets.
4) **Brokerage service**
   Some financial institutions like commercial banks and non-banking companies offer a different investment option for investors in form of brokerage. The institution serves as a broker

between investors and various companies for selling stocks, bonds, shares by getting a brokerage fee.

5) **Movement of financial resources**

Another function of financial institutions is the movement of financial resources from one area to another area. Through financial institutions, money transfer was made easy for large funds like investments, real estate purchases, and other huge transactions from one party to another party.

6) **Managing risk**

The financial institution manages the risk and uncertainties of companies and individuals. Financial institutions manage the risk by assembling a massive pool of individuals and businesses to share the risks and difficulties faced by businesses and people.

UNIT – 2 Banking Regulations in India

The Banking Regulation Act, 1949 controls the banking institutions from their birth to death. If any bank has to start business, it cannot do so unless it has obtained a licence under the provisions of Banking Regulation Act,1949 and if it has to close down business, the winding of operations will be as per the provisions of the Banking Regulations Act,1949. Even for the day today banking business, the Banking Regulation Act, 1949 lays down defined areas including provisions for penalties in case of violation by the concerned banks.

Banking in India is mainly governed by:

1. The Reserve bank of India Act, 1934

2. The Banking Regulation Act, 1949 and

3. The Foreign Exchange Management Act, 1999.

The Reserve Bank of India and the Government of India exercise control over banks from the opening of banks to their winding up by the virtue of powers conferred under the statutes.

Reserve Bank of India (RBI)

The Reserve Bank of India (RBI) is India's central bank. It controls the monetary policy concerning the national currency, the Indian rupee. The basic functions of the RBI are the issuance of currency, sustaining monetary stability in India, operating the currency, and maintaining the country's credit system.

- It was established on April 1, 1935, under the Reserve Bank of India Act, 1934. In the beginning, the headquarters of RBI was established in Calcutta. However, soon after, in 1937, it was permanently shifted to Mumbai.
- The Governor of the Reserve Bank of India is Mr Shaktikanta Das.
- The first Governor of RBI was Osborne Smith,
- The first Indian governor of RBI was C D Deshmukh.
- Originally, the Reserve Bank of India was privately owned; and was established as a private bank with two extra functions: the regulation and control of all banks in India, and to be the banker to the then government.
- Since its nationalization in 1949, RBI has been wholly owned by the Government of India and thus, some new roles were added to the list of functions of RBI.

Important Functions of RBI (Reserve Bank of India)

Being a central bank of India, RBI serves a critical role in regulating the financial transactions in the country. Some of the important functions of RBI are listed below:

1. Issue of Bank Notes
2. Banker to the Government
3. Custodian of the Cash Reserves of Commercial Banks
4. Custodian of country's forex reserves
5. Lender of last resort
6. Controller of credit

1. **The Issuer of Bank Notes**
   The most important function of RBI is the issuance of currency notes and coins, except the one rupee note and coin which are issued by the Ministry of Finance. All other notes bear the signature of the RBI Governor.

2. **Banker to the Government**
   Another chief function of RBI is that it takes care of the banking needs of the government, which includes maintaining & operating the deposit accounts of the government, collecting the receipts of funds, and making payments on behalf of the Government of India. It also represents the Indian Government, as a member of the International Monetary Fund and the World Bank.

3. **Custodian of Cash Reserves of Commercial Banks**
   Commercial banks are required to maintain the cash reserves at a rate decided by the RBI in its monetary policy.

4. **Custodian of Foreign Exchange Reserve**
   Another of the important functions of RBI is maintaining a reserve of foreign currencies that enables the RBI to deal with any crisis situation.

5. **Lender of the Last Resort**
   Often regarded as the banker of banks, the RBI acts as a parent to all commercial banks in India. Thus, it becomes the lender of the last resort for all banks when they are in a crisis situation. RBI helps them by lending money.

