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Directorate of Distance Education

B.B.A. [Banking]

I - Semester

122 13

BANKING THEORY

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BLOCK III: BANKS REGIONAL SET AND RRB	
UNIT X: Regional Rural and Co-operative Banks in India: Functions; Role of Regional Rural and Co-operative Banks in Rural India; Progress and Performance.	**Unit 10:** Regional Rural and Cooperative Banks in India **(Pages 172-203);**
UNIT - XI: Place of Private Sector Banks.- Role and Functions in India	**Unit 11:** Place of Private Sector Banks **(Pages 204-208)**
BLOCK IV: BANKER AND CUSTOMER SYSTEM	
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UNIT - XIII: Definition of the Term Banker and Customer - General Relationship - Special Relationship - Main Functions and Subsidiary Services Rendered by Banker - Agency Services and General Utility Services.	**Unit 13:** Banker and Customer: Relationship **(Pages 216-234);**
UNIT - XIV: Recent Trends in Indian Banking System	**Unit 14:** Recent Trends in Indian Banking System **(Pages 235-244)**

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INTRODUCTION

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Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India which started in 1786, and the Bank of Hindustan, both of which are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. The Reserve Bank of India (RBI) is the central banking system of India and controls the monetary policy of the rupee as well as 426 billion (2018) of currency reserves. The institution was established on 1 April 1935 during the British Raj in accordance with the provisions of the Reserve Bank of India Act, 1934 and plays an important part in the development strategy of the government. In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) 'to regulate, control, and inspect the banks in India.' The Banking Regulation Act also provided that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

Commercial Banks in India are broadly categorized into Scheduled Commercial Banks and Unscheduled Commercial Banks. The Scheduled Commercial Banks have been listed under the Second Schedule of the Reserve Bank of India Act, 1934. The modern Commercial Banks in India cater to the financial needs of different sectors.

The book is divided into fourteen units, dealing with commercial banking, money market, banking Regulation Act 1949, innovations in banking service, foreign exchange, banker and customer, Indian banking and Private sector banks.

The book is written in SIM (Self-Instructional Material) format for Distance Learning and each unit starts with an Introduction and Objectives. Then, the detailed content is presented in an understandable an organized manner. A Summary is provided at the end of each unit for a quick revision. That is followed by a list of Key Words. Each unit will also have Check Your Progress Questions to test the students' understanding of the topics covered, the answers to which are also provided at the end of the unit. It is followed by Questions and Exercises. Each unit also has a list of books for Further Reading.

BLOCK - I
BASIC THEORY OF BANKING

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UNIT 1 INTRODUCTION TO BANKING

Structure

1.0 INTRODUCTION

Banks play an inevitable role in a country's economy. The demographics of a country is majorly dependent on the banking structure for saving and loans. The fact that banks play the dual role of accepting deposits and issuing loans prove the mettle and importance of banks in a society.

The present banking structure of our country is coherent and constantly evolving to meet the immediate needs of the population. Despite the fact that there is a lot of pressure on the banks in the present scenario, one cannot do away with the efficiency with which banks have been delivering their services to the people.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Learn the definition of bank
- Understand the different kinds of banks
- Discuss the process of credit creation by banks
- Know about the balance sheet of banks

1.2 DEFINITION OF BANK

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Banking plays a pivotal role in modern trade and commerce. Banks perform the twin functions of accepting deposits from the public and making loans to needy and deserving people in society. Deposits become liabilities and loans appear on the assets side of their balance sheets. Banks lend money to different categories of borrowers. The interest received on those loans becomes their primary source of income and the interest on deposits constitutes the main item of expenditure for a bank.

Banks in India are regulated by the Banking Regulation Act, 1949. The repayment of deposit on demand is a necessary requirement to qualify to become a bank.

According to the Banking Regulation Act, 1949, banking means 'the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.'

1.3 KINDS OF BANKS

Banks in India are classified into the following categories in accordance to their functions, which include the following:

- Central Bank
- Commercial Banks
- Development Banks
- Cooperative Banks
- Specialized Banks

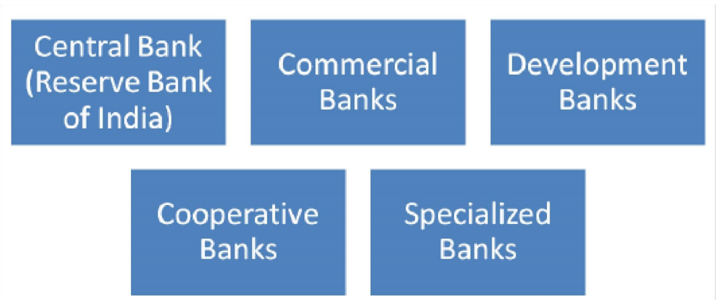

Fig. 1.1 *Classification of Banks in India*

Check Your Progress

1. Mention the act which regulates banks in India.
2. What is the necessary requirement to qualify to become a bank?
3. Define banking as per the Banking Regulation Act, 1949.

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1.4 CREDIT CREATION AND BALANCE SHEET

Commercial banks always try to maintain their holdings of idle cash to the lowest extent possible. In their attempt to achieve this end, they unwittingly increase the total amount of money in circulation in the community. It, however, does not mean that they increase the total amount of legal tender currency which is an exclusive prerogative of the central bank.

When it is said that a banker is lending money, he is actually lending money in the deposit credit with a right to the borrower to draw cheques against it. For instance, let us take the case of a loan granted to a customer. Instead of paying away the whole loan in the form of liquid cash, the bank will place the amount to the credit of the borrower. Thus, the borrower acquires a claim against the bank, just as a sum of money deposited by him with the bank creates a claim against the bank. Assuming the borrower draws cheques in favour of other people, they pay these cheques into their own banks for collection, and their deposits go up. Here one may agree with Hartley Withers in that '*every loan creates a deposit*'. Again, by purchasing securities or any other banking assets also a bank is adding to the total supply of money.

When the bank buys securities, it pays for them by its own cheque. This cheque, like a currency note issued by the central bank, is an IOU (*I Owe You)* of the bank issuing it. And this is accepted by the seller of the securities because of his faith in the ability of the bank to produce cash on demand. The seller deposits this cheque in the very same bank or with any other bank where he has an account, thereby creating additional deposit money. Thus, the commercial banks as a system can and do increase the total amount of money in circulation by increasing the purchasing power of the people through the deposit money created by them.

A close analytical study of the mechanism of banking will simplify matters more. Let us take the case of a community where there is only one bank and where the people are highly banking minded so that all transactions are settled by means of cheques. Further, let us assume that total amount of legal tender currency in circulation is ₹10,000 and the bank knows by experience that

10 per cent of its deposits as cash reserves is sufficient to meet the demands of its customers.

Since there is only one bank in the community, people will deposit all their money in this particular bank. The balance sheet of the bank would then be:

Liabilities	₹	Assets	₹
Deposits	10,000	Cash in Hand	10,000

According to our assumption, the bank would need to maintain a cash reserve of only 10 per cent of the deposits and can safely lend the balance amount of ₹9,000 to those who are in need of funds. The bank will place this amount to the credit of the borrowers, giving them the right to operate their accounts with cheques. Their deposits will consequently go up by this amount. The balance sheet of the bank, then, would be:

Liabilities	₹	Assets	₹
Deposits (original)	10,000	Cash in Hand	10,000
Deposits (i.e. credit Balance of borrowers)	9,000	Loans to clients	9,000
	19,000		19,000

These deposits, now standing to the credit of the borrowers are, as we know, claims against the bank. As such they command a purchasing power and hence they may be considered as good as money. Suppose the borrowers draw cheques in favour of their creditors. The payees of these cheques will not require liquid cash over the counter since they are highly banking minded, according to our supposition. On the other hand, they will deposit these cheques with our supposed single bank for collection. Here what happens is merely a transfer of the credit balance of the borrowers to the credit of the accounts of the payees of their cheques. In short, although the total amount of legal tender currency in circulation is only to the order of ₹10,000, our bank, through the process of creating additional deposit money, has brought into effective circulation an additional amount of ₹ 9,000, thereby raising the total supply of money from ₹10,000–19,000. The power of the bank to increase the amount of money in circulation does not come to an end here. It can further increase the supply of money.

As shown in the above balance sheet, the amount of the deposits of the bank is now ₹19,000. The assumption is that the bank should maintain a cash reserve ratio of only 10 per cent. To maintain this, the bank only needs to provide an additional amount of ₹900 over and above the amount of ₹1,000 which it already maintains. Even then there is a balance of ₹8,100 in the vaults of the bank which it can lend without undergoing any risk. Now the balance sheet position would be:

Liabilities	₹	Assets	₹
Deposits (original)	10,000	Cash in Hand	10,000
Deposits (deposited by the Payees of the cheques issued by the first borrowers	9,000	Loans to Clients.	
Deposits (credit balance of		9,000	
Subsequent borrowers)	8,100	8,100	17,100
	27,100		27,100

Here the bank has to keep an additional cash reserve of ₹810. The total cash reserves increase to ₹2,710. Still there is a balance of loanable funds with the bank, amounting to ₹7,290.

Thus, the bank can go on increasing the creation of additional money. However, there are questions that crop up. Is it possible for the bank to increase credit without any limit? Is the power of the bank to increase the supply of deposit money unlimited? The answer is definitely in the negative.

Limitations on the Creation of Credit

The power of commercial banks to create credit is limited mainly by the cash reserves which they have to hold against their deposits and the total amount of legal tender currency issued by the central bank. Every bank has to meet the demands of its customers to pay cash over the counter. So a working reserve of liquid cash is always necessary for a bank.

Of course, if the people are highly banking minded, a lower cash reserve will be sufficient. But in the case of a community where the habits are not well developed, a higher cash reserve will be essential. In either case, a cash reserve is necessary. This acts as a brake on the power of the banks to create credit. To revert to the previous illustration, our supposed bank can go on creating further and further credit money till it finds that it has no more liquid cash to maintain the 10 per cent cash reserve ratio. In other words, it is in a position to supply more and more credit up to an additional amount of ₹90,000. If it wants to expand credit still further, either there should be an additional supply of liquid cash, which entirely is the sole prerogative of the central bank, or the cash ratio should be lowered which can be done only at its own peril. Moreover, a minimum cash reserve ratio is prescribed by law in most countries. Thus, a bank's power to create credit is limited by two factors, viz., the cash reserve ratio and the total amount of legal tender currency.

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So far the analysis was confined to a community where there is only one bank. This is not a realistic assumption. But admittedly, the multiplicity of banks will not make any material alteration in the mechanism of credit creation and the limitations on it. The banking system, taken as a whole, will be conducting its operations on the very same lines. The only difference is that if any bank tries in an isolated manner to expand credit more than the other banks, it will lose cash to other banks. So in the case of a network of branches, each bank will have to keep in step with the others whenever it is creating credit.

In conclusion, commercial banks can increase the total amount of money in circulation through the process of credit creation. In the words of Sayers, 'Bankers are not merely purveyors of money, but also, in an important sense, manufacturers of money.'

Check Your Progress

4. 'A banker is lending money'. What does this statement actually mean?
5. How can commercial bank as a system add money in circulation?
6. Mention the two factors which limit the bank's power to create credit.

1.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Banks in India are regulated by the Banking Regulation Act, 1949.
2. The repayment of deposit on demand is a necessary requirement to qualify to become a bank.
3. According to the Banking Regulation Act, 1949, banking means 'the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.'
4. When it is said that a banker is lending money, he is actually lending money in the deposit credit with a right to the borrower to draw cheques against it.
5. The commercial banks as a system can and do increase the total amount of money in circulation by increasing the purchasing power of the people through the deposit money created by them.
6. A bank's power to create credit is limited by two factors, viz., the cash reserve ratio and the total amount of legal tender currency.

1.6 SUMMARY

NOTES

- Banking plays a pivotal role in modern trade and commerce.
- Banks perform the twin functions of accepting deposits from the public and making loans to needy and deserving people in society.
- Banks lend money to different categories of borrowers. The interest received on those loans becomes their primary source of income and the interest on deposits constitutes the main item of expenditure for a bank.
- Banks in India are regulated by the Banking Regulation Act, 1949.
- According to the Banking Regulation Act, 1949, banking means 'the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.'
- Banks in India are classified into Central Bank, Commercial Banks, Development Banks, Cooperative Banks and Specialized Banks.
- When it is said that a banker is lending money, he is actually lending money in the deposit credit with a right to the borrower to draw cheques against it.
- When the bank buys securities, it pays for them by its own cheque. This cheque, like a currency note issued by the central bank, is an IOU (*I Owe You)* of the bank issuing it.
- The power of commercial banks to create credit is limited mainly by the cash reserves which they have to hold against their deposits and the total amount of legal tender currency issued by the central bank.
- Commercial banks can increase the total amount of money in circulation through the process of credit creation.

1.7 KEY WORDS

- **Cheque:**A *cheque*, or check is a document that orders a bank to pay a specific amount of money from a person's account to the person in whose name the *cheque* has been issued.
- **Liquid cash:** *Liquid cash* represents the most *fluid* asset a company can own. These items can include *cash*, demand deposits, time and savings deposits, and short-term saving accounts easily converted to *cash*.
- **Loan:** A *loan* is money, property or other material goods that is given to another party in exchange for future repayment of the *loan* value amount.
- **Credit:** Credit refers to the ability of a customer to obtain goods or services before payment, based on the trust that payment will be made in the future.

1.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short-Answer Questions

1. What are the two important functions performed by a bank?
2. State the definition of bank.
3. What are the different kinds of banks in India?
4. How do banks add more to the supply of money?

Long-Answer Questions

1. 'When the bank buys securities, it pays for them by its own cheque.' Discuss the statement with examples.
2. How does a bank create credit? Explain.
3. What are the limitations of credit creation? Discuss.
4. What does a bank do when it buys securities? Analyse.

1.9 FURTHER READINGS

Somashekar, NT. 2009. *Banking.* NewAge International. New Delhi.

Goddard, John and Wilson O.S. John. 2016. *Banking: A Very Short Introduction*. Oxford University Press. United Kingdom.

Parameswaran, R. 2001. *Indian Banking.* S. Chand Publishing. New Delhi.

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UNIT 2 UNIT AND BRANCH BANKING

NOTES

Structure

2.0 INTRODUCTION

In order to meet the pressing needs of people, the banking structure of India has constantly evolved. Unlike the past when banks used to be confined to metropolitan cities, today one can witness the presence of banks in a wide range of areas. The focus of the banks has significantly moved towards establishing their presence in rural areas and isolated regions. Typically, there are two types of banking systems which are unit banking system and branch banking system. The unit banking system is a localized system. One typical example of unit banking system is of U.S.A. On the contrary, the branch banking system extend across regions such as the one followed in England.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning of unit banking
- Discuss the purpose of branch banking
- Learn the advantages of unit and branch banking
- Know about the disadvantages of unit and branch banking

2.2 UNIT BANKING AND BRANCH BANKING: BASICS

Group banking and chain banking systems, which have been referred to, are generally found in the USA only. More important systems of banking are the unit banking and branch banking. The USA and England may be taken as the typical

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countries which follow the systems of unit banking and branch banking, respectively. For instance, in England most part of the banking business is in the hands of four major banks which are popularly known as 'the Big Four', viz., the Midland, the Lloyds, the Barclays and the National Westminster. The branches of these banks extend to all parts of England. In addition to England, countries like Canada, South Africa, Australia, India, etc., follow branch banking system. In contrast to this is the banking system of the USA, which is predominantly a localized one. In the USA, unit banks are generally linked together by the 'correspondent bank' system. Under the correspondent bank system, the country banks deposit money with the city banks and the city banks with the reserve city banks. This arrangement helps each bank to make remittances through the correspondent.

Advantages and Disadvantages of Branch Banking and Unit Banking

The advantages of branch banking, which are the objections raised by the advocates of branch banking against unit banking, may be summarized as follows:

- Branch banks as compared to unit banks can provide better facilities to their customers because of the comparatively limited number of customers per banking office and because of the efficiency achieved through large scale operations.
- It is not necessary for any particular branch to maintain large amounts of idle cash reserves. Whenever any help is required by any branch the resources of the other branches can be transferred to that particular branch. Of course, a unit bank can draw on the correspondent banks, but in the case of branch banking the help will readily be forthcoming since it is in the interest of the bank as a whole.
- Management can be made more efficient by proper staff selection, training and appointment of the right person in the right place. This advantage arises as a corollary to the economies achieved through large-scale operations.
- Industrial and geographical diversification of loan risks is possible in the case of branch banking. Because of this even when a branch suffers a loss through the decline of the industries in that locality, the profits earned by the other branches will make up that loss. Whereas in the case of unit banks, those units situated in the depressed areas may undergo heavy losses which might be followed by a crop of bank failures.
- Branch banks increase the mobility of capital which brings uniformity of interest rates. In order to take advantage of the increased interest rates prevailing in any locality, banks under branch banking generally transfer the deposits from the branches situated in those localities where demand for money is relatively low (and consequently interest rates less) to those branches situated in those localities where the demand for money is relatively high (and consequently interest rates higher). In both these localities the

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supply of money is thus brought into equilibrium with the demand and hence the interest rates tend to uniformity over the whole area served by branch banks.

- Remittance facilities can be provided to the customers cheaply because inter-office indebtedness can be more easily adjusted than inter-bank indebtedness.
- Clearing of cheques is comparatively easy since cheques deposited at a branch can be sent to the office in the city where there is a clearing house and then can be cleared in the customary way. But in the case of unit banks clearing involves greater complications and greater expenses.
- Finally, it is said that branch banks give their customers the service of more powerful and solvent banks. A branch has not only the assets of a particular office behind it but the assets of all the offices of the bank.

Now, one may turn the attention to the objections to branch banking which are generally raised by the unit bankers in support of the unit banking system. These may be summarized as follows:

- The branch manager will have to get the permission of the Head Office, which, being totally ignorant of the borrowers, may require the branch to cover each and every loan by collateral securities, thus refusing to lend on the personal security of the borrowers even when they are desirable borrowers. In this respect, the unit banker is at an advantageous position because he will have personal knowledge of the borrowers and can easily decide which of them are desirable.
- Since the branch managers have to refer each and every loan to the Head Office, delay and red taspism are but natural. The unit banker, on the other hand, can use his discretion and can arrive at quick decisions.
- Branch managers are transferred too frequently and so they are liable to be unsympathetic with local needs.
- The failure of a bank with a large number of branches spread all over the country will have wide repercussions throughout the country. On the other hand, the failure of a unit bank will not have generally such countrywide effects since they carry on purely localized business.
- It is difficult to exert a very effective control over all the branches when a bank grows beyond the optimum size. Consequently, mismanagement on a large-scale is more likely under branch banking than under unit banking. As a result, expenses are likely to mount high, having an adverse effect on profits.
- Finally, it is said that market conditions are so localized that unit banking is more suitable.

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No doubt, these objections contain an element of truth. But they hardly constitute a very serious criticism on branch banking and cannot be considered as absolutely valid. For instance, the charge of red tapism and delay in the case of branch banking is not a very serious one as it can easily be remedied by the use of telephone or by giving the branch managers the discretion to lend up to fixed amounts. Therefore, efficiency in management and effectiveness in control can also be maintained by keeping the number of branches within limits and not allowing the bank to grow beyond the optimum. Again, some of the objections raised against branch banking may be considered as its advantages, when viewed from another angle, like the example of the objection on the remoteness of the Head Office. This will enable the branch manager to refuse a loan without straining his personal relationship with the customer by shifting the responsibility of loan refusal to the shoulders of the Head Office. Further, against the objection that branch banking retards local economic development by insisting on collateral securities against loans, it may be stated that it is always better to be on the safe side by following a careful loan policy, and an ideal banker should never underrate the importance of securing advances with proper collateral securities.

In conclusion, advantages weigh heavily with branch banking. That is why countries find increasing favour with branch banking system of banking. Even in the USA, which is known as the home of unit banking, branch banking is permitted by law to a certain extent. 18 states permit state wide branch banking, while 17 states permit limited area branch banking. Only the remaining states specifically prohibit branch banking. Among the leading banks of that country, the Bank of America has branches throughout the State of California.

Check Your Progress

1. Name the banks which hold most of the banking business in England.
2. Where does the money get deposited under the correspondent banking system?
3. Mention any one advantage of branch banks over unit banks.

2.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. In England most part of the banking business is in the hands of four major banks which are popularly known as 'the Big Four', viz., the Midland, the Lloyds, the Barclays and the National Westminster.
2. Under the correspondent bank system, the country banks deposit money with the city banks and the city banks with the reserve city banks.

3. Branch banks as compared to unit banks can provide better facilities to their customers because of the comparatively limited number of customers per banking office and because of the efficiency achieved through large scale operations.

2.4 SUMMARY

- Group banking and chain banking systems, which have been referred to, are generally found in the USA only.
- More important systems of banking are the unit banking and branch banking. The USA and England may be taken as the typical countries which follow the systems of unit banking and branch banking, respectively.
- Branch banks as compared to unit banks can provide better facilities to their customers because of the comparatively limited number of customers per banking office and because of the efficiency achieved through large scale operations.
- Branch banks increase the mobility of capital which brings uniformity of interest rates.
- Branch managers are transferred too frequently and so they are liable to be unsympathetic with local needs.
- It is difficult to exert a very effective control over all the branches when a bank grows beyond the optimum size. Consequently, mismanagement on a large-scale is more likely under branch banking than under unit banking.
- Even in the USA, which is known as the home of unit banking, branch banking is permitted by law to a certain extent.
- 18 states permit state wide branch banking, while 17 states permit limited area branch banking. Only the remaining states specifically prohibit branch banking.
- Among the leading banks of that country, the Bank of America has branches throughout the State of California.

2.5 KEY WORDS

- **Reserves:** Funds or material set aside or saved for future use are called reserves.
- **Unit banking:** Unit banking refers to a bank that is a single, usually small bank that provides financial services to its local community.
- **Branch banking:** Branch banking is engaging in banking activities such as accepting deposits or making loans at facilities away from a bank’s home office.

2.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short-Answer Questions

1. Which systems of banking are followed in the USA and England?
2. What is the advantage of correspondent banking system followed in the USA?
3. How are branch banks better than unit banks?
4. Which of the two banking systems, unit and branch, is more effective in dealing with red tapism?

Long-Answer Questions

1. Describe the advantages of branch banking.
2. Discuss the disadvantages of unit banking.
3. 'Industrial and geographical diversification of loan risks is possible in the case of branch banking.' Comment on the statement with reference to the text.
4. Discuss the objections to branch banking raised by unit bankers.

2.7 FURTHER READINGS

Somashekar, NT. 2009. *Banking.* NewAge International. New Delhi.

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UNIT 3 COMMERCIAL BANKING

NOTES

Structure

3.0 INTRODUCTION

The two most important functions of a commercial bank is accepting deposits and lending loans. Commercial banks are very important for a successful economy. Most people need loans either to buy house, vehicles or other such things. Banks play a very crucial role in providing debts or loans to people so that they can buy assets. The banking structure of India is very flexible which has been evolving to satisfy the immediate needs of the people.

3.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the structure of commercial banking
- Discuss the classification and functions of banks
- Learn about creation of credit and balance sheet
- Know about bank assets and banking structure

3.2 FUNCTIONS OF BANKS

As we have already discussed the classification of banks and creation of credit in the first unit, here we will discuss some other important concepts.

Functions of Commercial Banks and The Services Rendered by Them

The two essential functions of a commercial bank may best be summarized as the borrowing and the lending of money. They borrow money by taking all kinds of deposits. Deposits may be received on current account whereby the banker incurs

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the obligation to repay the money on demand. Interest is not payable on current account deposits. When deposits are received on savings bank account as well, the bank undertakes the obligation to repay them on demand. Interest is usually allowed on savings bank deposits although there are usually restrictions on the total amount that can be withdrawn and/or the number of times withdrawals are allowed during a defined period. When deposits are received on fixed deposit accounts, the banker incurs the obligation to repay the money together with an agreed rate of interest after the expiry of a fixed period. When deposits are received on deposit accounts, the banker undertakes to repay the customer together with an agreed rate of interest in return for the right to demand from him an agreed period of notice for withdrawals. In addition, a new banking account, which is similar to savings bank account, known as flexi bank account has been introduced by banks. Thus, a commercial bank mobilizes the savings of the society. This money is then provided to those who are in need of it by granting overdrafts or fixed loans or by discounting bills of exchange or promissory notes. In short, the primary function of a commercial bank is that of a broker and a dealer in money. By discharging this function efficiently and effectively, a commercial bank renders a very valuable service to the community by increasing the productive capacity of the country and thereby accelerating the pace of economic development. It gathers the small savings of the people, thus reducing the quantity of idle money to the lowest limits. Then, it combines these small holdings in amounts large enough to be profitably employed in those enterprises where they are most called for and most needed. Here it makes capital effective and gives industry the benefits of capital, both of which otherwise would have remained idle. For instance, take the practice of discounting bills of exchange. By converting future claims into present money, the commercial bank bridges the time element between the sale and the actual payment of money. This will enable the seller to carry on his business without any hindrance; and the buyer will get enough time to realize the money.

Thus, a commercial bank receives deposits which it has to repay according to its promise and makes them available to those who are really in need of them. The bank is actually distributing its deposits between the borrowers and its own vaults. Herein, lies the most delicate of the functions of a commercial bank.

Besides these two main functions, a commercial bank performs a variety of other functions which may broadly be grouped under two main heads, viz., the agency services and the general utility services.

Agency Services

A commercial bank provides a range of investment services. Customers can arrange for dividends to be sent to their bank and paid directly into their bank accounts, or for the bank to detach coupons from bearer bonds and present them for payment and to act upon announcements in the press of drawn bonds, coupons payable, etc. Orders for the purchase or sale of stock exchange securities are executed through the banks' brokers who will also give their opinions on securities or lists of securities. Similarly, banks will make applications on behalf of their customers for allotments arising from new capital issues, pay calls as they fall due and ultimately obtain share certificates or other documents of title. On certain agreed terms, the banks will allow their names to appear on approved prospectuses or other documents as bankers for the issue of new capital; they will receive applications and carry out other instructions.

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A commercial bank undertakes the payment of subscriptions, premia, rent, etc., on behalf of its customers. Similarly, it collects cheques, bills of exchange, promissory notes, etc., on behalf of its customers. It also acts as a correspondent or representative of its customers, other banks and financial corporations.

Most of the commercial banks have an 'Executor and Trustee Department'. Some may have affiliated companies to deal with this branch of business. They aim to provide a complete range of trustee, executor or advisory services for a small charge. The business of banks acting as trustees, executors, administrators, etc., has continuously expanded with considerable usefulness to their customers. By appointing a bank as an executor or trustee of his/her will, the customer secures the advantage of continuity, avoiding to have made changes, impartiality in dealing with beneficiaries and in the exercise of discretions and the legal and specialized knowledge pertaining to executor and trustee services. When a person dies without making a will, the next-of-kin can employ the bank to act as administrator and to deal with the estate in accordance with the rules relating to intestacies. Alternatively, if a testator makes a will but fails to appoint an executor, or if an executor is unable or unwilling to act, the bank can usually undertake the administration with the consent of the persons who are immediately concerned. Banks will act solely or jointly with others in these matters, as also in the case of trustee for stocks, shares, funds, properties or other investments. Under a declaration of trust, a bank undertakes the supervision of investments and distribution of income; a customer's investments can be transferred into the bank's name or control, thus enabling it to act immediately upon a notice of rights issue, allotment letters, etc. Alternatively, where it is not desired to appoint the bank as nominee, these services may still be carried out by appointing the bank as attorney. Where business is included in an estate or trust, a bank will provide for its management for a limited period, pending its sale to the best advantage as a going concern or transfer to a beneficiary.

Private companies wishing to set up pension funds may appoint a bank as custodian, trustee and investment advisor, while retaining the administration of the scheme in the hands of the management of the fund.

Most banks will undertake the preparation of income tax returns on behalf of their customers and claim for the recovery of overpaid tax. They also assist the customers in checking the assessments. In addition to the usual claims involving personal allowances and reliefs, claims are prepared on behalf of residents abroad, minors, charities, etc.

General Utility Services

These services are those in which the bank's position is not that of an agent for his customer. They include the issue of credit instruments like letters of credit and travellers' cheques, the acceptance of bills of exchange, the safe custody of valuables and documents, the transaction of foreign exchange business, acting as a referee as to the respectability and financial standing of customers, providing specialized advisory service to customers, etc.

Banker's Drafts and Letters of Credit

By selling drafts or orders and by issuing letters of credit, circular notes, travellers' cheques, etc., a commercial bank is discharging a very important function. A banker's draft is an order, addressed by one office of a bank to any other of its branches or by any one bank to another, to pay a specified sum to the person concerned. A 'letter of credit' is a document issued by a banker, authorizing some other bank to whom it is addressed, to honour the cheques of a person named in the document, to the extent of a stated amount in the letter and charge the same to the account of the grantor of the letter of credit. A letter of credit includes a promise by the issuing banker to accept all bills of exchange to the limit of credit. When the promise to accept is conditional on the receipt of documents of title to goods, it is called a 'documentary letter of credit'. When the promise is unconditional, it is called a 'clean letter of credit'. Letters of credit may again be classified as revocable and irrevocable. A 'revocable letter of credit' is one which can be cancelled at any time by the issuing banker. But the banker will still be liable for bills negotiated before cancellation. An 'irrevocable letter of credit' is one which cannot be cancelled before the expiry of the period of its currency. 'Circular letters of credit' are generally intended for travellers who may require money in different countries. They may be divided into 'travellers letter of credit' and 'guarantee letters of credit'. A 'travellers letter of credit' carries the instruction of the issuing bank to its foreign agents to honour the beneficiary's drafts, cheques, etc., to a stated amount which it undertakes to meet on presentation. While issuing a 'guarantee letter of credit', the bank secures a guarantee for reimbursement at an agreed rate of interest, or it may insist on sufficient security for the grant of credit. There is yet another type which is known as 'revolving credit'. Here the letter is so worded that the amount of credit available automatically reverts to the original amount after the bills negotiated under them are duly honoured.

Circular Notes, Travellers Cheques, Circular Cheques

Circular notes are cheques on the issuing banker for certain round sums in his own currency. On the reverse side of the circular note is a letter addressed to the agents specifying the name of the holder and referring to a letter of indication in his hands, containing the specimen signature of the holder. The note will not be honoured unless the letter of indication is presented. Travellers' cheques are documents similar to circular notes with the exception that they are not accompanied by any letter of indication. Circular cheques are issued by banks in certain countries to their agents abroad. These agents sell them to intending visitors to the country of the issuing bank.

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Safe Custody of Valuables

Another important service rendered by a modern commercial bank is that of keeping in safe custody valuables such as negotiable securities, jewellery, documents of title, wills, deed-boxes, etc. Some branches are also equipped with specially constructed strong rooms, each containing a large number of private steel safes of various sizes. These may be used for a small fee. Each user is provided with the key of an individual safe and thus not only obtains protection of his/her valuables but also retains full personal control over them. The safes are accessible at any time during banking hours, and often longer.

Night Safes

For shopkeepers and other customers who handle large sums of money after banking hours, 'night safes' are available at many banks. Night safe takes the form of a small metal door on the outside wall of the bank, accessible from the street, behind which there is a chute connecting with the bank's strong room. Customers who require this service are provided with a leather wallet, which they lock before placing in the chute. The wallet is opened by the customer when he calls at the bank the next day to get the contents credited to his account.

Referee as to the Respectability and Financial Status of the Customer

Another function of great value, both to banks and businessmen, is that of the bank acting as a referee as to the respectability and financial status of the customer.

Bank Giro

Among the services introduced by a modern commercial bank during the last quarter of a century or so, the 'bank giro' and 'credit cards' deserve special mention. The 'bank giro' is a system by which a bank customer with many payments to make, instead of drawing a cheque for each item, may simply instruct his bank to transfer to the bank accounts of his creditors the amount due from him. He writes one cheque debiting his account with the total amount. Credit advices containing the name of each creditor with the name of his bank and branch will be cleared through the 'credit clearing' of the clearing house, which operates in a similar way as for the clearing of cheques. Even non-customers of a bank may make use of this facility for a small charge. A direct debiting service is also operated by some banks. This service is designed to assist organizations which receive large number of payments on a regular basis. A creditor is thereby enabled, with the prior approval of the debtor, to claim any money due to him direct from the debtor's bank account. To some organizations, for example, insurance companies, which receive, say, six equal sums on six dates in a year, the scheme is only an extension of the standing order facility but for the public utilities and traders which send out invoices for valuable amounts at differing times, the scheme is an entirely new one.

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Credit Cards

A credit card is basically a payment mechanism which allows the holder of the card to make purchases without any immediate cash payment. Credit limit is fixed by the issuing bank and the limit is determined by the financial history as well as the type of card. Users are issued with a card on production of which their signatures are accepted on invoices in merchant establishments participating in the scheme. The issuing bank makes the payment to the merchant establishment selling the relevant goods or services. The holder to whom the card is issued, in turn, reimburses the bank on receipt of the billing statement. Generally it is not necessary to reimburse the bank with the entire amount on the billing statement. After making payment of the minimum amount due every month, the balance could be staggered over a period. Of course, outstanding balance plus any overdue will attract service charge at a certain rate. Also, users are generally required to pay a regular subscription for the use of the service. Different types of cards are available. The benefits attached to the card vary according to the type of the card.

Often, the bank which issues the card will be a member of a payments brand. For instance, VISA is a payments brand with global payments system. Its cards are accepted at numerous locations (about 23 million merchant establishments) all over the world. All establishments displaying VISA logo accept VISA cards for all transactions. Of course, VISA itself does not offer cards or financial services; it only advances new payment products and technologies on behalf of its members.

On every card transaction conducted, the merchant establishment will give a commission which will be shared by the issuing bank and the acquirer bank (i.e., the bank which approaches the merchant establishment for its acceptance of the card). If it is a branded card, a part of the commission will go to the payments brand. For instance, if it is a VISA card, a part of the commission will go to VISA. Suppose Bank 'A' has convinced merchant establishment 'X' to accept VISA cards. This means that all VISA cards will be accepted by establishment 'X'. In case establishment 'X' accepts the VISA card issued by Bank 'B', then the commission will be shared by Bank 'A', Bank 'B' and VISA. Establishment 'X' will collect the amount due to it from Bank 'A' and Bank 'A' will collect the amount from Bank 'B' (the bank which has issued the card). Bank 'B' will collect the amount from the card holder. The entire transaction is routed via VISA.

Kisan Credit Cards and Laghu Udyami Credit Cards

A Kisan Credit Card (used to be designated as 'green card' by some banks) issued by Indian banks, aimed at providing adequate and timely support from the banking system to the farmers for their cultivation needs including purchase of inputs in a flexible and cost effective manner. More specifically, kisan credit cards will facilitate farmers in the purchase of agricultural inputs such as seeds, fertilizers and pesticides and to draw cash for other production and ancillary needs as many times as they wish. Unlike the usual credit cards, kisan credit cards are issued based on the landholding of agriculturists. As such, the provision of one-by-six scheme (i.e., the provision requiring the holder of a credit card to furnish income tax return) is not applicable to holders of kisan credit cards. The credit extended in the case of a kisan credit card would be revolving cash credit and provides for any number of drawals and repayments within the limit. The quantum of limit is based on operational landholding, the cropping pattern and scales of finance approved for the area. The cards are valid for three years and subject to an annual review.

Encouraged by the kisan credit card scheme, Laghu Udyami Credit Cards have been introduced in India for providing simplified and borrower-friendly credit facilities to retail traders, artisans, professionals and self-employed persons, small industrial units and small businessmen including those in the tiny sector.

Debit Cards

The main difference between credit cards and debit cards lies in the words 'credit' and 'debit'. In case of a credit card, the card holder makes the cash payment at the end of the month. On other hand, in the case of a debit card, it runs down ones deposit account the moment the sale is made. In other words, while using a debit card, one is using ones own money in the bank account. Thus, while making a payment to a merchant establishment by using a debit card, it assumes the form of a transaction between the establishment and ones bank account. Debit cards are more readily accepted by merchant establishments since they get instant payment. Debit cards free the card holder from carrying cash for his/her purchases. Although debit cards are convenient in one sense, the card holder has to be extremely careful with the card. If the card is lost or is stolen, the entire balance in the bank account could be emptied with a single purchase by an unscrupulous person.

ATM Cards

An ATM (Automatic Teller Machine) Card is a variation of a debit card which one can use in a cash machine by punching in ones PIN (Personal Identification Number) for making cash withdrawals from ones bank account. ATM cards have the advantage over debit cards in that a person other than the card holder will not be able to use it for cash withdrawals because of the secrecy surrounding the card holder's Personal Identification Number. Also, most banks limit the amount of cash that can be withdrawn on any single day.

Budget Accounts

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Some banks are opening budget accounts for credit-worthy customers. The bank guarantees to pay, for a specific charge, certain types of annual bills (e.g., fuel bills, rates, etc.,) promptly as they become due, while repayments are spread over a twelve-monthly period from the customer's account.

All these money transmission services have particular regard to the developments in computerised book-keeping which the banks in most countries have already introduced.

EFT (Electronic Funds Transfer) Service

Another important service which is of comparatively recent origin is the Electronic Funds Transfer (EFT) service. This is a service under which funds are transferred electronically over the telephone, either nationally or internationally. International funds transfers from applicant to beneficiary are made in as little as a few seconds. The international network known as 'SWIFT' (Society for Worldwide Interbank Financial Telecommunications), an organization promoted by banks and financial institutions around the world, is utilized to facilitate the speedy transfer of funds across international destinations without any paper work and expeditious efficiency. SWIFT is the largest network in the world which has around 4,800 users in 130 countries. This is a path breaking technology that will ultimately pave the way for paperless banking. In addition to the service which it renders to individual customers, it will go a long way in curing the corporate sector's headaches of cash management in multiple locations.

Overseas Trading Services

Recognition of overseas trade has encouraged modern commercial banks to set up branches specializing in the finance of foreign trade. Banks in some countries have taken interest in export houses and factoring organizations. Assisted by banks affiliated to them in overseas territories, they are able to provide a comprehensive network of services for foreign banking business, and many transactions can be carried through from the start to finish by a home bank or subsidiary. In places where banks are not directly represented by such affiliated undertakings, they have working arrangements with correspondents so that the banks are in a position to undertake foreign banking business in any part of the world.

The banks provide more than just a means for the settlement of debts between traders, both at home and abroad for the goods they buy and sell. They are also providers of credit and enable the company to release the capital which would otherwise be tied up in the goods exported. An outline of some of the services provided by banks for overseas traders is given.

For centuries, the bill of exchange has been one of the chief means of settlement in trade. Its function is to enable a seller or exporter of goods to obtain cash as soon as possible after the dispatch of goods, and yet enable the buyer or importer to defer payment until the goods reach him or later.

There are many ways in which trade may be financed with bills of exchange. Two common ways are:

1. The exporter will draw a bill of exchange on the importer, or, by arrangement between the parties, on the importer's bank, for the amount of the exporter's invoice for the goods. Shipping documents (usually the invoice, marine insurance policy and the 'bill of lading' which is the shipowner's receipt for the goods) which will convey title to the goods are attached to the bill of exchange. The exporter will sell ('negotiate' in technical terms) the bill with the documents to a local banker. The receipt of the documents of title along with the bill means that, in effect, goods are in possession. Thus, the bank will be willing to pay the exporter practically the full amount of his invoice and bill. The bank will immediately forward the bill and the documents to its banking correspondents or agents in the importer's country to be presented to the importer, or the importer's bank as the case may be, for payment if the bill is payable on demand , or for acceptance if the bill is a 'term bill'.
2. The importer's bank, at its request, will arrange for its banking correspondents or agents in the exporter's country to accept a term bill drawn on them by the exporter, and to be accompanied by shipping documents mentioned in (1) above. (Such an arrangement is an example of 'opening credit' which is mentioned below). When the bill is accepted, it will be returned to the exporter who can either keep it until the period of the bill expires and then claim payment from the accepting bank, or, as is more likely in practice, sell the bill to his own or other banks. The accepting bank, upon accepting the bill, will detach the shipping documents and send them to the importer's bank.

If a bill is payable on demand (i.e., a 'demand bill'), the importer, or his bank on his behalf if the bill is drawn on that bank, has to pay the whole amount when the bill is presented.

If the bill is drawn payable at a later date (i.e., a 'time bill' or a 'term bill'), for example three months after presentation, it is, upon presentation, accepted by the importer if it is drawn on him, or by his bank on his behalf if it is drawn on it by special arrangement. But the importer is not called upon to pay until the three months are up.

Usually, the arrangement between the buyer and the seller will be that the shipping documents which accompany the bill are to be detached upon payment or acceptance of the bill by the importer or by a bank on his behalf. The documents thus become available to the buyer so that he can take delivery of the goods when the ship arrives, resell them in the ordinary way; and from the proceeds recoup himself or his bank, or make funds available to meet the bill when it matures.

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An overseas buyer may arrange through his bank in the home country to open a documentary credit in favour of the seller. This is an undertaking that the bank will honour drafts drawn in accordance with the terms of credit, if accompanied by stipulated shipping documents, insurance policies, etc., and presented not later than the date of expiry of the credit. The terms usually cover the nature, price and quantity of the goods, the method of shipment, the documents to be attached and the date by which shipment must be effected. The creditor may undertake payment of a demand draft or acceptance of a term draft. It may be expressed in home currency or in foreign currency, this depending on the condition of sale. It may be either revocable or irrevocable. The former may be cancelled at any time but the latter cannot be cancelled without the consent of both the parties. Therefore, an irrevocable credit provides much greater protection to the exporter.