6. **Controller of Credit**
   RBI controls the credit created by the commercial banks in India, in accordance with the economic priorities of the government of India. RBI uses quantitative and qualitative methods to control and regulate the flow of money in the market.

Measures of credit control:

(A) Quantitative measures of credit control are as follows:

1. **Bank Rate Policy**

The bank rate is the Official interest rate at which RBI rediscounts the approved bills held by commercial banks. For controlling the credit, inflation and money supply, RBI will increase the Bank Rate.

2. **Open Market Operations**
   Open Market Operations refer to direct sales and purchase of securities and bills in the open market by Reserve bank of India. The aim is to control volume of credit.

3. **Cash Reserve Ratio (CRR)**
   Cash reserve ratio refers to that portion of total deposits in commercial Bank which it has to keep with RBI as cash reserves.

4. **Statutory Liquidity Ratio (SLR)**
   SLR refers to that portion of deposits with the banks which it has to keep with itself as liquid assets(Gold, approved govt. securities etc.) If RBI wishes to control credit and discourage credit it would increase CRR & SLR.

5. **Repo Rate**
   A Repo rate is a rate at which commercial banks borrow money by selling their securities to the RBI to maintain liquidity. Commercial banks sell their securities in case of a shortage of funds or due to some statutory measures. It is one of the main instruments of the RBI to keep inflation under control.

6. **Reverse Repo Rate**
   Sometimes, the RBI borrows money from commercial banks when there is excess liquidity in the market. In that case, commercial banks get benefits by receiving the interest on their holdings with the RBI.
   At the time of higher inflation in the country, RBI increases the reverse repo rate that encourages banks to park more funds with the RBI, which will help it earn higher returns on excess funds.

(B) Qualitative measures of credit control are as follows:

1. **Rationing of Credit**
   Under this method, the RBI directs banks to give credit in accordance with the importance of various sectors in the economy from time to time.
   For eg. It has directed banks that they must give 40% of their total credit at any time to the priority sector as identified by the RBI which consists of sectors like Agriculture, Small Scale, Employment Generation, etc.

2. **Regulation of Credit for Consumption Purpose**

Under the measure of RBI which direct banks to restrict credit for the purchase of consumer durables like TV, Fridge, etc, and instead give more credit for productive purpose as too much of consumer credit fuel inflation.

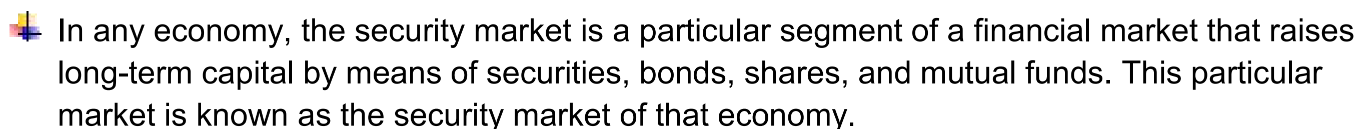
3. **Margin Requirement**
   Under this method, the RBI directs banks from time to time to vary (raise or lower) margins on loans given by banks particularly for sensitive and essential commodities in order to prevent speculation, hoarding, black marketing, etc.
   RBI has often done it for food grains and other essential commodities by directing banks to raise margins. Eg: Wheat Trader, Cement Manufacturers.

4. **Moral Suasion**
   Under this method, RBI urges commercial banks to help in controlling the supply of money in the economy.

Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI) was set up on 12th April, 1992 in Bombay, under the guiding principles of the Securities and Exchange Board of India Act, 1992. It is also known as the prime regulator of the Indian stock market.

- The SEBI has its regional offices in Ahmedabad, Chennai, New Delhi, and Kolkata.
- SEBI is chiefly concerned with the monitoring and regulating of the Indian capital and securities market, while taking measures to protect the best interest of the investors' community. It is also responsible for formulating regulations and guidelines which are to be followed by the concerned authorities.



- In any economy, the security market is a particular segment of a financial market that raises long-term capital by means of securities, bonds, shares, and mutual funds. This particular market is known as the security market of that economy.

- In India, in order to regulate the security market, the government set up the SEBI. Besides, the security market it also comprises stock exchanges, FIIs, different share indices, etc. The security market is further categorized into Primary and Secondary markets.

Primary Markets: A market where different instruments are traded directly between the entity responsible for raising the capital and the entity responsible for purchasing the instrument.

Secondary Markets: It is a market where the instruments of the security market are traded among the primary instrument-holders. These transactions are required to be regulated for floor trading, for which, the stock exchanges are set up.

Functions/ Role of SEBI

The functioning of the Securities Exchange Board of India is primarily divided into the following three categories:

1. Protective Function
2. Regulatory Function
3. Development Function

1. Protective Functions

To protect the interest of the investors and other stakeholders can be considered as one of the prime functions of SEBI. Some of the protective functions of include:

1. Preventing insider trading
2. Creating awareness among investors
3. Promoting fair practices
4. Prohibiting fraudulent/ unfair trade practices

2. Regulatory Functions

SEBI's regulatory functions are usually performed in order to keep tabs on the functioning of the business across the financial markets. Few of its regulatory functions are:

1. Performing and exercising powers
2. Conducting inquiries and audit of exchanges
3. Levying of fees
4. Regulating takeover of companies
5. Registering and regulating credit rating agencies

3. Development Functions

Apart from the above protective and regulatory functions, the SEBI is also responsible to undertake certain development functions. The following are a few examples of SEBI's development functions:

1. Carrying out research and development work
2. Promoting of fair trading practices
3. Reducing malpractices within the securities market
4. Imparting training to intermediaries
5. Buying-selling funds from the AMC directly through a broker

Insurance Regulatory & Development Authority of India (IRDAI)

The Insurance Regulatory & Development Authority of India is more commonly known as the IRDAI. Founded in 1999, the IRDAI acts as an authoritative body that is tasked with regulating the insurance

and reinsurance sectors in India. The IRDAI is constituted by the Insurance Regulatory and Development Authority Act, 1999. It is headquartered in Hyderabad.

IRDAI is the apex body of insurance providers in India. It primarily oversees the functioning of the General Insurance and Life Insurance companies operating across the country. Hence, it is mainly responsible to protect the interests of the policyholders and to regulate the insurance sector.

Features of IRDAI

- Acts as a regulator for the insurance sector
- Protects the policyholders' interests
- Provide the certificate of registration to new insurance companies in India
- Creates new rules and policies
- Supervising and regulating the insurance industry's activities to ensure a healthy environment for the insurers and policyholders.

Functions/ Role of IRDAI

1. To protect the interest of the policyholder and exercise their fair treatment
2. To frame policies regularly to ensure that the industry operates without any ambiguity
3. To regulate the insurance industry in fairness and ensure its financial soundness
4. To promote fairness and transparency in financial markets dealing with insurance
5. To ensure speedy settlement of genuine claims, prevent insurance frauds.

Pension Fund Regulatory and Development Authority (PFRDA)

The Pension Fund Regulatory and Development Authority (PFRDA) is an authoritative entity that oversees and regulates the distribution of pensions in India.

- It operates under the supervision of the Ministry of Finance in the Government of India. The inception of PFRDA was in 2003, following the recommendations of the OASIS report (an acronym for old age social & income security) by the Government of India. It was also a component of the National Pension Scheme.
- PFRDA is headquartered at New Delhi with various regional offices spread across the country.

Functions/ Role of PFRDA

The preamble of PFRDA states its objectives as – "to promote old age income security by establishing, developing and regulating pension funds, to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental thereto."

1. Promote pension scheme in the country by fostering mandatory as well as voluntary pension schemes in order to serve the old age income needs of retired personnel.