If, for instance, a foreign importer has no account with an Indian bank, he will open the credit with his local bank. The exporter may, however, prefer to receive a corresponding advice that the credit is opened from an Indian bank. Consequently, it is usual for the foreign bank to instruct its Indian banking correspondent to advise the credit to the exporter. As an additional safeguard, an Indian exporter may require his bank not only to advice but also to undertake responsibility by adding its confirmation. This is known as a 'confirmed credit'. Having received the advice on shipment of the goods, the exporter must lodge the documents within the time allowed by the credit. If the documents are in order as stipulated in the credit, the exporter will receive immediate payment if it provides for sight payment. If it calls for a bill drawn payable after sight, the bank will accept the bill which will then be available for discount. If, for any reason, the exporter is unable to present the document he must request the importer to instruct the relevant bank to extend or amend the credit.

In case where it is not possible to arrange a documentary credit and the arrangement is for payment to be made only when the goods have been sold, a bank can usually undertake the dispatch of the shipping documents and arrange the goods to be warehoused and insured in the name of a correspondent bank, pending delivery of the goods in part or in whole to the exporter's agent against payment. The correspondent bank will then remit proceeds of sales as and when they are made by the agent. Exporters who are dealing with first-class agents may be prepared to ship their goods on open account. In such cases, the exporter usually sends the documents directly by air mail to the consignee, who acts as his agent for the sale of the goods. Remittances, in order to avoid the inconveniences of collection, may be by a cheque on an Indian bank or by a telegraphic transfer.

Information and Other Services

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As part of their comprehensive banking services, many banks act as a major source of information on overseas trade in all its aspects. Some banks produce regular bulletins on trade and economic conditions at home and abroad, and special reports on commodities and markets. In some cases, they invite enquiries from those wishing to extend their foreign trade, and are able through their correspondents to furnish the names of reputable and interested dealers of goods and commodities and to advise on the appointment of suitable agents. For businessmen travelling abroad, letters of introduction indicating the purpose of journey undertaken, can be issued addressed to banking correspondents in the various centres it is proposed to visit. In this way, it is often possible to establish new avenues of business. On request, banks obtain confidential opinions on the financial standing of companies, firms or individuals at home or overseas for customers for the purpose of business.

Commercial banks furnish advice and information of trade, outside its scope. If it is desired to set up a subsidiary or branch overseas(or, for an overseas company to set up in the home country) they provide detailed information on local legal requirements on company formation, tax requirements, exchange control and insurance, helping to establish contact with local banking organizations.

To sum up, the services rendered by a modern commercial bank is of inestimable value. It constitutes the very life blood of an advanced economic society. In the words of Walter Leaf:

'The banker is the universal arbiter of the world's economy.'

Check Your Progress

1. What are the two essential functions of a commercial bank?
2. What are general utility services?
3. Define banker's draft.

3.3 INVESTMENT POLICIES

Investment banks are organizations which assist business corporations and governmental bodies to raise funds for long-term capital requirements through the sale of shares, stocks. bonds, etc. These banks, unlike commercial banks, act primarily as middlemen between business corporations and investors. Generally, they purchase the entire issue of new securities of the business corporations or of governmental bodies and re-issue them for public subscription at a higher price. Sometimes, they may act as agents on commission basis, but as a rule they underwrite the issue of securities.

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Investment banks are classified as 'originators', 'underwriters' and 'retailers.' As originators, they bring out new issues of securities; as underwriters they underwrite the issues; and as retailers they retail the securities to individual and institutional investors. Frequently a single institution may act in all these capacities.

The operative technique of the investment bankers may be briefly stated as follows. The originator enters into all the preliminary negotiations with the issuing corporation. Ordinarily, he requires detailed reports regarding the origin and history of the issuing corporation, the nature of its products, the condition of plant and machinery and other assets, its capital structure, the intention of the new issue, etc., authenticated by the opinions of expert technicians and professional accountants together with an attorney's report regarding the legality of the issue. On finding the details satisfactory, the originator enters into an agreement with the issuing authority undertaking to bring out the new issue. If the issue is a large one, the originator calls upon the other investment bankers to join him in forming an 'Underwriting Syndicate'. The next step is to invite the smaller retailers to join with the underwriting syndicate in order to form a selling group. Finally, the securities are offered for public subscription. Simultaneously, the originator adopts a method to avoid any possible glut in the market prices of these securities. Owing to the psychological reaction of the early buyers, they may, out of their nervousness, offer the securities for sale at very low prices in the market. In order to counter any such reaction, the originator leaves an 'open order' to repurchase these securities at a price slightly below the price at which they are offered to the public. However, if the market for these securities becomes very weak, this 'open order' may boomerang upon the originator himself resulting ultimately in the repossession of the securities previously sold to the public. But such cases are not frequent.

An investment banker, thus, performs a highly useful service to the business world by providing the necessary capital for long-term capital needs of industry. He has been aptly termed as the entrepreneur of entrepreneurs. The investing public is also benefited by the activities of the investment banker. This is because of the independent and comprehensive analysis which he makes in order to gauge the desirability of the securities which he proposes to underwrite. Of course, instances are not wanting where unscrupulous investment bankers have cheated the public, thereby damaging the goodwill of the entire investment banking system. However, it is gratifying to note that many countries have already enacted protective legislations providing for the prosecution of dishonest security dealers.

3.4 BANK ASSETS AND STRUCTURE

Just as in the case of any other commercial enterprise, the commercial banks strive to earn a profit. But is profitability everything which a bank should pay attention to? Can we justify a commercial bank in employing its funds in a risky manner in anticipation of windfall profits? The answer is definitely in the negative. A commercial bank is a custodian of others' surplus funds. Therefore, while earning

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a profit, the bank should never forget the fact that it is doing business with the funds of others, which it acquires because of its credit. It has been seen that these funds (deposits) are either repayable on demand or after the expiry of a fixed period. In either case, the bank must be ready to meet the liabilities whenever necessary. In other words, it means that the bank has many outstanding contracts for the future delivery of money. In case of failure, it will suffer in its credit which is the very basic foundation on which its business stands. Not only will it feel the shock of such a failure, but it will also be transmitted to the other links of the banking system, thereby precipitating nation-wide bank failures. Hence, a commercial bank should always bear in mind that it is the guardian of a very delicate mechanism which paves the way for future economic development and which, if disturbed, will create monetary disequilibrium with all the evil effects incidental thereto. Obviously, a commercial bank should take the necessary precautions to keep its assets as liquid as possible. Now the question arises as to what exactly is meant by the term 'liquidity.'

By 'liquidity' one means the capacity to produce cash on demand. No doubt, the most liquid asset is cash in the vaults of a bank. It is necessary for a bank to keep a certain percentage of the deposits in the form of liquid cash as reserve, either in its own vaults or with his bank, generally the Central Bank. But such liquid cash does not earn anything and as such it is purely idle money, intended to provide the necessary liquidity by meeting the immediate withdrawals of deposits. As a rule, successful banking is dependent on the capacity of these reserves to meet the immediate requirements. When liquidity is provided by the cash reserves as above, a bank should invest its excess money in some assets which are liquid in nature and at the same time which could earn an income.

'Liquid assets' may be explained briefly. These are which can be turned into cash quickly and without loss, to meet the claims of the customers. But if an asset is to be turned into cash quickly, it must be shiftable in nature. In other words, the liquidity of an asset depends on the question of shifting it to the central bank or to others willing to supply cash in exchange for it. For example, if a bank holds a first class bill of exchange, among its other assets, which satisfies the eligibility rules of the central bank, it can be rediscounted with the central bank when the bank is short of funds. Again, a government security satisfies the quality of an ideal liquid asset since it is in great demand in the stock exchange and as such shiftable. But it is important to remember that liquidity implies not only shiftability but also shiftability without loss. To take an example, the ordinary shares of an industrial enterprise may be shiftable but only at a discount. Here shiftability is possible only at a loss and hence it cannot be considered as an ideal banking asset.

The conclusion that one arrives at from the above analysis, is that commercial banks, while employing their funds, should pay regard both for profitability and liquidity. Liquidity in its turn is dependent on shiftability without loss. An important point to be remembered in this connection is that liquidity should not be sacrificed at the altar of profitability. At the same time no less important is it to remember that to maintain excessive liquidity is to sacrifice earnings, without which banking operations cannot be carried on successfully. An efficient and effective commercial bank would, therefore, follow a via media between liquidity and profitability while employing its funds and selecting its assets.

Employment of Funds by Commercial Banks

Generally, following are the important items seen on the assets side of the Balance Sheet of a commercial bank:

- Cash in hand
- Money at call and short notice
- Bills discounted
- Investments
- Loans and advances

The above items are given in the order of liquidity.

The first item appearing on the asset side of a commercial bank's balance sheet is 'cash in hand', including cash reserve at the central bank and demand deposits with other banks. This is the most liquid of all assets. From the point of view of profitability, a banker is tempted to minimize his cash holdings, while from the point of view of liquidity, he is tempted to maximize his cash holdings. To maintain more reserves than what is necessary is to impair the profits. The English bankers usually maintain a cash ratio of 8 per cent while in India, a higher cash ratio is desirable owing to the undeveloped and unpredictable nature of the money market.

A banker is generally guided by experience in deciding what proportion of his deposits in cash will enable him to meet all demands readily. In addition to the minimum requirements indicated by experience, a wise banker must necessarily allow for unpredictable needs. In this connection, certain important considerations influencing the cash reserves of a banker may be pointed out.

In the first place, if the customers are highly banking minded, the need for liquid cash will be small because in that case, depositors will seldom demand the payment of cash and will content themselves by the transfer of rights which the bank can do by mere book entries. Secondly, the banking habits of the customers and the business conditions of the locality will have an important bearing on the cash reserves. Certain businesses carried on by the depositors may make heavy occasional demands for cash which the banker will have to meet with adequate provision of liquid cash. Thirdly, it is also dependent on the reserves kept by other banks of the locality. If certain banks are keeping higher amounts of cash reserves, other banks will be compelled to increase their cash ratio in their bid for popularity. Further the nature of the accounts and the size of average deposits also influence cash reserves. For instance, if the accounts are of a fluctuating nature, a higher cash reserve may be required. So also the cash reserves of a bank having only a

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few large deposits will be generally large because of the chances of heavy withdrawals. On the other hand, if the bank has a large number of small sized deposits, the danger of large withdrawals by any individual customer will be less and hence it need not maintain a large amount of liquid cash. Again, the presence of a bankers' clearing house greatly reduces the need for liquid cash to be kept by a bank because it has only to provide for the difference between the cheques drawn on it and the cheques drawn by it on other banks. Even this difference is settled by mere book entries by the clearing house. Lastly, the bank has to take into account probable receipts of cash by it and probable demands upon it, in the near future.

Thus, the ratio of liquid cash to deposits which a banker should maintain is dependent upon a number of considerations. It varies from place to place and from bank to bank. Therefore, it is not possible to lay down any hard and fast rule regarding the exact cash reserve ratio which a bank should maintain. It has to give due consideration to the various factors discussed above and has to come to a conclusion as to the amount of liquid cash which it should maintain. In this connection, it may be pointed out that commercial banks, in most countries, are statutorily required to maintain a minimum reserve of liquid cash.

Earning Assets of a Bank

The cash reserves of a bank may be strengthened by a judicious selection of certain earning liquid assets. Among these 'Money at Call and Short Notice' stands first. This item represents largely the amounts lent to the discount market and/or to stock exchange which are recoverable either on demand or on serving a short notice. This constitutes the second line of defence. This asset has an advantage over 'Cash Reserves', the first line of defence of a commercial bank in so far as it satisfies, to a certain extent, both the attributes of a sound banking asset, viz., profitability as well as liquidity. It is liquid in the sense that it is recoverable at call or short notice; it is profitable in the sense that it earns interest.

'Bills discounted' is also considered as a highly earning liquid asset and is included among the 'money market assets.' It is considered to liquidate itself automatically out of the sale of the goods covered by such a bill (i.e., a first class bill of exchange is considered to be a self liquidating paper). Again, it is readily shiftable to the central bank (by rediscounting it with the central bank) without much loss because of the very short length of life of such a bill. As a matter of fact, a bill of exchange is generally of three months duration and as such the loss involved in rediscounting it will not be very great, even when it is not shifted. All this indicates that 'bills discounted' is one of the most earning liquid assets, satisfying both the qualities of an ideal banking asset.

It is not unusual for a commercial bank to invest its funds in stock exchange securities like government securities, semi-government securities, industrial securities, etc. These are represented by the term 'Investments'. They enable the bank to obtain more earning than that afforded by 'Loans at Call and Short Notice'

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or 'Bills Discounted', although they are less liquid. Here the bank gives importance not only to the safety of the investment but also to the possibility of easy conversion into cash without loss. The principles that influence a bank in rating these securities while selecting them are the safety of capital, easy marketability, stability of price and stability of income. The bank should always bear in mind that in buying these securities it is not its primary object to gain by a possible rise in the prices of these securities. Consideration should be given to this factor only if it is satisfied with the safety and stability of capital. Generally commercial banks prefer government securities to the shares and stocks of joint stock companies. The reasons are manifold. Firstly, the repayment of capital is ensured because this depends on the creditworthiness of the whole nation, whereas in the case of an ordinary stock exchange security, safety of capital is entirely dependent on the creditworthiness of a single institution. Secondly, the yield from a government security is steady and reasonable. Thirdly, they are easily saleable without causing a glut in their market prices, whereas in the case ordinary industrial securities, sale of a large block of shares is likely to depress their prices.

The item 'Loans and Advances' comes next in the order of liquidity. For all practical purposes they are not shiftable. Of course, this is the most profitable of a bank's assets, and a bank's earnings are mainly derived from these assets. As a rule, a commercial bank will lend only for short-term commercial purposes. It is not considered to be its duty to provide long-term loans for investment purposes. Such loans are provided by specialized agencies such as industrial banks. The reason advanced in support of this view is that in the case of long-term loans, the bank will find it difficult to realize them when emergencies arise. For example, in the case of a mortgage, the mortgaged property may cover the loan with a safe margin. But when the bank needs liquid cash most, it may find it difficult to convert the mortgaged property into liquid cash. Herein, lies the meaning of the oft-quoted statement. 'The art of banking lies in knowing the difference between a mortgage and a bill of exchange.' In the case of a bill of exchange, it is of a self liquidating character and offers an ideal security for a bank's investment for reasons already explained.

Certain general principles may be laid down which should guide a commercial bank when it is making loans and advances. Before granting a secured loan, it should carefully consider the margin of safety offered by the security, possibility of fluctuations in its vale and possibility of shiftability. In case of an unsecured loan, its repayment entirely depends on the credit of the borrower. As such, the cardinal principles which the bank should consider are 'character', 'capacity' and 'capital' (usually referred to as the three Cs) of the borrower. In either case the bank should aim at spreading these loans as widely as possible over many industries and localities. It is also advisable for a bank to advance moderate amounts to a large number of customers than advance large amounts to a small number of customers.

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In addition to the above items, certain other items also appear on the assets side of a bank balance sheet, viz., 'Acceptances and Endorsements as per Contra' and 'Furniture, Premises, etc'. Among these items, the item 'Acceptances and Endorsements as per Contra' refers to the amounts due from the customers on whose behalf the bank has accepted bills of exchange. These amounts are due from the customers and hence they are considered as assets. In a certain sense, this item represents a liability of the bank also since the liability to honour these obligations will fall upon the bank if the customers fail to meet them on the due dates.

The other items such as furniture, premises, etc., are not important from the point of view of the investment portfolio of a bank as they are the least liquid of all the assets. Further, they are not intended for conversion into cash to meet an emergency.

Self-Liquidating Paper Theory vs Anticipated Income Theory

Traditional banking theory favoured by the conservative bankers holds that the earning assets of a bank should be limited to short-term self liquidating productive loans. These include self liquidating commercial papers or short-term loans intended to provide the current working capital, which in itself is of a self liquidating nature. The merit of the 'self liquidating theory' of commercial bank loans is derived from the fact that such loans are considered to liquidate themselves automatically out of the sale of goods covered by such a transaction. For instance, look at the case of a bill of exchange, a typical example of a self liquidating paper, drawn for the purpose of purchasing raw materials. The bill is covered by a genuine commercial transaction. And a bank is justified in giving a loan against such a paper because such self liquidating papers automatically provide the bank with liquidity through loan repayments. Not only that but they are also shiftable to the central bank in times of emergencies since the central bank, being the lender of the last resort, is willing to rediscount such self liquidating papers. The loss avoiding aspect of liquidity is also present here because of the very short periods for which these loans are given. Moreover, they protect the business world against inflation because of their elastic nature to correspond with trade demands. Their volume increases as production increases and decrease as production decreases. No wonder, the traditional bankers heavily favoured the claims of self liquidating theorists.

The validity of the self liquidating theory, however, has been challenged by certain modern writers. They are contend that the transaction covered by a self liquidating paper does not by itself always guarantee the liquidity of the loan, especially when there is an abnormal fall in the prices of those commodities covered by the transaction. It is said that customers' loans to provide their current working capital are not a safe and reliable source of bank liquidity. The contention that self liquidating commercial loans provide protection against inflation has also been challenged by the critics. They argue that during boom periods, when the business conditions are prosperous, the borrowers increase their loans by offering more

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and more self liquidating papers. As full employment is reached, the prices increase because of the increase in the money supply as compared to the output, introducing inflationary tendencies in the economy. They conclude by saying that the theory of self liquidating loans has fallen out of date. And as an alternative, they advocate a new theory of bank liquidity, viz., 'Anticipated Income Theory of Liquidity.' The origin of this theory lies in the extension of term loans by the commercial banks of the USA for financing long-term capital needs of industry. The loans are granted on the specific condition on the part of the borrower to conduct the financial and other affairs in such a manner as agreed upon between him and the bank. The loans are to be liquidated out of the anticipated earnings of the borrowing enterprise.

Whatever be the merits of such a theory, a point may be said in favour of the traditional theory of commercial bank assets. When a bank provides short-term self liquidating productive loans, it is fairly easy for the bank to gauge the liquid position of its customer because of the short length covered by such loans. In the case of long-term loans granted on the basis of anticipated incomes of such loans, the question involved is not one of gauging the current liquidity position of the borrower, but the future earning capacity of the borrower. This depends on the correct assessment of a number of factors which may go wrong. Due to this, conservative bankers still find favour with the view that it is always good commercial banking to make short-term self liquidating productive loans.

Check Your Progress

4. Define investment banks.
5. How are investment banks classified?

3.5 CLEARING HOUSES

Let us begin with two banks, say, Bank A and Bank B. Everyday the customers of Bank A will be receiving cheques drawn on Bank B by its customers. The customers of Bank A will deposit these cheques with their bank for collection. The customers of Bank B will also be receiving cheques drawn on Bank A by its customers which they will deposit with their bank, Bank B, for collection. The simplest method for the banks is to send their peons to the respective drawee bank and to collect cash over the counter. This method, no doubt, appears very simple. But at the same time, it is very cumbersome and expensive. Both the banks will have to keep a large amount of legal tender currency to meet the cheques drawn on each. This affects the profit earning capacity of both the banks and hence their efficiency. At the end of the day, each bank would find that it had paid a certain amount of cash to the other and had received a certain amount of cash from the other. So, it would be much better if the accounts between these two banks were settled as at the end of each working day on the principle of setting off a debt which one owes to

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another by a claim against him and paying the difference in cash. Where there are many banks, business will be easily facilitated if this principle is extended so that the cross obligations are set off through a central organization. 'Clearing house' is such a central organization.

A clearing house may be defined as an organization of various banks constituted for the purpose of offsetting inter-bank indebtedness arising from the transfer of deposits by a customer of a particular bank to another bank.

The mechanism of offsetting inter-bank indebtedness through a clearing house operates as follows. Officials representing various banks meet at a common place, the clearing house, everyday. Each representative then delivers cheques to the others and other claims which his bank holds against them. So he also receives the claims from the others which their respective banks hold against his bank. Cheques and other documents dishonoured will be returned to the representative of the respective bank. The various amounts of receipts and deliveries are added up and a balance is struck therein. The final settlement is effected by the supervisor of the clearing house by transferring the balance kept at the central bank by these various clearing banks.

The advantages which a clearing house confers on society are manifold. It prevents the waste and cost involved in collecting each and every cheque and claim which a bank holds against another across the counter with all the danger of loss in transit incumbent upon it. Great economy is also achieved in the employment of liquid cash by settling the difference by simple transfer of credit from one account to another, thereby minimizing the necessity of holding large idle cash balances.

Check Your Progress

6. What are the important items seen on the asset side of the Balance Sheet of a commercial bank?
7. Define liquidity.

3.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The two essential functions of a commercial bank may best be summarized as the borrowing and the lending of money.
2. General utility services are those in which the bank's position is not that of an agent for his customer.
3. A banker's draft is an order, addressed by one office of a bank to any other of its branches or by any one bank to another, to pay a specified sum to the person concerned.

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4. Investment banks are organizations which assist business corporations and governmental bodies to raise funds for long-term capital requirements through the sale of shares, stocks, bonds etc.
5. Investment banks are classified as 'originators', 'underwriters' and 'retailers.'
6. The important items seen on the asset side of the Balance Sheet of a commercial bank are cash in hand, money at call and short notice, bills discounted, investments and loans and advances.
7. By 'liquidity' one means the capacity to produce cash on demand. No doubt, the most liquid asset is cash in the vaults of a bank.

3.7 SUMMARY

- The two essential functions of a commercial bank may best be summarized as the borrowing and the lending of money.
- Deposits may be received on current account whereby the banker incurs the obligation to repay the money on demand. Interest is not payable on current account deposits.
- A commercial bank receives deposits which it has to repay according to its promise and makes them available to those who are really in need of them.
- A commercial bank provides a range of investment services. Customers can arrange for dividends to be sent to their bank and paid directly into their bank accounts, or for the bank to detach coupons from bearer bonds and present them for payment and to act upon announcements in the press of drawn bonds, coupons payable, etc.
- General utility services are those in which the bank's position is not that of an agent for his customer.
- A Kisan Credit Card (used to be designated as 'green card' by some banks) issued by Indian banks, aimed at providing adequate and timely support from the banking system to the farmers for their cultivation needs including purchase of inputs in a flexible and cost effective manner.
- Among the services introduced by a modern commercial bank during the last quarter of a century or so, the 'bank giro' and 'credit cards' deserve special mention.
- The 'bank giro' is a system by which a bank customer with many payments to make, instead of drawing a cheque for each item, may simply instruct his bank to transfer to the bank accounts of his creditors the amount due from him.
- The main difference between credit cards and debit cards lies in the words 'credit' and 'debit'. In case of a credit card, the card holder makes the cash

payment at the end of the month. On other hand, in the case of a debit card, it runs down ones deposit account the moment the sale is made.

- Recognition of overseas trade has encouraged modern commercial banks to set up branches specializing in the finance of foreign trade.
- As part of their comprehensive banking services, many banks act as a major source of information on overseas trade in all its aspects.
- Investment banks are organizations which assist business corporations and governmental bodies to raise funds for long-term capital requirements through the sale of shares, stocks. bonds, etc.
- By 'liquidity' one means the capacity to produce cash on demand. No doubt, the most liquid asset is cash in the vaults of a bank.
- 'Liquid assets' may be explained briefly. These are which can be turned into cash quickly and without loss, to meet the claims of the customers.
- The cash reserves of a bank may be strengthened by a judicious selection of certain earning liquid assets. Among these 'Money at Call and Short Notice' stands first.

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3.8 KEY WORDS

- **Asset:** An *asset* is a resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide a future benefit.
- **Investment:** In an economic sense, an *investment* is the purchase of goods that are not consumed today but are used in the future to create wealth.
- **ATM:** An automated teller machine (*ATM*) is an electronic banking outlet that allows customers to complete basic transactions without the aid of a branch representative or teller.
- **Balance sheet:** A balance sheet is a statement of the assets, liabilities, and capital of a business or other organization at a particular point in time, detailing the balance of income and expenditure over the preceding period.

3.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are the functions of a commercial bank?
2. Write a short note on:
   a. Agency services
   b. General utility services

3. What was the main objective of Kisan Credit Card?
4. What is the difference between debit and credit card?
5. Mention the two ways by which trade may be financed with bills of exchange.

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Long-Answer Questions

1. What are the major investment policies? Discuss.
2. Discuss the general structure and methods of commercial banking.
3. Differentiate between self-liquidating paper theory and anticipated income theory.
4. What do you understand by clearing house system? Explain.
5. 'The cash reserves of a bank may be strengthened by a judicious selection of certain earning liquid assets'. Comment on the statement with reference to the text.

3.10 FURTHER READINGS

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UNIT 4 RESERVE BANK OF INDIA

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Structure

4.0 INTRODUCTION

The Reserve Bank of India plays a very crucial role when it comes to supervising Indian economy and other banks. The RBI performs all the typical functions of a central bank. The main function performed by RBI is to regulate the monetary mechanism comprising of the currency, banking and credit systems of the country. The RBI has the monopoly to issue notes and has a lot of other powers over the banking system.

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the objectives of Reserve Bank of India
- Discuss the functions of Reserve Bank of India
- Learn about the control of credit by Reserve Bank of India
- Describe the Indian money market

4.2 OBJECTIVES AND FUNCTIONS OF RESERVE BANK OF INDIA

The preamble to the Reserve Bank of India Act, 1934, lays down the object of the RBI to be 'to regulate the issue of bank notes and the keeping of reserve with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage'. The financial system of India, before the establishment of the RBI, had been utterly inadequate mainly because of the dual control of currency by the government and of credit by the Imperial Bank. The Hilton Young Commission pointed out the inherent weakness of a system in which the control of currency and credit is in the hands of two distinct authorities, whose policies may be widely divergent and in which the currency and banking services are controlled and managed separately from one another. Under the circumstances, the necessity of a single institution regulating the financial policy from the point of view of the economic development of the nation as a whole was keenly felt, and the RBI was constituted mainly with this object in view.

Secondly, according to Paragraph 32 of the introduction to White Paper on Indian Constitutional Reforms, the proposal for transfer of responsibility at the Centre from British to Indian hands was made dependent on the condition that a Reserve Bank, free from political influence, be established and be in successful operations. It was a 'fundamental condition of the success of the constitution that no room should be left for doubts as to the ability of India to maintain her financial stability and credit, both at home and abroad'.

Thirdly, the inadequacy of the Imperial Bank of India in controlling the money market was patent, because of the lack of confidence of other joint-stock banks on the Imperial Bank. The success of a central banking institution depends on the confidence which it inspires on the member banks and the influence which it exercises on them. But the Imperial Bank, which was acting as the central bank, was for all practical purposes a commercial bank competing with other joint-stock banks. Under these circumstances, it was decided to establish a Reserve Bank with the object of discharging purely central banking functions and thereby initiating a fresh start in the field of Indian central banking.

4.2.1 Functions

The RBI performs all the typical functions of a central bank. Its main function is to regulate the monetary mechanism comprising of the currency, banking and credit systems of the country. For this, the Bank is given the monopoly of note issue and has wide powers over the banking system. Another important function of the Bank is to conduct the banking and financial operations of the government. The Bank discharges certain other functions like maintaining the external value of the rupee, collection and publication of monetary and financial information, etc. The range of functions of the Bank has come to be steadily enlarged with the task of economic development assuming new urgency and dimensions. Implementation of appropriate monetary policies, no doubt, remains its most important function. At the same time, the Bank is taking an active part in fostering an adequate banking structure capable of meeting the needs of trade, industry, agriculture and commerce.

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Check Your Progress

1. What is the objective of the preamble of the Reserve Bank of India?
2. What is the main function of the Reserve Bank of India?
3. What does 'Direct Action' imply?

4.3 CONTROL OF CREDIT BY RBI

Besides quantitative controls discussed above, the RBI may resort to qualitative restrictions to make effective its monetary policy measures.

Under the Banking Regulation Act, 1949, the RBI is vested with powers to control the entire banking system. In pursuance of Section 21 of the Act, the RBI may give directions to banking companies with regard to their lending policies, which they are bound to comply with. The section runs as follows:

1. Where the Reserve Bank is satisfied that it is necessary or expedient in the public interest so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular and when the policy has been so determined, all banking companies or the particular company concerned, as the case may be, shall be bound to follow the policy so determined.
2. Without prejudice to the generality of the power vested in the Reserve Bank under sub section (1), the Reserve Bank may give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to the purpose for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances, and each banking company shall be bound to comply with any directions as so given.

Again,

1. Where the Reserve Bank is satisfied that:
   (a) in the national interest or
   (b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of depositors or in a manner prejudicial to the interests of the banking company or
   (c) to secure the proper management of any banking company generally.

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It is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

2. The Reserve Bank may, on representation made to it or on its own motion, Modify or cancel any directive issued under sub section (1), and in so modifying or cancelling any directive may impose such conditions as it thinks fit, subject to which the modification or cancellation shall have effect.

Further, under Section 36 (1) (a) of the RBI Act, the RBI is empowered to caution or prohibit banking companies generally, or any banking company in particular against entering into any particular transaction or class of transactions. It may call for periodical as well as ad hoc returns and in the public interest may also publish such information as it deems fit.

Implementation of Selective Credit Controls

In order to enforce the policy of selective credit controls, the RBI used to issue directives to scheduled banks since the beginning of the Second Five Year Plan. The first such directive was issued on 17 May 1956, to all scheduled banks not to increase any credit limit they had already sanctioned and not to issue any fresh credit limit against rice and paddy in excess of ₹50,000 to any party. In September, this control was further extended to cover bank advances against other foodgrains, gram and other pulses, and cotton manufactures. Since then, the Bank continued to issue directives; some were by way of replacement or modification of previous ones and dome by way of extension of control measures to new sectors.

Objective of Selective Credit Controls

By and large, selective credit controls are employed for the purpose of controlling inflationary tendencies which appear owing to an increase in the total amount of money in circulation through an over expansion of bank credit. But in a developing country like India, they are primarily intended to prevent the anti-social use of credit, which is associated with the speculative hoarding of stocks of strategic commodities like foodgrains, and to push down prices or at least to check an unwarranted increase in their prices. The Bank Rate policy, open market operations and variable reserve ratio system, which are employed in controlling the quantity of credit, are not effective in controlling the quality of credit and canalizing its flow into those lines where they are most called for and most needed, whereas selective credit controls are effective in controlling the quality of lending and investment operations of the banks and in restricting credit against particular commodities.

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Salient Features of Selective Credit Controls

The policy of the RBI, while instituting selective credit controls, had been one of flexibility. In other words, the directives were promptly withdrawn when circumstances no longer needed their continuance. For instance, the Bank, while maintaining the broad framework of controls regulating advances against foodgrains by banks, had made from time to time suitable modifications to the structure of control to meet the needs of the changing situations. In other words, there was no rigid formula for the Bank while instituting selective credit controls. On the other hand, the measures had been essentially flexible so that they were modified according to the developing circumstances.

Another salient feature of the control technique had been the endeavour of the Bank to ensure that the measures did not hamper production.

The Bank had also been careful to make the necessary modifications in the controls according to the circumstances prevailing in different areas.

Limitations of Selective Controls

The success of selective controls in arresting upward trends in prices does not depend on the availability of bank credit alone, but also on a variety of other factors including aggregate and individual demand and supply. It is unequivocally admitted that monetary techniques are no panacea for curing all ills in the economy caused by the scarcity of particular commodities in relation to their demand. In India, shortage of supply has always been one of the important factors contributing to hectic movements in prices.

Another limitation of this monetary technique arises from the fact that in so far as stocks of commodities are self-financed or privately financed, the role of bank finance is negligible.

Above all, it is a necessary pre-requisite for successful employment of the control measures that there should be an effective machinery for the preparation of the directives according to the peculiar circumstances of each commodity and for the monitoring of these measures.

Moral Suasion and Credit Rationing

'Moral Suasion' implies persuasion of banks to follow certain lines of policies, impressing upon them the necessity to do so. There is no element of compulsion in this persuasion and as such the efficacy of this measure depends on the active cooperation of banks and their goodwill to fall in line with the advices of the RBI. That is why certain quarters have expressed doubts about the success of this instrument of monetary policy. However, the success which the RBI could achieve has been somewhat encouraging. A brief discussion of the activities of the Bank in this direction is, it is hoped, not out of place in this context.

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After the devaluation of the rupee, as speculative activities were feared, the banks were advised to restrict their advances to genuine trade requirements and not to grant accommodation for any speculative purposes. During the recent years, the Governor of the RBI advises informally the commercial banks to follow the policy measures generally. The effect which these advices invoked has been, by and large, satisfactory; if not spectacular. The Bank's activities in this direction are facilitated by the concentration of resources in the hands of a few big banks which enables the Bank officials to have frequent informal consultations with the officials of these big banks and achieve satisfactory results.

'Direct Action' implies the refusal of the RBI to extend rediscounting facilities and other financial accommodation to banks following unsound banking principles, or to grant further accommodation to banks whose capital and reserves are considered inadequate. The Bank is not resorting to this weapon very often but cases of wilful and persistent violations of the rules could be met with the sharp blades of direct action with which the Bank is armoured.

4.4 INDIAN MONEY MARKET

The important constituents of the Indian Money Market are the Reserve Bank of India, the State Bank of India and its subsidiaries, the nationalized banks, the banks in the private sector, the development banks like the IFC, SFCs, IDBI, etc., the functional banks, the foreign banks, the NBFCs, the cooperative banks, the indigenous bankers and the money lenders. Presently let us have a bird's eye view of the general characteristics and the defects of the Indian Money Market.

Commercial Bills

Commercial bills are trade bills accepted by commercial banks. They include both inland bills and foreign bills. Discounting commercial bills at a prescribed discount rate is one of the methods adopted by banks for providing credit to customers. The bank will receive the face value of such bills from the drawees concerned. In the meanwhile if the bank is in need of funds, the same can be rediscounted in the commercial bill rediscount market at the market related rediscount rate. The eligibility criteria prescribed by the Reserve Bank of India for rediscounting commercial bills, inter alia, are that such bills should arise out of genuine commercial transactions evidencing sale of goods and the maturity date of the bills should not exceed 90 days from the date of rediscounting. In order to eliminate movement of papers and to facilitate multiple rediscounting, the Reserve Bank of India has introduced 'Derivative Usance Promissory Notes' backed by such eligible bills for required amounts and usance period up to 90 days. Stamp duty is not applicable in the case of such promissory notes. This has simplified and streamlined bill rediscounting by institutions in the secondary money market. Since such instruments are negotiable instruments, they are a good security for investment.

They are also liquid in the sense that they are transferable by endorsement and delivery.

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Hundis

These are short term credit instruments. They refer to indigenous bills of exchange generally drawn in vernacular languages and under various circumstances.

Treasury Bills

These are promissory notes of short-term maturity issued by the Union Government to meet its short-term financial needs. Government promises to pay a stated amount at the expiry of a stated period from the date of issue. There are 14, 91, 182 and 364 days Treasury Bills which are issued at a discount to the face value. On maturity, the holder is paid the face value. They are issued for a minimum value of ₹25,000 and multiples thereof. Individuals, firms, companies, corporate bodies, trusts and institutions can purchase them. These bills are eligible securities for SLR purposes.

Treasury Bills are auctioned by means of either 'multiple price auction' system (which is otherwise known as 'french auction system') or 'uniform price auction system' (which is otherwise known as 'dutch auction system'). Under multiple price auction system, successful bidders pay their own bid prices. In more clear terms, after receiving written bids at various levels of yield expectations, a certain yield is decided as the cut-off rate of the security concerned. Bidders (i.e., auction participants) who bid at yield levels lower than the yield determined as cut-off get 100 per cent allotment although at a premium which is equal to the yield differential expressed in rupee terms. This yield differential is the difference between the cut-off yield and the yield at which the bid is made. Those bids at yield levels higher than that determined as cut-off yield are rejected entirely. Since November 6, 1998, 91-days Treasury Bills are auctioned by means of uniform price auction. After determination of the market related cut-off rate, allotment is made to all the bidders at a uniform price.

Certificates of Deposit (CDs) and Commercial Papers (CPs)

In order to give greater flexibility to investors in the deployment of their short-term surplus funds, new money market instruments such as Certificates of Deposit (CDs) and Commercial Papers (CPs) were introduced during 1989–90.

Certificate of Deposit (CD)

A Certificate of Deposit (CD) is a fixed-deposit option offered by banks. It is primarily a short-term investment since the Reserve Bank of India guidelines on the issue of CDs stipulate specifically that the maturity period of a CD should not be less than 7 days and not more than one year from the date of issue. It is a money market instrument which is highly liquid since an investor can sell it to another investor. Higher returns are available on this form of investment as compared to conventional savings accounts. CDs are a secure form of investment. The investor in a CD receives a certificate wherein the details relating to the CD such as duration of the deposit, date of maturity, etc are clearly stated.

In India, CDs are introduced in 1989. Guidelines for the issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. Important features of the guidelines are briefly explained below:

- Certificate of deposit (CD) is a negotiable instrument and issued in dematerialised form or as a Usance Promissory Note against money deposited at the bank.
- CDs can be issued by scheduled commercial banks (excluding regional rural banks and local area banks).
- Banks have the freedom to issue CDs depending on their funding requirements.
- Minimum amount of a CD should be ₹1,00,000, i.e., the minimum deposit which could be accepted from a single investor should not be less than ₹1,00,000, and in multiples of ₹1,00,000 thereafter.
- CDs can be issued to individuals, corporations, companies, trusts, funds, associations, etc.
- CDs can be issued to non-residents, but only on non-repatriable basis, which should be clearly stated on the certificate. Such CDs cannot be endorsed to another non-resident Indian in the secondary market.
- The maturity period of CDs issued by banks should not be less than 7 days and not more than one year from the date of issue.
- CDs may be issued at a discount on face value like zero coupon bonds. Banks are also allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank is freed to determine the discount/ coupon rate. The interest rate on floating rate CDs has to be reset periodically in accordance with a pre-determined formula which indicates the spread over a transparent benchmark. The investor should be clearly informed of the same.
- CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred according to the procedure applicable to other demat securities.
- There is no lock-in period for CDs.
- Banks are not permitted to grant loans against the collateral of CDs. Also, they cannot buy-back their own CDs before maturity. The Reserve Bank of India may relax these restrictions for temporary periods through a notification.

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Commercial Papers (CPs)

These are unsecured debts of corporates. They are issued at a discount to the face value in the form of promissory notes and are redeemable at par. Only corporate with tangible net worth and working capital (fund based) limits of not less than ₹4 crore each and credit rating of at least P2/A2/PP2/Ind D2 or higher from any approved rating agency and is more than 2 months old of the date of issue of CP are allowed to issue CPs. They are issued for maturities between 15 days and less than one year from the date of issue and are issued in multiples of ₹5 lakhs. Prior approval of the Reserve Bank of India is not necessary for the issue of CPs and underwriting the issue is not mandatory. They are subject to stamp duty. The issuing entity bears all expenses for the issue such as dealers' fees, rating agency fee and charges for provision of stand-by facilities. The objective of introducing CPs was to release the pressure on bank funds for small and medium sized borrowers and allowing top rated companies to borrow directly from borrowers. The market for CDs and CPs is not very deep.

Commercial Bills

Commercial bills are trade bills accepted by commercial banks. Discounting commercial bills at a prescribed discount rate is one of the methods adopted by banks for providing credit to customers. The bank will receive the face value of such bills from the drawees concerned. In the meanwhile if the bank is in need of funds, the same can be rediscounted in the commercial bill rediscount market at the market related rediscount rate. The eligibility criteria prescribed by the Reserve Bank of India for rediscounting commercial bills, inter alia, are that such bills should arise out of genuine commercial transactions evidencing sale of goods and the maturity date of the bills should not exceed 90 days from the date of rediscounting. In order to eliminate movement of papers and to facilitate multiple rediscounting, the Reserve Bank of India has introduced 'Derivative Usance Promissory Notes' backed by such eligible bills for required amounts and usance period up to 90 days. Stamp duty is not applicable in the case of such promissory notes. This has simplified and streamlined bill rediscounting by institutions in the secondary money market. Since such instruments are negotiable instruments, they are a good security for investment. They are also liquid in the sense that they are transferable by endorsement and delivery.

Ready Forward Contracts (Repos)

These are money market instruments which assist in collateralized short-term borrowing and lending through sale/purchase operations in debt instruments. In a repo transaction, holders sell securities to an investor with an agreement to repurchase them at an agreed price at a future date. In a reverse repo transaction, securities are purchased with an agreement to sell them at an agreed price at a future date. Thus it can be considered as a combination of securities trading involving a purchase sand sale transaction and money market operation involving lending

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and borrowing. Borrowing and lending rate for use of the money during the intervening period is the repo rate. Internationally repos are used extensively in money market operations. Although in India repos were initially discouraged by laying down severe restrictions on their use, subsequently repo trading has been permitted to be resumed. All dated government securities are eligible for repo trading in the repo market. With a view to making the repo market an equilibrating force between the money market and the government securities market, the Reserve Bank of India gradually allowed repo transactions in all government securities and Treasury Bills. In order to broaden the repo market, government securities, public sector undertakings, banks and private corporate securities have been made eligible for repos.

Money Market Mutual Funds (MMMFs)

With a view to providing additional short-term avenues to individual investors and to bring money market instruments within their reach, a scheme of Money Market Mutual Funds (MMMFs) was introduced by the Reserve Bank of India in April 1992. In order to make the scheme more flexible and thereby attractive to banks and financial institutions and also to provide greater liquidity and depth to the money market, certain changes were made in early 1996 in the scheme of MMMFs by bringing them on par with all mutual funds by allowing investments by corporate and others. Lock-in period was reduced from 45 days to 15 days. Again, during 1999 – 2000, a number of policy measures were undertaken essentially to provide greater flexibility in the operations of the mutual fund sector.

Resources mobilized from MMMFs are required to be invested in call money, CDs, CPs, commercial bills, Treasury Bills and government dated securities with unexpired maturity up to one year. SEBI revises the guidelines on MMMFs from time to time.

Dichotomy of the Indian Money Market

There is a clear demarcation of the Indian Money Market into two sectors, viz., the organized sector and the unorganized sector. The organized sector is composed of the Reserve Bank of India, the State Bank of India and its subsidiaries, the nationalized banks, the banks in the private sector, the development banks, the functional banks, the foreign banks, the registered NBFCs and the exchange banks. The unorganized sector is composed of the indigenous bankers and the moneylenders and the unregistered NBFCs. The cooperative banks may be considered as a middle sector between the organized and the unorganized sectors. There is little coordination and cooperation between these sectors. This makes the uniform and effective implementation of monetary policy by the Reserve Bank of India in these sectors difficult.

Lack of Cooperation and Coordination between the Various Sectors of the Money Market

Till the establishment of the Reserve Bank of India in 1935, the erstwhile Imperial Bank of India was acting as the central bank of the country. At the same time, the Imperial Bank was also acting as a commercial bank. This naturally weakened the role of the Imperial Bank as a bankers' bank and as a lender of the last resort. The foreign banks stand in a class by themselves. The indigenous bankers, the moneylenders and the unregistered NBFCs are not connected with the organized sector of the money market.

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Lack of Control by the Central Bank over the Unorganized Sector of the Money Market

The indigenous bankers and the money lenders occupy a prominent position in the money-lending business in the rural areas. No clear-cut distinction is made between short-term lending and long-term lending or between the purposes of loans. They hesitate to come under the control of the Reserve Bank of India. This naturally loosens the control of the Reserve Bank over the money market. Of course, the authorities are currently taking an active interest to control the activities of the NBFCs.

Unhealthy Competition

Unhealthy competition exists not only between the organised and the unorganised sector, but also among the members of these sectors individually.. The relationship between the various segments of the money market is not cordial; they are loosely connected with each other. In general, they follow separatist tendencies. For instance, the public sector banks and the private sector banks look down each other as rivals. Unhealthy competition also exists between Indian joint stock banks and foreign banks.

Multiplicity in Interest Rates

In countries with developed money markets, the rates of interest prevailing over the entire money market will not vary very much. But in the case of the Indian Money Market, the rates of interest charged by the various institutions not only vary but also they vary from season to season. For instance, the rates of interest charged by the indigenous bankers or moneylenders do not bear any comparison with the rates of interest charged by the commercial banks. Even in the case of commercial banks, the rates of interest are not uniform. This limits the efficacy of the monetary policy of the Reserve Bank of India. Immobility of funds from one place to another could be considered as one of the important reasons for this multiplicity in interest rates which, in turn, is, by and large, owing to the credit immobility as a result of inadequate, expensive and time-consuming means of money transfer. Multiplicity of interest rates affect adversely the smooth and effective functioning of the money market. Of course, the recent steps taken by the Reserve Bank of India to remedy this defect, which are detailed in the section 'Payment and Settlement System' in the Chapter 'Reserve Bank of India' are noteworthy.

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Seasonal Stringency of Funds

During the busy season from November to June seasonal shortage of funds is experienced. On the other hand, during the slack season from June to November accumulation of idle funds is experienced. Of course, credit situation on the basis of seasonality is no longer much meaningful because of the introduction of quarterly credit budgeting within the framework of annual credit budget. The essence of the new budgeting system is to have an annual perspective demand for and supply of funds so as to bring about a meaningful correction between projected output increase and supply of credit.

Absence of a Well-developed Bill Market

The existence of a well organised and properly developed bill market is a pre-requisite for the proper and efficient functioning of a money market. The reasons for the absence of a well-developed bill market in the Indian money market and the attempts taken by the authorities to popularize the bill habit have already been referred to. In spite of all this, even now the bill market remains undeveloped. The short-term bills form a much smaller proportion of the bank finance in India as compared to that in other countries with well developed money markets. To remedy the shortcomings of the bill market in India, suggestions are often made by various quarters for the establishment of Acceptance Houses and Discount Houses which were instrumental in the development of an organized bill market in the London Money Market. While accepting the validity of this statement, we should be aware of the impracticability of building-up London style money markets in quite improbable places. As observed by A F W Plumptre, The need of developing countries is not for the trappings of financial maturity, but for institutions much close to the economic and political grass-roots. Indeed, with the pressing need to allocate very scarce capital with highly urgent uses, the establishment and development of financial markets may actually lead to a diversion and wastage of capital. In this connection, the setting-up of the Discount and Finance House of India Limited in 1988, referred to earlier, has been a step in the right direction. It is hoped that this would go a long way towards the development of a secondary market in treasury bills, commercial bills and other money market instruments.

Absence of Specialized Financial Institutions

Till recently, the Indian Money Market had been conspicuous by the absence of specialized financial institutions carrying out specialized jobs in their respective fields. It is gratifying to note that this is no longer the case although scope still exists for the establishment of more specialized institutions of this type.

Inadequate Banking Facilities

Inadequate banking facilities and the lop-sided branch expansion programme of the commercial banks had been pointed out in the past as an important defect of the Indian Money Market. Although much yet remains to be done, these problems have been tackled successfully to a large extent through the planned branch expansion programme and the establishment of the Regional Rural Banks, especially after the nationalization of the banks.

Capital Shortage

There is a general shortage of capital in the Indian money market, i.e., capital available in the money market is insufficient to meet the needs of industry and trade. Low saving capacity of the people, lack of developed banking habits among the people and inadequate banking facilities especially in the rural sector are the main reasons for this shortage of capital.

Lack of an all-India Money Market

Indian money market is divided into small segments mostly catering to the local financial needs. Thus it has not been organised into a single integrated all-India money market. For instance, there is little contact between the money markets in the metropolitan cities and those in small cities and towns.

Summary

Money market does not refer to any specific place where money is lent or borrowed. It is a mechanism through which short-term funds are loaned or borrowed and through which a large part of the financial transactions of a country or of the world are cleared.

The major items dealt with in a money market are trade bills, bankers' acceptances, treasury bills, short dated government securities, commercial papers and hundis.

The important sectors of a money market are call loan market, acceptances market, bill market or discount market and collateral loan market.

The importance of a money market stems from the various functions it performs in the overall interest of the economic development of the country.

Existence of an effective and efficient central bank, well organized commercial banking system, specialized sectors, free flow of funds between the various sub-markets, adequate facilities for transfer of funds, uniformity in interest rates, availability of ample funds, availability of ample short-term credit instruments, sensitiveness to internal and external events and existence of specialized financial institutions are the important features of a developed money market.

Items dealt within the Indian Money Market are Commercial Bills, Hundis, Treasury Bills, Certificates of Deposit (CDs) and Commercial Papers (CPs), Ready Forward Contracts (Repos) and Money Market Mutual Funds (MMMFs).

The important constituents of the Indian Money Market are the Reserve Bank of India, the commercial banks, the development banks, the foreign banks, the non-banking financial companies, the cooperative banks, the indigenous bankers and the money lenders.

General characteristics and defects of the Indian Money Market include dichotomy, unhealthy competition lack of cooperation and coordination between various sectors, lack of control by the central bank over the unorganized sector, seasonal stringency of funds, absence of a well-developed bill market, absence of specialized financial institutions and inadequate banking facilities, capital shortage and lack of an all-India money market.

Check Your Progress

4. Define hundis.
5. What is a Certificate of Deposit (CD)?
6. What are the powers assigned to RBI under the Banking Regulation Act, 1949?

4.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The preamble to the Reserve Bank of India Act, 1934, lays down the object of the RBI to be 'to regulate the issue of bank notes and the keeping of reserve with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage'.
2. The main function of Reserve Bank of India is to regulate the monetary mechanism comprising of the currency, banking and credit systems of the country.
3. 'Direct Action' implies the refusal of the RBI to extend rediscounting facilities and other financial accommodation to banks following unsound banking principles, or to grant further accommodation to banks whose capital and reserves are considered inadequate.
4. Hundis are short term credit instruments. They refer to indigenous bills of exchange generally drawn in vernacular languages and under various circumstances.
5. A Certificate of Deposit (CD) is a fixed-deposit option offered by banks. It is primarily a short-term investment since the Reserve Bank of India

guidelines on the issue of CDs stipulate specifically that the maturity period of a CD should not be less than 7 days and not more than one year from the date of issue.

6. Under the Banking Regulation Act, 1949, the RBI is vested with powers to control the entire banking system.

4.6 SUMMARY

- The preamble to the Reserve Bank of India Act, 1934, lays down the object of the RBI to be 'to regulate the issue of bank notes and the keeping of reserve with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage'.
- The financial system of India, before the establishment of the RBI, had been utterly inadequate mainly because of the dual control of currency by the government and of credit by the Imperial Bank.
- The RBI performs all the typical functions of a central bank. Its main function is to regulate the monetary mechanism comprising of the currency, banking and credit systems of the country.
- Another important function of the Bank is to conduct the banking and financial operations of the government.
- Besides quantitative controls discussed above, the RBI may resort to qualitative restrictions to make effective its monetary policy measures.
- Under the Banking Regulation Act, 1949, the RBI is vested with powers to control the entire banking system. In pursuance of Section 21 of the Act, the RBI may give directions to banking companies with regard to their lending policies, which they are bound to comply with.
- In order to enforce the policy of selective credit controls, the RBI used to issue directives to scheduled banks since the beginning of the Second Five Year Plan.
- The policy of the RBI, while instituting selective credit controls, had been one of flexibility. In other words, the directives were promptly withdrawn when circumstances no longer needed their continuance.
- 'Moral Suasion' implies persuasion of banks to follow certain lines of policies, impressing upon them the necessity to do so.
- After the devaluation of the rupee, as speculative activities were feared, the banks were advised to restrict their advances to genuine trade requirements and not to grant accommodation for any speculative purposes.

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- The important constituents of the Indian Money Market are the Reserve Bank of India, the State Bank of India and its subsidiaries, the nationalized banks, the banks in the private sector, the development banks like the IFC, SFCs, IDBI, etc., the functional banks, the foreign banks, the NBFCs, the cooperative banks, the indigenous bankers and the money lenders.
- Commercial bills are trade bills accepted by commercial banks. They include both inland bills and foreign bills.
- Commercial bills are trade bills accepted by commercial banks. Discounting commercial bills at a prescribed discount rate is one of the methods adopted by banks for providing credit to customers.

4.7 KEY WORDS

- **Bill:** Bill refers to a printed or written statement of the money owed for goods or services.
- **Lenders:** Lenders refer to someone or something that lends money, especially a large financial organization such as a bank.
- **Cooperative bank:** A bank that holds deposits, makes loans and provides other financial services tocooperatives and member-owned organizations is called cooperative bank.

4.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are the objectives of the Reserve Bank of India?
2. Write a short note on the major functions performed by RBI.
3. What are the salient features of selective credit controls?
4. Mention the important features of guidelines for the issue of CDs.
5. What do you understand by commercial papers?

Long-Answer Questions

1. Analyse the role of the Reserve Bank of India in the Indian economy.
2. Discuss the important constituents of Indian money market.
3. What are the important features of the guidelines for the issue of CDs? Discuss.
4. Discuss Ready Forward Contracts and Money Moarket Mutual Funds in detail.

4.9 FURTHER READINGS

NOTES

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UNIT 5 INTRODUCTION TO MONEY

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Structure

5.0 INTRODUCTION

The term 'Money Market' does not refer to any specific place where money is lent or borrowed. As a matter of fact, it is a mechanism through which short-term funds are loaned or borrowed and through which a large part of the financial transactions of a particular country or of the world are cleared. Although money market does not refer to any specific place, it may be located in or associated with a particular place or geographical locality where short-term funds from an entire region or country or countries are attracted. Mumbai Money Market is a typical example. It not only serves Mumbai but also the whole of India in borrowing and lending short-term funds. There are also a few money markets which are international in character, e.g., London Money Market. It serves several countries of the world. New York Money Market is another example.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the kinds, functions and significance of money
- Understand the demand for and supply of money
- Describe monetary standards and gold standard
- Explain bimetallism and paper currency systems

5.2 KINDS, FUNCTIONS AND SIGNIFICANCE

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A 'Money Market' is a mechanism which makes it possible for borrowers and lenders to come together. Essentially it refers to a market for short-term funds. It meets the short-term requirements of the borrowers and provides liquidity of cash to the lenders. In the words of Crowther, money market is the name given to the various firms and institutions that deal in various grades of near money. According to Madden and Nadler, … *a money market is a mechanism through which short-term loans are loaned and borrowed and through which a large part of the financial transactions of a particular country or of the world are cleared…. A money market is distinct from but supplementary to the commercial banking system.* The importance of the money market for the nation does not solely lie on its size. It lies rather in its liquidity, in the capacity for furnishing cash to any part of the country at a few hours' notice. What a bank balance is to the individual, the money market is to the country's credit system.

As explained in detail later, a money market is not homogenous in character. It consists of several sectors or sub markets such as 'call loan market', 'bill market' or 'discount market', 'acceptance market', 'collateral loan market', etc. That is why Crowther describes a money market as the various firms and institutions that deal in various grades of near money.

As in the case of any form of market, the question of supply of and demand for the items dealt with arises in the case of a money market also. The items dealt with in a money market, in general terms, are described as 'short-term funds'. Their supply comes from lenders comprising of the central bank, the commercial banks and other financial institutions. Their demand comes from the borrowers comprising of the government, the business houses, the commercial banks, the stock exchange dealers and private individuals.

Items Dealt within a Money Market

The major short term credit instruments dealt with in a money market include trade bills, bankers acceptances, treasury bills, short dated government securities, commercial papers, certificates of deposits and money market mutual funds. A description of these items is given in the section 'Items Dealt within the Indian Money Market' under 'Indian Money Market'. Reader's attention is invited to that section.

Composition of the Money Market

As mentioned earlier, a money market consists of several sectors or sub markets, each specializing in a particular type of lending. The important sectors are:

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Call Money Market

This is the sub market specializing in call loans which are sometimes referred to as 'loans at call and short notice'. These are the extreme form of short-term loans. They are granted for overnight use or for 24 hours or a maximum of seven days. They can be recalled on demand or at the shortest possible notice. Normally, collateral securities are not insisted for these loans. In India, this sector of the money market provides facilities for inter-bank lending. In UK, such loans are provided by the banks to bill brokers and discount houses and in the US, to the stock brokers and stock exchange dealers.

Acceptance Market

This is the sub market specializing in the acceptance of bills of exchange on behalf of the customers. Acceptance Houses in the London Money Market provide an example of institutions specializing in this business. Commercial banks also accept bills of exchange on behalf of their customers. Although both inland and foreign bills are accepted like this, the service rendered by the acceptance market is especially important in the case of foreign bills. The exporter may not know the creditworthiness of the importer. As such it is only natural that the exporter usually insists that the bill should be accepted by a commercial bank or by an institution of repute on behalf of the importer. Once the bill is accepted in this manner, it is easier for the same to be discounted.

Bill Market (Discount Market)

This is another sector of the money market specializing in the discounting of short-term commercial bills and treasury bills. In the London Money Market, the Discount Houses specialize in this field. As a matter of fact, English commercial banks do not undertake the discounting of commercial bills. Instead, they get these bills from the Discount Houses according to their maturity needs. With the decline in the total volume of commercial bills, the Discount Houses turned their attention to the treasury bills and short-dated government securities also. In most other countries, discounting of commercial bills is considered to be a subsidiary function of the commercial banks. In India, the establishment of the Discount and Finance House of India Limited in 1988 has been an important step towards the development of an active discount market.

The discount market provides valuable services to the commercial banks, the trading community and to the government. It imparts greater flexibility to the commercial banks in their funds management. To the trading community, it facilitates the financing of home and foreign trade by its operations in commercial bills. As for the government, it creates a market for treasury bills and short-dated government securities.

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Collateral Loan Market

This sector of the money market specializes in the granting of short-term loans against collateral securities. Such loans are usually granted by the commercial banks to stock exchange dealers and brokers. Business houses also avail of short-term loans against the security of goods, documents of title to goods, stock exchange securities, etc.

Importance of the Money Market

The importance of a properly organized and well developed money market stems from the various functions it performs in the overall interest of the economic development of the country. These functions may be summarized as under :

Influences the Capital Market

Indirectly money market influences the development of the capital market. This is because conditions in the money market influence the short-term rate of interest which, in turn, influence the rate of interest in the long-term capital as well as the resource mobilization in the capital market. Thus development of capital market depends upon the development of capital money market.

Develops Trade and Industry

An important source of financing trade and industry is the money market. Through discounting operations of bills and commercial papers, the money market finances the short-term working capital requirements of trade and industry and facilitates their development. It also protects many industrial units from turning sick. In other words, money market plays a key role in financing both national as well as international trade. Commercial finance is made available through bills of exchange which are discounted by the bill market. Long-term loans are also necessary for industries. This is provided in the capital market. Long-term interest rates in the capital market are influenced by the short-term interest rates in the money market. Thus money market indirectly assists industry through its link with and influence on long-term capital market.

Bridges the time Element Between the Sale and Actual Payment of Money

As an extension to the above point, by discounting bills and commercial papers, the money market bridges the time element between the sale and the actual payment of money. This enables the seller to carry on his/her business without any hindrance. At the same time, the buyer gets enough time to realize the money from the sale of the goods covered by the bills. Thus by discharging this function efficiently, the money market helps the industrial and commercial sector to meet its working capital requirements.

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Helps in the Proper Allocation of Resources

Money market exercises an equilibrating influence on the demand for and supply of loanable funds. The savings in the community are converted into investment which results in the proper allocation of resources in the economy.

Facilitates Economic Growth

A well organized and properly developed money market safeguards the liquidity and safety of financial assets. This facilitates economic growth.

Reduces Disparities in Interest Rates

By effecting quick and efficient transfer of funds as between the various regions served by the money market, it helps to achieve uniformity in interest rates. In any case, violent fluctuations in interest rates are avoided.

Acts as an Outlet for the Excess Short-term Funds of Commercial Banks

The call loan market, the bill market and the collateral loan market are the main outlets for the commercial banks to invest their excess short-term funds in a profitable manner without impairing the liquidity of these funds. In case the banks are in need of fundsat any time, they can meet this requirement by recalling their short-term loans from the money market. Also, the money market assists the commercial banks to earn profit by investing their surplus funds by purchasing Treasury Bills and short dated government securities. These short-term credit instruments are not only safe but also highly liquid in that they can easily be converted into cash at short notice. Thus the commercial banks gain immensely by economizing on their cash balances and at the same time meeting the demands for any large withdrawals of their customers. Additionally, it enables them to meet their statutory requirements of cash reserve ratio (CRR) and statutory liquidity ratio (SLR) by making use of the money market mechanism.

Guides Policies of the Central Bank

Changes in the short-term rates of interest prevailing in various sectors of the money market act as good indicators to the central bank in assessing the monetary and credit conditions prevailing in the economy. This will help the central bank to shape the monetary and credit policies according to the developing circumstances. The Central Bank absorbs excess short-[term liquidity through the sale of Treasury Bills and injects liquidity through the purchase of Treasury Bills. Thus the central bank regulates the flow of money in order to promote economic growth with stability.

Makes Policies of the Central Bank Effective

The various policy measures initiated by the central bank will have their first impact on the different sub-markets of the money market. The sub-markets generally react quickly to these measures. Such reactions will be transmitted to the other sectors of the economy. Thus, the link between the central bank and the economy in general is established through the money market.

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Features of a Developed Money Market

Existence of an Efficient and Effective Central Bank

The central bank of the country is the leader of the money market. It has a pivotal role. The entire money market operations will be controlled by making funds available depending upon the economic cycles. As such the existence of an efficient and effective central bank which is capable of guiding, directing, regulating and controlling the various sectors of the money market is an essential feature of a developed money market. It formulates an appropriate monetary policy to meet the needs of the money market, influences the supply of money in step with the changing requirements of the economy and comes to the rescue of the banking system by granting funds through rediscounting operations of eligible securities.

Well Organized and Developed Commercial Banking System

The commercial banks can rightly be considered as the nucleus of the whole money market. As such a developed money market will have a well organized and properly integrated commercial banking system capable of meeting the genuine short-term credit needs of the economy. The policy of the commercial banks in relation to loans and advances will have an impact on the money market. The commercial banks act as a connecting link between the central bank and the various sectors of the money market because of their close relation with the central bank.

Existence of Sub-markets

In a developed money market there will be well organized sub-markets, each specializing in a particular type of financial asset. The larger the number of sub-markets, the broader and more developed will be the structure of the money market. Commercial paper market, bankers acceptance market, certificates of deposit market, Treasury Bills market, Federal funds market, repurchase agreement market, etc which are found in the New York Money Market are examples of such sub-markets. The various sub-markets together make a coherent money market.

Integration of Sub-markets

As an extension of the above point, there will be perfect integration among various sub-markets. Their functioning will be interdependent. Flow of funds from one sub-market to another and the activities of a particular sub-market will influence the activities of other sub-markets also. There will be free and unhindered flow of funds as between the various sub-markets. In each sub-market there will be reasonable and healthy competition. In other words, in a developed money market there will be a large number of borrowers, lenders and dealers. That way each sub-market will be active enough to achieve the purpose of its existence.

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Uniformity in Interest Rates

In a developed money market rates of interest prevailing in different parts of the money market will not vary very much. Thus comparative uniformity in different parts of the country is a characteristic feature of a developed money market.

Availability of Ample Funds

A developed money marker will have at its disposal ample funds to carry on the numerous dealings in various sub-markets without any hindrance.

Availability of Sufficient Short-term Credit Instruments

A developed money market will have adequate supply of a variety oif short-term credit instruments such as trade bills, promissory notes, Treasury Bills, short dated government securities, etc.

Sensitiveness to Internal and External Events

A developed money market will be highly sensitive to the economic and political developments at home and abroad. Such a money market will attract funds from abroad. It will also attract borrowers, lenders and dealers of other countries to participate in the activities of the money market in the country. Favourable conditions for foreign investment, absence of discrimination against foreign firms and stable political conditions are some of the other important factors which facilitate development of the money market in the country.

Existence of Specialized Financial Institutions

This is yet another feature of a developed money market. Specialised financial institutions like the Export-Import Bank will find a place in a developed money market. Such institutions specialize in particular types of assets. They assist in increasing the efficiency of the money market and making it more competitive. The acceptance houses which specialize in accepting bills of exchange and the discount houses which specialize in discounting bills which are found in the London Money Market are typical examples.

Developed Industrial System

A highly developed industrial system is a necessary pre-requisite for a developed money market. Then only will it be possible for the money market to function smoothly and achieve the basis purpose of its existence.

Stability of Prices

The effective functioning of a developed money market will result in comparative stability of prices all over the country.

Check Your Progress

1. What does 'Money Market' system refer to?
2. What does money market consist of?

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5.3 SUPPLY OF MONEY

In the literature on monetary theory while the analysis of the demand for money—-motives for holding cash balances—has been the main focus of economists' attention, study of the supply of money has received relatively scant attention. For one thing, the factors influencing the demand for money have been assumed as not influencing the supply of money with the result that in the monetary theory, the supply of money and the demand for money have remained separate and mutually exclusive. The classical economists and the quantity theorists believed that the important factors affecting the supply of money did not affect the demand for money. In this connection, the views of Milton Friedman-—one of the leading monetarists—are worth repeating. According to Milton Friedman, the quantity theorist.... holds that there are important factors affecting the supply of money that do not affect the demand for money... A stable demand function is useful precisely in order to trace out the effect of changes in supply, which means that it is useful only if supply is affected by at least some factors other than those regarded as affecting demand.' Although Milton Friedman recognizes that the conditions affecting the demand for money do influence the supply of money, all the same he states that 'it seems useful to regard the nominal quantity of money as determined primarily by conditions of supply, and the real quantity of money and the income velocity of money as determined primarily by conditions of demand.'

Secondly, the supply of money has been considered as an exogenous variable, being autonomously determined by the monetary authority whose policy actions were largely non-responsive to the monetary needs of the economy. In other words, the supply of money did not change in response to changes in the demand for it, i.e., in response to changes in the economy's monetary requirements as the economy expanded or shrank. Don Patinkin has succinctly expressed it in the words mentioned in the following page.

> '....in most discussions of monetary theory the nominal quantity of money supplied is taken as an exogenous variable. But though we continuously shy away from this fact in our theoretical work, we do nevertheless know that in the real world this is not the case for money is largely the creature of a banking system which responds to such endogenous variables as the rate of interest, the wages of clerks, etc. How then can we take account of these responses? And in particular, is there a limit to the extent to which endogenous influences can be assumed to operate? Conversely, must a determinate monetary system necessarily retain some exogenous element.'

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In the lines above, Don Patinkin has pointed out to the tradition of treating the money supply as an exogenous variable. He, however, holds that the endogenous variables exert their influence on the supply of money no less than do the exogenous variables. In fact, Don Patinkin has praised Gurley and Shaw for their penetrating study in which the authors have focussed on the influence of the endogenous variables on the supply of money which has traditionally been treated as an exogenous variable. As a matter of fact, interest rate is a strategic endogenous variable which influences both the demand for and the supply of money in the economy.

Under a full-fledged gold-coin standard, with either gold coins actually in circulation or with banks keeping 100 per cent reserves against the full-bodied representative money circulating in the economy, the banks are virtually powerless to create the credit money. Consequently, the total money supply (M) would comprise the gold coins minted by the monetary authority. However, even under these restrictive conditions the public could influence the money supply to suit the total needs of the economy by influencing–by increasing or decreasing the rate (V) per time unit each coin circulated in the economy as the medium of transactions. This naturally gives the total money supply as a product of the total high-powered money M issued by the monetary authority and its transactions velocity V, i.e., MV. However, in a monetary system operating under a fractional reserves system the banking system acquires the power to influence significantly the total money supply in the economy by creating deposit money since every rupee of legal reserve is a high-powered money in the sense that each rupee of reserves can support several rupees of the derived bank deposits. Apart from the power of banks to create credit, the public also influences the size of total bank deposits by influencing the velocity of these bank-created deposits. Consequently, the total money supply becomes the sum of the high-powered money issued by the monetary authority multiplied by its velocity, i.e., MV and the bank-created deposit money M' multiplied by its velocity V', i.e., $M'V'$. In short, the total money supply in circulation in the economy equals $M\,V + M'V'$.

Even if it is assumed that the supply of high-powered money (M) is exogenously determined by the monetary authority whose actions are non-responsive to economy's needs (demand for money), the other components of the money supply being endogenously determined (V and V' are directly under public's control while the M' is responsive to the interest rate changes and other endogenous variables), the total money supply cannot be treated entirely as an exogenous variable without inviting the legitimate criticism.

There is an overwhelming evidence that lends support to the hypothesis concerning the commercial banks' supply response to interest rate changes albeit the exact nature of this response is not yet fully understood. A rise (fall) in the interest rate, *ceteris paribus,* induces the commercial banks in the economy to increase (decrease) their total credit. Consequently, it is not correct to assume that the total stock of money in the economy is determined exogenously only by the monetary authority without any reference to credit creation by the commercial banking system.

As opposed to the views of the monetarists who argue that the total supply of money is primarily determined exogenously by the monetary authority—central bank—are the views of the Keynesians who hold that the total money supply in the economy is largely determined endogenously in response to the economy's needs. Led by Professor Nicholas Kaldor, the Keynesians have strongly asserted their point and have argued the issue *ad nauseam.* To cite as a case, A B Cramp hammers the point that 'it is strongly arguable that, in practice, whatever, textbook theory says, the quantity of money has been largely determined "endogenously" by the demands/needs of the economy, rather than "exogenously" imposed on the economy by the Central Bank as the monetarist doctrine presumes.'

The views of the monetarists are sharply opposed to those of the Keynesians. This divergence of the two views is due to the fact that while the monetarists stress the power of the central bank to control the issue of money to an extent that it can ignore the monetary needs of the economy (it should, however, be noted that in the final analysis, the total stock of money depends on the willingness of the central bank to acquire assets), the Keynesians believe in a responsible central bank which responds to the monetery requirements of the economy that are strictly determined by the portfolio analysis. A critical evaluation of the two approaches to the supply of money leads us to the conclusion that neither of these two approaches is entirely correct and the truth lies somewhere in between. In fact, the supply of money in the economy depends on (a) the degree of responsibility of the central bank; and (b) the judgement, effectiveness and scientific authority with which the central bank performs its functions. It also depends on the supply response of the commercial banks to the interest rate changes which might be initiated by the central bank itself as a necessary part of its monetary policy action in order to influence the total money supply in the economy.

Position in India

In India, the Reserve Bank of India (RBI) has adopted the narrow and broad concepts of the money supply. According to the narrow approach, the money supply (M_1) comprises of the, (i) currency with the public (C), and (ii) demand deposits with the banks (D) while the major components of the broad money supply (M_3) comprise the (i) currency with the public, (ii) demand, deposits with the banks, and (iii) time deposits with the banks. Major sources of supply of M_3 comprise the (i) net RBI credit to government; (ii) other banks' credit to government; (iii) other banks' commercial credit; and (iv) net foreign exchange assets of the banking sector.

Besides the familiar concepts of M_1 and M_3 pertaining to the supply of money, the second working group set up by the RBI in 1977 propounded the

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money supply concepts of M_2 and M_4. The concept of the M_2 comprises M_1 and deposits in post office saving banks while the concept of M_4 comprises the M_3 and total deposists of post office savings organization (excluding national savings certificates). In other words,

M_1 = currency with public (C) + demand deposits with banks (D):

$M_2 = M_1$ + deposits with post office savings banks;

$M_3 = M_1$ + time deposits with banks: and

$M_4 = M_3$ + deposits with post office savings organization.

The Reserve Bank of India publishes the statistics relating to the major components and major sources of supply of the M_1 and M_3 fortnightly.

Currency with the public is the most important component of money supply as it can be used directly, instantly and without any restrictions to make the payment. Its close substitutes—demand deposits in banks, traveller's cheques issued by banks and other known non-banking firms, like the American Express Company are also included in the definition of money.

Included in the broad money supply are the time or fixed deposits in the banks, funds in the savings banks accounts in the banks; bank drafts, commercial papers, short-term treasury deposits credit cards issued by the banks, etc., are also included in the concept of broad money supply as these can be converted in to money proper at short notice.

5.3.1 Demand for Money

In any analysis of the demand for money, the basic question is: why do people demand money? People demand money because money performs the basic important functions of the medium of exchange and the store of value in the economy. There are three principal approaches to the demand for money, namely the classical approach, the Keynesian approach and the post-Keynesian or modern approach. We may now discuss each one of these three approaches or theories of the demand for money beginning with the classical explanation of the demand for money.

Classical Approach

The classical approach to the demand for money is best summed up in the naive quantity theory of money which states that people hold cash balances or money only to carry on economic transactions—for making purchases and sales of goods and services—in the economy. According to the classicists, money did not influence the real processes of production and distribution in the economy. As the medium of exchange, money merely facilitated the exchange of goods and services serving in the process as a labour-saving device in the economy. Behind the 'veil of money', Say's Law of Markets operated in the same manner as it did in the barter economy. According to John Stuart Mill, money was intrinsically insignificant, By serving as the medium of exchange, it had relieved society of the great inconveniences of barter.

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According to the classicists, the demand for money primarily depends on the level of transactions which was determined by the level of aggregate income. The level of aggregate income was the full employment income because in the classical economic analysis there was no obstacle to the attainment of such a level of income since supply always created its own demand. The classical approach to the demand for money has been best summarized by Don Patinkin in the following words.

'In its cash balance version...neo-classical theory assumed that, for their convenience, individuals wish to hold a certain proportion, K, of the real volume of their planned transactions, T, in the form of real money balances. The demand for these balances thus equals KT. Correspondingly, the demand for nominal money balances is KPT, where P is the price level of the commodities transacted. The equating of this demand to the supply of money, M, then produced the famous Cambridge equation, $M = KPT$. In the transactions version—associated primarily with the names of Newcomb and Fisher—the velocity of circulation, V, replaced its reciprocal, K, to produce the equally famous equation of exchange, $MV = PT$. These equations were the parade grounds on which neo-classical economists then put the classical quantity theory of money through it paces.'

The classicists considered only the transactions demand for money which depended on the volume of total money transactions in the economy within the framework of static equilibrium analysis. However, since under the static assumptions, the income and payments flows are perfectly synchronized in time in the economy, no transactional cash balances would be needed. In reality, however, the income and spending flows do not arise simultaneously—the income flow is discrete and lumpy occurring in the case of salaried workers once in a month while the spending flow, being more continuous, occurs almost daily. Similarly, a firm has to pay for the purchase of raw materials, hiring of labour and other inputs more frequently while the revenue from the sale of manufactured goods is received long after the factor payments are made. Thus, the two flows occur at different points in time. The disparity in time which exists between the income and spending flows in the economy is necessary for holding money for purposes of transactions. In other words, as the means of payment, money is demanded as a temporary abode of purchasing power to bridge the time interval gap between the flows of money receipts or income and money spending. It is not, however, sufficient to explain the presence of transactional cash balances. If the institutional structure permitted the people to convert their idle transactional cash balances into riskless yield-giving almost perfectly liquid financial assets, (e.g., savings bank deposits in banks with no restriction on withdrawals), they would convert all their cash balances into such assets since these could be readily and without suffering any loss converted into cash when needed for the transactional purpose. Thus, according to the modern economists, it is the lack of synchronization between the income and spending flows together with the institutional framework which does not make available

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perfectly liquid income-yielding financial assets which creates the transactional demand for money in the economy.

Some later writers, trained in the classical tradition, had recognized that since under the static assumptions no one would like to hold cash, K would be zero or V would approach infinity. But in practice V was finite. In their opinion, it was due to the uncertain nature of future transactions needs. This motive for holding money is termed as the *precautionary motive.* The basis for this motive for holding cash is that unforeseen contingencies may arise requiring immediate money spending and which might lead to further expenses and inconvenience (as in the case of an accident, sudden illness of oneself or other family members or any other unforeseen mishap) or the loss of an unexpected excellent opportunity if sufficient purchasing power was not available ready at hand. Like the transactions demand for money, the precautionary demand for money was also regarded as a function of the level of income. The modern approach to the demand for money explains that the transactions demand for money depends on the ratio of the cost of converting money into and out of the income-yielding financial assets and the return which could be enjoyed by owning these assets.

In summary, the classical approach to the demand for money treated it as a constant function of the level of money income, i.e., $M = KY$. In the equation, M, K and Y denote respectively the transactions demand for money, the constant positive fraction or percentage of Y which the community holds in the form of money and the money value in terms of the current rupees of national product or real income.

The asset demand for money arising from money's function as a *permanent store of value* was least stressed by the classicists. According to them, money was barren or unproductive and wealth stored in the form of money did not multiply. Unlike the government bonds, bills and debentures money yields no interest income to its owner; unlike corporate equities it promises no dividends, capital gains or insurance against inflation; and it offers none of the services for which real assets—land, house, refrigerator, etc.,—are held. One could always go to the money or capital market and store wealth in the productive form by purchasing the government bonds or corporate debentures and shares. By converting one's surplus money into the riskless fixed interest-income yielding government bonds one can earn interest income while storing one's wealth. For example, a one hundred rupee bank note remains a one hundred rupee bank note even after one year if it is stored in the suitcase or safe-vault while a one-year maturity government bond of the face value of '100 bearing 6 per cent interest rate becomes worth '106 after one year. A rational individual wealth-holder would, therefore, always prefer government bonds, debentures, savings banks deposits or equity shares to money for storing value—unspent portion of his current earnings. In the classical scheme of things no one would demand money for asset purposes. This behaviour would, however, prevail only if the current rate of interest was also expected to prevail in

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future, i.e., if the elasticity of expectations was zero. The neglect of the asset demand for money was a serious lacuna in the classical approach to the demand for money.

Keynesian Approach

John Maynard Keynes' approach to the demand for money is contained in Chapter 15 of his well-known book titled *The General Theory of Employment, Interest and Money.* The classical economists did not stress the permanent store of value function of money. Consequently, the asset demand for money remained completely neglected in their analysis. According to Keynes, the classical approach to the demand for money was faulty because it ignored the possibility of people choosing to hold money as an asset instead of holding the other financial assets, particularly government bonds when their prices are expected to fall. Keynes explained that the fall in the capital value of a government bond consequent upon even a small increase in the market rate of interest might more than offset the interest income received on such a bond. If the market price of bonds was expected to fall, (i.e., the market rate of interest was expected to rise), a rational wealth-holder would not always convert money into government bonds even though money was sterile in the sense that it yielded no return in the form of interest income to its owner. To account for such a behaviour, Keynes added the speculative or asset demand for money to the transactions and precautionary demand for money.

According to Keynes, an individual's aggregate demand for money in the given circumstances is the result of a single decision which is the composite of the *transactions*, *precautionary* and the *speculative motives* for holding money. The transactions motive has been further classified into the income motive and the business motive. Under the *income motive,* the aggregate amount of money demanded depends on 'the amount of income and the normal length of the interval between receipt and its disbursement.' Under the *business motive,* the aggregate amount of money demanded chiefly depends on the value of current output, i.e., current income and the number of hands through which the current output passes. The precautionary demand for money, which depends on the *precautionary motive,* arises from the need 'to provide for contingencies requiring sudden expenditure and for unforeseen opportunities of advantageous purchases.'

The strength of the transactions and precautionary motives for holding money depends partly on the cheapness and the reliability of various methods of obtaining cash when required and partly on the relative cost of holding cash. For example, if people can borrow temporarily through the overdraft facilities provided by the banking system, there will be no necessity to hold cash balances to bridge the time interval between the receipt of income and its disbursement on various items of expenditure. Similarly, if the opportunity cost of holding the cash balances in the form of interest income forgone is high, the strength of these motives will be weak and people will not hold large cash balances for satisfying the transactions and precautionary motives for holding money.

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According to Keynes, the demand for money to satisfy these motives, 'is generally irresponsive to any influence except the actual occurrence of a change in the general economic activity and the level of incomes; whereas experience indicates that the aggregate demand for money to satisfy the speculative motive usually shows a continuous response to gradual changes in the rate of interest, i.e., there is a continuous curve relating changes in the demand for money to satisfy the speculative motive and changes in the rate of interest as given by changes in the prices of bonds and debts of various maturities.' In short, Keynes regarded the transactions and precautionary demand for money as a direct and positive function of the level of money income and the speculative demand for money as a negative function of the rate of interest. We may now discuss each one of these three demands for money in detail.

5.4 MONETARY STANDARDS: GOLD, BIMETALLISM AND PAPER CURRENCY SYSTEMS

There are two types of monetary standards—one far more prevalent in developed economies than other. Monetary standards refer to the 'system' or 'framework' that controls or facilitates the movement of money. The following are the two monetary standards:

- Commodity standard
- Inconvertible 'managed' paper standard

1. The Commodity Standard

This standard exists where the value of monetary units equal the value of specific amounts of commodity (e.g., gold).

Examples of commodity standards are as follows:

- Monometallic/metallic coin standards
- Metallic exchange standard
- Bimetallic standard

There are some pros and more cons. There are evidently problems with these standards since they have been discarded as the monetary standard of choice. One inherent problem for the bimetallic standard is described in Gresham's Law.

On one hand, it does restrain the government from excessively expanding the money supply because MS is driven by physical availability of metal not political experience. However, metal reserves may expand excessively, or conversely contract when the economy needs liquidity to grow.

Pros also include the intrinsic value of silver and gold. Cost of producing metals is inversely related to general level of prices (it provides stability to economic output and prices), however, the process may be too slow.

2. Inconvertible 'managed' paper standard

This monetary standard is created by the government. Another term given to it is 'fiat' money. This system only works because the government values the legal tender and the public accepts the standard. The public has to accept the standard since the paper itself isn't actually worth anything—it's an abstraction. It fails when the government does not exhibit proper economic restraint and responsibility (i.e., massive hyperinflation).

Classification of Money

Gresham's law is an economic principle 'which states that when government compulsorily overvalues one money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation'. It is commonly stated that 'bad money drives out good', but is more accurately stated: 'Bad money drives out good if their exchange rate is set by law.'

This law applies specifically when there are two forms of commodity money in circulation which are required by legal-tender laws to be accepted as having similar face values for economic transactions. The artificially overvalued money tends to drive an artificially undervalued money out of circulation and is a consequence of price control.

Gresham's law is named after Sir Thomas Gresham (1519–1579), an English financier during the Tudor dynasty. However, the law had been stated forty years before by Nicolaus Copernicus, so in Poland it is known as the Copernicus-Gresham Law. The phenomenon had been noted even earlier, in the 14th century, by Nicole Oresme. The fact of bad money being used in preference to good money is also noted by Aristophanes in his play The Frogs, which dates from around the end of the 5th century BC.

'Good' money and 'bad' money'Good' money and 'bad' money

'Good' money is money that shows little difference between its nominal value (the face value of the coin) and its commodity value (the value of the metal of which it is made, often precious metals, nickel, or copper.)

In the absence of legal-tender laws, metal coin money will freely exchange at somewhat above bullion market value. This is not a purely theoretical result, but may instead be observed today in bullion coins such as the South African Krugerrand, the American Gold Eagle, or even the silver Maria Theresa thaler (Austria). Coins of this type are of a known purity and are in a convenient form to handle. People prefer trading in coins rather than in anonymous hunks of precious metal, so they attribute more value to the coins. The price spread between face

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value and commodity value is called seignorage. Since some coins do not circulate, remaining in the possession of coin collectors, this can increase demand for coinage.

On the other hand, 'bad' money is money that has a commodity value considerably lower than its face value and is in circulation along with good money, where both forms are required to be accepted at equal value as legal tender.

In Gresham's day, bad money included any coin that had been debased. Debasement was often done by the issuing body, where less than the officially specified amount of precious metal was contained in an issue of coinage, usually by alloying it with a base metal. The public could also debase coins, usually by clipping or scraping off small portions of the precious metal. Other examples of 'bad' money include counterfeit coins made from base metal.