2. National Pension System, both tier 1 and tier 2 are under the purview of PFRDA and are dictated by the same
3. PFRDA performs the function of appointing various intermediate agencies like Pension Fund Managers, Central Record Keeping Agency (CRA) etc.
4. Educating the general public and stakeholders about the importance of pension.
5. Training of intermediaries that perform the task of popularizing and educating people about the importance of pension.
6. Addressing grievances related to various pension schemes in the country.
7. Addressing and resolving disputes between various intermediaries like banks and between customers and intermediaries.

UNIT – III and IV

Financial Statements:

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'. It is basically a study of relationship among various financial facts and figures as given in a set of financial statements, and the interpretation thereof to gain an insight into the profitability and operational efficiency of the firm to assess its financial health and future prospects. The term 'financial analysis' includes both 'analysis and interpretation'. The term analysis means simplification of financial data by methodical classification given in the financial statements. Interpretation means explaining the meaning and significance of the data. These two are complimentary to each other. Analysis is useless without interpretation, and interpretation without analysis is difficult or even impossible.

Significance of Analysis of Financial Statements :

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the various items of the balance sheet and the statement of profit and loss. Financial analysis can be undertaken by management of the firm, or by parties outside the firm, viz., owners, trade creditors, lenders, investors, labour unions, analysts and others. The nature of analysis will differ depending on the purpose of the analyst. A technique frequently used by an analyst need not necessarily serve the purpose of other analysts because of the difference in the interests of the analysts. Financial analysis is useful and significant to different users in the following ways:

(a) Finance manager: Financial analysis focuses on the facts and relationships related to managerial performance, corporate efficiency, financial strengths and weaknesses and creditworthiness of the company. A finance manager must be well-equipped with the different tools of analysis to make rational decisions for the firm. The tools for analysis help in studying accounting data so as to determine the continuity of the operating policies, investment value of the business, credit ratings and testing the efficiency of operations. The techniques are equally important in the area of financial control, enabling the finance manager to make constant

reviews of the actual financial operations of the firm to analyze the causes of major deviations, which may help in corrective action wherever indicated.

(b) Top management: The importance of financial analysis is not limited to the finance manager alone. It has a broad scope which includes top management in general and other functional managers. Management of the firm would be interested in every aspect of the financial analysis. It is their overall responsibility to see that the resources of the firm are used most efficiently and that the firm's financial condition is sound. Financial analysis helps the management in measuring the success of the company's operations, appraising the individual's performance and evaluating the system of internal control.

(c) Trade payables: Trade payables, through an analysis of financial statements, appraises not only the ability of the company to meet its short-term obligations, but also judges the probability of its continued ability to meet all its financial obligations in future. Trade payables are particularly interested in the firm's ability to meet their claims over a very short period of time. Their analysis will, therefore, evaluate the firm's liquidity position.

(d) Lenders: Suppliers of long-term debt are concerned with the firm's long term solvency and survival. They analyse the firm's profitability over a period of time, its ability to generate cash, to be able to pay interest and repay the principal and the relationship between various sources of funds (capital structure relationships). Long-term lenders analyse the historical financial statements to assess its future solvency and profitability.

(e) Investors: Investors, who have invested their money in the firm's shares, are interested about the firm's earnings. As such, they concentrate on the analysis of the firm's present and future profitability. They are also interested in the firm's capital structure to ascertain its influences on firm's earning and risk. They also evaluate the efficiency of the management and determine whether a change is needed or not. However, in some large companies, the shareholders' interest is limited to decide whether to buy, sell or hold the shares.

(f) Labour unions: Labour unions analyse the financial statements to assess whether it can presently afford a wage increase and whether it can absorb a wage increase through increased productivity or by raising the prices.

(g) Others: The economists, researchers, etc., analyse the financial statements to study the present business and economic conditions. The government agencies need it for price regulations, taxation and other similar purposes.

Objectives of Analysis of Financial Statements:

- to assess the current profitability and operational efficiency of the firm as a whole as well as its different departments so as to judge the financial health of the firm.
- to ascertain the relative importance of different components of the financial position of the firm.
- to identify the reasons for change in the profitability/financial position of the firm.
- to judge the ability of the firm to repay its debt and assessing the short-term as well as the long-term liquidity position of the firm.

Meaning of Ratio Analysis: Accounting ratios are an important tool of financial statements analysis. A ratio is a mathematical number calculated as a reference to relationship of two or more numbers and can be expressed as a fraction, proportion, percentage and a number of times.

It is one of the tools of measuring financial performance of the organization

× It is a comparative analysis between two factors

× Business performance can be measured by the use of ratios

× It must be interpreted against some standards

× Apart from the absolute profit figures, the management might find a need of relative data/information about the variables, thus, at this time, ratio analysis assists the management.

× It evaluates the financial conditions and the purpose of a firm through various yardsticks

× This tool is useful for all the various stakeholders of the company like, shareholders, bankers, creditors, lenders, investors, government, etc.

Objectives of Ratio Analysis:

Ratio analysis is indispensable part of interpretation of results revealed by the financial statements. It provides users with crucial financial information and points out the areas which require investigation. Ratio analysis is a technique which involves regrouping of data by application of arithmetical relationships, though its interpretation is a complex matter. It requires a fine understanding of the way and the rules used for preparing financial statements. Once done effectively, it provides a lot of information which helps the analyst:

1. To know the areas of the business which need more attention;

2. To know about the potential areas which can be improved with the effort in the desired direction;

3. To provide a deeper analysis of the profitability, liquidity, solvency and efficiency levels in the business;

4. To provide information for making cross-sectional analysis by comparing the performance with the best industry standards; and

5. To provide information derived from financial statements useful for making projections and estimates for the future.

Advantages of Ratio Analysis:

The ratio analysis if properly done improves the user's understanding of the efficiency with which the business is being conducted. The numerical relationships throw light on many latent aspects of the business. If properly analysed, the ratios make us understand various problem areas as well as the bright spots of the business. The knowledge of problem areas help management take care of them in future. The knowledge of areas which are working better

helps you improve the situation further. It must be emphasised that ratios are means to an end rather than the end in themselves. Their role is essentially indicative and that of a whistle blower. There are many advantages derived from ratio analysis. These are summarised as follows:

1. **Helps to understand efficacy of decisions**: The ratio analysis helps you to understand whether the business firm has taken the right kind of operating, investing and financing decisions. It indicates how far they have helped in improving the performance.

2. **Simplify complex figures and establish relationships**: Ratios help in simplifying the complex accounting figures and bring out their relationships. They help summarise the financial information effectively and assess the managerial efficiency, firm's credit worthiness, earning capacity, etc.

3. **Helpful in comparative analysis**: The ratios are not be calculated for one year only. When many year figures are kept side by side, they help a great deal in exploring the trends visible in the business. The knowledge of trend helps in making projections about the business which is a very useful feature.

4. **Identification of problem areas**: Ratios help business in identifying the problem areas as well as the bright areas of the business. Problem areas would need more attention and bright areas will need polishing to have still better results.

5. **Enables SWOT analysis**: Ratios help a great deal in explaining the changes occurring in the business. The information of change helps the management a great deal in understanding the current threats and opportunities and allows business to do its own SWOT (StrengthWeakness-Opportunity-Threat) analysis.

6. **Various comparisons**: Ratios help comparisons with certain bench marks to assess as to whether firm's performance is better or otherwise. For this purpose, the profitability, liquidity, solvency, etc., of a business, may be compared: (i) over a number of accounting periods with itself (Intra-firm Comparison/Time Series Analysis), (ii) with other business enterprises (Inter-firm

Comparison/Cross-sectional Analysis) and (iii) with standards set for that firm/industry (comparison with standard (or industry expectations).