In the case of clipped, scraped, or counterfeit coins, the commodity value was reduced by fraud, as the face value remains at the previous higher level. On the other hand, with a coinage debased by a government issuer, the commodity value of the coinage was often reduced quite openly, while the face value of the debased coins was held at the higher level by legal tender laws.

Examples of Gresham's Law

Silver coins were widely circulated in Canada (until 1968) and in the United States (until 1965 for dimes and quarters and 1971 for half-dollars). However, these countries debased their coins by switching to cheaper metals as the market value of silver rose above that of the face value. The silver coins disappeared from circulation as citizens retained them to capture the higher current or perceived future intrinsic value of the metal content over their face value, using the newer coins in daily transactions. In the late 1970s, the Hunt Brothers attempted to corner the worldwide silver market but failed, temporarily driving the price far above its historic levels and intensifying the extraction of silver coins from circulation.

The same process occurs today with the copper content of coins such as the pre-1997 Canadian penny, the US one-cent coin, and the pre-decimal UK copper pennies and halfpence. This also occurred even with coins made of less expensive metals such as steel in India.

Gresham's law states that any circulating currency consisting of both 'good' and 'bad' money (both forms required to be accepted at equal value under legal tender law) quickly becomes dominated by the 'bad' money. This is because people spending money will hand over the 'bad' coins rather than the 'good' ones, keeping the 'good' ones for themselves. Legal tender laws act as a form of price control. In such a case, the artificially overvalued money is preferred in exchange, because people prefer to save rather than exchange the artificially demoted one (which they actually value higher).

Consider a customer purchasing an item which costs five pence, who possesses several silver sixpence coins. Some of these coins are more debased, while others are less so—but legally, they are all mandated to be of equal value.

The customer would prefer to retain the better coins, and so offers the shopkeeper the most debased one. In turn, the shopkeeper must give one penny in change, and has every reason to give the most debased penny. Thus, the coins that circulate in the transaction will tend to be of the most debased sort available to the parties.

If 'good' coins have a face value below that of their metallic content, individuals may be motivated to melt them down and sell the metal for its higher intrinsic value, even if such destruction is illegal. As an example, consider the 1965 United States half dollar coins, which contained 40 per cent silver. In previous years, these coins were 90 per cent silver. With the release of the 1965 half dollar, which was legally required to be accepted at the same value as the earlier 90 per cent halves, the older 90 per cent silver coinage quickly disappeared from circulation, while the newer debased coins remained in use. As the price of bullion silver continued to rise above the face value of the coins, many of the older half dollars were melted down. Beginning in 1971, the US government gave up on including any silver in the half dollars, as even the metal value of the 40 per cent silver coins began to exceed their face value.

A similar situation occurred in 2007 in the United States with the rising price of copper and zinc, which led the US government to ban the melting or mass exportation of one-cent and five-cent coins, respectively.

In addition to being melted down for its bullion value, money that is considered to be 'good' tends to leave an economy through international trade. International traders are not bound by legal tender laws as citizens of the issuing country are, so they will offer higher value for good coins than bad ones. The good coins may leave their country of origin to become part of international trade, escaping that country's legal tender laws and leaving the 'bad' money behind. This occurred in Britain during the period of the gold standard.

History of the concept

The law was named after Sir Thomas Gresham, a sixteenth century financial agent of the English Crown in the city of Antwerp, to explain to Queen Elizabeth I what was happening to the English shilling. Her father, Henry VIII, had replaced 40 per cent of the silver in the coin with base metals, to increase the government's income without raising taxes. Astute English merchants and even ordinary subjects would save the good shillings from pure silver and circulate the bad ones; hence, the bad money would be used whenever possible, and the good coinage would be saved and disappear from circulation.

Gresham was not the first to state the law which took his name. The phenomenon had been noted much earlier, in the 14th century, by Nicole Oresme. In the year that Gresham was born, 1519, it was described by Nicolaus Copernicus in a treatise called Monetae cudendae ratio: 'bad (debased) coinage drives good (un-debased) coinage out of circulation.' Copernicus was aware of the practice of exchanging bad coins for good ones and melting down the latter or sending them abroad, and he seems to have drawn up some notes on this subject while he was

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at Olsztyn in 1519. He made them the basis of a report in German which he presented to the Prussian Diet held in 1522 at Grudzidz, attending the session with his friend Tiedemann Giese to represent his chapter. Copernicus's Monetae cudendae ratio was an enlarged, Latin version of that report, setting forth a general theory of money for the 1528 diet. He also formulated a version of the quantity theory of money.

According to the economist George Selgin in his paper 'Gresham's Law':

> As for Gresham himself, he observed 'that good and bad coin cannot circulate together' in a letter written to Queen Elizabeth on the occasion of her accession in 1558. The statement was part of Gresham's explanation for the 'unexampled state of badness' England's coinage had been left in following the 'Great Debasements' of Henry VIII and Edward VI, which reduced the metallic value of English silver coins to a small fraction of what it had been at the time of Henry VII. It was owing to these debasements, Gresham observed to the Queen, that 'all your fine gold was conveyed out of this your realm.'

Gresham made his observations of good and bad money while in the service of Queen Elizabeth, with respect only to the observed poor quality of British coinage. The earlier monarchs, Henry VIII and Edward VI, had forced the people to accept debased coinage by means of their legal tender laws. Gresham also made his comparison of good and bad money where the precious metal in the money was the same metal, but of different weight. He did not compare silver to gold, or gold to paper.

5.5 MONEY MARKET

Money market is a very important segment of the Indian financial system. It is the market for dealing in monetary assets of a short-term nature. Short-term funds up to one year and for financial assets that are close substitutes for money are dealt in the money market. Money market instruments have the characteristics of liquidity (quick conversion into money), minimum transaction cost and no loss in value. Excess funds are deployed in the money market which, in turn, are availed to meet temporary shortages of cash and other obligations. Money market provides access to providers (financial and other institutions and individuals) and users (comprising institutions and government and individuals) of short-term funds to fulfil their borrowings and investment requirements at an efficient market clearing price. The rates struck between borrowers and lenders represent an array of money market rates. The interbank overnight money rate is referred to as the call rate. There are also a number of other rates such as yields on treasury bills of varied maturities, commercial paper rate and rates offered on certificates of deposit. Money market performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity and in the process, facilitate the conduct of monetary policy. Short-term surpluses and deficits are evened out. The money market is the major mechanism through which the Reserve Bank influences liquidity and the general level of interest rates. The bank's interventions to influence liquidity serve as a signalling device for other segments of the financial system.

The Indian money market was segmented and highly regulated and lacked depth till the late 1980s. It was characterized by a limited number of participants, regulation of entry and limited availability of instruments. The instruments were limited to call (overnight) and short notice (up to 14 days) money, interbank deposits and loans and commercial bills. Interest rates on market instruments were regulated. Sustained efforts for developing and deepening the money market were made only after the initiation of financial sector reforms in the early 1990s.

Check Your Progress

3. Mention the names of the two monetory standards.
4. Where does the commodity standard exist?
5. After whom is Gresham's law named?

5.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Money Market system refers to a market for short-term funds.
2. Money market consists of several sectors or sub markets such as 'call loan market', 'bill market' or 'discount market', 'acceptance market', 'collateral loan market', etc.
3. The two monetary standards are commodity standard and inconvertible 'managed' paper standard.
4. The commodity standard exists where the value of monetary units equal the value of specific amounts of commodity (e.g., gold).
5. Gresham's law is named after Sir Thomas Gresham (1519–1579).

5.7 SUMMARY

- A 'Money Market' is a mechanism which makes it possible for borrowers and lenders to come together.
- A money market is not homogenous in character. It consists of several sectors or sub markets such as 'call loan market', 'bill market' or 'discount market', 'acceptance market', 'collateral loan market', etc.
- The major short term credit instruments dealt with in a money market include trade bills, bankers acceptances, treasury bills, short dated government securities, commercial papers, certificates of deposits and money market mutual funds.

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- Call Money Market is the sub market specializing in call loans which are sometimes referred to as 'loans at call and short notice'.
- An important source of financing trade and industry is the money market. Through discounting operations of bills and commercial papers, the money market finances the short-term working capital requirements of trade and industry and facilitates their development.
- Money market exercises an equilibrating influence on the demand for and supply of loanable funds.
- The central bank of the country is the leader of the money market. It has a pivotal role. The entire money market operations will be controlled by making funds available depending upon the economic cycles.
- The commercial banks can rightly be considered as the nucleus of the whole money market. As such a developed money market will have a well organized and properly integrated commercial banking system capable of meeting the genuine short-term credit needs of the economy.
- In the literature on monetary theory while the analysis of the demand for money— -motives for holding cash balances—has been the main focus of economists' attention, study of the supply of money has received relatively scant attention.
- In India, the Reserve Bank of India (RBI) has adopted the narrow and broad concepts of the money supply.
- The classical approach to the demand for money is best summed up in the naive quantity theory of money which states that people hold cash balances or money only to carry on economic transactions—for making purchases and sales of goods and services—in the economy.
- There are two types of monetary standards—one far more prevalent in developed economies than other. Monetary standards refer to the 'system' or 'framework' that controls or facilitates the movement of money.
- Gresham's law is an economic principle 'which states that when government compulsorily overvalues one money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation'.
- Gresham's law is named after Sir Thomas Gresham (1519–1579), an English financier during the Tudor dynasty.
- Gresham's law states that any circulating currency consisting of both 'good' and 'bad' money (both forms required to be accepted at equal value under legal tender law) quickly becomes dominated by the 'bad' money.
- Money market is a very important segment of the Indian financial system. It is the market for dealing in monetary assets of a short-term nature.

5.8 KEY WORDS

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- **Currency:** Currency refers to a system of money in general use in a particular country.
- **Market:** A *market* is defined as the sum total of all the buyers and sellers in the area or region under consideration.
- **Economy:** Economy refers to the state of a country or region in terms of the production and consumption of goods and services and the supply of money.

5.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. Write a short note on money market.
2. What do you understand by bill market and collateral loan market?
3. What is the narrow aprroach towards the supply of money?
4. What is the classical approach to the demand for money?

Long-Answer Questions

1. What are the features of a developed market? Discuss.
2. Discuss the different approaches to the supply of money.
3. Write a detailed note on the monetary standards in India.
4. What is Gresham's law? Give some examples of Gresham's law.

5.10 FURTHER READINGS

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BLOCK - II
INDIAN BANKING SYSTEMS

NOTES

UNIT 6 FOREIGN EXCHANGE AND CONTROL

Structure

6.0 INTRODUCTION

It has been widely recognized that a country should conserve its foreign exchange resources. It is all the more important in the case of developing economies. Foreign currency is required for the purpose of importing essential capital goods from other countries. These countries have to resort to a number of artificial restrictions in the realm of dealing in foreign currency. At the same time, they have to ensure that other countries would not retaliate. It is well-known that external monetary stability is as important as internal stability. In a way both are closely inter-related in such a manner that the shock recorded in one sector will automatically be transmitted to the other sector.

6.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning of foreign exchanges
- Discuss exchange market and rates of exchange
- Know about exchange control

6.2 FOREIGN EXCHANGE

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With the development of international trade and the subsequent international division of labour, it has become imperative for countries to devote more and more attention to the complicated mechanism of 'foreign exchange'. We may take a very simple example. Suppose a person in India imports goods worth £10,000 from England. The exporter in England has to be paid in pound sterling. This simple operation involves a number of complicated problems. The first one is the method by which to determine the value of rupees in terms of pound sterling. Then there is the problem of finding out ways and means to settle this transaction. Under the gold standard system, gold can be used as a medium of exchange and the transaction can be settled without difficulty since it is easy to find out the gold contents of a unit of each currency. But with the suspension of the gold standard system, the problem became complicated. Besides the problem of finding out a common medium of exchange and the rate at which one currency can be converted into another, countries began to face such problems as the artificial restrictions imposed on the exports and imports and the arbitrary fixation of the rate of exchange. The actions taken by one country led to similar actions by other countries. The result was a war on the economic front. Thus, countries found it advisable to have an organization on the lines of the United Nations established for the purpose of avoiding war. The result was the establishment of the International Monetary Fund with a view to assuming international monetary cooperation. The Fund could, to a certain extent, remedy the disastrous results of fixing arbitrary exchange rates. The problems of finding out a common medium of exchange and the rate at which one currency can be converted into another were partially solved. This does not, however, means that trade between countries flows on smoothly.

The question of mitigating frequent fluctuations in the rate of exchange is also important. Unless there is a stability in exchange rates, international trade is rather difficult. For instance, let us take the case of an importer in India who has imported raw materials worth $10,000 from the US which amount has to be paid after three months. Suppose the existing rate of exchange is $1 = ₹48. So, the importer in India will consider the cost of raw materials as ₹4,80,000. By the time he has to pay the amount to the exporter, suppose the exchange rate goes up to, say, $1 = ₹50. Here the importer stands to lose. In the opposite case, the exporter will be the loser. In short, there must be some mechanism to lessen such fluctuations in the rates of exchange and also to relieve genuine businessmen from the risks of such fluctuations. A detailed knowledge and study of these and other allied problems are, therefore, necessary for understanding international trade. Herein lies the importance of 'Foreign Exchange'.

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The term 'foreign exchange' is used to denote either a foreign currency or the rate at which one currency is converted into another or the means and methods by which one currency is exchanged for another. Thus, foreign exchange is concerned with the settlement of international indebtedness, the methods of effecting the settlements and the instruments used in this connection, and the rates of exchange at which the settlements of international indebtedness are made.

Balance of Trade and Balance of Payments

The term 'balance of trade' denotes the relation between the imports and exports of commodities of a country. Balance of trade refers to only visible items entering into international trade. In other words, balance of trade takes into account only the goods imported or exported. These goods are visible in the sense that they are recorded in the returns of the customs department.

When the difference is an excess of exports over imports, a country is said to have a 'favourable balance of trade' from the point of view of that country. When the imports are more than exports, it is called an 'unfavourable balance of trade' from the point of view of that country. These terms, viz., favourable balance of trade and unfavourable balance of trade are often misleading. A favourable balance of trade need not necessarily indicate the economic prosperity of a country. There are a number of items other than the export and import of goods which have to be taken into consideration while settling international indebtedness. For instance, suppose India is exporting more goods than what she imports. We can consider India as having a favourable balance of trade. But she may be indebted to other countries on various other accounts such as cost of transportation, insurance, services of foreign technicians, interest payments on foreign loans, etc. The total payment which she has to make on these accounts may far outweigh the excess of exports over imports, viz., the balance of trade. Thus, a favourable balance of trade is not always a sign of economic prosperity. In the same manner, an unfavourable balance of trade need not necessarily mean that the economic position of the country is weak. In this connection, it may be pointed out that England had a steadily growing unfavourable balance of trade for many years while her national wealth had been steadily increasing. Therefore, in order to know whether a country is economically prosperous or not, all the items entering into international trade have to be taken into consideration. In other words, it is 'balance of payments' and not 'balance of trade' that is important.

'Balance of payments' includes not only the visible items of exports and imports but also the invisible items of exports and imports which make a country creditor to another and vice versa. Invisible items refer to those items which are not recorded in the customs returns as they have no tangible form. They take the form of services rendered by one country to another and include the services of foreign shipping, banking and insurance, etc. Balance of payments is ascertained by taking into consideration the following items:

1. The most important item entering in the balance of payments is the balance of trade.
2. Secondly, invisible items of exports and imports form part of the balance of payments. Invisible items may be of various kinds like transport service, shipping freights, passenger fares, harbour and canal dues, telephone and telegraph fares, commercial services (fees and commission), financial services (brokers' fees, etc.,) and services connected with tourist traffic.
3. Another item entering in balance of payments is interest payment. If a country has invested money in foreign countries, it will receive interest payments. Conversely, a debtor country will have to pay interest to other countries.
4. Items of government transactions such as the salaries of diplomatic representatives, reparations, gifts, donations, etc., are also reckoned with while arriving at the balance of payments. They are generally grouped under the head 'miscellaneous items'.

Sometimes these items are broadly classified under visible and invisible items. The former embrace the items entering into balance of trade, and the latter all other items creating international indebtedness.

There is another classification of balance of payments into Current Account Balance and Capital Account Balance. The current account balance consists of all receipts and payments arising out of transactions in goods and services during the current period. In other words, the current account balance consists of all receipts and payments which do not create a new capital item or cancel a previously existing capital item. The capital account balance is composed of receipts and payments which do not relate to the current period. It may be divided into two parts, viz., the short-term capital account and the long-term capital account. The former includes all changes in gold, foreign bank balances and other short-term debits and credits. The latter is composed of receipts and payments which give rise to long-term capital claims.

Check Your Progress

1. Why is foreign currency required?
2. What does the term 'balance of trade' denote?

6.3 EXCHANGE MARKET AND RATE OF EXCHANGE

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The rate of exchange between two currencies is the amount of one currency that will be exchanged for one unit of another currency. For instance, if $1 can be exchanged for ₹47.25, the rate of exchange between dollars and rupees is $1 = ₹47.25. When the rate of exchange is quoted as so many rupees per dollar, it is known as the 'dollar rate'. On the other hand, when it is quoted as so many dollars per rupee, it is known as the 'rupee rate'. In the same way, the sterling rate between India and the UK is the amount of rupees that will be exchanged for one unit of pound sterling.

Rate of Exchange under the Gold Standard System

When a country is on the gold standard system, actual gold coins will be in circulation, or the currency note will be convertible into metallic gold by tendering it at the central bank. There will not be any artificial restrictions in the movement of gold into or out of the country.

When two countries are on the gold standard system, determination of the rate of exchange between their currencies is comparatively easy. It will be in proportion to the gold contents of one unit of one currency expressed in terms of the gold contents of one unit of the other currency. Let us assume that India and the US are on the gold standard. Further that one rupee contains one unit of gold of 11/12 fineness and one dollar contains 47.25 units of gold of the same fineness. Then the rate of exchange between the US dollar and rupee will be $1 = ₹47.25. This rate is known as the equilibrium rate of exchange or the 'mint par of exchange'. The mint par of exchange has been defined as 'the number of units of the one currency which should legally contain the same amount of pure metal as does, legally, a given number of units of the other currency'.

Limits to the Fluctuations in the Rate of Exchange under the Gold Standard System

The fluctuations in the rate of exchange under the gold standard system are limited. Even if the market rate of exchange is temporarily different from the mint par of exchange, it will always have a tendency to come back to the equilibrium level, viz., the mint par. Let us examine how the forces operate to make the market rate equal to the mint par.

Suppose, 'A' in India is importing goods worth $1,000 from the US. 'A' can settle this transaction either by sending 47,250 units of gold (assuming that the mint par is $1 = ₹47.25) or by purchasing $1,000 from an exchange dealer. The exchange dealer will be in possession of foreign exchange sold to him by exporters. Let us further assume that the exchange dealer quotes an exchange rate of

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$1 = ₹48. In other words, 'A' has to spend ₹48,000 to purchase $1,000. In that case, he will prefer to send 47,250 units of gold to the US, where the exporter in that country can change it for $1,000. This is because 'A' can purchase 47,250 units of gold with ₹47,250 whereas if he purchases $1,000 he will have to spend ₹48,000. This will have the effect of decreasing the demand for dollars in India, forcing the exchange dealers to bring down the market rate of exchange for dollars. This process will go on till the market rate becomes equal to the mint par.

This, however, is subject to one modification. Sending gold involves certain expenses like packing charges, shipping charges, loss of interest while gold is in transit, insurance charges, refining charges, etc. To continue the above example, if 'A' wants to send gold worth $1,000, he will have to buy 47,250 units of gold by spending ₹47,250. Then he will have to get it packed and send it by sea or air, thereby incurring freight charges. Further, he should see that the gold is refined so as to bring it on a par with the fineness of gold obtainable with the American monetary authorities. This involves refining charges. Again, during the course of transit, gold is locked up in an idle manner. Assuming that it takes one month for transportation of gold from India to the US, 'A' will be losing interest for ₹47,250 during that period. Furthermore, 'A' has to incur insurance charges in connection with the insurance of gold transported. Let us suppose, these expenses amount to ₹250. This means that to send gold worth $1,000, 'A' has to incur ₹47,500 in all. Thus, although the mint par of exchange is $1 = 47.25, the rate as far as 'A' is concerned works out to ₹47.50 when he uses gold as the medium of exchange. If the market rate of exchange is above this point, 'A' will prefer to send gold. This will be the case with other importers also. The resulting decrease in the demand for dollars will force the exchange dealers to bring down the market rate of exchange to $1 = 47.50. This point is known as the 'Gold Export Point' or the 'Upper Specie Point' from the point of view of India and the 'Gold Import Point' or the 'Lower Specie Point' from the point of view of the US. Likewise, there is a 'Gold Import Point' for India and a 'Gold Export Point' for the US. These points are known as the 'Gold Points' or the 'Specie Points'. To sum up, the equilibrium rate of exchange (or, the mint par of exchange) under the gold standard system is likely to fluctuate but these fluctuations are strictly limited to the gold export point and the gold import point, otherwise known as the specie points.

Rate of Exchange under the Inconvertible Paper Currency System

The Purchasing Power Parity Theory

Determination of the rate of exchange under the gold standard system has now only a theoretical importance. Today no country is following the gold standard system. The system being followed now is the inconvertible paper currency system. Under this system, the currency authorities do not undertake any obligation to convert currency notes into gold. In other words, the notes are inconvertible. The determination of the rate of exchange under such a system is complicated.

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During the inter-war period, Prof. Gustav Cassel, a Swedish economist, advanced a theory known as the 'Purchasing Power Parity Theory', explaining the determination of the rate of exchange under the inconvertible paper currency system. According to him, the rate of exchange will depend on the price levels in the respective countries. To take a simple example, if the price of a commodity in India is ₹4,725 in India and if the same commodity is priced in the US at $100, the rate of exchange between US dollar and rupee will be $1 = ₹47.25. Cassel wrote:

'Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this money posses a purchasing power as against commodities and services in that foreign country. On the other hand, when we offer so-and-so much of ones own money, we are actually offering a purchasing power as against commodities and services in our own country. Our valuation of a foreign currency, therefore, depends mainly on the relative purchasing power of the two currencies in their respective countries'. Again, the rate of exchange between two currencies must stand essentially on the quotient of the internal purchasing power of these currencies. Evelyn Thomas explains the theory thus:

'…while the value of the unit of one currency is determined at any particular time by the market conditions of demand and supply, in the long run that value is determined by the relative values of the two currencies as indicated by their relative purchasing power over goods and services'. In other words, the rate of exchange tends to rest at that point which expresses equality between the purchasing power of the two currencies. This point is called the 'purchasing power parity'.

So long as the price levels in the two countries remain the same, the rate of exchange will also remain the same. A concrete example will make the point more clear. Suppose one dollar purchases 47 units of rice in the US and one rupee purchases one unit of rice of the same quality in India. Then the equilibrium rate of exchange is $1 = ₹47. Let us assume that the market rate of exchange moves to the level of $1 = ₹94. The demand for Indian rice in the US will immediately go up. This is because an American can convert one dollar into ₹94 and with this amount he can purchase 94 units of rice in India whereas in his own country he can get only 47 units of rice. Conversely, the demand for American rice in India will decrease. The combined effect of these two forces will be to push up the value of rupees. Suppose the rate of exchange moves up in India's favour to $1 = ₹80. Even then it will be cheaper for Americans to purchase Indian rice. The demand for rupees will continue to remain high. This process will go on till the rate of exchange becomes equal to $1 = ₹47. At this point, Americans will have no preference for Indian rice. The rate of exchange can not move below this point. This is because in such a case Indians will prefer to purchase rice from America and the demand for dollars will increase. This will tend to bring back the rate of exchange back to the equilibrium level. Thus, so long as the price levels remain the same, the rate of exchange has always a tendency to remain at the equilibrium rate of exchange, otherwise known as the 'purchasing power parity'. If the price levels change, the equilibrium rate will also record corresponding changes.

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Although the theory is stated in such simple terms, we have to take into consideration the cost of transporting goods from one country to another as also the duties and other restrictions imposed by the importing country. The equilibrium rate of exchange will no doubt be influenced by these factors.

Criticisms

Purchasing Power Parity Theory is one of the most widely criticized theories. In the first place, it is said that the term 'price level' is a very vague one. The general price level of a country includes the prices of both nationally traded and internationally traded commodities. At the same time, it is important to note that all prices do not enter into the calculations of those who carry on foreign trade. This introduces a complication into the theory. Are we to take into consideration the price levels of only internationally traded commodities? If we accept this as the basis of price levels, there is a further difficulty. It is not easy to divide commodities under the two strict heads of nationally traded and internationally traded. This is because changes are constantly taking place in the assortment of commodities entering national trade and international trade. For instance, rise in the price of a foreign currency will make hitherto nationally traded commodities exportable. So also, certain imported articles hitherto will move out of the list of internationally traded commodities.

Further, as Lord Keynes has remarked, when the price level is confined to the prices of internationally traded commodities, the Purchasing Power Parity Theory breaks down to an empty truism. This is because the national prices of internationally traded commodities follow the movements in exchange rates rather than determine them. In order to overcome this difficulty, if we take into consideration the general price level of both nationally traded and internationally traded commodities another difficulty will arise. The only method to measure price levels in two countries is to ascertain the index numbers. For this purpose, the index number of wholesale price levels is more suitable. The result obtainable by comparing the index numbers is acceptable only if they are representative of costs and prices of things that move in international trade. But when we compare the index numbers of wholesale price levels, it is doubtful whether the prices of goods entering into international trade will move in the same direction as indicated by the index numbers. Of course, in the long run they will move in the same direction. Thus, the theory holds good only in the long run. During the short-term period, the actual exchange rate may be different from the equilibrium rate. In other words, the theory attempts to explain the ultimate rather than the immediate forces determining the rate of exchange.

Another criticism against the theory is that it does not take into consideration the fact that fluctuations in prices are not the only factor influencing the exchange rate. It is also influenced by changes in the economic relations between two countries even when the price levels remain the same. For instance, when a new competitor as a purchaser or seller emerges in the world market, the trade between two countries will be affected. As observed by Ragnar Nurkse, 'the Purchasing Power

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Parity Theory treats demand simply as a function of price, leaving out of account the wide shifts in aggregate income and expenditure which occur in the business cycle (as a result of market forces or government policies) and which lead to wide fluctuations in the volume and hence the value of foreign trade even if prices or price-relationship remains the same. It is possible for a country to maintain its exchange rate well above the purchasing power parity for a number of years if it resorts to borrowing from foreign countries'.

Further, as Cassel himself has admitted, even in the long-term period changes in transportation costs, customs duties, terms of trade etc., will influence the rate of exchange. The equilibrium rate of exchange as determined with the help of Purchasing Power Parity Theory may not be on a par with the existing market rate of exchange. For example, if the transportations costs suddenly increase, the exchange value of the currency will be affected even though the price levels remain the same. In the words of Cassel, 'differences in the two countries' economic situation particularly in regard to transport and customs may cause the normal exchange rate to deviate from the quotient of the currencies' intrinsic purchasing powers'.

In the same way, sales and purchases of foreign securities, banking transactions, etc., affect demand and supply of currencies. We do not consider these factors while constructing index numbers.

Another objection is raised against the view of Cassel is that while changes in price levels bring about changes in exchange rates, changes in exchange rates have no influence over price levels. This view is not correct. Changes in exchange rates can and do influence the price levels. Let us take a concrete example. Suppose the exchange rate between US dollars and rupees is $1 = ₹47. This means a commodity worth ₹470 in India will cost $10 in the US. As a result of certain capital movements suppose the value of dollars decreases so as to bring the exchange rate to the level of $1 = ₹30. The commodity worth ₹ 470 in India will now cost $15.66 in the US. At the same time imports from the US will become cheaper. The demand for American goods will increase in the world market. It will have the effect of raising their prices in the US. Simultaneously, India will reduce her prices so as to encourage exports. Thus, price levels in the US increase and price levels in India decrease. In other words, a change in the exchange rate influences the price levels. This has actually happened in the case of the UK subsequent to the fall of the pound sterling in 1931.

To sum up, Purchasing Power Parity Theory has a number of limitations. Nevertheless, the theory can not be rejected as such. It gives us at least a rough idea as to where the exchange rate should be located in the long run. During periods of unstable and fluctuating exchange rates, Purchasing Power Parity Theory provides a rough estimate of the extent to which the market rate of exchange deviates from the equilibrium rate.

Balance of Payments Theory

The Balance of Payments Theory is an extension of the theory of value to the field of foreign exchange. In easy and simple terms, the theory states that the rate of exchange is fixed at the point where the demand for foreign currency is equal to its supply. The various items of imports give rise to the demand for foreign currency and the various items of exports give rise to its supply. Thus, the rate of exchange is that rate which equates imports and exports.

The balance of payments theory thus states that the rate of exchange is determined by the balance of payments in the sense of supply and demand. The theory places emphasis upon changes in the terms of trade between countries and international capital movements as the leading forces governing exchanges rates and internal prices. Superficially viewed, the principle involved is correct. But differences will arise when we endeavour to analyse the forces governing the supply of and demand for foreign currency. In terms of the explanation given by the advocates of the theory, the supply of and demand for foreign currency (balance of payments) are determined mainly by factors that are independent of variations in the rate of exchange. They contend that there are certain independent factors which are fixed such as interest on foreign loans, reparation payments, etc. Further, they hold that the demand for many of the items entering in the import trade is perfectly inelastic so that variations in the rate of exchange will not have any influence on them. In support of their argument, they point out the example of certain raw materials which have to be purchased from particular countries whatever the price may be.

The merit of this theory lies in the fact that it is in line with the demand and supply theory of value. Besides, it correctly states that exports and imports of visible items alone are not the only consideration influencing the rate of exchange. Balance of payments includes both visible and invisible items. Obviously, the invisible items have a bearing on the rate of exchange. Further, the theory explains that the disequilibrium in the balance of payments can be corrected by an adjustment in the exchange rate.

The most important criticism raised against the theory is that it considers balance of payments to be a fixed quantity. We have seen earlier that balance of payments is not generally a fixed quantity. Balance of trade is one of the most important items entering into balance of payments. The balance of trade depends on the price levels existing at home and abroad and it fluctuates according to the fluctuations in price levels. Lord Keynes has criticized the theory by comparing balance of trade to a sticky mass and suggesting that it applies to the theory of solids where that of liquids would be more appropriate.

The contention of the advocates of the theory that the demand for many imported raw materials is inelastic is also criticized. There is practically no commodity, the demand for which is perfectly inelastic. Even in the case of internal trade, the demand for any commodity can not be considered as perfectly inelastic,

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let alone the question of inelasticity of demand in the field of international trade. Changes in the rate of exchange do cause variations in the balance of payments. Thus, balance of payments which is influenced by the rate of exchange can not be considered as the only factor determining the rate of exchange.

Factors Causing Fluctuations in Exchange Rates

The theories discussed above indicate only the determination of the long-term exchange rates. The market rate of exchange existing on any particular day need not be the same. The causes giving rise to such fluctuations may be grouped as follows:

Short- term Factors:

1. Commercial
2. Financial

Long-term Factors:

1. Currency and Credit Conditions
2. Political and Industrial Conditions

The short-term factors, viz., commercial and financial factors, directly influences the supply of and demand for foreign currency. They may further be sub divided into trade factors, stock exchange factors and banking factors.

Trade factors relate to the influence arising from the exports and imports. Suppose, the equilibrium rate of exchange between India and the US is $1 = ₹47. For some reasons, the exports from the US increase more than the imports. That means India will have to give more dollars to the US. The demand for dollars increases. Obviously the market rate of exchange will move away from the equilibrium rate in favour of the US. Conversely, if the imports to the US are more than her exports, the rate of exchange will fluctuate in India's favour.

Stock exchange factors relate to the influences arising from the granting of loans, repayment of loans, receipt of interest payments, purchases and sales of foreign securities, etc. For example, suppose America is granting a loan to India. The demand for rupees will increase in America. The result is fluctuation of the rate of exchange in India's favour. Conversely when the loan is repaid the rate will fluctuate in America's favour. In the same way, payment of interest, sales and purchases of foreign securities, etc., will cause fluctuations in the equilibrium rate of exchange.

Banking factors relate to the influences arising from the operations of banks such as purchases or sales of bankers' drafts, traveller's letters of credit, arbitrage operations, changes in bank rate, etc. For instance, the sale of a draft on a foreign centre creates demand for foreign currency and raises its value. The exchange

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rate will move in favour of the foreign currency concerned. Again, a high bank rate will make investments lucrative in the home country. Foreigners will try to transfer their funds to that country. This will raise the demand for the currency of the country concerned and the rate of exchange will move in favour of that country.

Currency and credit conditions of a country also influence the rate of exchange. Exchange dealers are always careful to watch the probable trend of the internal and external value of a country's currency. If the total quantity of note issue is steadily rising without a corresponding increase in the total volume of goods, the result will be inflation. The increased prices of the commodities will cause a decrease in its exports. An adverse balance of payments position will develop. Such a state of affairs is likely to induce exchange dealers to dispose off their stock of home currency as early as possible. This will increase the supply of home currency relative to its demand, thus causing a fluctuation in the rate of exchange unfavourable to the home currency. In the same way, the budgetary policies of a country will also cause fluctuations in the rate of exchange. Where it appears that the extent of public expenditure is incompatible with the national prosperity of the country, exchange dealers will try to dispose off their stock of that currency. This results in the fluctuation of the rate of exchange unfavourable to the country concerned. Conversely, if public expenditure is justified by the national income, exchange dealers will anticipate a movement of the rate of exchange in that country's favour. They will then try to stock more of that currency. The resulting increase in demand will cause a movement in the rate of exchange in that country's favour.

The political conditions and the internal industrial situation of a country also cause fluctuations in the rate of exchange. As observed by Evitt:

'A stable government, the strict maintenance of law and order, the protection of property and of the rights of owners of wealth will all induce an inflow of foreign capital, either for interest gaining purposes or for safety; political unrest, attempts to overthrow the government either by force or by constitutional methods, the growth of and possible accession to power of a body of political thought inimical to capital, will all include the withdrawal of capital and prevent any further influx of funds from abroad'. Again, 'settled and amicable conditions between capital and labour, a stable level of wages commensurate with selling prices on the level of world prices, evidence of enterprise and efficiency on the part of those responsible for the direction of industry, will all operate as long-term factors in causing an appreciation of the international exchange value of the currency'. In short, stable political and industrial conditions will cause fluctuations in the rate of exchange in favour of the country concerned. Conversely, unstable political and industrial conditions will cause fluctuations in the rate of exchange against the country concerned.

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Problem of Stabilization of Exchanges: Fluctuating Rates

(Free Exchanges) vis-à-vis Stable Rates (Fixed Exchanges)

The question as to whether the exchange rates should be kept stable or whether they should be allowed to fluctuate freely is a disputed one. A categorical answer in favour of any of these propositions can not be given because it will be advantageous for a country to keep the rate stable at some time and allow it to fluctuate freely at some other time. The following paragraphs examine the arguments raised for and against each of these.

The most important argument raised in favour of freely fluctuating rate is that if the rate of exchange is kept rigidly fixed, the inflationary and deflationary conditions developing in other countries will automatically be transmitted to such a country. The validity of this argument is, however, dependent on the question as to whether the foreign trade of the country concerned is considerable or not. In the case of a country where foreign trade plays a large part, this argument holds good. For instance, let us assume that India is importing a large volume of goods from the US. Suppose, a commodity entering into the trade between India and the US is priced at $100 in the US. Taking the rate of exchange as $1 = ₹57, its price will be ₹ 5,700 in India, subject to freight and other expenses. Now, if inflationary conditions develop in the US, these will be reflected in India also. For example, if the price of this commodity increase to $200 in the US, its price in India will also be doubled (assuming stable or fixed rate of exchange is maintained). Conversely, a fall in the prices of commodities or depression in the US will cause similar economic conditions in India also. In short, fixed rates of exchange are liable to transmit inflationary and deflationary conditions from abroad.

It should be remembered in this connection that freely fluctuating exchange rates are also inimical to the balanced and stable growth of the economy. Frequent fluctuations in the rate of exchange are likely to cause violent fluctuations in the prices of many commodities. Such fluctuations in the prices may displace certain commodities from the international trade. The country will be compelled to reallocate its resources between the export and home-market industries. Such reallocation is often disturbing and wasteful.

Another argument raised in favour of fluctuating rates is that such fluctuation will enable the countries to prevent a balance of payment crisis, thus facilitating international trade. This argument is also not as weighty as it apparently appears to be. On the other hand, freely fluctuating exchange rates often lead to a breakdown in international trade since traders will not be willing to undertake the risks of unanticipated fluctuations in exchange rates. Of course, it is true that a part of such risks can be eliminated through the device of forward exchange. However, in one sense this is also a serious disadvantage of free rates. Unscrupulous speculators will start dealings in foreign exchange markets in order to make profits from such fluctuations. The very dealings of a speculative nature of such transactions are liable to cause serious fluctuations in exchange rates without any rational justification behind it. As observed by Ragner Nurkse in International Currency Experience:

'Anticipatory purchases of foreign exchange tend to produce or at any rate hasten the anticipated fall in the exchange value of the national currency, and the actual fall will set up or strengthen expectations of a further fall. The dangers of such cumulative and self-aggravating movements under a regime of freely fluctuating exchanges are clearly demonstrated by the French experience of 1922–26'.

Moreover, because of the chances of making windfall profits, businessmen will try to maintain a high state of liquidity. Only then they will be able to take advantage of sudden fluctuations in the rates of exchange. Obviously this discourages investment, thus affecting adversely production and employment.

Thus many of the arguments raised by the advocates of freely fluctuating exchanges rates have lost much of their significance. It is rather unwise for any country to leave its exchange rate to fluctuate according to the demand and supply formula and allow the equilibrating influence of the balance of payments work freely and automatically. No doubt, it is true that in the case of a country with a large volume of foreign trade, stable rates are liable to attract the inflationary and deflationary conditions developing in other countries.

In conclusion, we may say that while exchange rate variations are certainly an unsuitable and undesirable means of dealing with short-term discrepancies in the balance of payments, an absolute rigidity of rates of exchange in the face of drastic changes in other factors at home and abroad may thus be equally harmful. The overall interest may call for an occasional readjustment of the value of currencies in order to eliminate, as far as possible, any chronic and structural disparity between price levels and rates of exchange in different countries. The realization of this objective has led to the establishment of the International Monetary Fund, the details of which are elaborated in the next chapter.

Check Your Progress

3. What do you understand by the rate of exchanges between two currencies?
4. What does the balance of payments theory state?

6.4 EXCHANGE CONTROL

'Exchange control', in the simplest sense, denotes the methods by which a country controls the demand for and supply of foreign exchange. Haberler defines exchange control as 'the state regulation excluding the free play of economic forces from the foreign exchange market'. With the abandonment of the gold standard system and the disappearance of the 'automatic' controls of exchange, countries found it necessary to adopt some methods of control over the internal and external value

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of their currencies. Such controls date back to the First World War period. However, the world-wide depression of the late 1920s which culminated in the financial collapse of the 1930s gave birth to new techniques of exchange control. During the Second World War period, the severity of the exchange control methods followed by various countries led to a complete breakdown of international economic relations. Complete domination over the foreign exchange market was the order of the day. Payments and receipts of foreign currency on any account were subjected to strict government control. The post-war period witnessed a relaxation of these controls. But the return of the pre-war independence of the exchange market was out of question. Moreover, countries emerging from the war-torn economies found it absolutely necessary to continue some form of control in the realm of foreign exchange.

AIMS of Exchange Control

The primary objective of exchange control in the case of vast majority of countries is to stimulate exports and discourage imports. The exchange value of the country's currency will be artificially kept down. This reduces the price levels of home products in the world market. At the same time, prices of imported commodities increase. Thus, imports are discouraged and exports are encouraged. For example, suppose the price of a commodity is ₹2,000 in India when the rate of exchange between India and the US and India was $1 = ₹50. In terms of US dollars, the price of that commodity is $40. In case the exchange value is brought down to $1 = ₹100, the same commodity will cost $20 although the internal price remains at ₹2,000. At the same time, price of a commodity priced in the US at $40 will go up to ₹4,000 as far as India is concerned. Hence, from the point of view of the American people the price of Indian commodity decreases and from the point of view of Indians the price of American commodity increases. The depreciation of the Japanese yen provides an early example of this type of exchange control, which was later adopted by many other countries.

Another object of exchange control is to prevent capital exports. Citizens of the country will be prohibited from entering into any contract leading to export of capital. Foreigners are also prohibited from withdrawing their assets.

A third object of exchange control is to provide short run exchange stability. Under the inconvertible paper currency system, the automatic free interplay of demand and supply formula does not operate. This makes exchange rates very unstable. Short run stability of the exchanges is particularly important from the point of view of promoting international trade. As such, countries adopt various methods of controlling the exchange rates temporarily. The Exchange Equalization Funds provide a suitable example.

Exchange control is also adopted to maintain stable relations with some other foreign currency. This is all the more important when a country has important trade relations with such a country. For example, rupee had a strong link with

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pound sterling. The devaluation of pound sterling during the late 1940s was followed by the devaluation of rupee.

A further objective of exchange control is to conserve a country's foreign exchange resources so that they may be used for the purpose of meeting international obligations. Closely connected with this is the objective of ensuring the available supply of foreign exchange resources to repay the principal and interest to the creditor countries. During the 1930s, many debtor countries resorted to exchange control because they could not float new loans to repay their outstanding debts. The export proceeds were subject to strict government control.

During times of war exchange controls are designed to restrict the use of purchasing power of enemy nations, their subjects and agents. The control measures adopted by various countries during the Second World War provide an example.