Limitations of Ratio Analysis Since the ratios are derived from the financial statements, any weakness in the original financial statements will also creep in the derived analysis in the form of ratio analysis. Thus, the limitations of financial statements also form the limitations of the ratio analysis. Hence, to interpret the ratios, the user should be aware of the rules followed in the preparation of financial statements and also their nature and limitations. The limitations of ratio analysis which arise primarily from the nature of financial statements are as under:

1. **Limitations of Accounting Data:** Accounting data give an unwarranted impression of precision and finality. In fact, accounting data "reflect a combination of recorded facts, accounting conventions and personal judgements which affect them materially. For example, profit of the business is not a precise and final figure. It is merely an opinion of the accountant based on application of accounting policies. The soundness of the judgement necessarily depends on the competence and integrity of those who make them and on their adherence to Generally Accepted Accounting Principles and Conventions". Thus, the financial statements may not reveal the true state of affairs of the enterprises and so the ratios will also not give the true picture.

2. **Ignores Price-level Changes:** The financial accounting is based on stable money measurement principle. It implicitly assumes that price level changes are either non-existent or minimal. But the truth is otherwise. We are normally living in inflationary economies where the power of money declines constantly. A change in the price-level makes analysis of financial statement of different accounting years meaningless because accounting records ignore changes in value of money.

3. **Ignore Qualitative or Non-monetary Aspects**: Accounting provides information about quantitative (or monetary) aspects of business. Hence, the ratios also reflect only the monetary aspects, ignoring completely the non-monetary (qualitative) factors.

4. **Variations in Accounting Practices:** There are differing accounting policies for valuation of inventory, calculation of depreciation, treatment of intangibles Assets definition of certain financial variables etc., available for various aspects of business transactions. These variations leave a big question mark on the cross-sectional analysis. As there are variations in accounting practices followed by different business enterprises, a valid comparison of their financial statements is not possible.

5. **Forecasting:** Forecasting of future trends based only on historical analysis is not feasible. Proper forecasting requires consideration of non-financial factors as well.

6. **Means and not the End:** Ratios are means to an end rather than the end by itself.

7. **Lack of ability to resolve problems:** Their role is essentially indicative and of whistle blowing and not providing a solution to the problem.

8. **Lack of standardised definitions**: There is a lack of standardised definitions of various concepts used in ratio analysis. For example, there is no standard definition of liquid liabilities. Normally, it includes all current liabilities, but sometimes it refers to current liabilities less bank overdraft.

9**. Lack of universally accepted standard levels**: There is no universal yardstick which specifies the level of ideal ratios. There is no standard list of the levels universally acceptable, and, in India, the industry averages are also not available.

Types of Ratios:

1. **Liquidity Ratios:** To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as 'Liquidity Ratios'. These are essentially short-term in nature.
2. **Solvency Ratios:** Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as 'Solvency Ratios'. These are essentially long-term in nature.

3. **Activity (or Turnover) Ratios:** This refers to the ratios that are calculated for measuring the efficiency of operations of business based on effective utilisation of resources. Hence, these are also known as 'Efficiency Ratios'.
4. **Profitability Ratios:** It refers to the analysis of profits in relation to revenue from operations or funds (or assets) employed in the business and the ratios calculated to meet this objective are known as 'Profitability Ratios'.

What is Risk Management in Banking?

Banking risk management is the process of a bank identifying, evaluating, and taking steps to mitigate the chance of something bad happening from its operational or investment decisions. This is especially important in banking, as banks are responsible for creating and managing money for others.

The Importance of Risk Management in Banking

Banks are cornerstone institutions of national and global financial systems. So while they are allowed to have some degree of risk, they are typically afforded much less risk than other industries. This is because if they fail, it slows or halts the creation and exchange of money, which has far-reaching impacts on the rest of the economy.

Some specific reasons for the importance of risk management in the banking sector are that it helps banks to:

- Avoid wasting or needlessly losing the money they need to stay in business
- Avoid disruptions to their operations
- Maintain confidence from investors and customers to continue doing business with them
- Comply with laws and regulations to avoid paying non-compliance fines

The risk management process in banking typically involves six components:

- **Identification:** Defining the nature of risks, including where they originate from and why they pose a threat to the bank.
- **Assessment and Analysis:** Evaluating how likely a risk will pose a threat to the bank, and how grave that threat will likely be. This helps a bank prioritize which risks deserve the most attention.