A state of national emergency such as a major war demands the complete mobilization and state control over national resources of all kinds. As observed by Evitt, 'In addition to imposing measures which give the state complete control over all the external resources of the country, further measures to control the volume and direction of both export and import trade will be introduced, so as to conserve national resources by preventing unessential expenditure abroad and to ensure that only goods surplus to the national war effort are exported, and then only (as far as possible) to countries from which essential purchases must be made and for which the export proceeds can be used in payment'.

Crowther describes three possible objects of exchange control. These are:

1. Undervaluation (Devaluation)
2. Overvaluation
3. Maintenance of the exchange rate at stable level equivalent to the equilibrium level (Avoidance of Fluctuations)

Undervaluation

Undervaluation or devaluation denotes the lowering of the external value of currency. It means depreciation in the external value of the currency of the devaluing country and appreciation to the extent of devaluation in the external value of the currency or currencies of the country or countries in whose relationship the country has devalued her currency. Such a step would promote exports and discourage imports. This is because, as observed earlier, the internal prices will be relatively advantageous as compared to prices prevailing in the world market. Undervaluation is generally resorted to when there is an over-production of goods and a sort of depression in the market. It will help in lifting the economy from the depressed state by stimulating exports.

However, it should not be assumed that a policy of undervaluation will always have the desired effects. Sometimes the external prices will fall. This danger is particularly important in the case of countries enjoying a good share of the

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international trade. Also, since prices are affected through exports and imports, the desired objective of modifying the price levels is more likely to be achieved when foreign trade is extensive than when it forms only a small proportion of the aggregate trade of the country. It is important to note in this connection that devaluation will be successful only if the foreign country or countries in relation to which a country devalues its currency accepts such a policy. The foreign country or countries can effectively defeat the objects of devaluation by adopting counter measures such as raising tariff rates or granting subsidies to the producers so that their prices are also lowered. For example, suppose India devalues her currency from \$1 = ₹50 to \$1 = ₹100. A commodity which was priced at \$10 (₹500) will now cost only \$5 (₹500, since the new rate of exchange is \$1 = ₹100). This decrease in the price level is supposed to stimulate exports. Suppose the US raises the tariff rate on this commodity by \$5. For all practical purposes, the price remains at \$10. The foreign country or countries may also resort to depreciation of its/their currencies. Thus, the effects of depreciation of one currency will be neutralized by the depreciation of the other currency/currencies. The great depression provides us with numerous examples of competitive exchange depreciation. As observed by Crowther: 'undervaluation is a game that any one can play but if everyone plays at it and currencies enter upon a competition to see which can be pushed far those below its real value, it quickly develops into a race to render all currencies worthless'.

Overvaluation

Overvaluation denotes the fixing of the value of a currency at a higher level than it would be if there was no intervention to the foreign exchange market. Such a step is generally adopted when there is a serious imbalance in a country's balance of payments. The ultimate result would be a fall in the exchange value of a currency. At the same time the country may be in need of foreign goods essential either for war time needs or for economic development of the country. If, under these circumstances, the exchange rate is allowed to fall the cost of imported goods will become very high. The only possible course is to keep up artificially the value of the currency. For instance, during the Second World War period, the British Government maintained the value of pound sterling at a higher level than its actual position because of the necessity to purchase essential raw materials from abroad.

Secondly, a country suffering from inflation will have to overvalue its currency. If some sort of control is not resorted to, the value of the currency will decline sharply. This is especially important when foreign trade plays a significant role in a country's economy. Unless the downward course of the exchange value is arrested, inflationary tendencies will become more serious. Under such conditions, a country will overvalue its currency.

Thirdly, overvaluation is necessary for countries which have to make large payments of money expressed in terms of foreign currencies. Such countries are under the necessity of acquiring large amounts of foreign currency. The cost of

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their debt repayment will at least appear to be less if the value of their currencies is kept at a high level relatively to those of the foreign currencies. For example, suppose India has to make a payment of $10 million to the US and the debt was contracted when the rate of exchange was $1 = ₹60. The total amount of the debt in terms of our currency is ₹600 million. If rupee is overvalued at $1 = ₹50, the debt will at least appear to be ₹500 million.

However, there is another side of the picture of overvaluation. It will have the effect of raising the internal price levels relatively to the price levels prevailing in the world market. Thus, the exports of the country resorting to overvaluation will be crippled. History has shown us the adverse effects of overvaluation to a country's economy. Great Britain between 1925 and 1931, France between 1932 and 1936 and other countries at other times have learnt that overvaluation is a most violent malady, the more puzzling as the effects seem to be far larger than the cause. It is one of the surest ways of producing a general economic depression. To quote Crowther again, 'a sort of progressive paralysis appears to creep over the whole economy of a country whose currency is overvalued'.

Although overvaluation appears as affecting exports adversely by causing an upward trend in the export prices when expressed in terms of a foreign currency, such a course may be desirable and necessary under certain circumstances. It may not be possible to lay down any rigid formula as to when a country should overvalue its currency or undervalue its currency. We may agree with Crowther when he says that in times of war and scarcity overvalue your currency. In times of slump and surfeit undervalue your currency.

Avoidance of Fluctuations

The third object of exchange control is avoidance of temporary exchange fluctuations. Though admirable in theory, this object is difficult to be achieved in practice. It is not easy to identify temporary fluctuations. Exchange Equalization Funds provide an example of the attempt to iron out temporary ups and downs in exchange value. The history of the British Exchange Equalization Fund contains instances of occasions which necessitated both overvaluation and undervaluation.

Devaluation of the Rupee

In 1949, the rupee was devalued. The decision came in the wake of the devaluation of the pound sterling. In September 1949, Britain announced its decision to devalue pound sterling by reducing the sterling-dollar exchange rate from £1 = $4.03 to £1 = $4.80. In September itself, the Government of India announced its decision to devalue rupee by the same extent. As a result, the rupee-sterling rate remained the same as before, viz., ₹1 = 1s 6p, while the rupee-dollar rate was changed to ₹1 = 21 cents (instead of ₹1 = 30.225 cents).

Of course, there was no legal obligation for India to maintain its link with pound sterling. Nevertheless, in view of the fact that most of our trade connections were with the sterling area countries, we had no alternative. Incidentally, it may be

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remarked that 28 currencies followed the devaluation of pound sterling. The large volume of trade of India with most of these countries actually compelled India to devalue her currency as well. The decision was taken 'not on conviction born of logic necessarily but, so to speak, by the compulsion of events' Taking 1948–49, the volume of our trade with the sterling area countries was around ₹592 crore as compared to ₹ 262 crore with the hard currency area. If the rupee had maintained its value in spite of the devaluation of so many currencies, Indian goods would have become more costly with the result of a decrease in demand in the usual markets. Devaluation, thus, became a defensive necessity.

Effects of Devaluation

1. The rupee equivalent of our borrowings from the IMF and the World Bank increased overnight from ₹47.64–₹68.57 crore.
2. The cost of imports from dollar area suddenly increased by nearly 30–50 per cent. Of course, cost of imports from sterling area countries (which had devalued their currencies) remained the same.
3. Prices of Indian goods in the dollar area markets decreased by nearly 30 per cent. This was an advantage since this had the effect of stimulating our exports to those markets.
4. The index number of wholesale prices and the cost of living index did not show any appreciable increase. This indicates that the internal price levels and trade equilibrium were not adversely affected by devaluation. Although by June 1950, the index numbers began to rise. This rise was not entirely due to devaluation.The outbreak of the Korean War played a significant role in this price increase.
5. The immediate effect of devaluation on India's balance of trade was favourable.

Nevertheless, the advantages of devaluation in India were short lived as compared to the advantages derived by other countries from the devaluation of their currencies. In the case of India, the export surplus was limited while most of the other countries could make full use of their productive capacity they had, thus increasing the export surplus for dollar market area. The productive capacity of India, on the other hand, was limited and was further handicapped by the increased prices of essential imports of capital goods and raw materials from foreign markets, especially the dollar area countries.

Proposals for Revaluation of the Rupee

The inflationary conditions that had prevailed in the economy since 1950 led to a controversy regarding the desirability of revaluing the rupee. It was contended by the advocates of revaluation that the fixing of a higher exchange rate for the rupee would check inflation and would result in considerable saving in the country's import costs. Late Dr John Mathai was an ardent advocate of revaluation.

According to him, the recognized internal remedies for inflation were by themselves not likely to be immediately operative in India. He pointed out that in spite of the government's strenuous efforts, no substantial economies in public expenditure were within sight. According to him, 'Taxation has already been pushed to the point of diminishing returns. Savings on a voluntary basis are difficult to come by and schemes of compulsory saving will encounter serious administrative difficulties… Credit control which in other countries is frequently put forward as a means of combating inflation has little application in India…. The development schemes now in progress are not expected to reach the stage of production for some years to come while scarcity of materials and lack of capital for replacement and expansion are hampering existing industries. Price control, besides being increasingly difficult to administer, is in reality no remedy for inflation but only serves to spare some of its obvious symptoms'.

The opponents of revaluation pointed out that revaluation of rupee would seriously affect our exports to sterling area countries because such a step would make our goods costly. Indian exports would find it difficult to compete in the international market. The government was opposed to a policy of revaluing the currency. In 1951, the then Union Minister of Finance stated that a revaluation of the rupee would not be in the interest of the country. According to him, 'the conclusion that the Reserve Bank experts have arrived at is that a 15 per cent revaluation would probably involve a balance of payment deficit of round about ₹50 crore and a 30 per cent revaluation would involve a deficit in the balance of payments of ₹135 crore whereas, if we do not revalue we shall probably hold things square'. The question of revaluing the rupee was thus rejected.

Second Devaluation of the Rupee

Since independence, rupee was devalued for a second time in June 1966. The par value of the rupee was changed from 18.66 grams of gold per 100 rupees to 11.85 grams of gold. In other words, this involved a reduction in the external value of rupee by 36.5 per cent. The immediate provocation for the devaluation of the rupee for a second time was the suggestion made by the IMF and the World Bank to the Government of India to devalue the rupee. It was true that prices in India had been continuously rising since the beginning of the First Five Year Plan. During the decade 1956–1966, the general price level rose by about 80 per cent. This made the internal value and the external value incompatible since the official rate of exchange was remaining the same all through this period. Devaluation of the rupee thus became an immediate necessity. The problem assumed significance especially in view of the fact that the unofficial rate of exchange prevailing was much different from the official rate.

Moreover, as admitted by the then Union Minister of Finance, the rise in prices in India had no comparison to the rise in prices in other countries with which India traded. As a result, our exports had been meeting with increasing competition. In addition, it was pointed out that devaluation would reduce leakages in foreign exchange earning caused through anti-social practices such as under-invoicing of exports, over-invoicing of imports, remittances through unofficial channels, smuggling, etc.

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De-linking of the Rupee with Pound Sterling

In September 1975, India decided to delink rupee with pound sterling. Following the snapping of rupee's link with pound sterling, a series of revaluations started as far as rupee was concerned. The first one was in December 1975. As a sequel to the delinking of the rupee from the pound sterling, the Indian strategy had been to prevent the rupee from sliding down with pound sterling on a long-term basis. A part of the strategy had been to permit an effective devaluation of the rupee for short spells in terms of the US dollar, Japanese yen, etc., in order to give a boost to exports.

Linkage of the Rupee with a Basket of Currencies

At present, the rupee is linked with a small number of chosen currencies known as 'basket of currencies'. The currencies selected for inclusion is the basket are the currencies of those countries which are our major trading partners. The object is obviously to give a degree of stability to the rupee. Since all the currencies included in the basket are not likely to fluctuate in one direction all at the same time, it is expected that violent fluctuations in the rate of exchange are unlikely. Of course the day-to-day rate may vary within a small margin which will be announced from time to time. Thus, what we follow today is neither a rigidly fixed rate nor a freely fluctuating rate; but a floating rate within certain limits.

Methods of Exchange Control

The methods of exchange control may be broadly grouped under two heads, viz., intervention and restrictions. Intervention denotes the activities of the government in entering the exchange market either to purchase or sell foreign exchange in order to bring the rate of exchange up or down to the desired level. Restrictions denote the activities of the government in preventing the existing demand for or supply of the currency in which they are interested from reaching the exchange market.

Intervention

This is a direct method of intervening in the exchange market. The government will be ready to purchase any amount of home currency that can not be taken by the market and to sell foreign currencies in exchange for that. Thus the existing demand for and supply of foreign exchange are artificially controlled by the authorities. For example, the internal value of currency depreciates owing to inflation. The government wants to maintain its external value at a higher level than that warranted by the purchasing power parity in order to facilitate international transactions. This can be done by increasing the supply of foreign currencies in the exchange market.

Large scale purchase of the home currency in the exchange market in exchange for foreign currencies will also have the effect of reducing the supply of home currency. Conversely, a country which wants to fix the exchange value of the currency at a lower level may do so by increasing the supply of home currency in the exchange market. These acts of fixing the exchange value of a currency to a particular rate are known as pegging operation. Pegging operation generally means pegging up. The term pegging down is used to signify the maintenance of the exchange value of the home currency at a lower level. Obviously the ability of a government to carry on pegging operations depends on the volume of foreign exchange at its disposal. Of course, in the case of pegging down, its success depends on the ability of the authorities to increase the supply of home currency through taxation, public borrowing or creation of additional legal tender currency. As observed by Crowther: 'a government that is pegging its currency must be in a position to pay out foreign currencies and receive its own currency. A government that is 'pegging down' its currency must be in a position to pay out its own currency and receive foreign currencies and both must be prepared to go on indefinitely unless they want either to resort to restrictions or to fail in their purpose of controlling the rate of exchange'. It is true that pegging down is easier than pegging because it is easier for a country to produce more of its currency in times of emergencies which is not so easy in the case of foreign currencies. However, it should not be forgotten that the adoption of such a short cut will bring in its wake all the evils of inflation. As a matter of fact, inflation would assist the pegging down operation because any rise in prices would tend to lower the equilibrium value of the currency. If the operations are continued indefinitely, it will result in disastrous inflation. Hence, it should be adopted only as a temporary expedient. Both pegging up and pegging down should be adopted only as temporary measures, and even then with caution.

The maintenance of the exchange value of pound sterling during the First World War period is a good instance of pegging up. The exchange value of pound sterling began to depreciate under the adverse balance of payments position. To counter this, the British Government undertook pegging operations. It raised loans in the US and with these funds, the supply of dollars was maintained at a fixed rate. France and Italy had also adopted the same procedure to peg their currencies to pound sterling.

Exchange Equalization Fund

Intervention is also used for the purpose of ironing out temporary fluctuations in the exchange value of a currency. Exchange Equalization Funds are the outcome of such a policy. An Exchange Equalization Fund (or, Exchange Equalization Account) may be defined as a collection of assets segregated under a central control for the purpose of intervention in the exchange market to prevent undesirable fluctuations in the rates of exchange. With the help of this fund foreign currency is purchased or sold at fixed rate of exchange, maintaining the exchange value of the home currency more or less fixed. This, of course, involves the overvaluation of

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the currency in question at sometimes and undervaluation at others. The British Exchange Equalization Fund provides a typical example.

The British Exchange Equalization Fund was set up in April 1932, immediately after the suspension of the gold standard system by England. It was the depreciation of sterling in terms of gold currencies that prompted the British Government to establish such a fund. The seriousness of the depreciation of pound sterling can be gauged from the fact that the exchange value of sterling in terms of US dollar steadily declined from £1 = $4.86 2/3 to £1 = $ 3.23 on 8 December 1934. The importance of London as an international financial centre which caused speculative movements of funds in and out of the country was the main factor which imparted a degree of instability to pound sterling.

The main object of the British Exchange Equalization Fund is to prevent undue fluctuations in the rates of exchange. The objective of the Fund is not to aim at maintaining pound sterling at a fixed parity with gold or the dollar or any other currency, but is to be operated, in the first instance, for the purpose of counteracting temporary fluctuations in the exchange transactions and capital movements and allow sterling to depreciate or appreciate only in accordance with the major movements in the net balance of payments.

The initial capital of the fund was £ 25 million in US dollars together with an undisclosed amount of gold which the treasury had purchased from time to time in the open market since the abandonment of the gold standard system. These assets were supplemented by an authority for the Fund to raise an amount of £ 150 million by borrowing, which amount has since been raised from time to time. Besides, the entire gold holdings of the Bank of England are now under the management of the Fund.

The mode of operation of the Fund is as follows:

When there is a flight of capital to London, the Fund readily purchases it with the help of pound sterling at its disposal. This helps to avoid an over-supply of the foreign currency concerned causing fluctuations in the rate of exchange. At the same time, the Fund accumulates large amounts of foreign exchange. When there is a flight of capital from London, the Fund readily supplies the necessary foreign exchange in exchange for pound sterling. This is done with the help of previously accumulated foreign exchange. Such an action equilibrates demand and supply. Moreover, the Fund acts as a shock absorber in neutralizing the effects of capital transfers on the internal credit structure.

Following the example of England, various other countries established such Funds. Though the activities of these Funds did not reach the same level as those of the British Exchange Equalization Fund, the main objectives and mode of operation are the same. A study of these funds shows that their main objectives are to iron out temporary fluctuations in the rate of exchange and to safeguard against the disturbing influence arising from the flight of capital and gold into and out of the country.

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Restrictions

Exchange restrictions are exchange control proper. The term ‘exchange restrictions’ refers to the policy of the state in preventing the existing demand for and supply of foreign exchange from reaching the exchange market. Austria and Germany were the pioneers in the field of exchange restrictions. The financial crisis of 1931 witnessed the emergence of many forms of exchange restrictions. The types and methods of these restrictions were different in different countries and in the same country at different periods. Following are given certain types of restrictions usually met with:

1. Unofficial discouragement of capital export and speculation.
2. Official prohibition of capital export and speculation applied by the banks.
3. Prohibition of capital export and speculation applied by the authorities.
4. Application of the prohibition of export on foreign capital—transfer moratoria and legal authorization to defer payment.
5. Allocation of foreign exchange for importers by permits.
6. Compulsory surrender of existing foreign exchange holdings by private interests.
7. Compulsory suspension of free dealings.

Multiple Exchange Rates

Under this method, different exchange rates are fixed for exports and imports of different goods. The object is to earn as much foreign exchange as possible by encouraging exports and discouraging imports. For instance, different varieties of German marks used to be sold in London at different rates. Many countries followed this practice during the immediate post-war period.

Clearing Agreements

Under a clearing agreement between two countries, importers in both countries pay into an account in their respective central banks the purchase price of all commodities imported. The proceeds are then used to meet the export obligations. The agreement generally fixes the rate of exchange. When export credits and import debits do not offset each other, exporters are paid only when funds are available on the clearing agreement. The objects of such an agreement are to regulate imports according to the wishes of the government, to ensure equilibrium in the balance of payments and to prevent uncertainties of fluctuating exchanges. Clearing agreements are criticized on the ground that they are bilateral agreements standing in the way of the development of international trade. Another criticism is that such an agreement is likely to enable an economically stronger nation to exploit an economically weaker nation. In order to obtain payments for its exports under a clearing agreement, the weaker country may be compelled to import unwanted commodities.

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Payments Agreements

Payments agreements are slightly better than clearing agreements. Under the former, mutual credit facilities are allowed so that the exporter will be paid by his central bank as soon as information is received that the importer has honoured his obligation. This avoids delay in payment and the consequent difficulties of the exporter.

Standstill Agreements

Under these agreements, the short-term debts are either converted into long-term debts or arrangements are made for their gradual payment. In effect, a moratorium is given on capital movements.

Transfer Moratoria

Under this restriction, people who owe money to foreigners pay the amounts to a specified authority in local currency. The foreigners will be paid only after the lifting of the moratorium. Sometimes foreigners are allowed to use these amounts in the home country in certain specified ways.

Blocked Accounts

This is a combination of standstill agreements and transfer moratoria. The accounts are blocked in the sense that the foreigners will not be allowed to draw on them. The main objects of blocking the accounts are the removal of the immediate threat to the rate of exchange arising from attempts to transfer such funds out of the country and the reduction of interest charges on foreign debts.

In addition to the above, certain indirect methods of exchange control are applied by countries. They include the fixation of import tariff, import quotas, changes in interest rates, etc.

Spot and Forward Exchange

Generally currencies are exchanged on the spot. The rate of exchange quoted for the purchase or sale of immediate foreign exchange is known as the 'Spot Rate'. In contrast to this there is the forward exchange and the 'Forward Rate'. Forward exchange denotes foreign exchange to be delivered after a certain period of time. The rate of exchange for selling such future transactions is known as the 'Forward Rate'. Sometimes it will be necessary for business people to sell or purchase forward exchange. An example will make the point clear. Suppose a businessman in India is importing certain raw materials from the US on a D/A bill for three months, priced at US $100,000. Assuming the current rate of exchange is $1 = ₹50, his cost of the raw materials is reckoned as ₹50,00,000. Suppose at the end of the three months, when the payment of the bill is due, the rate of exchange moves against rupee to $1 = ₹60. The total cost for the importer on account of the raw materials will go up to ₹60,00,000, thereby incurring a loss of ₹10,00,000. This risk can be avoided by purchasing three months forward dollars. This operation is similar to a hedging operation. The rate quoted by the exchange dealer for the forward exchange will be based on the spot rate. The forward rate is at a premium, when less amount of foreign currency is given for one unit of domestic currency. The forward rate is at a discount, when more amount of foreign currency is given for one unit of domestic currency. The following factors are taken into consideration while quoting the forward rate:

1. **Rate of interest at home and abroad–** If the rate of interest is higher at the foreign centre, it is more profitable for the exchange dealer to transfer funds abroad. Hence the forward rate will be quoted at a discount. Conversely, if the rate of interest is higher in the home country, forward exchange will be quoted at a premium.
2. **Possibilities to offset one transaction by an opposite one–** Some people want to sell forward exchange and others may require to purchase the same. The exchange dealer comes in as an intermediary by purchasing from the former and selling to the latter. This is technically termed as 'marrying a contract'. The forward rate will be quoted at a discount if the exchange dealer has already purchased forward exchange.
3. **Currency conditions–** If the foreign currency is expected to depreciate, the exchange dealer will be unwilling to purchase it forward and hence it will be quoted at a premium.

Though forward exchanges are liable to wide fluctuations during periods of unstable exchange, it relieves the trader, especially the small traders, of the risk of fluctuations. The 'rate of exchange hedging' relieves the manufacturer of the risks of fluctuations in the prices of raw materials which he imports from foreign countries.

Check Your Progress

5. What do you understand by exchange of control?
6. What is the primary objective of exchange control?
7. Define overvaluation.

6.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Foreign currency is required for the purpose of importing essential capital goods from other countries.
2. The term 'balance of trade' denotes the relation between the imports and exports of commodities of a country.

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3. The rate of exchange between two currencies is the amount of one currency that will be exchanged for one unit of another currency.
4. The balance of payments theory thus states that the rate of exchange is determined by the balance of payments in the sense of supply and demand.
5. Exchange control denotes the methods by which a country controls the demand for and supply of foreign exchange.
6. The primary objective of exchange control in the case of vast majority of countries is to stimulate exports and discourage imports.
7. Overvaluation denotes the fixing of the value of a currency at a higher level than it would be if there was no intervention to the foreign exchange market.

6.6 SUMMARY

- With the development of international trade and the subsequent international division of labour, it has become imperative for countries to devote more and more attention to the complicated mechanism of 'foreign exchange'.
- It has been widely recognized that a country should conserve its foreign exchange resources.
- The term 'foreign exchange' is used to denote either a foreign currency or the rate at which one currency is converted into another or the means and methods by which one currency is exchanged for another.
- The term 'balance of trade' denotes the relation between the imports and exports of commodities of a country.
- 'Balance of payments' includes not only the visible items of exports and imports but also the invisible items of exports and imports which make a country creditor to another and vice versa.
- The rate of exchange between two currencies is the amount of one currency that will be exchanged for one unit of another currency.
- When a country is on the gold standard system, actual gold coins will be in circulation, or the currency note will be convertible into metallic gold by tendering it at the central bank.
- Determination of the rate of exchange under the gold standard system has now only a theoretical importance.
- Purchasing Power Parity Theory is one of the most widely criticized theories. In the first place, it is said that the term 'price level' is a very vague one.
- The Balance of Payments Theory is an extension of the theory of value to the field of foreign exchange.
- The short-term factors, viz., commercial and financial factors, directly influences the supply of and demand for foreign currency.

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- Stock exchange factors relate to the influences arising from the granting of loans, repayment of loans, receipt of interest payments, purchases and sales of foreign securities, etc.
- 'Exchange control', in the simplest sense, denotes the methods by which a country controls the demand for and supply of foreign exchange.
- The primary objective of exchange control in the case of vast majority of countries is to stimulate exports and discourage imports.
- Undervaluation or devaluation denotes the lowering of the external value of currency.
- Overvaluation denotes the fixing of the value of a currency at a higher level than it would be if there was no intervention to the foreign exchange market.

6.7 KEY WORDS

- **Trade:** Trade is the activity of buying, selling, or exchanging goods or services between people, firms, or countries.
- **Exchange:** An exchange is a marketplace in which securities, commodities, derivatives and other financial instruments are traded.
- **Devaluation:** Devaluation is a deliberate downward adjustment of the value of a country's currency relative to another currency, group of currencies or standard.

6.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What is the difference between balance of trades and balance of payments?
2. Write as short note on rate of exchange under the gold standard system.
3. How is the rate of exchange determined under the inconvertible paper currency system?
4. What are the three possible objects of exchange control?
5. What are the effects of devaluation of money?

Long-Answer Questions

1. Discuss the meaning and significance of foreign exchange.
2. What is the Purchasing Power Parity Theory? Mention major criticisms to this theory.
3. What are the main factors causing fluctuations in exchange rates? Discuss.

4. Define exchange control. What are the major aims of exchange control?
5. What are the major proposals for revaluation of money? Discuss.

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6.9 FURTHER READINGS

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UNIT 7 BANKING REGULATION ACT, 1949

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Structure

7.0 INTRODUCTION

The enactment of the Banking Regulation Act in 1949 has been a milestone in the history of Indian joint stock banking. The present unit is an attempt to highlight certain important provisions in the said Act, which are intended to foster a sound and healthy banking system in India and the various other measures taken by the authorities in the recent past to reform and regulate the banking system.

7.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the Banking Regulation Act, 1949
- Understand the history of Banking Regulation Act, 1949
- Explain about the social applicability of the Banking Regulation Act

7.2 HISTORY, SOCIAL CONTROL AND APPLICABILITY

Let us analyse the history of Banking Regulation Act, 1949 and discuss its important provisions.

1. Section 6 of the Act lays down specifically the forms of business in which banking companies may engage. The forms of business specified are in consonance with accepted banking principles. This section prohibits banking companies from taking part in trading and speculative activities, thereby landing themselves in danger. The importance of this section lies in the fact that one of the main causes that led to the failure of Indian joint stocks

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during the early part of their development was the varied nature of the transactions which many of them undertook and which could never be characterized as banking transactions. The danger was clearly demonstrated in the case of the failure of the Indian Specie Bank in 1914. The bank lost about ₹111 lakh on silver speculation alone. The loss in budla deals amounted to ₹14 lakh; and loss on advances against pearls amounted to ₹36 lakh.

2. Section 7 of the Act, as amended in 1963, prohibits the use of any of the words 'bank', 'banking' or 'banking company' to a company other than a banking company, or firms, individuals or group of individuals.
3. The Act lays down certain important provisions regarding the minimum paid-up capital and reserves. According to the original provision (Section 11), it was possible for a bank with only one place of business to be started with as low a capital as ₹50,000. In terms of the Amendment Act of 1962, the limit of minimum paid-up capital in the case of an Indian banking company commencing banking business for the first time after the commencement of the Banking Companies (Amendment) Act, 1962 is fixed at ₹5 lakh, irrespective of whether it has only one place of business or places of business in only one state. Further, if a bank has places of business in more than one state, and if any such place is situated either in Mumbai or Kolkatta or both, the minimum amount of paid-up capital is ₹10 lakh.

   It may be noted in this connection that according to the guidelines issued by the Reserve Bank of India in January 1993, the minimum paid-up capital for the new private sector banks shall be ₹100 crore. Similarly, according to the announcement made by the bank in August 1996, the minimum paid-up capital of a local area bank shall be ₹5 crore. The reader's attention is invited to the relevant topics discussed in detail later in this chapter.
4. Section 17 of the Act, as amended in 1962, requires every banking company to transfer to its reserve fund a sum equivalent to not less than 20 per cent of its profits irrespective of whether or not its reserves have equalled the paid-up capital. This provision is intended to act as a brake on the policy of declaring large dividends to satisfy the shareholders, thus undermining sound banking principles. The Amendment Act was necessitated as a result of the fact that the paid-up capital and reserves of banks have not kept pace with the increase in deposits brought about by the growing economic activity during the past few years. It may be noted in this connection that with effect from the year ending 31 March 2001, all scheduled commercial banks operating in India (including exchange banks) are required to transfer not less than 25 per cent of the net profit (before appropriations) to the reserve fund. This transfer may be made after adjustment/provision towards bonus to staff.
5. Certain unscrupulous banks used to mislead the ignorant public by showing large figures of authorized capital as against very fractional amount of paid-up capital. Also, by calling only a small portion of the subscribed capital, the promoters of banking companies used to persuade persons to purchase

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a very large number of shares than they could actually afford to. For instance, the Poona Bank which went into liquidation in 1924 had an authorized capital of ₹10 crore as against a subscribed capital of ₹50 lakh and a paid-up capital of ₹3 lakh. To remove these malpractices, Section 12 (1) of the Act lays down that the subscribed capital of a banking company must not be less than one half of the authorized capital and the paid-up capital must not be less than one half of the authorized capital.

6. The maximum voting rights of any one shareholder is fixed by the Act, as amended in 1994, at 10 per cent of the total voting rights. This controls the concentration of power in any banking company in the hands of a few shareholders.
7. Interlocking directorates which pave the way for mismanagement are prohibited under the Act. According to Section 16 of the Act, no banking company incorporated in India shall have as director any person who is a director of another banking company.
8. To protect the interests of depositors and to impose restrictions on indiscriminate loans and advances to directors and concerns in which the bank or the directors are interested, the Act prohibits a banking company from making loans or advances on the security of its own shares; or granting unsecured loans or advances to any of its directors or to firms or private concerns in which the bank or any of its directors is interested as partner or managing agent. The nature of loans and advances made by certain banks before the imposition of this restriction was really unsatisfactory. The failure of People's Bank of Lahore indicates the malpractices done by the directors and such other persons at the helm of affairs. When the bank ceased operations it was found that ₹86 lakh out of its total deposits of about ₹1 crore were advanced to enterprises in which the managing director was directly and personally interested.

   Further restrictions have been imposed in terms of the Banking Laws (Miscellaneous Provisions) Act, 1963, which are discussed in detail subsequently in this chapter.
9. Section 24 of the Act as amended in 1962 requires every banking company to maintain in gold, cash or unencumbered securities, valued at a price not exceeding the current market price, an amount of not less than 25 per cent of its total time and demand liabilities. This provision is intended to ensure the liquidity of the assets of the banks. This section is especially important since one of the main reasons which led to a number of bank failures in the past had been the negligence on the part of banks to maintain the liquidity of their assets in their greed to earn more profits.
10. To safeguard the interests of the depositors, the Amendment Act, 1958 provides for the simplification and speedy disposal of winding up proceedings of banks.

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11. The Act provides for the public examination of directors and auditors of any bank under liquidation, who are found guilty in the promotion, formation or proper conduct of business of the bank. Special provisions for assessing damages against delinquent directors, etc are also laid down in the Act.

Banking Companies and the Reserve Bank of India

In addition to the above provisions, the Banking Regulation Act confers certain powers on the Reserve Bank of India to control the banking companies.

1. Section 21 of the Act confers powers on the Reserve Bank of India to determine the policy in relation to advances to be followed by banking companies. Subsection (2) of that section empowers the Reserve Bank to issue directions to banking companies as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances. This section has been amended in 1963 so as to extend the powers of the Reserve Bank to give directions to banking companies regarding the maximum amount of advances that may be granted to or the maximum amount up to which guarantees may be given on behalf of any one company, firm, association of persons or individual.
2. Section 22 of the Act requires every banking company to obtain a licence from the Reserve Bank for carrying on or commencing banking business in India. This is mainly intended to check the growth of unsound banks and to arrest the indiscriminate floatation of mushroom banks. The Reserve Bank, before granting a licence to any bank established before the commencement of the Act in 1949, inspects the whole affairs of the institution concerned and satisfies itself that the institution is in a position to pay its depositors in full and that its affairs are not conducted to the detriment of the depositors. The Reserve Bank is also empowered to cancel a licence already granted.
3. The failure of banks during the past has been attributed, among other reasons, to the defective management of the banks by persons untrained in banking techniques and ignorant of sound banking principles. In this connection, it would of interest to note the failure of the Credit Bank of India. In the course of the trial, the manager pleaded ignorance of banking or accountancy. He was ignorant of the meaning of a bill of exchange. The Chairman of the Board of Directors confessed: 'Before I became acquainted with the bank, I had absolutely no knowledge of finance or banking nor I have any now.'

   To remedy this defect, the Act of 1949, as amended in 1965, gives power to the Reserve Bank to regulate the appointment and remuneration of the senior officers of banks. Further, the Amendment Act of 1956 has empowered the Reserve Bank to remove from office the Chairman or Chief Executive Officer of a banking company, if such a person has been found by any tribunal or any authority to have contravened the provisions of any law. The Banking Laws (Miscellaneous Provisions) Act, 1963 provides for such removal even when a person has not been found to have contravened any law; but when he is considered by the Reserve Bank to be acting in a manner detrimental to the interests of the banking company or to the interests of the depositors, and covers not only the directors or the chief executive but also any other officer or employee.

4. The Reserve Bank is empowered to inspect any banking company at any time to ensure itself about the efficient performance of the responsibilities of the banking company concerned. This is particularly useful to promote sound banking methods among the banking companies. It can call a meeting of the directors of a bank or change its management when disclosures arising out of inspection make such a step desirable.
5. The Reserve Bank is authorized to caution any individual bank or banks generally against a particular transaction or a class of transactions or to offer advice.
6. The Reserve Bank may, if it thinks necessary, apply to the High Court for the winding up of any banking company.
7. According to Section 36 of the Act, the Reserve Bank is required to make an annual report to the Central Government on the trend and progress of banking in the country, including its suggestions, if any, for the strengthening of the banking business throughout the country.
8. The provision relating to amalgamation of banks is an important one. The Act requires any scheme of amalgamation of banks to be approved by the Reserve Bank. The Reserve Bank, although encourages amalgamation among sound banking units, does not sanction any scheme of amalgamation unless it is satisfied that the relevant amalgamation is in the interest of the depositors, and the amalgamated unit will be able to play a useful role in the strengthening of the banking structure in the area of operation of the amalgamating units.

The Reserve Bank is vested with more powers through the recent banking legislations which are discussed in the following paragraphs.

The Banking Companies (Amendment) Act, 1960

The Banking Companies (Amendment) Act, 1960 inserts a new Section 34 A in the Banking Regulation Act to make it clear that information, which according to law is not required to be published in the balance sheet or profit and loss account of a banking company, need not be disclosed to the authorities set up under the Industrial Disputes Act. However, the relevant authorities have been empowered to call for a certificate from the Reserve Bank regarding the amount of such reserves which may be taken into account for the purpose of the proceedings under the Act.

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This amendment is intended to protect the secrecy of the inner reserves of banks, which is important from the point of maintenance of the confidence of the depositors, while providing for an independent assessment of the magnitude of such reserves by the Reserve Bank.

The Banking Companies (Second Amendment) Act, 1960

The Banking Companies (Second Amendment) Act, 1960 invests the Reserve Bank and the government with additional powers aimed at rehabilitation of banks' difficulties.

The rehabilitation of a bank in difficulties would require a reasonable period of investigation and negotiation into its position. In order to ensure that during such a period the bank's position is not adversely affected, it is advisable to grant the bank a temporary moratorium. The amended Act provides that the Central Government may, on an application from the Reserve Bank, make an order up to a period of six months granting moratorium to a banking company. It is further provided that during the period of moratorium, the Reserve Bank may prepare a scheme for reconstruction of the banking company, if this is considered necessary, and submit it to the Central Government, who may sanction the scheme with necessary modification. The scheme as sanctioned shall come into force on such date as shall be specified by the Central Government and shall be binding on the banking company and also on all the members and creditors thereof.

The Banking Companies (Amendment) Act, 1961

Subsequent to the failure of two scheduled banks in 1960, the Reserve Bank had taken powers to formulate and carry out, with the sanction of the government, schemes for the reconstruction and compulsory amalgamation of sub standard banks with well managed institutions. The bank faced certain operational difficulties in implementing this programme. As promptness in dealing with the vulnerable banking institution is as important as the action proposed, the amended Act confers power on the Reserve Bank to prepare a scheme for the compulsory amalgamation of any banking company with the State Bank of India or its subsidiaries. It also permits the amalgamation of more than two banking companies under a single scheme. Any amalgamation proposed under this scheme is binding not only on the concerned banking companies, their members and creditors, as applicable hitherto, but also on their employees and other persons possessing any right or liability in relation to such banking companies. The Act authorizes the Central Government to sanction such a scheme with or without modification and to bring it into force on the date specified by the government. Provision was also made in the amendment to absorb the entire working staff on existing terms and conditions of service for a period not exceeding three years. The transfer of assets and liabilities from the transferor to the transferee bank is facilitated by the provision that by virtue of the scheme and to the extent provided therein, the properties and assets of the transferor bank shall vest in the transferee bank and the liabilities of the transferor bank shall be taken over by the transferee bank.

Banking Companies (Amendment) Act, 1962

The Reserve Bank of India (Amendment) Act, 1962 and the Banking Companies (Amendment) Act, 1962 have come into force in September 1962. The amendments were necessitated mainly by two considerations, viz., to strengthen the banking system and to enable scheduled banks to provide larger credit to exporters for a longer period.

Several provisions in the original Banking Companies Act, 1949 such as those relating to capital funds and liquidity ratio of banks were of minimal character prescribed in the then prevailing context of raising the standard of performance of many sub-standard banks which had come into existence during the war years. Since then the conditions have altered and it was considered necessary to strengthen the financial position of commercial banks. Similarly, in the light of the emphasis on export promotion and the situation in world markets where other exporting countries offer medium and long-term credit facilities to the buyers abroad, it was felt necessary to recognize the paramount need for providing larger credit at reasonable rates to Indian exporters. This apart, it was found that even existing lending facilities afforded by the Reserve Bank were not made use of by banks in view of procedural difficulties. It was, therefore, considered necessary to amend the Reserve Bank of India Act to simplify the procedures.

The salient features of the amendments to both the banking Regulation Act and the Reserve Bank of India Act are summarized below.

(a) Statutory Cash Balances

Section 42 of the Reserve Bank of India Act, which stipulates cash reserves of scheduled banks to be kept with the Reserve Bank, has been simplified to require scheduled banks to maintain with the Reserve Bank an average daily balance of 3 per cent of their total time and demand liabilities. The cash reserve may now be varied between 3 per cent and 15 per cent. While fixing the ratio at 3 per cent of the aggregate of time and demand liabilities, changes in the pattern of deposits of scheduled banks in the last few years, viz., the large increase in time liabilities as well as the fall in the usance period of fixed deposits—were also borne in mind. To bring the non-scheduled banks in line with the scheduled banks, except in regard to variation of cash reserves, Section 18 of the Banking Regulation Act was amended so as to require non-scheduled banks to maintain with themselves or in current account with the Reserve Bank or its agencies, cash balance to the extent of 3 per cent of their total time and demand liabilities in India as against 5 per cent of demand and 2 per cent of time liabilities prior to the amendment. Both the scheduled and non-scheduled banks are required to comply with the respective provisions from the date of commencement of the concerned Acts.

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(b) Liquidity Ratio

The liquidity ratio of scheduled banks showed a sizeable decline from around 43 per cent in 1950 to around 33 per cent in 1961. The credit-deposit ratio of banks, on the other hand, moved up from 49 per cent to about 70 per cent during the same period. With prospects of a further rapid rise in bank credit to finance the expanding requirements of trade and industry and the resulting pressure on the liquidity of banks in the coming years, it was considered necessary to safeguard the soundness of the banking system by ensuring that certain desirable minimum standards of liquidity were adhered to by banks. The amendment to Section 24 of the Banking Regulation Act provides that the liquid assets required to be maintained should be 25 per cent of the total demand and time liabilities instead of 20 per cent, and banking companies were required to comply with the above stipulation after the expiry of two years from the commencement of the banking Companies (Amendment) Act, 1962. When the requirement of the amendment came into force, the practice of computing the liquidity ratio of banks after taking into account the deposits required to be kept with the Reserve Bank under Section 42 of the Reserve Bank of India Act (in the case of scheduled banks) and cash balances required to be maintained under Section 18 of the Banking Regulation Act (in the case of non-scheduled banks) was discontinued. Thus, when the requirement of the amendment became operative, the overall minimum liquidity ratio of commercial banks stood at 28 per cent (made up of 3 per cent of cash reserve and 25 per cent liquid assets) as against the previous minimum of 20 per cent. By virtue of the power to vary the cash reserves of scheduled banks with the Reserve Bank from 3 per cent to 15 per cent, their overall liquidity ratio may be pushed up to 40 per cent. In the case of non-scheduled banks, however, since the cash balance of 3 per cent to be maintained under Section 18 of the Banking Regulation Act cannot be varied, their overall liquidity remains at 28 per cent.

The effect of the amendment is to split up the overall liquidity requirement of scheduled banks into two portions:

(i) statutory reserve balance required to be maintained under Section 42 of the Reserve Bank of India Act and

(ii) cash or till money, gold, excess over statutory reserves, balances with the State Bank of India and with notified banks and unencumbered securities. This splitting up became necessary in the light of the experience of the Reserve Bank in respect of the operations of the variable reserve requirements. It was observed that when additional reserve requirements were imposed, scheduled banks implemented this partly by liquidating government bonds. This tended to shift the impact of varying the reserves intended to restrict bank credit in particular to reducing investments in government securities. It was, therefore, considered necessary to minimize the impact of any future action to raise reserve requirements on security holdings. The overall liquidity requirements were also raised correspondingly.

(c) Capital Funds

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The paid-up capital and reserves of commercial banks failed to keep pace with the increase in deposits brought about by the growing economic activity, with the result that the ratio of paid-up capital and reserves to deposits of scheduled banks steadily declined from about 9 per cent in 1950 to less than 5 per cent in 1960. The average ratio of capital funds to deposits was on the low side as compared to the position in many other countries, where there had always been a concerted effort to get the shareholders' money in business into a proper trading relationship to the deposits. Under Section 17 of the Banking Regulation Act, Indian banks were required to transfer to reserves 20 per cent of their balance of profit until the reserves together with the balance in the share premium account equalled with paid-up capital. In terms of the present amendment, a banking company incorporated in India is required to continue transferring to the reserve fund created under Section 17 of the Act even if the reserves have already equalled paid-up capital, out of the balance of profit each year, as disclosed in the profit and loss account and before any dividend is declared, a sum equivalent to not less than 20 per cent of such profit. In respect of a foreign bank, Section 11 (2) of the Banking Regulation Act prescribes that a sum of ₹15 lakh, or if it has a place or places of business in Mumbai or Kolkatta or both ₹20 lakh, should be deposited with the Reserve Bank in lieu of paid-up capital. In terms of the amendment to that section, banking companies incorporated outside India are required to deposit with the Reserve Bank, in addition to the deposits required to be maintained as aforesaid, as soon as may be after the expiration of each calendar year, an amount calculated at not less than 20 per cent of the profit for that year in respect of all business transacted through the branches in India as disclosed in the profit and loss account prepared with reference to that year.

The Central Government may, on the recommendation of the Reserve Bank, and having regard to the adequacy of the paid-up capital and reserves in relation to deposit liabilities in the case of Indian banks, and having regard to the adequacy of the amounts deposited in relation to deposit liabilities in the case of foreign banks, exempt them from transferring 20 per cent of their profits for a specified period.

The amendment to Section 11 of the Banking Regulation Act raised the limit of minimum paid-up capital in the case of an Indian banking company which commences banking business for the first time after the commencement of the Banking Companies (Amendment) Act, 1962 to ₹5 lakh irrespective of whether it has only one place of business or places of business in only one state as against the previous lowest minimum capital requirement of ₹ 50,000 which was fixed long back and which in the light of the subsequent changes in economic conditions was considered too low.

(d) Credit Information

It was felt that in the absence of any regular and systematic arrangement for the collection, pooling and supply of particulars relating to the loans and advances or other credit facilities granted by the various banks and financial institutions to those borrowing from them, individual banks or financial institutions were handicapped in obtaining reliable information about the creditworthiness or financial position of the various persons/institutions to whom credit had been or may have to be granted. In order to enable the Reserve Bank to collect and supply the relevant information in a consolidated form to the lending institutions, a new chapter has been introduced to the Reserve Bank of India Act enabling the Reserve Bank to collect credit information from banks and financial institutions and defining the functions of the Reserve Bank in regard to the pooling, consolidation and publication of such information.

(e) Export Finance

The Reserve Bank of India Act, 1934 did not generally permit the bank to make any loans or advances or to grant financial accommodation in any other form to commercial banks for periods in excess of 90 days. It was also not possible for the bank to make any such accommodation on the security of documents bearing only a single signature on behalf of any borrowing institution. It was appreciated that these restrictions rendered it difficult for banks to extend to exporters credit facilities for the periods for which, or on the conditions on which, such credit may be required by them. In terms of the amended provisions:

(i) The period of maturity of eligible bills of exchange and promissory notes which the Reserve Bank is authorized to purchase or rediscount or lend against is increased from 90 days to 180 days of the bills of exchange or promissory notes, as the case may be, relating to the export of goods from India.

(ii) The Reserve Bank of India is authorized to grant loans to scheduled banks or to State cooperative banks against the signature of the borrowing institutions themselves, if the borrowing institutions furnish declarations to the effect that they are holding and will continue to hold, so long as the advances granted to them by the Reserve Bank remain outstanding, bills drawn by Indian exporters on foreign countries maturing within 180 days, the amount of which will not be less than the amount of outstanding loans and advances.

(iii) The Reserve Bank is authorized to grant normal banking accommodation to the scheduled banks and State cooperative banks for 180 days if the accommodation is for the purpose of financing exports.

The Banking Laws (Miscellaneous Provisions) Act, 1963

With a view to restrain the control exercised by particular groups or persons over the affairs of banks and to providing for stricter control over banks by the Reserve Bank, the Banking Laws (Miscellaneous Provisions) Act was passed in 1963. The Act amends the Reserve Bank of India Act, the Banking Regulation Act and the State Bank of India (Subsidiary Banks) Act. The Act empowers the Reserve Bank to supervise, control and regulate the activities of institutions carrying on the business of accepting deposits or any other business allied to banking. The details of these provisions are given below:

A new chapter has been introduced in the Reserve Bank of India Act, empowering it to regulate or prohibit the issue of any prospectus or advertisement by non-banking institutions soliciting deposits from the public and call for returns and information from such institutions relating to deposits received by them. The non-banking institutions include companies, corporations and firms. The Reserve Bank is also empowered to give directions to non-banking institutions in regard to the receipt of deposits, including the rates of interest payable on such deposits and the periods for which deposits may be received. If any non-banking institution fails to comply with any direction given by the Reserve Bank, the bank may prohibit the acceptance of deposits by that institution. The bank may also require a non-banking institution receiving deposits from the public to send a copy of its annual balance sheet and profit and loss account to every person whose deposits with the institution as on the last day of the accounting year exceeds the sum specified by the Reserve Bank.

The Reserve Bank is further empowered to:

(i) call from financial institutions information or statements relating to their business, including information in respect of paid-up capital, reserves or other liabilities, investments made and advances granted by them and

(ii) give directions to such institutions relating to the conduct of their business. In this connection, 'financial institution' means any non-banking institution which carries:

- on as its business or part of its business the financing of trade, industry, commerce or agriculture or
- on as its business or part of its business the acquisition of shares, stocks, bonds, debentures or debenture stock or securities issued by a government or local authority, or other marketable securities of like nature or
- on as its principal business hire purchase transactions or the financing of such transactions.

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The bank is also empowered to inspect any non-banking institution and its books and accounts for the purpose of verifying the correctness or completeness of any statement or information furnished by it or for the purpose of obtaining information or particulars which such institution has failed to furnish on its being called upon to do so. The Act provides penalties for persons and institutions for failure to comply with the directions of the Reserve Bank and for wilful submission of incorrect information to the Reserve Bank.

Certain amendments in regard to procedural matters have also been made. These relate to the suspension of the provision that currency notes, if not presented for payment within 40 years after the date of issue, would be deemed to have gone out of circulation and that the value of rupee coins, including one rupee notes held as assets in the Issue Department of the Reserve Bank, should not be less than ₹50 crore or one-sixth of the total assets held in the Issue Department, whichever was higher.

The Act amends the Banking Companies Act, 1949 with a view to providing further powers to the Reserve Bank so as to ensure stricter supervision and control over the commercial banks. Section 10 of the Principal Act has been amended so that the term of office of a person managing the affairs of a bank cannot, at any one time, be in excess of five years. The Act also provides that renewal of contract cannot be sanctioned earlier than two years from the date on which it is to come into force. If the term of office of any person managing the affairs of the bank is for an indefinite period, it should come to an end immediately on the expiry of five years from the date of his appointment or on the expiry of three months from the date of commencement of the amendment, whichever is later.

The amendment Act reduced the maximum voting rights of individual shareholders of a banking company from 5 per cent to 1 per cent of the total voting rights of all the shareholders of that company.

Amendments to Section 20 prohibit the grant of unsecured loans by a banking company to any company in which the Chairman of the Board of Directors of the banking company appointed for a fixed term is interested as the Chairman or Managing Director of the company or as the managing agent or director or partner of the managing agent of such company. These restrictions do not, however, apply to the granting of advances by a banking company against trust receipt or against bills for supplies for services made or rendered to government or bills of exchange arising out of bonafide commercial or trade transactions.

The Act further provides that a banking company shall not, without the approval of the Reserve Bank, remit any debt due to it by any of its directors or by any company or firm in which any of its directors, managing agent or guarantor, or by any individual if any of the directors is his partner or guarantor.

Section 21 of the principal Act has been amended so as to extend the powers of the Reserve Bank to give directions to banks regarding the maximum amount of advances that may be granted or the maximum amount up to which

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guarantees may be given on behalf of any one company, firm, association of persons or individual.

Under the existing legislation, there was no provision for the Reserve Bank to remove a person connected with the management of a banking company except as a sequel to contravention by him of any law, or to make appointment directly on its own initiative to the post of a director or chief executive officer of a banking company. In order to strengthen the power of the Reserve Bank in this regard, a new section has been introduced in the principal Act, under which the bank can, by an order in writing, remove any person associated with the working of a banking company, whether or not that person has been found to have contravened the provisions of any law, or the Reserve Bank considers it necessary or desirable either in the public interest or in the interest of the depositors or for the better management of the banking company. The Reserve Bank may also appoint a suitable person in place of the person removed from office. A person proposed to be removed from office will, however, be given reasonable opportunity of making a representation to the Reserve Bank against his removal. In case the bank feels that any delay would be detrimental to the interests of the banking company or its depositors, it may, at the time of giving the opportunity, or at any time thereafter, direct that pending consideration of the representation the person concerned shall not take any part in the management or working of the banking company. Any person against whom an order for removal from office is made by the Reserve Bank will have the right to prefer an appeal to the Central Government, within 30 days from the date of the order. A new section has also been included in the Banking Regulation Act conferring on the Reserve Bank the power to appoint, for a period up to three years at a time, one or more additional directors in the case of a banking company, provided that such additional directors shall not exceed five or one-third of the maximum strength of directors, excluding the additional directors appointed by the Reserve bank, of the company fixed by its Articles, whichever is less.

The following are the other amendments:

(i) The prohibition on the use of any of the words ‘bank’, ‘banking’ or ‘banking company’ hitherto applicable to a company other than a banking company under Section 7 of the Act has been extended to firms, individuals or groups of individuals.

(ii) The amendment to Section 34–A extends to all banking companies the benefit of protection of the secrecy of information regarding their inner or undisclosed reserves, which was hitherto available only to banking companies with offices in more than one state.

(iii) The amendment to Sections 44–A and 45, relating to the voluntary amalgamation sanctioned by the Reserve Bank or the compulsory reconstruction and/or amalgamation of banking companies under the order of the Central Government, makes it clear that the orders of

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sanction passed by the Reserve Bank or the Central Government, as the case may be, will be conclusive evidence as to the fulfilment of all requirements of law relating to reconstruction and/or amalgamation, and that copies of such order duly certified by an officer of the Reserve Bank or the Central Government, as the case may be, shall in all legal proceedings, be admitted as evidence to the same extent as the original orders.

7.2.1 Banking Laws (Application to Cooperative Societies) Act, 1966

An important and growing element in the overall banking system, namely cooperative banks, was brought within the ambit of the Reserve Bank's statutory control under the Banking Laws (Application to Cooperative Societies) Act which came into force from 1 March 1966.

The Act extends to State Cooperative Banks, Central Cooperative Banks and the more important primary non-agricultural credit societies including, in particular, Urban Cooperative Banks, the provisions of the Reserve Bank of India Act and the Banking Companies Act, except those relating to incorporation, management and winding-up which will continue to be governed by the State Cooperative Societies Acts.

The amendments to the Reserve Bank of India Act make State cooperative banks eligible to be included in the second schedule, with its attendant privileges and obligations. Further, all cooperative banks to which the provisions of the Reserve Bank of India Act have been extended are now eligible to borrow in an emergency from the Reserve Bank. The more important among the provisions of the Banking Regulation Act which are applicable to cooperative banks are those in regard to the maintenance of reserves, liquid assets, control on advances, licensing, inspection and issue of directives. A cooperative bank other than a scheduled state cooperative bank has to maintain under Section 18 of the Banking Regulation Act a cash reserve of not less than 3 per cent of its total demand and time liabilities either with itself or in current account with the higher financing agencies. Under Section 24 of the Act, all cooperative banks are required to maintain liquid assets, including the minimum cash reserve of 3 per cent, of not less than 20 per cent of the total time and demand liabilities in India, for a period of two years from the commencement of the Act or for such further period not exceeding one year as the Reserve Bank may allow in a particular case. This is in the nature of a transitional provision, for thereafter all the cooperative banks will have to maintain, as commercial banks are required to do, liquid assets of not less than 25 per cent of total time and demand liabilities, in addition to the cash reserve of 3 per cent. The borrowings of the cooperative banks from their higher financing agencies are excluded from the computation of time and demand liabilities.

Under Section 20 of the Act, cooperative banks are prohibited from granting unsecured advances to the directors, but the Reserve Bank is empowered to allow primary cooperative banks to grant, if necessary, to their directors unsecured loans and advances on such terms and conditions as may be approved by it. Section 21 of the Act empowers the Reserve Bank to issue directives to cooperative banks or any of them regarding the terms and conditions on which advances and guarantees may be given by them. This section, incidentally, confers on the Reserve Bank the power to extend the various selective credit controls to the operations of the cooperative banks. Under Section 22 of the Act, all existing cooperative banks are required to apply to the Reserve Bank for a licence within a period of three months from the commencement of the Act. Such banks will be permitted to carry on banking business if licences are granted to them or until they are informed by the Reserve Bank that a licence cannot be granted to them. A new cooperative bank will be required to obtain a licence before the commencement of banking business. Section 23 of the Act has conferred on the Reserve Bank powers to licence the opening of branches so as to bring about a proper coordination between the branch expansion programmes of commercial banks and cooperative banks. Section 35 of the Act empowers the Reserve Bank to inspect the cooperative banks either directly or through state cooperative banks.

Deposit Insurance Corporation Act, 1962

The main object of the Deposit Insurance Corporation Act is to give a measure of protection to depositors, especially small depositors, against the risk of losing their savings in the event of a bank's inability to meet its liabilities and thereby assist banks in mobilizing deposits. An assurance of the safety of funds also assists in the active development of the banking habit of the community, reduces the occurrence of panicky withdrawals of deposits with banks and generally contributes to the stability and orderly growth not only of the individual banks but also collectively of the banking system.

The Deposit Insurance Corporation has an authorized capital of ₹1 crore which is fully paid-up by the Reserve Bank of India. The Act, under Section 26, empowers the corporation to borrow from the Reserve Bank up to a maximum of ₹5 crore. In order to obtain a clear picture of the net balance of the results of the insurance operations, the Act requires the corporation to maintain a separate Deposit Insurance Fund. To this fund would be credited:

(a) all amounts received by the corporation as premium;
(b) all amounts received by the corporation from the liquidator;
(c) all amounts transferred to that fund from the general fund;
(d) the amounts advanced by the Reserve Bank and
(e) all income arising from the investments made out of that fund.

In addition, the corporation would maintain a general fund, built-up with the capital and reserves as well as income accruing from the investment of those funds, after meeting the working expenses of the corporation. If at any time the amount

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available in the Deposit Insurance Fund is insufficient to meet the requirements of the fund, the corporation may transfer from the general fund such amount as may be necessary to meet the requirements of the Deposit Insurance Fund on such terms and for such periods as may be determined by the Board with the approval of the Reserve Bank. (Section 27)

The Deposit Insurance Fund would be applied:

(a) to make payments in respect of insured deposits;
(b) to meet liabilities in respect of an advance taken from the Reserve Bank under Section 26 and
(c) to meet liability in respect of the amounts transferred to the Deposit Insurance Fund from the general fund under Section 27.

The corporation is required to invest its funds only in Central Government securities and treat the Reserve Bank as its sole banker.

Management of the Corporation

The general superintendence, direction and management of the affairs of the corporation are vested in a Board of Directors, consisting of:

(a) the Governor for the time being of the Reserve Bank, who is the Chairman of the Board;
(b) a Deputy Governor of the Reserve Bank nominated by the bank;
(c) an officer of the Central Government nominated by that government;
(d) two directors nominated by the Central Government in consultation with the Reserve Bank, having special knowledge of commercial banking or of commerce, industry or finance, neither of whom is an officer of the government or of the Reserve Bank or an officer or other employee of the corporation or a director, an officer or other employee of a banking company or actively connected with a banking company.

The term of office of the first three directors is fixed by the respective authorities nominating them. The term of office of the non-official directors is limited to four years.

A person is not capable of being nominated as a director if:

(a) he has been removed or dismissed from the service of government or of a corporation or a company in which not less than 51 per cent of the paid-up share capital is held by the government;
(b) he is or at any time has been adjudged an insolvent or has suspended payment of his debts or has compounded with his creditors;
(c) he is of unsound mind and stands so declared by the Court and
(d) he has been convicted of any offence which, in the opinion of the Central Government, involves moral turpitude.

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The day-to-day affairs of the corporation are entrusted to an Executive Committee constituted by the Board from among its members and consisting of such number of directors as may be prescribed by the Board. The Act requires the corporation in matters of policy involving public interest as the Central Government may, after consulting the Reserve Bank, give to it in writing.

Registration of Banking Companies as Insured Banks and Liability of the Corporation to Depositors

In terms of the Act, banks which are already licensed are not refused a licence and those which are notified as banks under Section 51 of the Banking Regulation Act, viz., the State Bank of India and its subsidiaries, functioning at the time when the Act came into force were to be registered as insured banks. All new banks commencing operations in future would also have to be registered as insured banks.

The registration of a banking company as an insured bank shall stand cancelled on the occurrence of any of the following events, namely:

(a) if it has been prohibited from accepting fresh deposits or

(b) if it has been informed in writing by the Reserve Bank that its licence has been cancelled under Section 22 of the Banking Regulation Act, or that a licence under the Section cannot be granted to it or

(c) if it has been ordered to be wound-up or

(d) if it has transferred all its deposit liabilities in India to any other institution or

(e) if it has ceased to be a banking company within the meaning of subsection (2) of Section 36–A of the Banking Regulation Act, or has converted itself into a non-banking company or

(f) if a liquidator has been appointed in pursuance of a resolution for the voluntary winding up of its affairs or

(g) if in respect of it any scheme of compromise or arrangement of reconstruction has been sanctioned by any competent authority and the said scheme does not permit the acceptance of fresh deposits or

(h) if it has been amalgamated with any other banking institution.

Section 16 of the Act lays down the liability of the corporation in respect of insured deposits. In terms of this section:

1. ‘Where an order for the winding-up or liquidation of an insured bank is made, the corporation shall, subject to the other provisions of this Act, be liable to pay every depositor of that bank in accordance with the provisions of Section 17 an amount equal to the amount due to him in respect of his deposit in that bank at the time when such order is made:

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Provided that the liability of the corporation in respect of an insured bank shall be limited to the deposits as on the date of the cancellation of registration;

Provided further that the total amount payable to any one depositor in respect of his deposit in that bank in the same capacity and in the same right shall not exceed ₹1,500;

Provided further that the corporation may, from time to time, having regard to its financial position and to the interests of the banking system of the country as a whole, raise, with the previous approval of the Central Government, the aforesaid limit of ₹1,500.

2. Where in respect of an insured bank a scheme of compromise or arrangement of reconstruction or amalgamation has been sanctioned by any competent authority and the said scheme provides for each depositor being paid or credited with, on the date on which the scheme comes into force, an amount which is less than the original amount and also a specified amount, the corporation shall be liable to pay every such depositor in accordance with the provisions of Section 18 an amount which is equal to the difference between the amount so paid or credited and the original amount, or the difference between the amount so paid or credited and the specified amount, whichever is less—

   Provided that where any such scheme also provides that any payment made to a depositor before coming into force the scheme shall be reckoned towards the payment due to him under that scheme shall be deemed to have provided for that payment being made on the date of its coming into force.

3. For purpose of this section, the amount of a deposit shall be determined after deducting therefrom any ascertained sum of money which the insured bank may be legally entitled to claim by way of set-off against the depositor in the same capacity and in the same right.'

Thus, according to the Act, the amount of insurance cover provided by the corporation originally was ₹1,500 in respect of each depositor in each bank, in the same capacity and in the same right. However, deposits of the Central and state governments, foreign governments and banking companies were not covered by the scheme. With Effect from 1 April 1967, the Corporation increased the limit of insurance cover from ₹1,500–5,000. It was further increased ₹10,000 with effect from 1 April 1970; to ₹20,000 with effect from 1 July 1980 and to ₹1,00,000 with effect from 1 May 1993. This enhanced insurance cover of ₹1,00,000 will apply in the case of any liquidation or winding-up of an insured bank on or after 1 May 1993, and compromise or arrangement of reconstruction or amalgamation of an insured bank sanctioned on or after that date not providing for payments of amounts due to its depositors.

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The Act sets out in detail the manner of payment by the corporation in the event of an insured bank ceasing to function. It sets a definite time limit within which the corporation should make payment to the depositors, namely five months from the date of winding-up of a bank. In terms of Section 17 of the Act:

1. 'Where an insured bank has been ordered to be wound-up or taken into liquidation and a liquidator, by whatever name called, has been appointed in respect thereof, the liquidator shall, with the least possible delay and in any case not later than three months from the date of his assuming charge of office, furnish to the corporation a list in such form and manner as may be prescribed by the corporation showing separately the deposits in respect of each depositor and the amounts of set-off referred to in subsection (3) of Section 16.
2. Before the expiry of two months from the receipt of such list from the liquidator, the corporation shall pay to each depositor of the insured bank in respect of his deposit the amount payable under Section 16 either directly or through the liquidator or through any other agency as the corporation may determine.'

Where a scheme of compromise or arrangement of reconstruction or amalgamation has been sanctioned for an insured bank, the bank concerned or the transferee bank in the case of amalgamation should furnish to the corporation a list showing separately deposits of each depositor, if any, and the amount paid or credited to his accounts under the scheme. Within three months from the receipt of such list, the corporation is required to make the payment to the depositors (Section 18). The corporation, of course, is entitled to reimburse itself for such payment from the assets of the insured bank.

Payment of Premium by an Insured Bank

Section 35 of the Act lays down:

1. 'Every insured bank shall, so long as it continues to be registered, be liable to pay a premium to the corporation on its deposits at such rate or rates as may, with the previous approval of the Central Government, be notified by the corporation in the Official Gazette from time to time—

   Provided that premium payable by any insured bank for any period shall not exceed fifteen paisa per annum for every hundred rupees of the total amount of the deposits in that period or where its registration has been cancelled during that period, on the date of its cancellation;

   Provided further that where the registration of any insured bank is cancelled under Section 13, such cancellation shall not affect the liability of that bank for payment of premium for the period before such cancellation and of any interest due under the provisions of this section.
2. The premium shall be payable for such periods, at such times and in such manner as may be prescribed.

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3. If an insured bank makes any default in payment of any amount of premium, it shall, for the periods of such default, be liable to pay to the corporation interest on such amount at such rate not exceeding eight per cent per annum as may be prescribed.'

Thus, the maximum premium which the corporation is empowered to charge the insured banks is 15 paisa per annum for every ₹100 of the total amount of deposits with the bank (excluding the deposits by the Central and state governments, a foreign government or a banking company). The premium payable by the insured banks on their assessable deposits has been marginally raised from four paisa to five paisa per ₹100 per annum with effect from 1 July 1993.

Inspection of Insured Banks

In terms of Section 36 of the Act:

1. 'The corporation may for any of the purposes of this Act request the Reserve Bank to cause an inspection of the books and accounts or an investigation of the affairs of an insured bank to be made and on such request the Reserve Bank shall cause such inspection or investigation to be made by one or more of its officers.
2. The provisions of subsection (2) and subsection (3) of Section 35 of the Banking Companies Act, 1949 shall apply to an inspection or investigation under subsection (1) as they apply to an inspection under that section.
3. When an inspection or investigation has been made under this section, the Reserve Bank shall furnish a copy of its report to the corporation. Neither the bank inspected or investigated, nor any other bank shall be entitled to be furnished with a copy of such report.
4. Notwithstanding anything contained in any law for the time being in force, no court, tribunal or other authority shall compel the production or disclosure of a report under this section or of information or material gained during the course of an inspection or investigation under this section.'

Further in terms of Section 38, the Reserve Bank shall, on a request in writing from the corporation, furnish to it any report or information relating to an insured bank made or obtained by it under or in pursuance of the Reserve Bank of India Act or the banking Regulation Act.

The Act also empowers the corporation to ask insured banks to furnish any information relating to their deposits and to have free access to any of their records which it considers necessary. The relevant provisions are laid down in Sections 34 and 35 of the Act.

Deposit Insurance and Cooperative Banks

At the time of launching the system of deposit insurance itself, the exclusion of cooperative banks from the scope of the scheme was pointed out as a shortcoming.

In fact, at the time of introducing the Deposit Insurance Corporation Bill in the Lok Sabha, a suggestion had been made that the cooperative banks should be brought within the scope of the scheme. But it was stated that as the cooperative banks were exempted from the provisions of the Banking Companies Act they were not subject to the same degree of control as the commercial banks and hence there would be practical difficulties in extending the scheme to cooperative banks.

Subsequently, the cooperative banks were brought within the ambit of the Reserve Bank's statutory control under the Banking Laws (Application to Cooperative Societies) Act which came into force from 1 March 1966. With a view to extending the scheme of Deposit Insurance to cover State and central cooperative banks and the larger primary non-agricultural credit societies, i.e., urban cooperative banks with paid-up capital of ₹1 lakh or more, the Deposit Insurance Corporation (Amendment) Act was passed in 1968.

Complaints against the Scheme

Although there cannot be two opinions as to the effectiveness of deposit insurance in safeguarding the interests of the depositors and in avoiding panicky withdrawals, certain quarters have raised a few opposing arguments to it.

In the first place, it is argued that the ceiling limit will cause disintegration of accounts. Since protection is available, most depositors, especially the small and medium depositors, will try to take full advantage of it by depositing only the minimum with any particular bank. Against this, it is pointed out that the ceiling limit alone will not induce a person to keep deposits with a number of banks in order to get full protection. Moreover, whatever might have been the validity of this criticism at the time of launching the scheme, it may be noted that the ceiling limit has been considerably raised from ₹1,500–1,00,000.

Another complaint, and closely related to the previous one, is that the limited insurance cover will place the bigger banks in a disadvantageous position as compared to the smaller units. This is because they are also called upon to pay premia on the total deposits. However, one should not forget that the bigger units benefit indirectly in that a system of deposit insurance promotes a sound banking system and avoids panicky withdrawals consequent on the failure of the smaller units. The heavy withdrawals experienced by one of the 'Big Five' of India consequent on the failure of the Palai Central Bank is a clear case in point. However, it is advisable for the Deposit Insurance Corporation of India, as in the case of the Federal Deposit Insurance Corporation of America, to adopt a refund system of the premia at the end of each year from the surplus that remains with the corporation after taking into account the total cost of operation including administrative expenses, net addition to reserves and insurance losses. A deviation from the American system of applying this surplus against assessment for the following year is on a pro rata basis. Instead, in India, refund may be made on the basis of premia paid by the banks on uninsured deposits. This will reduce the grievance of the bigger banks.

Another criticism is that the Act does not confer direct power of inspection on the corporation. Of course, it can direct an insured bank to furnish to it such statements and information relating to the deposits as the corporation may consider necessary. As regards inspection, it can only request the Reserve Bank to cause an inspection and furnish it with copies of the inspection reports. Certainly this avoids duplication of work. Nevertheless, it would be better if the corporation is given direct authority to inspect the insured banks. This need not necessarily mean that the corporation should conduct regular inspections. In special cases, as in the case of FDIC of America, the corporation will then be enabled to gather first hand information.

A recent suggestion in certain quarters is that since the bigger commercial banks have already been brought under the public sector, there is not much meaning in continuing the scheme any further. It is true that these banks along with the State Bank of India group command a sizeable proportion of the banking resources in the country at present. But this suggestion does not carry much weight in the light of the establishment of the new private sector banks and the local area banks as a result of the recent banking reforms.

Deposit Insurance and Credit Guarantee Corporation

With the merger of the Credit Guarantee Corporation of India with the Deposit Insurance Corporation in 1978, the Deposit Insurance Corporation has been renamed as the Deposit Insurance and Credit Guarantee Corporation (DICGC). In this connection, the reader's attention is invited to the section 'Credit Guarantee Scheme for Small Borrowers' dealt with in the chapter 'Commercial Banks and Industrial Finance.'

Economic Importance of Deposit Insurance

The economic importance of deposit insurance stems from the fact that the liabilities of banks are essentially to demand liabilities to the public. These liabilities constitute the country's principal means of payment, i.e., cheque money. Distress calling of loans with forced liquidation of securities by banks and bank borrowers has led to widespread bank suspensions and to a drastic destruction of the principal part of money supply, bank deposits.

Deposit insurance is useful in correcting these unfortunate periodic experiences from two major closely related viewpoints—that of the individual and that of the nation. From the individual's standpoint, deposit insurance provides protection, within limits, against the banking hazards of deposit ownership. But the major virtue of deposit insurance is for the nation as a whole. By assuring the public, individuals and businesses alike, that cash in the form of bank deposits is insured up to a prescribed maximum, a major cause of instability in the nation's money supply is removed.

The guarantee of the kind envisaged and the assurance of immediate payment in the event of loss tend to encourage the banking habit particularly from the point of view of the small savers who generally deal with relatively smaller institutions.

At the same time, the fact should not be overlooked that the successful working of a scheme of deposit insurance depends to a large extent on the supervision of the insured banks and the efforts of the banks themselves towards improving their standard of operation. Deposit insurance should not be considered as a panacea curing all ills of the banking organism. No doubt, a system of deposit insurance would make a significant contribution in the direction of eliminating chain reactions of runs by instilling confidence in the minds of the depositors. But it must be properly supplemented with other measures to get the desired results.

Deposit Insurance Reform

Consequent upon the changes made in the operation of the three Credit Guarantee Schemes operated by the DICGC, a large number of banks have opted out of the Credit Guarantee Scheme. While the viability of the Corporation in relation to credit guarantee has come into focus, there may be need for an alternative arrangement.

With the gradual deregulation of interest rates on advances to priority sector, a re-look into the role and functions of the DICGC has become necessary. Simultaneously, reforming the deposit insurance system is a crucial component of the present phase of financial sector reforms in India. Accordingly, the Reserve Bank set up a Study Group on Reforms in Deposit Insurance in India under the Chairmanship of Shri Jagdish Capoor. The terms of reference of the working group included:

(a) to review the role of deposit insurance in financial sector and economic developments, including a review of the international experience with regard to deposit insurance;

(b) to conduct a detailed survey of the nature of deposit insurance in India—instruments, institutions and legal framework and

(c) to propose changes in the existing system.

The group submitted its report in October 1999. The major recommendations of the group include:

(a) fixing the capital of Deposit Insurance and Credit Guarantee Corporation at ₹ 500 crore, to be contributed fully by the Reserve Bank;

(b) withdrawing the function of credit guarantee on loans from DICGC; and

(c) risk-based pricing of the deposit insurance premium in lieu of the present flat rate system.

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In relation to the third recommendation mentioned above, it may be noted that in India, at present, the deposit insurance premium is a flat rate, irrespective of the risk profile of the financial entity concerned. This creates a moral hazard problem in that depositors have limited incentive to monitor the condition of the financial institution. This has raised the obvious question as to whether the premium should be risk-based which requires establishment of an agreeable basis of assessment of risk profile of banks. Various alternate choices such as Federal Deposit Insurance Corporation model of supervisory rating (CAMELS), risk-adjusted assets basis and option pricing model exist. There is also the question whether the onus of monitoring the bank should fall on the Deposit Insurance Corporation and whether it should be conferred legal status to take penal action including liquidation. Another issue relates to the size of deposit that is insured. From the point of view of legal requirements, the scope of revision of the present deposit insurance set up will have to deal with a number of statutory amendments. Several enactments, including the Bank Nationalization Act and the State enactments on cooperatives present difficulties for the Deposit Insurance Corporation to act as a receiver/liquidator in the case of failure of an insured entity.

Keeping all the issues in mind, a revised deposit insurance scheme is being contemplated. The task of preparation of a new draft law has already been taken up in supersession of the existing law.

Conclusion

The number of registered insured banks as at March 2011 was 2217 comprising 82 commercial banks, 82 regional rural banks, 4 local area banks and 2049 co-operative banks. With the present limit of deposit insurance at ₹1 lakh, the number of fully protected accounts (977 million) as at March 31, 2011 constituted 93 per cent of total number of accounts (1052 million) against the international benchmark of 80 per cent. Amount-wise, insured deposits at ₹17,35,800 crore constituted 35 per cent of assessable deposits at ₹49,52,427 crore against the international benchmark of 20– 40 per cent. At the current level, the insurance cover works out to 1.63 times per capita GDP as on March 31, 2011 as against the international benchmark of around 1 to 2 times per capita GDP prior to the financial crisis.

The Corporation builds up its Deposit Insurance Fund (DIF) through transfer of its surplus, i.e., excess of income (mainly comprising premia received from insured banks, interest income from investments and cash recovery of assets of failed banks) over expenditure each year, net of taxes. This Fund is used for settlement of claims of depositors of banks taken into liquidation/reconstruction/ amalgamation, etc. The size of DIF stood at ₹24,704 crore as on March 31, 2011, yielding a Reserve Ratio (DIF/insured deposits) of 1.4 per cent.

An assessment team comprising representatives of IADI and IMF visited DICGC in end-September 2010 to undertake a field test of the Draft Assessment Methodology for Core Principles for Effective Deposit Insurance Systems.

According to the assessment of the team, DICGC is compliant or largely compliant on all core principles. However, weaknesses in the overall insolvency framework which are outside the control of the DICGC makes overall compliance with many core principles limited. The report made several recommendations such as removing insolvent cooperative banks from the system, obtaining deposit-specific information from banks in a standard format, executing MoUs by DICGC with other deposit insurers whose banks have a presence in India, granting DICGC an access to 'fast-track' source of funding from either Reserve Bank of India or Ministry of Finance to provide funds needed for prompt depositor reimbursement, developing a formal public awareness programme and establishing a reasonable target reserve fund by DICGC. The Working Group on Reforms in Deposit Insurance, including Amendments to DICGC Act is looking into the recommendations of the field test team.

7.2.2 Social Control Over Banks

The Banking Laws (Amendment) Act, 1968

The Banking Laws (Amendment) Act which amends the Banking Regulation Act, the Reserve Bank of India Act and the State Bank of India Act and which provides for the extension of social control over banks came into force with effect from February 1969.

The objectives of the amendments to the banking Regulation Act are mainly to achieve an equitable distribution of the resources of the banking system in conformity with the requirements of the country so that priority sectors receive their due and particular clients or groups of clients are not favoured.

The Act has coined certain new expressions which have far reaching significance. The terms 'banking policy' and 'substantial interest' are the most important among these expressions.

'Banking Policy', as defined in the Act, means any policy specified from time to time by the Reserve Bank in the interest of the banking system or in the interest of monetary stability or sound economic growth having due regard to the interest of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources. Thus, the term covers in a single phrase all the diverse matters like the interests of depositors or of the banking system, monetary stability, sound economic growth and equitable allocation and efficient use of resources. The widening of the scope of Reserve Bank's directives to cover the requirements of banking policy, in Sections 21, 35–A, 36 and 36–AB of the Banking Regulation Act, has the effect of enlarging the Reserve Bank's power to issue directions to banks in regard to the policy to be followed by them in making loans and advances, or generally on any matter concerning the affairs of a bank, whether arising out of inspection or otherwise, and in regard to the appointment of observers or additional directors by the Reserve Bank.

Another important term in the Act is 'Substantial Interest'. This is defined 'Substantial Interest':

1. in relation to a company, means the holding of beneficial interest by an individual or his spouse or minor child, whether singly or taken together, in the shares thereof, the amount paid-up on which exceeds ₹5 lakh or 5 per cent of the paid-up capital of the company, whichever is less;
2. in relation to a firm, means the beneficial interest held therein by an individual or his spouse or minor child, whether singly or taken together, which represents more than 5 per cent of the total capital subscribed by all the partners of the said firm.

The idea of combining the interests in shares or partnership capital of any person with those of his spouse and minor children is new, somewhat revolutionary and it has been prompted by the prevalence or possibility of large scale abuses.

The following are the more important provisions of the Act having a bearing on social control over banks:

1. Banks are required to reconstitute their Board of Directors, so that not less than 51 per cent of the total number of members is persons having special knowledge of or practical experience in certain fields such as accountancy, agriculture and rural economy, small-scale industry, cooperation, banking, economics, finance and law. The directors representing these sectors should not have substantial interest in or be connected as employee or manager with large or medium sized industrial undertakings or trading or commercial concerns. Of these directors, not less than two are to represent agriculture or rural economy, cooperation and small-scale industry.

   The object of this provision is to distinguish clearly between the majority of 'non-industrialist' directors and the majority of the industrialists and businessmen on the Boards of banks and to ensure that the majority directors are not closely connected with any trade, industry or business of their own.
2. The Act empowers the Reserve Bank to reconstitute the Board of Directors of banks if the composition of the Board does not fulfil the requirements of law and the bank does not comply with the directions given by the Reserve Bank in this regard.
3. The Act requires every Indian bank to have a full time Chairman who is a professional banker and possesses experience in finance, economics or business administration. So long as he is the Chairman of a banking company, he should not be a director of any company or a partner of any trading or industrial business concern or should not have substantial interest in any company or firm and should not be engaged in other business or concern. The appointment, removal or termination of

appointment of the Chairman, and the terms to be granted to him would require approval of the Reserve Bank. The bank is also empowered to remove from office a Chairman of a banking company and appoint a suitable person, after giving a reasonable opportunity to the Chairman and the bank to represent their case.

4. The Act prohibits the grant of any new loans and advances, whether secured or unsecured, to directors or members of any committee or Board appointed by the banks in India or to concerns in which they are interested as partner, director, manager, employee or guarantor or in which they hold substantial interest. Subsidiaries of banking companies, government companies and non-profit making companies are exempted from this provision. Any loan which has already been granted or granted after the commencement of this section because of an earlier commitment must be recovered within the period stipulated at the time of the grant of the loan or advance or where no such period has been stipulated, before the expiry of one year from the commencement of the Act. The Reserve Bank may, however, in special cases extend the period up to three years.
5. The object of this provision is to eliminate the possibility of any abuse of the position in a bank to obtain credit. Hereafter, the position of a person as a director of a bank will not mean easy assistance from that bank. The importance of this provision can be gauged from the fact that as at the end of 1966, a total of 673 directors served on the Board of 85 banking companies and these held among themselves as many as 3021 directorships in companies registered under the Indian Companies Act, including directorships held by them in banks. Further, 1583 non-banking companies were connected with 72 Indian banks through a single director; 177 non-banking companies were connected with 67 banking companies through two or more directors.3 Thus, interlocking of directorship in non-banking companies with individual banks was a conspicuous feature of the Indian banking system.
6. The appointment, re-appointment or removal of the auditors of a banking company requires the approval of the Reserve Bank. The bank is also authorized to direct the auditors to conduct a special audit of any transaction or class of transactions and to report.
7. The Reserve Bank's powers to appoint directors or observers and to issue directions to banks have been amplified. Such directions may hereafter be issued not only in the interests of depositors or proper management of the banking companies, but also in the interest of banking policy.
8. In view of the special responsibilities of banks under the Negotiable Instruments Act towards the depositors and the public in general, the Act provides a new section which makes it unlawful to: (a) obstruct any

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person from lawfully entering or leaving a bank's office or from carrying on any business there; (b) hold within such office, demonstrations which are violent or are calculated to prevent the transaction of normal business; or (c) act in any manner calculated to undermine the confidence of the depositors in the bank concerned. This provision will not, however, be used to curtail normal and lawful trade union rights by the employees.

9. Under the Act, the Central Government is empowered to acquire the business of any bank, if it fails more than once to comply with any directions issued to it under Section 21 or Section 35–A of the Banking Regulation Act in so far as such directions related to banking policy or if the Central Government is satisfied that a banking company is being managed in a manner detrimental to the interests of its depositors, or in the interest of banking policy, or for the better provision of credit generally, or of credit to any particular section of the community or in any particular area. Provision has been made for payment of compensation in the event of such acquisition.

In consonance with the spirit of the above provisions, all foreign banks operating in India have been asked to set up advisory boards consisting of Indians (with the exception of the Chief Executive Officer when he is a member) with a majority of persons having special knowledge of or practical experience in one or more of the fields mentioned above.

Since the incorporation, regulation or winding up of cooperative banks are governed by state laws, the various new provisions of the Act regarding management, business, auditors or acquisition of banks do not apply to cooperative banks.

Check Your Progress

1. Which powers does Section 21 of the Banking Regulations Act confer on the Reserve Bank of India?
2. What does the Banking Companies (Second Amendment) Act, 1960 invest?
3. What is the main objective of the Deposit Insurance Corporation Act?

7.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Section 21 of the Banking Regulations Act confers powers on the Reserve Bank of India to determine the policy in relation to advances to be followed by banking companies.

2. The Banking Companies (Second Amendment) Act, 1960 invests the Reserve Bank and the government with additional powers aimed at rehabilitation of banks' difficulties.
3. The main object of the Deposit Insurance Corporation Act is to give a measure of protection to depositors, especially small depositors, against the risk of losing their savings in the event of a bank's inability to meet its liabilities and thereby assist banks in mobilizing deposits.