- **Mitigation:** Designing and implementing bank policies and processes that limit the chance that risks will become threats, and that minimize the damage threats may cause.
- **Monitoring:** Gathering data on threat prevention and incident response to determine how well a bank risk management strategy is working. This also involves researching emerging risk trends to determine if a bank's risk management framework needs (or will need) updating.
- **Cooperation:** Establishing relationships between risks and mitigation strategies across different areas of the bank's operations to create a more centralized and coordinated threat response system.
  - **Reporting:** Documenting and reviewing information related to the bank's risk management efforts to gauge their effectiveness. This is also used to track how the bank's overall risk profile changes over time.

Types of Risk:

The risk may more generally be defined as the possibility of loss either in financial terms or loss of reputation. Considering the relationship between risk and return, banks are prudent enough to identify, measure and price the risk that they take and also maintain appropriate capital to take care of any unforeseen event. The different types of risk in the banking industry are:

- Liquidity Risk
- Market Risk
- Credit or Default Risk
- Operational Risk

We have discussed all these types of risks in detail below:

Liquidity Risk

This type of risk arises when an institution is unable to meet its financial commitments or is able to do so only by external borrowing. This may be due to the conversion of assets into NPAs. In the modern banking model, this is the most vulnerable risk that banks are subjected to.

So, how do banks manage liquidity risk? Well, it can be efficiently managed by creating a difference in the timeframe between asset maturity and liability maturity. And then, by ensuring that those differences keep enough funds flowing in the bank to both increase assets and meet obligations when customers ask for their money.

Market Risk

It will not be an understatement to say that banks operate at the whims of the market! Market risk is the risk that stems from the idea that the value of investment might decrease due to changes in factors governing a market. It is also known as a systematic risk because it is related to factors governing the market such as recession that impacts the entire market and not just one industry.

Managing market risk is very crucial in times like today when the market is extremely volatile and unpredictable. The most efficient way to do manage market risk is by diversification of funds. Ensuring that the assets are held in a wide range of investment options can minimize the market risk.

Credit or Default Risk

Credit or Default Risk is simply the potential of the borrower to fail to meet its obligations in accordance with the signed contract. Loans are the largest and most obvious source of credit or default risk for most banks. Amongst all, this is the most significant risk typically in the Indian banking sector where NPA size is significantly high.

Although this risk can't be avoided, there are certain ways that can help in mitigating the risk. The banks manage this risk mostly by assessing the worthiness of the borrower before sanctioning the loan. A credit score is generated keeping various factors in mind, and on the basis of the score, a loan is sanctioned or suspended.

Operational Risk

Operational Risk is the risk of loss that arises due to breakdown in the internal procedures, people and systems or from external events. It is important to manage operational risk for banks because banks are exposed to a higher volume of global financial interlinkages and a high level of automation is being used in rendering banking and financial services.

Credit rating agencies are agencies which provide ratings to represent objective analyses and independent assessments of companies, entities or countries that issue

such debt securities. These ratings are an indication to the buyers of this debt how likely they are to be paid back.

Core Functions Of a Credit Rating Agency

- Compiling financial data essential for loan decisions and insurance.
- Statistical assessment that is involved in ascribing a rating to a borrower.
- Providing investors an objective analysis of the organization's ability to pay back.

What are These Ratings?

A credit rating issued by a rating agency is an assessment of the creditworthiness of securities issued by corporations, governments and other entities. The ratings given to such securities are mostly represented as AAA, AAB, Ba3, CCC etc. It is very similar to a marking system wherein the highest rating AAA is given to a borrower who has the highest probability of paying back. In that way, AAA is considered to be one of the safest debt securities to buy.

Importance of Credit Ratings

Credit rating represents an objectively analyzed assessment of the creditworthiness of the borrower. So, the scorecard affects the amount that companies or governments are charged to borrow money. A downgrade, in other words, pushes down the value of the bonds and raises interest rates. These, in turn, influence the overall investor sentiment concerning the Borrower Company or Country.

If a company perceives to have undergone a downturn in fortunes and its rating is lowered, investors might ask for higher returns to lend to it, thereby judging it to be a riskier bet. Similarly, if the economic and political policies of a country look gloomy, its ratings are downgraded by global credit agencies thereby influencing the flow of investments in that country.

On a macroscopic level, these changes affect economic policies of a nation. An endorsement from a convincing rating agency makes life easier for countries and financial institutions issuing bonds. It basically tells investors a firm has a track record and indicates how likely it is to be able to pay back the money.

Who are These Credit Rating Agencies? Globally, Standard & Poor's (S&P), Moody's and Fitch group are recognized as The Big Three credit rating agencies. In terms of acceptability and influence, these three collectively have a global market share of 95% as per the CFR report, USA 2015. The Indian credit rating Industry has also evolved with the emergence of professionally competent agencies like CRISIL, ICRA, ONICRA, CARE, CIBIL, SMERA, and others.

Role of Rating Agencies in Capital Markets

Rating agencies assess the credit risk of specific debt securities and the borrowing entities. In the bond market, a rating agency provides an independent evaluation of the creditworthiness of debt securities issued by governments and corporations. Large bond issuers receive ratings from one or two of the big three rating agencies. In the United States, the agencies are held responsible for losses resulting from inaccurate and false ratings.

The ratings are used in structured finance transactions such as asset-backed securities, mortgage-backed securities, and collateralized debt obligations. Rating agencies focus on the type of pool underlying the security and the proposed capital structure to rate structured financial products. The issuers of the structured products pay rating agencies to not only rate them, but also to advise them on how to structure the tranches.

Rating agencies also give ratings to sovereign borrowers, who are the largest borrowers in most financial markets. Sovereign borrowers include national governments, state governments, municipalities, and other sovereign-supported institutions. The sovereign ratings given by a rating agency shows a sovereign's ability to repay its debt.

The ratings help governments from emerging and developing countries to issue bonds to domestic and international investors. Governments sell bonds to obtain financing from other governments and Bretton Woods institutions such as the World Bank and the International Monetary Fund.

Benefits

At the consumer level, the agency's ratings are used by banks to determine the risk premium to be charged on loans and bonds. A poor credit rating shows that the loan has a higher risk premium, and this prompts an increase in the interest charged to individuals and entities with a low credit rating. A good credit rating allows borrowers to easily borrow money from the public debt market or financial institutions at a lower interest rate.

At the corporate level, companies planning to issue a security must find a rating agency to rate their debt. Rating agencies such as Moody's, Standards and Poor's,

and Fitch perform the rating service for a fee. Investors rely on the ratings to decide on whether to buy or not to buy a company's securities.

Although investors can also rely on the ratings given by financial intermediaries and underwriters, ratings provided by international agencies are considered more reliable and accurate since they can access lots of information that is not publicly available.

At the country level, investors rely on the ratings given by the credit rating agencies to make investment decisions. Many countries sell their securities in the international market, and a good credit rating can help them access high-value investors. A favorable rating may also attract other forms of investments like foreign direct investments to a country.

In addition, a low credit rating or relegation of a country from a high rating to a low rating can discourage investors from purchasing the country's bonds or making direct investments in the country. For example, the downgrading of Greece, Portugal, and Ireland by S&P in 2010 worsened the European sovereign debt crisis.

Credit ratings also help in the development of financial markets. Rating agencies provide risk measures for various entities, and this allows investors to understand the credit risk of various borrowers. Institutions and government entities can access credit facilities without having to go through lengthy evaluations by each lender.

The ratings provided by rating agencies also serve as a benchmark for financial market regulations. Some laws now require certain public institutions to hold investment-grade bonds, which have a rating of BBB or higher.