7.4 SUMMARY

- The enactment of the Banking Regulation Act in 1949 has been a milestone in the history of Indian joint stock banking.
- Section 6 of the Act lays down specifically the forms of business in which banking companies may engage. The forms of business specified are in consonance with accepted banking principles.
- Section 7 of the Act, as amended in 1963, prohibits the use of any of the words 'bank', 'banking' or 'banking company' to a company other than a banking company, or firms, individuals or group of individuals.
- Section 21 of the Act confers powers on the Reserve Bank of India to determine the policy in relation to advances to be followed by banking companies.
- The Banking Companies (Amendment) Act, 1960 inserts a new Section 34 A in the Banking Regulation Act to make it clear that information, which according to law is not required to be published in the balance sheet or profit and loss account of a banking company, need not be disclosed to the authorities set up under the Industrial Disputes Act.
- The Banking Companies (Second Amendment) Act, 1960 invests the Reserve Bank and the government with additional powers aimed at rehabilitation of banks' difficulties.
- The rehabilitation of a bank in difficulties would require a reasonable period of investigation and negotiation into its position.
- The Reserve Bank of India (Amendment) Act, 1962 and the Banking Companies (Amendment) Act, 1962 have come into force in September 1962.
- Section 42 of the Reserve Bank of India Act, which stipulates cash reserves of scheduled banks to be kept with the Reserve Bank, has been simplified to require scheduled banks to maintain with the Reserve Bank an average daily balance of 3 per cent of their total time and demand liabilities.
- The liquidity ratio of scheduled banks showed a sizeable decline from around 43 per cent in 1950 to around 33 per cent in 1961.

- With a view to restrain the control exercised by particular groups or persons over the affairs of banks and to providing for stricter control over banks by the Reserve Bank, the Banking Laws (Miscellaneous Provisions) Act was passed in 1963.
- With the merger of the Credit Guarantee Corporation of India with the Deposit Insurance Corporation in 1978, the Deposit Insurance Corporation has been renamed as the Deposit Insurance and Credit Guarantee Corporation (DICGC).
- The economic importance of deposit insurance stems from the fact that the liabilities of banks are essentially to demand liabilities to the public.
- Deposit insurance is useful in correcting these unfortunate periodic experiences from two major closely related viewpoints—that of the individual and that of the nation.
- The Banking Laws (Amendment) Act which amends the Banking Regulation Act, the Reserve Bank of India Act and the State Bank of India Act and which provides for the extension of social control over banks came into force with effect from February 1969.

7.5 KEY WORDS

- **Insurance:** Insurance is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from aninsurance company.
- **Deposit:** Deposit refers to a sum payable as a first instalment on the purchase of something or as a pledge for a contract, the balance being payable later.
- **Liabilities:** A liability is defined as a company's legal financial debts or obligations that arise during the course of business operations.
- **Amendment:** An *amendment* is a formal or official change made to a law, contract, constitution, or other legal document.

7.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. Write a short note on the Banking Regulation Act.
2. What are some of the main reasons for the failure of banks in the past?
3. What was the main purpose of the Banking Companies (Amendment) Act, 1960?

4. State the main purpose of Banking Laws (Application to Cooperative Societies) Act, 1966.

Long-Answer Questions

1. What are the important provisions of the Banking Regulation Act? Discuss.
2. State the powers that the Banking Regulation Act confer on the Reserve Bank of India to control the bank companies.
3. Discuss the salient features of the amendments to the Reserve Bank of India Act.
4. What are the main powers of the Reseerve Bank of India? Explain.

7.7 FURTHER READINGS

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UNIT 8 INDIAN BANKING

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Structure

8.0 INTRODUCTION

Indian banking system is a prerogative of establishing milestones and flexibility. The RBI along with other banks help to regulate the monetary exchanges, debts and loans. Apart from these, indigenous banks also aid the overall banking structure. By far the most important constituent of the bazar money market is the indigenous banker. The Central Banking Enquiry Committee defines indigenous bankers as all bankers other than the Imperial Bank of India, the Exchange Banks, the joint stock banks and the co-operative societies and includes any individual or private firm receiving deposits and dealing in hundis and lending money.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the organization of the RBI
- Discuss the management and structure of the RBI
- Learn about NABARD, Commercial Banks, Indigenous Banks and Cooperative Banks

8.2 RESERVE BANK OF INDIA: ORGANIZATION, MANAGEMENT AND FUNCTIONS

Let us analyse the management, structure and functions of RBI.

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8.2.1 Management and Structure

The Reserve Bank is fully owned and operated by the Government of India. As mentioned in the Preamble of the Reserve Bank of India, the basic functions of the Reserve Bank are:

- To regulate the issue of Banknotes
- To secure monetary stability in India
- To modernise the monetary policy framework to meet economic challenges

The Reserve Bank's operations are governed by a central board of directors, RBI is on the whole operated with a 21-member central board of directors appointed by the Government of India in accordance with the Reserve Bank of India Act. The Central board of directors comprise of:

- **Official Directors** – The governor who is appointed/nominated for a period of four years along with four Deputy Governors
- **Non-Official Directors** – Ten Directors from various fields and two government Officials

Organizational structure

Fig. 8.1 Central Board of Directors

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8.2.2 Major Functions of RBI

Let us discuss the major functions of RBI.

Monetary Authority

- Formulating and implementing the national monetary policy.
- Maintaining price stability across all sectors while also keeping the objective of growth.

Regulatory and Supervisory

- Set parameters for banks and financial operations within which banking and financial systems function.
- Protect investors interest and provide economic and cost-effective banking to the public.

Foreign Exchange Management

- Oversees the Foreign Exchange Management Act, 1999.
- Facilitate external trade and development of foreign exchange market in India.

Currency Issuer

- Issues, exchanges or destroys currency and not fit for circulation.
- Provides the public adequately with currency notes and coins and in good quality.

Developmental role

- Promotes and performs promotional functions to support national banking and financial objectives.

Related Functions

- Provides banking solutions to the central and the state governments and also acts as their banker.
- Chief Banker to all banks: maintains banking accounts of all scheduled banks.

8.2.3 State Bank of India

State Bank of India (SBI) is an Indian multinational, public sector banking and financial services company. It is a government-owned corporation headquartered in Mumbai, Maharashtra. The company is ranked 216th on the Fortune Global 500 list of the world's biggest corporations as of 2017. It is the largest bank in India with a 23% market share in assets, besides a share of one-fourth of the total loan and deposits market.

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The bank descends from the Bank of Calcutta, founded in 1806, via the Imperial Bank of India, making it the oldest commercial bank in the Indian subcontinent. The Bank of Madras merged into the other two "presidency banks" in British India, the Bank of Calcutta and the Bank of Bombay, to form the Imperial Bank of India, which in turn became the State Bank of India in 1955. The Government of India took control of the Imperial Bank of India in 1955, with Reserve Bank of India (India's central bank) taking a 60% stake, renaming it the State Bank of India. In 2008, the government took over the stake held by the Reserve Bank of India.

8.2.4 Commercial and Cooperative Banks

The functions and objectives of the commercial banks are different from the Co-operative banks. In this article we are giving some notable difference between these two types of banks.

1. Commercial banks operate with the approach of commercialization while Co-operative banks woks on the principle of co-operation. That is why state Co-operative banks get loans at least 2% cheaper from the Reserve bank of India.
2. Commercial banks have been constituted by an act passed by the parliament while Co-operative banks are constituted by different sates under various acts related to Co-operative societies of various states.
3. Co-operative banks have three tier set up in India i.e. state Co-operative at the apex level, central/district co-operative banks at the middle level and primary co-operative banks at the lower level while commercial banks don't have any such tier system in India.
4. Every commercial bank has the authority to take loan directly from the Reserve Bank of India while in Co-operative banks, only state Co-operative banks can enjoy this facility.
5. Commercial banks can establish its branches in any district/state of the country while on the other hand Co-operative banks can operate its activities only within limited area. As district cooperative banks can perform banking activities only within the boundary of the concerned district and Primary Co-operative banks can operate only in concerned villages.

8.2.5 Indigenous Banks

As in the case of money-lenders, there is absence of reliable statistics regarding the position of indigenous bankers in different part of the country, their financial resources and their scale of operations but it is recognised that amongst the agencies financing agriculture and the internal trade and small industries the indigenous bankers occupy a prominent position. The indigenous banker, in addition to making loans like the money-lender, receives deposits or deals in bundles or performs both these functions, unlike the money-lender. He has usually a larger working capital.

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Whereas both the indigenous banker and money-lender lend partly with and partly without security, the former more often does with than without and the latter more often without than with security. The clients of the indigenous banker repay punctually and the rates of interest charged by the banker are lower than in the case of the money-lender. The indigenous banker is particular about the objects of the loan and runs lessor risk. The money-lender lends for heterogeneous purposes and incurs a bigger risk. As between the indigenous banker and the urban money-lender, the former finances trade and industry rather than consumption, the letter finances consumption rather than trade. In general, these two broad groups shade-into each other, the difference between them being often of degree rather than of type.

Check Your Progress

1. What are the basic functions of the Reserve Bank?
2. Who does the Central board of directors of the Reserve Bank comprise of?

8.3 NABARD

On the recommendations of the committee to review arrangements for Institutional Credit for Agriculture and Rural Development, the National Bank for Agricultural and Rural Development Act, 1981 was passed by the Parliament and the National Bank for Agricultural and Rural Development (NABARD) was established in July 1982 with an initial capital of ₹100 crore. The capital has been subsequently raised to ₹2,000 crore. NABARD started its operations in November 1982 by taking over the developmental and refinancing functions of the ARDC on the one hand and the RBI on the other. The Bank was organized with the basic objective of establishing an apex institution in the field of agricultural and rural development finance in such a way as to integrate the financing of various institutions involved in the development of rural areas.

The paid-up capital of NABARD is shared equally by the Government of India and the RBI. It can augment its resources by drawing funds from the Central Government, the state governments, the RBI, international agencies including the World Bank group and by raising funds from the market through bonds and debentures. In addition, the resources of the National Agricultural (Long-term Operations) and the National Agricultural (Stabilization) Funds of the RBI stand transferred to the National Rural Credit (Long-term Operations) and the National Rural Credit (Stabilization) Funds of the NABARD. It can also borrow from the RBI for financing its short-term lending operations. In short, NABARD is well equipped with adequate financial resources to meet its commitments in the field of agricultural and rural development.

The management of NABARD is vested in a Board of Directors, consisting of the following members:

(a) A Deputy Governor of the RBI as Chairman.
(b) Three nominees of the RBI.
(c) Three nominees of the Central Government.
(d) Three members, two with experience in cooperative banking and one in commercial banking.
(e) Two nominees of the state governments.
(f) Two experts in rural economics and rural development.
(g) A managing director.
(h) One or more full time directors.

Functions

NABARD is established as a development bank, in terms of the preamble of the Act, 'for providing and regulating credit and other facilities for the promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto'. As an apex institution, it is accredited with all matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas. It performs all the functions performed by the erstwhile ARDC as well as those performed by the Agricultural Credit Department of the RBI in the field of agricultural and rural credit. Briefly, these include:

1. Provision of short-term, medium-term and long-term financial assistance to cooperative credit institutions, RRBs and commercial banks for promoting agricultural and rural development;
2. Provision of long-term loans to state governments for contribution to the share capital of cooperative credit institutions;
3. Provision of long-term loans to any institution approved by the Central Government
4. Contribution to the share capital of ordinary/rural debentures issued by any institution involved in agricultural and rural development;
5. Provision of necessary resources by way of refinance to the institutions providing investment and production credit for promoting the various developmental activities in rural areas;
6. Participation in institution building for improving absorption capacity of the credit delivery system including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.;

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7. Coordination of the rural financing activities of all the institutions engaged in developmental work at the field level and maintaining liaison with Government of India, state governments, RBI and other national level institutions concerned with policy formulation;
8. Preparation, on an annual basis, rural credit plans for all districts in the country (these plans form the basis for annual credit plans of all rural financial institutions);
9. Undertaking monitoring and evaluation of projects refinanced by it;
10. Promotion of research in agricultural and rural development;
11. Inspection of cooperative credit institutions and RRBs.

It is gratifying to note that NABARD has played its dual role as an apex institution and as a refinancing agency creditably by participating actively in the development of policy formulation, planning, coordination, monitoring research, training and consultancy as well as refinancing areas relating to agricultural and rural development. The Research Cell of the Bank is paying particular attention to ensure that weaker sections of the rural population benefit more by schemes of refinance by the Bank, that there is simplification of procedures so that quick disposal of applications is possible and that the government's programmes of poverty eradication are supported in a meaningful way.

Resources of NABARD

Since 31 December 2006, the RBI has stopped providing funds to NABARD through general line of credit (GLC) limit and it was advised to consider accessing the market on a regular basis. Accordingly, in 2006–07 NABARD raised resources mainly by way of bonds and debentures, besides the RIDF deposits. During 2007–08, NABARD had sizable amount of resources for lending activity due to the substantial rise in the RIDF deposits and other liabilities such as corporate bonds, Bhavishya Nirman bonds and NABARD rural bonds. Besides, NABARD was also permitted to raise resources during 2007–08 through a new source, viz., certificate of deposits. Also, an amount of ₹ 400 crore was transferred to the NRC (LTO) fund and ₹10 crore to NRC (stabilization) fund. The resources of NABARD increased to ₹17,486 crore during 2007–08.

Cooperative Development Fund

An important development in the area of institutional strengthening programmes in 1992–93 was the setting up of a Cooperative Development Fund. The fund was set up for providing assistance to cooperative credit institutions to improve their functional efficiency. Under the scheme, financial assistance is provided to various StCBs/SCARDBS/CCBs/PCARDBS for infrastructural development, building up of a Management Information System (MIS), hiring of outside agencies for conducting special studies/seminars, etc., and meeting the expenses in connection with performance awards given to cooperative banks based on their performance.

Rural Infrastructure Development Fund (RIDF)

RIDF was initially set up in NABARD in 1995–96 with a corpus of ₹2,000 crore with the major objective of providing funds to state governments and state-owned corporations at reasonable rates to enable them to complete various types of rural infrastructure projects pertaining to irrigation, flood protection, rural roads, bridges, etc. The fund was set up as a joint initiative by the Central Government and NABARD in order to develop infrastructure in rural areas , particularly in the backdrop of declining public investments in agriculture and rural sectors. Under the scheme, the Central Government, through budgetary outlays, contributes to the corpus fund of RIDF. Commercial banks can, in turn, deploy their shortfalls in priority sector lending target to the fund. In order to encourage commercial banks towards direct lending to agriculture/priority sector, interest rates earned by commercial banks on RIDF deposits are kept inversely related to the shortfall in lending to agriculture. Furthermore, for ensuring parity in risk weights assigned to direct priority sector lending and RIDF deposits, credit risk weights for both types of fund deployments by commercial banks have been fixed at 100 per cent.

The Fund has completed 16 years of operation by 2010–11. As at the end of March 2011, the total amount of deposits collected under RIDF scheme stood at ₹95,785 crore. A separate window, namely National Rural Roads Development Agency (NRRDA) was introduced in 2006–07. NRRDA was introduced with the objective of funding the rural roads component of Bharat Nirman Programme introduced by the Central Government. As at end-March 2011, the aggregate allocation of NRRDA stood at ₹18,500 crore.

Credit Extended by NABARD

NABARD provides short-term credit facilities to StCBs for financing seasonal agricultural operations, marketing of crops, pisciculture activities, production/ procurement and marketing activities of industrial cooperatives, financing of individual artisans through PACs, purchase and distribution of fertilizers and allied activities and marketing activities. Medium-term facilities were provided to StCBs and RRBs for converting short-term loans for financing seasonal agricultural operations to medium-term (conversion) loans and approved agricultural purposes. Long-term loans are provided to the state governments for contributing to share capital of cooperative credit instituions. During 2007–08, NABARD sanctioned total credit limits of ₹18,689 crore for various short and medium-term purposes to StCBs and RRBs. The interest rate charged by NABARD has been uniform irrespective of the size and purpose of the loan.

Kisan Credit Card Scheme

The Kisan Credit Card (KCC) scheme introduced in August 1998 aims at providing adequate, timely and cost effective and hassle-free credit support to the farmers and is being implemented across India by all public sector commercial banks, RRBs and cooperative banks. The scheme is popular among both farmers and

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issuing bankers. Farmers have the flexibility to avail of production credit and also avoid procedural delays in getting credit sanctioned. For bankers, the need for repeated processing of credit applications is avoided. To cater to the comprehensive credit requirements of farmers under a single window, the scope of KCC is broadened by NABARD from time to time. In addition to short-term credit needs and term loans for agriculture and allied activities, a certain component of loans through KCC also covers consumption needs of the farmers, including defaulters, oral lessees, tenant farmers and share croppers, among others, who might have left out of the KCC scheme as also to identify new farmers. Banks were also advised to issue KCCs in a hassle-free manner and extend crop loans only through KCCs. To further expand the coverage of borrowers under KCC, the scheme was extended to borrowers of long-term cooperative credit structure, viz., PCARDBs and SCARDBs. As at the end of March 2011, the total number of KCCs issued stood at 104 million all over the country.

Gramin Tatkal Scheme

The Gramin Tatkal scheme formulated by NABARD is a unique loan product combining investment, production and consumption needs of rural families. The approach towards lending is 'family-centric' and the credit needs are assessed and loan decisions and repayment potential are determined on the basis of family cash flow, thus, allowing banks to decide the loan size and interest rate payable. The scheme is being implemented from 2006–07.

Role of NABARD in Rural Credit

The role of NABARD in rural credit has been highlighted in the previous paragraphs. This may be recapitulated briefly here : In the area of rural credit, NABARD is the apex organization and as such it has been playing a very important role in enhancing the credit flow to the rural economy since its inception in 1982. It is actively involved in refinancing of rural lending institutions such as regional rural banks and cooperative credit institutions as also in the recapitalisation of these institutions. NABARD is also entrusted with the responsibility of supervision of rural cooperative credit institutions. Special schemes to improve credit flow to the rural economy, viz., Rural Infrastructure Development Fund and Kisan Credit Card are also entrusted with NABARD.

Role of NABARD in Reviving Rural Co-operative Credit Institutions

The short-term credit provided by NABARD to cooperatives is mainly used for financing seasonal agricultural activities, marketing of crops, and pisciculture activities. The medium-credit is used for financing other approved agricultural purposes and the long-term credit involves loans given to state governments. During 2010–11, the total credit disbursed by NABARD was significantly higher as compared to the previous years.

Revival of Short-term Structure

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The approved revival package for rural cooperative credit institutions prepared based on the Vaidyanathan Committee (Task Force on Revival of Rural Cooperative Credit Institutions) Report is under implementation. Government of India has entered into agreements with multilateral agencies such as World Bank, Asian Development Bank and KFW (Kreditanstalt fur Wiederaufbau) for financial assistance to implement the revival package at the State level. The National Implementation and Monitoring Committee (NIMC) has been constituted for guiding and monitoring the implantation of the package at national level. At State level, the progress is being monitored by State level Implementing and Monitoring Committees and at district level by DCCB Level Implementing and Monitoring Committees. At NABARD level, review meetings of Regional Offices of Implementing States are periodically held for the same.

Till the end of 2009–10, 25 state governments (except Goa, Himachal Pradesh and Kerala) have signed the MOU with Government of India and NABARD, which covers 96 per cent of short-term rural cooperative credit units in the country. Further, an amount of ₹7,972 crore has been released by NABARD as Government of India's share for recapitalisation of 49,764 PACs in 14 states, while state governments have released ₹756 crore as their share. The State Co-operative Societies Acts have been amended in 21 states through legislative process.

For conducting the statutory audit of StCBs and DCCBs, NABARD provided a panel of chartered accountants to 13 states. The audit process in rest of the states is under different stages. Further, in order to bring qualified professionals in the management of cooperatives, the Reserve Bank of India has prescribed 'fit and proper criteria' for appointment of the directors and chief executive officers (CEOs) of cooperatives. professional directors as well as CEOs as per fit and proper criteria were put in place in many of the banks across states. Elected Boards are in place in almost all units of STCCS in all states except Andhra Pradesh, Arunachal Pradesh, Manipur, Nagaland and Tamil Nadu. The Common Accounting System (CAS) was introduced from April 1, 2009 in almost all PACs in 11 states. Guidelines on computerisation of CAS and Management Information System (MIS) for PACs were issued in two separate modules, and it is in progress in 3 states. As per decision of NIMC, it has been decided to develop core software for PACs at the national level.

Training and Human Resource Initiative

A working group set up by NABARD designs training modules for training electoral directors and staff of PACS. Till the end of 2010–11, training has been imparted to 254 master trainers from 23 states. These master trainers have trained 2039 district level trainers to conduct field level training programmes for PACS. 81,037 PACS secretaries have been trained in 17 states and 12,354 elected members of PACS have been trained in 14 states.

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A new programme on business development and profitability for PACS secretaries has since been rolled out and 76 master trainers from 12 implementing states were trained at Bankers Institute of Rural Development, Lucknow. Till the end of 2010–11, 36,125 PACS staff in eight states have been trained. Also, a five-day in-campus orientation programme for branch managers and senior officers of CCBs/StCB for business development/diversification has been developed and 1,582 branch managers/senior officers of DCCBs, StCB have been trained.

Check Your Progress

3. What is the full form of NABARD?
4. Mention the aim of the Kisan Credit Card scheme introduced in 1998.

8.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank are:
   - Regulating the issue of Banknotes
   - Securing monetary stability in India
   - Modernising the monetary policy framework to meet economic challenges
2. The Central board of directors of the Reserve Bank comprise of:
   - **Official Directors** – The governor who is appointed/nominated for a period of four years along with four Deputy Governors
   - **Non-Official Directors** – Ten Directors from various fields and two government Officia
3. The full form of NABARD is National Bank for Agricultural and Rural Development.
4. The Kisan Credit Card (KCC) scheme introduced in August 1998 aims at providing adequate, timely and cost effective and hassle-free credit support to the farmers and is being implemented across India by all public sector commercial banks, RRBs and cooperative banks.

8.5 SUMMARY

- The Reserve Bank is fully owned and operated by the Government of India.
- The Reserve Bank's operations are governed by a central board of directors, RBI is on the whole operated with a 21-member central board of directors

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appointed by the Government of India in accordance with the Reserve Bank of India Act.

- State Bank of India (SBI) is an Indian multinational, public sector banking and financial services company.
- By far the most important constituent of the bazar money market is the indigenous banker.
- On the recommendations of the committee to review arrangements for Institutional Credit for Agriculture and Rural Development, the National Bank for Agricultural and Rural Development (NABARD) was established in July 1982.
- The paid-up capital of NABARD is shared equally by the Government of India and the RBI.
- An important development in the area of institutional strengthening programmes in 1992–93 was the setting up of a Cooperative Development Fund.
- The Kisan Credit Card (KCC) scheme introduced in August 1998 aims at providing adequate, timely and cost effective and hassle-free credit support to the farmers and is being implemented across India by all public sector commercial banks, RRBs and cooperative banks.
- The Gramin Tatkal scheme formulated by NABARD is a unique loan product combining investment, production and consumption needs of rural families.
- The short-term credit provided by NABARD to cooperatives is mainly used for financing seasonal agricultural activities, marketing of crops, and pisciculture activities.

8.6 KEY WORDS

- **Cooperatives:** A *cooperative* is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.
- **Commercial Banks:** A *commercial bank* is an institution that provides services such as accepting deposits, providing business loans, and offering basic investment products.
- **Loan:** A *loan* is money, property or other material goods that is given to another party in exchange for future repayment of the *loan* value amount.

8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short-Answer Questions

1. Write a short note on the management of the Reserve Bank of India.
2. What are indigenous banks?
3. What do you understand by NABARD?
4. What is Rural Infrastructure Development Fund (RIDF)?
5. How has NABARD played an influential role in rural credit?

Long-Answer Questions

1. Comment on the major functions of the Reserve Bank of India.
2. What are the major differences between commercial and cooperative banks?
3. Dicuss the management and functions of NABARD.
4. Discuss the major provisions of Kisan Credit Crad Scheme and Gramiin Tatkal Scheme.

8.8 FURTHER READINGS

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UNIT 9 STATE BANK OF INDIA

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Structure

9.0 INTRODUCTION

The State Bank of India is a regional banking behemoth and is one of the largest financial institutions in the world. Among Indian commercial banks, its market share in deposits and loans is around one-fifth. It is the largest Big Four banks in India, the others being ICICI Bank, Punjab National Bank and HDFC Bank. In July 2011, the State Bank of India agreed to grant a loan of ₹100 billion to National Thermal Power Corporation (NTPC), making it the largest loan given to any single customer in its entire history of two centuries.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the history of the State Bank of India
- Understand the management of the State Bank of India
- Describe the objectives and functions of the State Bank of India
- Describe the structure of the State Bank of India

9.2 THE STATE BANK OF INDIA: BRIEF HISTORY

The State Bank of India, the oldest and the largest commercial bank in India, by revenue, assets and market capitalisation with its presence covering all time zones in the world, stands in a class by itself. As at end-March 2012, the assets of the bank stood at US Dollars 360 billion and had more than 14,000 branches including

173 foreign offices spread over 34 countries, comprising of 50 branches, 8 representative offices, 103 offices of foreign banking subsidiaries and 12 other offices, and agents globally. It has been ranked 285th in the Fortune Global

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Under the Imperial Bank of India Act, 1920, the governing body of the bank was the central Board. Its functions were defined in the by-laws. There were also local boards at the three Presidency Towns with fairly wide powers for managing local business; but they were under the control of the Central Board. The Central Board was comprised of the Presidents and Vice-Presidents of the Local Boards, representing the shareholders, the Comptroller of Currency, representing the Government of India, four Governors nominated by the government to serve representation of the interests of the Indian community in general, the secretaries of the Local Boards, and two Managing Governors appointed by the Government of India, on the recommendations of the Central Board, holding office for such periods as the government directed from time to time.

Until the establishment of the Reserve Bank of India in 1935, the Imperial Bank had in effect been discharging certain central banking functions. Briefly stated, the main central banking functions that the bank was discharging were:

1. Acting as a sole banker to the government and as the custodian of public funds and government cash balances, central and local, and also the balances of the Secretary of State through its London Office.
2. Undertaking the functions arising from the issue of new loans by the government and managing the public debt in return for a specified remuneration.
3. Giving the public facilities for the transfer of money between its branches at rates approved by the Comptroller of Currency.

In addition to the above central banking functions (the Act, of course, did not give power to the bank to issue notes), the bank performed the ordinary commercial banking business. But, because of the special nature of the bank, certain restrictions were imposed by the government on its ordinary commercial banking functions. According to these restrictions, the bank was prohibited from making loans to a longer period than six months or on the basis of immovable properties or on the security of its own shares or stocks; from discounting or making loans against any bill of exchange unless it carried the several responsibilities of at least two persons or firms unconnected with each other in general partnership, and from granting unsecured overdraft in excess of ₹1 lakh. The bank was statutorily debarred from dealing in foreign exchange except to meet the bonafide needs of its own clients.

With the establishment of the Reserve Bank of India in 1935, the Imperial Bank ceased to be the banker to the government directly. Further, the Imperial Bank of India (Amendment) Act, 1934, removed all the restrictions which were formerly imposed on its lending operations. Under the Act, the bank could transact foreign exchange business and undertake banking business of any kind.

Although the Imperial Bank ceased to be the banker to the government directly with the establishment of the Reserve Bank, it was authorized to act as the sole agent of the Reserve Bank in places where the latter did not have its own branches. Accordingly, the Imperial Bank was permitted on behalf of the government to pay, receive, collect and remit money, bullion and securities as the agent of the Reserve Bank, and to undertake and transact any other business which the Reserve Bank may from time to time entrust to the bank. Thus, the Imperial Bank stood in a special category and it was the leader of the Indian money market.

Nationalization of the Imperial Bank

When the question of nationalization of the Imperial Bank of India came up first in February 1948, the government accepted the principle of nationalization. But this was opposed by the Central Board of Directors and shareholders. They put forward many arguments against nationalization, and ultimately, the government announced in 1949 the indefinite postponement of the question of nationalization of the Imperial Bank. But the question came up again when the All India Rural Credit Survey Committee recommended the creation of a State Bank of India by amalgamation of certain state-owned banks with the Imperial Bank. Accordingly, the State Bank of India Act was passed in May 1955, and the State Bank of India came into existence on 1 July 1955.

The State Bank of India (SBI) was established by the statutory amalgamation of the Imperial Bank of India and certain major state associated banks. The branches of these state associated banks along with the branches of the Imperial Bank of India would have a larger coverage of several areas and also greater scope for much larger future extension to rural areas. That is why the Rural Banking Enquiry Committee stated in its report that 'if these banks could be integrated into one institution, and if that one institution could be aligned to national policies, then indeed that would be an extremely important and extremely desirable line of development'. Thus, the nationalization of the Imperial Bank and the establishment of the State Bank of India was an important milestone on the road to the establishment of an integrated commercial banking unit with branches all over the country under effective state control.

9.2.1 Organization and Structure

Originally, the State Bank of India was established with an authorized share capital of ₹20 crore and an issued share capital of ₹5.625 crore which was allotted to the Reserve Bank of India. In order to enhance the capital adequacy ratio, the authorized capital of the SBI was raised from ₹20 crore to ₹200 crore in 1985. Its subscribed and paid-up capital was raised to ₹50 crore, while those of the associate banks were raised to ₹10 crore each. Again, an ordinance was issued in 1993 leading to an amendment of the SBI Act, 1955 to enable SBI to raise money from the market. Accordingly, SBI entered into the capital market successfully. With this, the issued and paid-up capital of the bank reached ₹456 crore.

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Management of the SBI is vested with a Central Board which consists of:

1. A Chairman and a Vice-Chairman to be appointed by the Central Government in consultation with the Reserve Bank and after consideration, except in case of first appointments, of the recommendations made by the Central Board.
2. Not more than two Managing Directors, appointed by the Central Board, with the approval of the Central Government.
3. Six directors to be elected by the shareholders other than the Reserve Bank of India whose names are entered in the various branch registers.
4. Eight directors to be nominated by the Central Government in consultation with the Reserve Bank to represent territorial and economic interests in such a manner that not less than two of them have special knowledge in the working of the co-operative institutions and of rural economy and the others have experience in commerce, industry, banking or finance.
5. One director to be nominated by the Central Government.
6. One director to be nominated by the Reserve Bank.

The Chairman and the Vice-Chairman shall hold office for such term, not exceeding five years, as the Central Government may fix. The Managing Director shall hold office for such term, not exceeding five years, as the Central Board or, in the case of the first two appointments, the Central Government may fix.

Besides the Central Board, there are local boards at Mumbai, Kolkata, Chennai and New Delhi.

Some time back, SBI restructured its organizational structure to bring about decision-making. The top management team now comprises the Chairman, group executives for the national banking group, corporate banking group, international banking and associates and subsidiary banks. In addition, four staff functionaries have been appointed in charge of financial management, credit, human resources and technology management, and inspection and audit.

9.2.2 Objectives

The main objective in nationalizing the Imperial Bank of India has been the setting up of a strong State-partnered commercial banking institution with an effective machinery composed of a large network of branches over the whole country. It was made clear by the then Union Minister of Finance that the nationalization of the Imperial Bank was not based on ideological grounds. But it was intended to acquire control over a strategic section of commercial banking with a view to developing credit facilities for areas of the national economy not well served in this respect.

Further, the activities of the SBI are expected to be in conformity with the broad economic policies pursued by the government. This will have an effect on the activities of other commercial banks since the SBI commands nearly one-third of the entire commercial bank resources.

Another important objective for which the Bank has been established is to promote agricultural finance and to remedy the defects in the system of agricultural finance. The role played by the Bank in this field is discussed in detail subsequently.

Moreover, the SBI is expected to be of service to the Reserve Bank in its monetary policies and to check any disequilibrium that is likely to develop in the money market.

For the first phase of the branch expansion programme, the SBI Act had provided for the opening of not less than 400 branches within a period of five years beginning from 1 July 1955. This statutory obligation was successfully fulfilled within the specified time limit. In fact, the Bank had opened 416 branches by the end of June 1960. A noteworthy feature of the branch expansion programme was that the number of new branches opened by the Bank at the sub-treasury centres worked out about one branch for every three non-banking centres as against one branch for every five recommended.

The Bank had opened its 5000th branch in early 1979. As at the end of March 2012, the Bank had more than 14,000 branches including 173 foreign offices spread over 34 countries.

Simultaneously, the Bank is giving attention to the necessity of extending banking facilities to the rural areas. The attention given by the Bank over the years in extending banking facilities in rural and semi-urban areas is reflected in the proportion of such offices to the total number of offices.

SBI is the only Indian bank that figures in Fortune top 100 banks. With nearly 11,000 branches and 5,600 ATMs, it has a reach throughout the length and breadth of the country; it has a work force of nearly 200,000. It is the second largest bank in the world measured by the number of branches and employee strength. It had total assets of ₹5,66,565 crore and posted a net profit of ₹4,541 crore as on 31 March 2007.

SBI offers the services of banking as well as whole array of financial services which include mutual funds, credit cards, life insurance, merchant banking, security trading and primary dealership in the money market. The bank is actively involved in non-profit activity termed community services banking apart from its normal banking activity.

Information Technology

The Bank has adopted and is pursuing vigorously its information technology (IT) policy with the aim of achieving efficiency in operations, meeting customer and market expectations and staying ahead in competition, especially in the context of the emergence of the new generation private sector banks equipped with state-of-the-art technology.

In December 2000, the Bank has introduced Electronic Nostro Account Reconciliation (ELENOR). This helps fast, accurate and fully integrated reporting

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of foreign exchange transaction and has made a major breakthrough in effectively tackling NOSTRO reconciliation. It has enabled online reporting of forex transactions from 444 forex intensive branches. In January 2001, State Bank Electronic Payment Systems (STEPS) became operational. This facilitates instantaneous electronic transfer of funds in 1,557 branches. At the end of March 2002, tele-banking has been implemented at 106 branches where customers can access their accounts through telephone from anywhere at any time. As at that date, the number of fully computerized branches of the Bank stood at 3,035, covering 80 per cent of the Bank's domestic business. The computerized branches have brought improvement in customer service, introduced features such as network ATMs, internet banking, tele-banking and customer enquiry terminals.

State Bank Group has variants of ATMs 'namely' Bunch Note Acceptors, Biometric ATMs, low-cost rural ATMs, solar-powered ATMs, multi-function kiosks-for printing passbooks, statement of accounts, bar code readers for utility bill payments, internet banking etc. Cash deposit facility has been activated at some of the ATMs and the Bank is in the process of deploying a large number of cash deposit machines (bunch note acceptors) at ATM locations which customers can use 24 × 7 to deposit cash. Cash out incidents in ATMs have been eliminated.

As on 31st March 2012, there were 3.65 Million customers using mobile banking service with more than 1.20 lacs daily transactions, around 46 per cent of which are financial transactions amounting to ₹2.45 crores. SBI is the market leader in this space, both in the number and value of the financial transactions with 83.70 per cent market share in number of transactions and 49 per cent share in transaction value. State Bank Freedom Premium, the new GPRS based mobile banking service has been rolled out. SBI has launched mobile technology based prepaid payment services under the brand name of State Bank MobiCash on pilot basis in Delhi and Mumbai Circles of the bank.

Internet banking service is available for both retail and corporate customers of the bank. Retail Internet Banking: SBI 'Instapay' for utility billspayment, Corporate Internet Banking: CINB Saral—a simplified single user Corporate Internet Banking facility for small entrepreneurs etc., have been added during 2011–12.

Bank offers Real Time Gross Settlement System (RTGS) & National Electronic Fund Transfer system (NEFT) which enables an efficient, secure, economical and reliable system of transfer of funds from bank to bank as well as from remitter's account in a particular bank to the beneficiary's account in another bank across the country.

RTGS is an electronic payment system in which payment instructions between banks are processed and settled individually and continuously, on a real time basis, throughout the day NEFT is another electronic payment system in which payment instructions between banks are processed and settled on deferred net settlement

(DNS) basis at fixed times during the day. There is no minimum or maximum stipulated transaction value for using this facility.

State Bank MobiCash is a pre-paid wallet on Mobile phone. It is usable anytime, anywhere. It offers facilities like money transfer, cash payments, mobile top ups, etc. The services are available beyond regular banking hours. Its features include cash deposit, cash withdrawal, fund transfer from wallet to wallet, fund transfer from wallet to SBI account, fund transfer from wallet to another bank account, mobile / utility bill payments, and recharge of prepaid mobile / DTH / broadband.

Risk Management

In view of the critical importance given to risk management under the present day circumstances, the Bank's risk management policies are based on the premise that the management of risks can be segregated by types, and the risks can be better comprehended by units most capable of understanding them.

Central Board of the Bank is primarily responsible for management of risks. The Central Board approves the risk management policies and structure of risk management. Credit Policy and Procedures Committee/Chief Credit Officer is responsible for the management of credit risks relating to domestic loans. Assets and Liability Management Committee/Chief Financial Officer is responsible for the management of market risks. The forex risks and international exposure are looked after by the Group Executive, International Banking. The Bank has constituted an Integrated Risk Management Committee at the apex level in order to examine and decide upon the issues relating to integrated risk management.

The Risk Governance Structure in place in the Bank is as under:

In relation to Integrated Risk Management covering Enterprise, Credit, Market, Operational and Group Risks, a Risk Governance structure is operating. This framework visualises empowerment of Business Units at the operating level, with technology being the key driver, enabling identification and management of risk at the place of origination.

Basel Implementation

- The Bank has migrated to the Basel II framework in step with the guidelines of the Reserve Bank of India Guidelines, with the Standardised Approach for Credit Risk and Basic Indicator approach for Operational Risk with effect from 2008, having already implemented the Standardised Measurement Method for Market Risk with effect from 2006.
- RBI has issued Guidelines on Implementation of Basel III Capital Regulations in India in May, 2012. These Guidelines will become effective from January 1, 2013. Bank is in the process of putting in place appropriate mechanism to comply with these guidelines.

Enterprise Risk Management

- During 2011–12, the Bank has set in motion the due process required for filing of application/letter of intent to RBI for implementing Advanced Approaches under Basel II, comprising of the three Pillar I Risks viz. Internal Rating Based (IRB) approach for Credit Risk, Internal Model Approach for Market Risk and Advanced Measurement Approach for Operational Risk.
- The Bank has in place the Internal Capital Adequacy Assessment Process (ICAAP)Document as required by Pillar II of New Capital Adequacy Framework under Basel II in accordance with the Guidelines of the Reserve Bank of India.
- The ICAAP process covers identification, measurement, management, capital assessment and stress testing of material risks and also detailed additional capital requirements on account of such risks. In addition to the aforesaid three Pillar I Risks, the ICAAP also covers Pillar II Risks such as Liquidity Risk, Interest Rate Risk in the Banking Book, Credit Concentration Risk, Reputation Risk, Strategic Risk, etc.

Credit Risk Management (CRM)

- Besides implementing the Standarised Approach, well defined credit risk practices such as use of Credit Risk Assessment (CRA) Models, Industry Exposure Norms, Counterparty Exposure Limits, Substantial Exposure Norms, Macro Economic Stress Tests etc., have also been put in place to improve credit risk management.
- The Bank has set in process a project to migrate to Internal Rating Based(IRB) Approach.
- Models for estimation of Probability of Default (PD), Loss Given Default (LGD),and Exposure At Default (EAD) are being developed.
- Credit risk data mart is being set up.
- Retail scoring and behavioural scoring models are being implemented.

Market Risk Management (MRM)

As contained in the Reserve Bank of India Guidelines Market Risk Management is governed by the Board approved policies covering Investment, Trading, Foreign Exchange, Derivatives, Value at Risk & Stress Testing which stipulate limits for various products and risk types in the portfolio. These limits along with Management Action Triggers & Stop Loss Triggers are monitored on a daily basis and in case of breaches; appropriate actions are initiated by the business units as per the policy prescriptions.

Operational Risk Management (ORM)

- Continuous review of systems and control mechanisms, creating awareness of operational risk throughout the Bank, assigning risk ownership, alignment of risk management activities with business strategy and ensuring compliance with regulatory requirements are the chief objectives of the Bank's ORM .
- The Operational Risk Management Policy of the Bank establishes a consistent framework for systematic and proactive identification, assessment, measurement, monitoring and mitigation of operational risk & applies to all business and functional areas within the Bank, and is supplemented by operational systems, procedures and guidelines which are updated.at periodical intervals.

Group Risk Management (GRM)

- A Group Risk Management policy is in operation which applies to all Associate Banks, Banking and Non-banking Subsidiaries and Joint Ventures of the State Bank Group under the jurisdiction of specified regulators and complying with the relevant Accounting Standards, where SBI has investment in equity shares of 30 per cent and more with control over management of the entity.
- All Group entities are encouraged to align their policies and practices with the Group, follow Basel prescriptions, guidelines of their regulators besides international best practices.
- The Group ICAAP Document for the State Bank Group is also prepared and submitted to the Reserve Bank of India as required by Pillar II of New Capital Adequacy Framework.
- Chief Information Security Officer [CISO]

A robust IT policy and Information System Security policy has been implemented by the Bank. These policies are reviewed at periodical intervals and suitably strengthened with a view to addressing emerging threats. Regular security drills and employee awareness programs are conducted in order to ensure security and increase awareness among staff. Bank is among the forerunners in the process of implementing the new Reserve Bank of India Guidelines for the Banking Sector in this area.

Internal Controls

The Bank has in-built internal control systems with well-defined responsibilities at each level and conducts internal audit through its Inspection & Management Audit Department. Supervision and control over the functioning of the department are done by the Audit Committee of the Board(ACB) . The inspection system plays an important and critical role in identification, control and management of risks by using international best practices in the internal audit function which is regarded as one of the most important components of Corporate Governance. Mainly two streams of audits—Risk Focussed Internal Audit (RFIA) and Management Audit covering different facets of Internal Audit requirement are carried out by the Bank. All accounting units of the Bank like branches, Business Process Reengineering (BPR) entities, major critical corporate centre departments like Foreign Account Office, Treasury operations, Central Accounts Office etc., are subjected to RFIA. Management Audit covers administrative offices and examines policies and procedures in addition to quality of execution thereof.

Additionally, the department conducts Credit Audit, Concurrent Audit, Information Systems Audit, Home Office Audit (audit of foreign offices) and Expenditure Audit. Risk Focussed Internal Audit (RFIA) helps in appropriately capturing all types of risks residing in operating units. Credit Audit is conducted for units with large credit limits and Concurrent Audit is carried out at branches including BPR outfits having large deposits, advances & other risk exposures. Expenditure Audit is conducted at administrative offices including Corporate Centre Establishments and Lead Bank Offices, etc. With a view to verifying the level of rectification of irregularities by branches, audit of compliance at select branches is also undertaken. The Information System Audit (IS Audit) of the centralised IT establishments is also conducted.

Vigilance

The concept of Vigilance as an investigative process and an exercise for punitive action has evolved to that of 'Vigilance for Corporate Growth', the emphasis getting shifted from punitive vigilance to "Preventive and Proactive Vigilance" through an active participation of all concerned.

In this context, two important issues deserve a special mention viz. (i) Preventive Vigilance Committee (PVC) Meetings being held at the branches and the BPR outfits and (ii)Whistle Blower Scheme. Through PVC meetings give a chance to every employee to share his/her views on preventive vigilance, suggest and implement various measures specifically suited to his/her workplace and participate in a collective exercise of ensuring watchfulness and alertness in his/her official functions. Under 'Whistle Blower Scheme' the staff members are expected to advise appropriate authorities about irregular and unethical practices, if any, being indulged in by colleagues and even seniors.

While Vigilance Administration seeks, as one of its functions, to suitably punish the delinquent employees, it also protects the legitimate and bona fide decisions taken in the interest of the organization. The number of vigilance case brought to conclusion during the year 2011–12 is 1447, in which 1307 employees have been inflicted with various penalties for their proven misconducts.

Non-performing Assets (NPAs) Management

Management of NPAs receives focused attention at all levels. At the corporate level a Task Force consisting of top executives monitors all NPAs above ₹5 crore.

At the local Head Office level, the Circle Management Committee monitors all NPAs above ₹1 crore. The NPA management policy lays stress, among other things, on early identification of problem loans, effective response to early warning signals and appropriate recovery strategy including one-time settlement. Other measures taken by the Bank include upgradation of appraisal skills of the officers dealing in credit through special training programmes and an effective audit mechanism, which throws warning signals for taking action to prevent performing assets turning into non-performing ones.

9.3 STATE BANK OF INDIA: WORKING AND PROGRESS

SBI had disbursed ₹1,32,300 crore under priority sector till March 2008.

Small-scale Industries

State Bank Group has been the most single source of institutional credit to small-scale industries (SSIs) in the country. The assistance rendered by the Group to the small-scale sector has been characterized as being need based, comprehensive and liberal. The Group gives importance to the capacity, industry and integrity of the small man. The assessment of the credit needs is done in a scientific manner, aimed at covering the entire range of working capital advances as also the requirements covering the acquisition of fixed assets.

In tune with the priorities laid down by the Reserve Bank of India, the approach of the State Bank of India in particular in the field of small-scale industries is selective. Units producing goods for export, mass consumption goods, capital goods and inputs for the core sector and those situated in backward areas are given preferential treatment. The Bank's policy also aims at stimulating investment in these selected industries by providing increasing quantum of term loans. The approach towards the larger among the small-scale units is one of emphasis on a greater degree of financial discipline, improvement in operational efficiency and strengthening of managerial competence.

Following are given brief outlines of the various schemes formulated by the Bank in the field of small-scale industries sector.

General Purpose Term Loans

Introduced in 2001–02, SBI grants term loans to small scale industrial units for meeting general commercial purposes like substitution of high cost debt, research and development, shoring up networth and funding business expansion. The tenure of the loan is normally three years, and the pricing is fine-tuned to suit the risk profile of the borrower. The SSI unit that takes the loan should not have history of any defaults in payment of interest or instalments of the principal.

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Equity Fund Scheme

Under the scheme, the Bank grants financial assistance to entrepreneurs who are not able to meet their share of equity fully, by way of interest-free loans repayable over a long period. Equity Fund assistance is extended only to new projects, which are also eligible for the Bank's Liberalized scheme and the Entrepreneur scheme. The project cost should be more than ₹25,000.

Liberalized Credit for SSIs

Production-linked credit facilities to SSIs, ancillary industrial units and village and cottage industrial units are granted on liberal terms and conditions. Under this scheme, the quantum of advances is not linked to the security furnished, but the genuine requirements of the unit. The scheme offers a range of financial products including—

(a) term loans for acquisition of fixed assets;

(b) working capital loans for financing current assets;

(c) letter of credit for acquisition of machinery and purchase of raw materials;

(d) bank guarantee in lieu of security deposits to be made with government departments/other departments for execution of orders;

(e) deferred payment guarantees for purchase of machinery on deferred payment basis;

(f) bill facility for purchase of raw materials and for sale of finished goods;

(g) composite loans (term loans plus working capital) up to ₹25 lakh.

Entrepreneur Scheme

Under this scheme, financial assistance is provided to technically qualified, trained and experienced entrepreneurs for setting up new viable industrial projects. Advances are granted to technocrats who are unable to meet the normal margin requirements under the Liberalized schemes. The Bank provides term loans, working capital finance and equity fund finance. For requirements up to ₹5 lakh, no margins are involved. Beyond that, the margin is set at 10 per cent.

Stree Shakti Package

This package is aimed at supporting entrepreneurship among women by providing certain concessions. For availing facilities under this package, the enterprise should have more than 50 per cent of its share capital owned by women. The concessions offered are:

(a) the margin will be lowered by 5 per cent as applicable to separate categories;

(b) the interest rate will be lowered by 0.5 per cent in case the loan exceeds ₹2 lakh; and

(c) no security is required for loans up to ₹5 lakh in case of tiny sector units.

SME Credit Plus

Introduced in 2001–02, SME Credit Plus provides an additional credit limit to existing borrowers who have a proven track record and it is structured to help them meet unforeseen expenditure. The additional credit limit is capped at 20 per cent of the fund-based working capital limit of the borrower, or a maximum of ₹25 lakh and is repayable in two months.

Export Credit

Pre-shipment Export Credit

SBI offers pre-shipment credit (packing credit) to the exporters, for financing purchase, processing, manufacturing or packing of goods prior to shipments. This means loans and advances extended on the basis of:

(i) letter of credit opened in favour of the client or in favour of some other person, by an overseas buyer;

(ii) a confirmed and irrevocable order for the export of goods from India;

(iii) any other evidence of an order or export from India having been placed on the exporter or some other person, unless lodgement of export order or letter of credit with the bank has been waived.

Packing credit is granted for a period depending upon the circumstances of the individual case, such as the time required for procuring, manufacturing or processing (where necessary) and shipping the relative goods. Packing credit is released in one lump sum or in stages, as per the requirement for executing the orders. The pre-shipment/packing credit granted has to be liquidated out of the proceeds of the bill drawn for the exported items, once the bill is purchased/discounted, thereby converting pre-shipment credit into post-shipment credit.

Post-shipment Export Credit

The Bank extends post-shipment credit that is any loan/advance granted or any other credit provided by the Bank for purposes such as export of goods from India. It runs from the date of extending credit, after shipment of goods to the date of realization of export proceeds and includes any loan/advance granted on the security of any duty drawback allowed by the government from time to time. This credit should be liquidated by the proceeds of export bills received from abroad in respect of goods exported.

The following options are available to the exporter at post-shipment stage, viz.,

(i) to get export bills purchased/discounted/negotiated;

(ii) to get advances against bills for collection and

(iii) to receive advances against duty drawback receivable from the government.

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The exporter has the option to avail of pre-shipment and post-shipment credit either in rupee or in foreign currency. However, if the pre-shipment credit has been availed in foreign currency, the post-shipment credit has necessarily to be under EBR scheme since foreign currency pre-shipment credit has to be liquidated in foreign currency.

The Bank's role in the field of export promotion is not confined to export financing alone; but also extends to exploring and developing new markets for Indian exports, both traditional and non-traditional. The Bank maintains an information service for its customers on export possibilities for various commodities. The Bank receives numerous requests from foreign banks for furnishing them with names of Indian exporters of specific commodities. Such enquiries are widely circulated through the medium of the Bank's own offices as also through Chambers of Commerce and other similar organizations at different centres.

One impediment to better export performance is the ignorance of Indian exporters, particularly small exporters, in regard to export procedures and market opportunities abroad. To bridge this information gap, the Bank has the International Division in Mumbai. The Division seeks to bring together Indian exporters and foreign importers, besides collecting and disseminating a wide range of information and providing expert advice to exporters on trading conditions abroad.

The Bank is an active participant in the area of financing of project exports involving execution of turnkey/civil construction contracts and export of engineering goods on deferred payment terms. Some of the important activities supported include overseas construction, railway and telecom related projects and power projects.

Agricultural Banking

The Bank caters to the needs of agriculturists and landless agricultural labourers through a network of 6,600 rural and semi-urban branches. There are 972 specialized branches set up in different parts of the country exclusively for the development of agriculture through credit deployment. These branches include Agricultural Development Branches, branches with Agricultural Banking Divisions and Agricultural Business Branches. These branches cover a whole gamut of agricultural activities like crop production, horticulture, plantation crops, farm mechanization, land development and reclamation, digging of wells, tube wells and irrigation projects, forestry, construction of cold storages and godowns, processing of agri-products, finance to agri-input dealers, allied activities like dairy, fisheries, poultry, sheep-goat, piggery and rearing of silk worms. Specialized branches are provided with technical staff who provide technical guidance and counselling to the farmers on their problems relating to farming activities. They also hold farmers' meet in villages to explain farmers about packages of practices of crops before the onset of every crop season.

The various schemes tailored to meet the needs of agriculturists are briefly given below:

Crop Loans

Crop loans are extended to cultivators in the form of short-term direct finance. Agriculturists, tenant farmers and share croppers who actually cultivate the lands are eligible for crop loans.

Produce Marketing Loans

In order to avoid distress sale, assistance is provided to the farmers to stock the produce on their own.

Agricultural Term Loans

These are provided in the form of direct finance to cultivators to create assets facilitating crop production/income generation for periods ranging from 3 and 15 years. Activities broadly covered are land development, minor irrigation, farm mechanization, plantation and horticulture, dairying, poultry, sericulture, dry land, waste land development schemes, etc.

Minor Irrigation Schemes

Loans under these schemes cover activities like digging of new wells, deepening of existing wells, laying of pipelines, installing drip/sprinkler irrigation system and lift irrigation system. Repayment is spread over 5–15 years, depending on the farm income.

Farm Mechanization Schemes

The Bank provides credit for purchase of farm equipments and machinery for agricultural operations. This mode of finance covers activities such as purchase of tractors, trailers, cultivators, cage wheels, power trillers, combine harvestors, etc.

Kisan Credit Card

The Bank offers kisan credit card for farmers under short-term credit introduced as per RBI/NABARD guidelines, providing a running account facility to farmers to meet their production credit needs and contingency needs. This scheme follows simplified procedures to enable the borrowers to avail the crop loan.

Farmers with excellent repayment record for at least past five years are eligible for the product. The scheme is intended to provide investment credit for which term loans are ordinarily sanctioned. The scheme also includes major family expenditure like marriage and education of children. Loan amount is fixed on the basis of five times annual farm income or 50 per cent of the value of the land mortgaged as collateral security, whichever is less, subject to a maximum of ₹5 lakh. Since its introduction in 1998–99, the scheme has become increasingly popular.

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Micro-credit: Self-help Groups (SHGs)

Self-help groups are self-managed homogenous groups of economically backward people that promote savings among themselves and pool the savings. These pooled resources are supplemented by external resources, i.e., bank credit when these groups gain experience. Since 1992, the Bank has been implementing the SHG Linkage Programme. As at March-end 2006, SBI's branches had opened 6,36,067 savings bank accounts of SHGs out of which more than 5.41 lakh SHGs had been provided with credit facilities, thus benefiting more than 75 lakh poor people. Majority of these SHGs are women SHGs.

State Bank Group

The State Bank of India is the founder and the flagship member of the State Bank Group which is a giant commercial and investment banking group that dominates the Indian banking scene with its seven commercial banking associates and several subsidiaries and joint ventures, both foreign and domestic. With 18,324 branches as in 2012, the SBI Group has the largest branch network in India. It is the only Indian bank to set up a subsidiary incorporated in Europe, namely, the SBI European Bank Ltd, at London. The six associate Banks of SBI are:

(i) State Bank of Bikaner & Jaipur;

(ii) State Bank of Hyderabad;

(iii) State Bank of Indore;

(iv) State Bank of Mysore;

(v) State Bank of Patiala;

(vi) State Bank of Travancore.

Proposals are there to merge all the associate banks with the State Bank of India to create a 'mega bank' and stream line operations. The first step towards unification was taken in 2008 when State Bank of Saurashtra was merged with SBI. In 2009, the Board of Directors approved the merger of Bank of Indore. The process of merger was completed in 2010 with SBI holding 98.3 per cent in State Bank of Indore and government holding the balance of 1.77 per cent.

The Bank's domestic subsidiaries/joint ventures include the following:

Banking Subsidiary

SBI Commercial and International Bank Ltd (SBICI)

The Bank holds 100 per cent equity in SBICI, amounting to ₹100 crore. As per Notification issued by Government of India, the acquisition of SBI Commercial and International Bank Ltd. (SBICI) by state Bank of India (SBI) has become effective from 29 July 2011. All branches/offices of SBICI are now functioning as branches of State Bank of India.

Non-banking Subsidiaries/Joint Ventures

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SBI Capital Markets (SBICAP)

SBICAP undertakes merchant banking services. It is engaged in an array of financial services including advisory services for PSU disinvestments, infrastructure advisory and syndication, private placement of debt, buy-back of shares and securitization of receivables. SBI holds equity of ₹ 50 crore in SBICAP, being 86 per cent of its share capital.

SBI Securities Ltd, (SBISL)

SBISL was set up as the broking arm of the SBI and had, accordingly, acquired membership of the Stock Exchange, Mumbai and National Stock Exchange of India Ltd. However, pursuant to a change in policy, the membership of both the stock exchanges was transferred to SBICAP in March 2001.

SBI Factors and Commercial Services Ltd, (SBI FACTORS)

SBI FACTORS provides book debt financing. During 2001–02, it introduced product variants like non-recourse factoring, purchase bill factoring and factoring of usance bills backed by letter of credit/bank guarantee. SBI holds equity of ₹13.50 crore in SBI FACTORS, being 54 per cent of the latter's share capital.

SBI Gilts Ltd, (SBIGL)

This is a primary dealer in the debt market, undertaking trading in government and non-government securities. SBI holds equity of ₹61 crore in SBIGL, being 61 per cent of the latter's share capital.

SBI Funds Management Ltd, (SBIFML)

This is an Asset Management company set up for managing the affairs of SBI Mutual Fund.

SBI Cards and Payments Services Ltd, (SBICPSL)

This is a credit card subsidiary and handles work relating to marketing, distribution, risk management accounting and merchant acquiring. GE Capital is a partner in this. GE Capital is the world's largest private label card processor, managing over 80 million cards for over 300 clients in 20 countries.

SBICPSL which commenced operations in 1998–99, had nine lakh active cards at March-end 2002. It is the third largest credit card issuer in the country. The card has a market share of 15.25 per cent, and it is issued from 41 centres.

Credit Information Bureau (India) Ltd, (CIBIL)

In January 2001, SBI,HDFC, Dun & Bradstreet Information Services India Pvt. Ltd, and Trans Union International Inc signed the shareholders' agreement to establish the Credit Information Bureau (India) Ltd SBI and HDFC have 40 per cent shareholding each and the other two companies have 10 per cent shares each in CIBIL. The role of CIBIL is to:

(a) gather credit related information regarding individual and corporate/ commercial credit users;

(b) maintain a database of this information and sell this information in the form of credit reports to a closed user group for a price.

The potential users of CIBIL are banks, financial institutions, non-banking financial companies, housing finance and credit card companies.

SBI Life Insurance Company Ltd, (SBIL)

SBIL is a joint venture between SBI and Cardiff S.A., a leading insurance company in France and a 100 per cent subsidiary of BNP Paribas, the third largest bank in Europe. The authorized capital of SBIL is ₹250 crore, and the paid-up capital of ₹125 crore is owned by SBI, 74 per cent and Cardiff, 26 per cent. The company was licensed by the Insurance Regulatory and Development authority in March 2001.

SBI General Insurance Company Limited

SBI General Insurance Company Limited is a joint venture between the State Bank of India and Insurance Australia Group (IAG). SBI owns 74 per cent of the total capital and IAG the remaining 26 per cent.

SBI General is in the process of setting up a unique multi-distribution model encompassing Bancassurance, Agency, Broking & Retail Direct channels. Bancassurance will be the major channel during the initial years.

SBI General's current geographical coverage extends to 20 cities pan India and plans are on to extend this reach to another 25 cities by mid-2012. The company is currently serving 3 key customer segments, i.e., Retail Segment (catering to Individual & Families), Corporate Segment (catering mid to large size Companies) and SME segment. In a short span, SBI General has emerged as one of the few General Insurance companies in India to have a dedicated SME Team catering exclusively to the needs of SME segment.

Current Policy offering of SBI General covers Motor & Home Insurance for Individuals and Fire, Marine, Package, Construction & Engineering, Group Health & Miscellaneous Insurance for Businesses.

Clearing Corporation of India Ltd (CCIL)

CCIL having an authorized capital of ₹50 crore was set up with the SBI as the chief promoter with an equity holding of 26 per cent. CCIL commenced operations from February 2002. The setting-up of CCIL is expected to deepen and widen the debt market and impart to it the much needed liquidity; it will also facilitate retailing in government securities. The Reserve Bank of India has made it compulsory to route individual trades in government securities up to ₹20 crore through CCIL.

The State Bank of India (Subsidiary Banks Laws) Amendment Act, 2007

The State Bank of Hyderabad Act, 1956 and the State Bank of India (Subsidiary Banks) Act, 1959 were amended in 2007 with a view to:

(i) remove the difficulties faced by the shareholders of the subsidiary banks of the State Bank of India;

(ii) facilitate increase in the capital of the subsidiary banks and

(iii) enable subsidiary banks to raise resources from the market.

The Act which came into force with effect from 9 July 2007 amended the said Acts, inter alia to:

(i) increase the authorized capital of subsidiary banks to ₹500 crore and divide the authorized capital into shares of one hundred rupees each or of such denomination as may be decided by the subsidiary banks, with the approval of the State Bank of India;

(ii) allow the subsidiary banks to issue share certificates of such denomination as may be prescribed by regulations made by the State Bank of India with the approval of the Reserve Bank of India to the existing shareholders;

(iii) allow the subsidiary banks to raise issued capital through preferential allotment or private placement or public issue in accordance with the procedure as may be specified by regulations made by the State Bank of India with the approval of the Reserve Bank of India and to issue preference shares in accordance with the guidelines framed by the Reserve Bank of India;

(iv) allow reduction of the State Bank's shareholding in the subsidiary banks from 55 per cent to 51 per cent;

(v) remove the restriction on individual shareholdings in excess of two hundred shares and increase the percentage of voting rights of shareholders (other than the State Bank of India) from one per cent to ten per cent of the issued capital of the subsidiary bank concerned;

(vi) enable the Reserve Bank of India to nominate one director, possessing necessary expertise and experience in the matter relating to regulation or supervision of commercial banks, and to make provision for nomination of additional director by the Reserve Bank of India as and when considered necessary, in the interest of banking policy and depositors' interest;

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(vii) increase the number of elected directors representing shareholders of subsidiary bank limited to a maximum of three, subject to different percentage of public ownership;

(viii) specify the qualification regarding eligibility criteria including 'fit and proper' criteria for elected directors of subsidiary bank and to confer power upon the Reserve Bank of India to remove elected directors who are not 'fit and proper' and also to allow the board of directors of a subsidiary bank to co-opt any other person who is 'fit and proper' in his place;

(ix) confer power upon the Reserve Bank of India to supersede the board of directors of subsidiary banks in public interest or depositors' interest, or for securing proper management of the subsidiary banks on the recommendation of the State Bank of India and to appoint an administrator and a committee to assist the administrator;

(x) enable the board of a subsidiary bank to frame regulation after consultation with the State Bank of India and with the previous approval of the Reserve Bank of India;

(xi) enable the banks to hold board meeting through video-conferencing or such other electronic means and

(xii) entitle the shareholders present in the annual general meeting to adopt the balance sheet.

The State Bank of India (Amendment) Bill, 2010

The State Bank of India (Amendment) Bill, 2010 seeks to amend the State Bank of India Act, 1955. The Bill, inter alia, provides for:

(i) Raising the authorized capital of the State Bank of India to ₹5,000 crore;

(ii) The issued capital of the State Bank of India to consist of equity shares or equity and preference shares;

(iii) Allowing the State Bank of India to raise the issued capital by preferential allotment or private placement or public issue or frights issue;

(iv) Allowing the State Bank of India to issue bonus shares to existing equity shareholders;

(v) Reducing the shareholding of the Central Government from 55 per cent to 51 per cent consisting of equity shares of issued capital;

(vi) Providing nomination facility in respect of shares held by individuals or joint share holders;

(vii) Restricting the voting rights of preference share holders only to resolutions affecting their rights and also restricting the preference shareholders, other than Central Government to exercising voting rights in respect of preference shares held by them to a ceiling of ten per cent of total voting rights of all preference share holders;

(viii) Specifying qualifications for directors elected by shareholders of the State Bank of India and conferring power upon the Reserve Bank of India to notify the fit and proper criteria for such directors;

(ix) Empowering the Reserve Bank of India to appoint additional directors as and when it is considered necessary;

(x) Conferring upon the Central Government the power to supersede the Central Board of the State Bank of India in certain cases on the recommendations of the Reserve Bank of India and to appoint an Administrator;

(xi) Allowing the State Bank of India to hold their Central Board meetings through video-conferencing or other electronic means;

(xii) Allowing the Central Government to appoint not more than four Managing Directors in consultation with the Reserve Bank of India; and

(xiii) Abolish the post of Vice-Chairman.

The Bill has been passed by both the Houses of Parliament in August 2010.

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Check Your Progress

1. Which is the oldest and the largest commercial bank in India?
2. When was the Reserve Bank of India established?
3. What is SBI General Insurance Company Limited?

9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The State Bank of India is the oldest and the largest commercial bank in India.
2. The Reserve Bank of India was established in 1935.
3. SBI General Insurance Company Limited is a joint venture between the State Bank of India and Insurance Australia Group (IAG).

9.5 SUMMARY

- The State Bank of India has a history of almost two centuries. It originated with the establishment of the Imperial Bank of India. The Bank, in its present form, came into existence in 1955 through the nationalization of the Imperial Bank of India.

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- Management of the State Bank of India is vested with a Central Board. There are also local boards at Mumbai, Kolkata, Chennai and New Delhi.
- The main objective in nationalizing Imperial Bank of India has been the setting up of a strong state-partnered banking institution with an effective machinery composed of a large network of branches over the whole country.
- The State Bank of India is the only Indian bank that figures in Fortune top 100 banks.
- In addition to banking services, the Bank offers a whole array of financial services.
- The Bank has adopted and is pursuing vigorously its information technology policy.
- The Central Board is primarily responsible for management of risk.
- The Bank plays a vital role in priority sector, export credit and agricultural financing.
- The Bank is the founder and the flagship member of the State Bank Group.

9.6 KEY WORDS

- **Risk:** *Risk* is the potential of gaining or losing something of value. Values can be gained or lost when taking *risk* resulting from a given action or inaction, foreseen or unforeseen.
- **Management:** *Management* includes the activities of setting the strategy of an organization and coordinating the efforts of its employees (or of volunteers) to accomplish its objectives through the application of available resources, such as financial, natural, technological, and human resources.
- **Credit:** *Credit* is a contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some later date with consideration.

9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. Write a short note on the origin of the State Bank of India.
2. Give the reasons for the nationalization of the Imperial Bank of India.
3. Give a short description of the information technology policy of the State Bank of India.

4. Write a short note on the risk management by the State Bank of India.
5. What is ‘entrepreneur scheme’ of the State Bank of India?
6. What is ‘stree shakti package’ of the State Bank of India?
7. What is ‘SME Credit Plus’ of the State Bank of India?
8. Give a brief description of ‘Kisan Credit Card’ of the State Bank of India.
9. Write a short note on the ‘State Bank Group’.
10. Outline the salient features of the State Bank of India (Amendment) Bill, 2010.

Long-Answer Questions

1. Discuss the role of the State Bank of India in the priority sector.
2. Examine the role of the State Bank of India in the field of export credit.
3. Discuss the role of the State Bank of India in agricultural banking.
4. Discuss the risk governance structure of the State Bank of India.
5. Examine the State Bank of India (Subsidiary Banks Laws) Amendment Act, 2007.

9.8 FURTHER READINGS

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BLOCK - III
BANKS REGIONAL SET AND RRB

UNIT 10 REGIONAL RURAL AND COOPERATIVE BANKS IN INDIA

Structure

10.0 INTRODUCTION

Regional rural banks were started to work in rural perspectives so that they can lend more to farmers who are in need for money.

Urban cooperative banks are registered under Cooperative Societies Acts of the respective state governments. Prior to 1966, UCBs were exclusively under the purview of the state governments. Effective from 1 March 1966, certain provisions of the Banking Regulation Act have been made applicable to these banks. Consequently, the Reserve Bank of India became the regulatory and supervisory authority of UCBs for their banking related operations. Managerial aspects of such banks continue to remain with the state governments under the respective Cooperative Societies Acts. UCBs with multi-presence are regulated by the Central Government and registered under the Multi-state Cooperative Societies Act.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the roles and functions of regional banks
- Discuss the functions of rural banks
- Describe the functions of cooperative banks

10.2 FUNCTIONS, ROLE AND PERFORMANCE

The client profile of cooperative and RRBs today predominantly comprise of priority sector segments viz. Crop loans to farmers, Small business establishments, SSIs, retail traders, professionals, self-employed persons and SRTOs, etc. who would not normally find it easy to have access to large commercial banks. In urban areas, however, there are a number of under banked people like artisans, labourers, small business men, retailers, etc. of smaller means who find it difficult to organize themselves in keeping with the requirements of modern times. It is highly desirable on social as well as on economic grounds, that members of this class be enabled to be covered into the banking fold and the cooperative banks and RRBs certainly can take a lead into this.

The RRBs have played a key role in rural institutional financing in terms of geographical coverage, clientele outreach, business volume and contribution to the development of the rural economy. Between 1975 and 1987, 196 RRBs were established. From a modest beginning of 17 branches covering 12 districts of the country in December 1975, they grew to 14,446 branches in 518 districts of the country by the end of June 2005. The RRBs have been in sharp focus over the last few years with several measures initiated towards strengthening them and making them vibrant channels of credit delivery, particularly for the rural sector. The most prominent of these has been the process of state-wise amalgamation of RRBs sponsored by the same sponsor bank. The process of amalgamation, initiated in 2005, is now nearing completion. As a result of the amalgamation process, the number of RRBs in the country declined from 196 to 96 at the end of March 2007 and further to 88 at the end of June 2008.

The High Power Committee on Urban Cooperative Banks (1999) made a number of recommendations concerning the regulatory aspects in relation to UCBs.

A Profile of UCBs

The urban co-operative banking sector comprises a number of institutions which vary in terms of their size, nature of business and geographic spread. UCBs play an important role by providing banking services to the wider sections of the society, especially in rural and semi-urban areas. During the period 1991–2004 the UCB sector witnessed substantial growth possibly encouraged in post reform period. Alongside, a number of entities became weak and unviable, eroding public confidence and posing systemic risk to the sector. Keeping in view the heterogeneity of this sector, the Reserve Bank of India proposed a multi-layered regulatory and supervisory approach specifically aimed at revival and strengthening of UCBs in the Vision Document for UCB sector, 2005. In the Vision Document, details of which are given subsequently, the Reserve Bank of India proposed merger/ amalgamation of viable entities within the sector and non-disruptive exit of the unviable ones. In the recent years there has been a decrease in total number of UCBs as an outcome of the ongoing consolidation process in this sector. As at end-March, 2011, there were 1,645 UCBs with deposits amounting to ₹2,12031 and advances amounting to ₹1,36341. Grade-wise distribution of UCBs. UCBs are classified into four grades, namely Grade I, II, III and IV, in the order of their performance assessment based on capital adequacy, level of NPAs, history of profit/loss, among others. UCBs categorized as Grade I and II are considered financially stronger than that of Grade III and IV. As an outcome of the ongoing consolidation process of the UCB sector in the form of merger/acquisition among financially viable banks and exit of the non-viable ones, there was a concentration of number of UCBs in Grade I and II categories in recent years. The percentage of banks in Grade I and II together constituted 82 per cent of total UCBs as at end-March 2011. The share of banking business also witnessed a concentration in favour of financially sound UCBs in the recent past. The shares of deposits as well as advances of UCBs in grade I and II together were 89.5 and 89.9 per cent of total deposits and advances of UCBs, respectively, at end-March 2011.

An analysis of performance of the UCB sector according to assets, deposits and advances size-wise confirmed that there was concentration of business in favour of UCBs with larger asset size. As at end-March 2011, UCBs with asset size more than ₹500 crore constituted 6 per cent of total number of UCBs while the same category of UCBs accounted for a share of 50 per cent of total assets of the sector. UCBs with medium asset size (₹100–500 crore) had a share of 21 per cent of total number of UCBs and 12 per cent of total asset size. The remaining share of 14 per cent of total assets was attributable to UCBs with smaller asset size (₹15–100 crore), which accounted for almost 73 per cent of the total number of UCBs.

An analysis of deposits and advances base-wise distribution of UCBs revealed that banking business was predominantly concentrated in favour of larger UCBs. UCBs with larger deposit base (more than or equal to ₹500 crore), though accounted for only 4 per cent of total number of UCBs, contributed almost 53 per cent of total deposits. Similarly, only 3 per cent of total number of UCBs had advances base of more than ₹500 crore, but they accounted for almost 47 per cent total advances disbursed in 2010–11.

Apart from grade-wise classification, UCBs are classified into two categories, viz., Tier I and Tier II for regulatory purposes. All UCBs which followed the below stated criteria are classified as Tier I banks while all other banks are classified as tier II banks:

1. Banks having deposits below ₹100 crore operating in a single district.
2. Banks with deposits below ₹100 crore operating in more than one district provided the branches are in contiguous districts and, deposits and advances of branches in one district separately constitute at least 95 per cent of total deposits and advances, respectively of the bank.
3. Banks with deposits below ₹100 crore, whose branches were originally in a single district but subsequently became multi-district due to reorganization of the district.

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There was an increase in the number of tier II banks while the number of tier I banks reduced. As at end-March 2011, tier I banks accounted for more than three-fourths of total number of UCBs. As against this, their share in total deposits as well as advances were less than 20 per cent. Tier II banks, though constituted less than one-fourth of total number of banks, accounted for majority share of advances and deposits. Similarly, the distribution of total assets was also heavily skewed in favour of tier II banks with these banks accounting for almost 81 per cent of total assets of the UCB sector.

Capital adequacy

As at end-March 2011, almost 90 per cent of the UCBs were found to have CRAR of more than 9 per cent. However, almost 20 per cent of the scheduled UCBs failed to comply with the prescribed minimum CRAR of 9 per cent whereas their non-scheduled counterparts performed better in terms of capital adequacy with only 8 per cent of them reporting CRAR below the prescribed limit.

Refinance Facilities

The RBI extends refinance to UCBs at bank rate against their advances to tiny and cottage industrial units. Since 2000–01, NABARD has designated scheduled UCBs as eligible institutions for drawing refinance in respect of loans issued for rural non-farming sector, including rural housing and other non-agricultural activities.

Priority Sector Lending

UCBs are required to channelize 60 per cent of total loans and advances towards priority sector. Furthermore, within the priority sector lending, lending to weaker sections should constitute 15 per cent of the total loans and advances of UCBs. Fulfilment of priority sector lending targets are taken into consideration by the RBI while granting permission for branch expansion, expansion of areas of operation, scheduled status, etc.

Based on the revised guidelines on the priority sector issued in August 2007, 52.7 per cent of cash advances were extended to the priority sector by UCBs. Small enterprises constituted the largest share (16.9 per cent of the priority sector lending followed by housing loans (13.4 per cent) and retail trade (11.5 per cent). Lending to the weaker sections constituted 13.7 per cent of advances.

The priority sector lending target for UCBs was brought down to 40 per cent of the adjusted bank credit (ABC) (total loans and advances plus investments made by UCBs in non-SLR bonds) or credit equivalent of off-balance-sheet exposure (OBE), whichever is higher, as on 31 March of the previous year and thus brought at par with the target applicable to commercial banks. The revised target came into effect from 1 April 2008. Sectors that qualify for inclusion as priority sectors now include:

(i) total agricultural credit (both direct and indirect);

(ii) total credit to small enterprises (direct and indirect);

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(iii) retail trade;

(iv) micro credit;

(v) state sponsored organizations for SC/ST;

(vi) education and

(vii) housing.

As at end-March 2011, advances to priority sectors by the UCBs constituted almost 46 per cent of the total advances disbursed by them. Of this, small enterprises and housing loans constituted almost 59 per cent and 26 per cent, respectively, of total priority sector advances.

Conclusion

Recognizing the importance of UCBs in providing banking services to the middle and lower income group of people, the RBI in March 2005 drafted a Vision Document for UCBs, pointing out the problem of dual control as a restrictive mechanism, inhibiting its ability to handle the weaknesses of the entities within the sector. The details of the Vision Document are given in the following section.

Draft Vision Document for Urban Cooperative Banks

Urban Cooperative Banks (UCBs) are an important part of the financial system in India. It is, therefore, necessary that the UCBs emerge as a sound and healthy network of jointly owned, democratically controlled, and ethically managed banking institutions providing need-based quality banking services, essentially to the middle and lower middle classes and marginalized sections of the society. This document sets out the broad approach and strategies that need to be adopted to actualize this vision.

1. Background

(a) The urban cooperative banking system has witnessed phenomenal growth during the last one and a half decades. From 1307 urban cooperative banks (UCBs) in 1991, the number of UCBs has risen to 2105 in the year 2004. Deposits have increased by over 1100 per cent from ₹8,600 crore to over ₹100, 000 crore, while advances have risen from ₹7,800 crore to over ₹65,000, i.e., by 733 per cent during the above 15-year period. This growth path has been possible mainly on account of the enabling policy environment in the post 1991 period, which encouraged setting-up of new urban cooperative banks. Further, the deregulation of interest rates, as available to commercial banks, enabled the UCBs to mobilize vast deposits, which, together with the liberal licencing policy propelled the growth of UCBs in terms of numbers as also in size. This significant growth in business, which has come about in a competitive environment was largely due to the efforts and the ability of the sector to harness resources from the small depositors.

(b) Thus, while the sector has shown spectacular growth during the last decade exhibiting substantial potential for sustained growth, there are certain infirmities in the sector that have manifested in the form of weakness of some of the entities resulting in erosion of public confidence and causing concern to the regulators as also to the sector at large. There is, thus, a need to harness the benefit of rapid growth and mitigate the risk to which individual banks and the system are exposed by providing a regulatory and supervisory framework that will address the problems of the sector as also the shortcomings of dual control.

2. Objective

(a) In the light of above, the broad objectives of the document can be set out as under:

   (i) To rationalize the existing regulatory and supervisory approach keeping in view the heterogeneous character of entities in the sector.

   (ii) To facilitate a focussed and continuous system of supervision through enhanced use of technology.

   (iii) To enhance professionalism and improve the quality of governance in UCBs by providing training for skill upgradation as also by including large depositors in the decision-making process/management of banks.

   (iv) To put in place a mechanism that addresses the problems of dual control, given the present legal framework, and the time consuming process in bringing requisite legislative changes.

   (v) To put in place a consultative arrangement for identifying weak but potentially viable entities in the sector and provide a framework for their being nurtured back to health including, if necessary, through a process of consolidation.

   (vi) To identify the unviable entities in the sector and provide an exit path for such entities.

3. The Operating Environment

(a) Urban cooperative banks form a heterogeneous group in terms of geographical spread, area of operation, size or even in terms of individual performance. As such, development of the urban cooperative banking institutions into safe and vibrant entities requires the small banks in the group to be insulated from systemic shocks by emphasizing their cooperative character. Further, the weak banks may have to be strengthened as a group, through a process of consolidation that may entail mergers/amalgamations of viable entities and exit of the unviable ones, if there are no other options available. It is also felt that it is necessary to set up a supervisory system that is based on an in-depth analysis of the heterogeneous character of the urban cooperative banks and one that is in tandem with the policy of strengthening the sector.

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4. Structures and Spread of UCBs

In terms of geographical spread, UCBs are unevenly distributed across the states. Five states, viz., Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu account for 1523 out of 1924 banks that presently comprise the sector. Further, the UCBs in these states account for approximately 82 per cent of the deposits and advances of the sector.

For all UCBs in the country, the total deposits are ₹1,10,25,642 lakh and total advances are ₹67,93,017 lakh.

5. Regulatory Environment

The urban cooperative banks are regulated and supervised by State Registrars of Cooperative Societies, Central Registrar of Cooperative Societies in case of multi-state cooperative banks and by Reserve Bank. The Registrars of Cooperative Societies of the states exercise powers under the respective Cooperative Societies Act of the states in regard to incorporation, registration, management, amalgamation, reconstruction or liquidation. In case of the urban cooperative banks having multi-state presence, the Central Registrar of Cooperative Societies, New Delhi, exercises such powers. The banking related functions, such as issue of licence to start new banks/branches, matters relating to interest rates, loan policies, investments, prudential exposure norms, etc., are regulated and supervised by the Reserve Bank of India under the provisions of the Banking Regulation Act, 1949(AACS). Various committees in the past, which went into working of the UCBs, have found that the multiplicity of command centres and the absence of clear-cut demarcation between the functions of state governments and the Reserve Bank have been the most vexatious problems of urban cooperative banking movement. This duality of command is largely responsible for most of the difficulties in implementing regulatory measures with the required speed and urgency and impedes effective supervision.

6. Strategy—State Specific Approach

The strategy to deal with the UCBs may need to be state specific, one that involves the concerned state government, RBI and the UCBs operating in the state. A state level Task Force on Cooperative Urban Banks (TAFCUB) comprising the Regional Director (RD) of the RBI for the concerned state, Registrar of Cooperative Societies, an official from Central Office of Urban Banks Department (UBD), in-charge of UBD of the concerned Regional Office of RBI and a representative each from NAFCUB and the State Federation of the UCBs, could be set up, in each of the five states with high concentration of UCBs and in a few other states having, say, more than 50 banks to explore viable state specific solutions, including, on the future set up of the existing unlicenced banks whose licence applications are pending with the RBI. Similar approaches may be considered for other states in a second phase after assessing the working of the state specific approach in the five states and in states with more than 50 UCBs. However, if any state prefers to

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adopt the approach in the first phase itself, RBI could consider the proposal appropriately.

The Regional Director (RD) of the RBI and RCS of the concerned state could be the Chairman and co-chairman of TAFCUB, respectively. Each TAFCUB could identify the weak but viable (non-scheduled) UCBs in the respective states and frame a time bound programme for revival of such entities. It would identify the nature and extent of funds required to be infused, the changes in management where necessary and suggest periodical milestones to be achieved. The RBI would closely monitor the progress made by the bank vis-à-vis the revival plan and initiate appropriate action, in case of non-achievement of the targets, as per the plan. Further, UCBs which are not found viable by the TAFCUB, could be required to exit from banking business either through merger with strong banks, if such merger makes economic sense to the acquiring bank, or through voluntary conversion into a cooperative society by paying off the non-member deposits and withdrawing from the payment system and if there is not other viable option they could even be taken into liquidation by the Registrar at the behest of the RBI.

The guidelines on merger and amalgamations (M&A) of UCBs have been issued. These guidelines provide that Reserve Bank of India may consider proposals for merger and amalgamation in the following circumstances:

(i) When the networth of the acquired bank is positive and the acquirer bank assures to protect entire deposits of all the depositors of the acquired bank.

(ii) When the networth of acquired bank is negative and the acquirer bank on its own assures to protect deposits of all the depositors of the acquired bank.

(iii) When the networth of the acquired bank is negative and the acquirer bank assures to protect the deposits of all the depositors of the acquired bank with financial support from the state government extended upfront as part of the process of merger.

In all cases of merger/amalgamation the financial parameters of the acquirer bank, post merger, should conform to the prescribed minimum prudential and regulatory requirement for urban cooperative banks and the realizable value of assets has to be assessed through a process of due diligence. TAFCUB shall make suitable recommendations on M&A based on the above guidelines.

7. Memorandum of Understanding with State Governments

As per provisions of the State Cooperative Societies Act as also the BR Act 1949 (AACS), the Reserve Bank is not empowered to take action against the management of an urban cooperative bank, in case of need, as in respect of commercial banks. It may be useful to have a working arrangement in the form of Memorandum of Understanding (MoU) between the RBI and the State Government/CRCS to ensure that the difficulties caused by dual control are suitably addressed through such MoU/s. The state governments may, through the MoU, agree to take immediate action on requisitions of RBI for supersession of the Board of Directors, appointment of liquidators, initiating action for removal of CEO/Chairman of a bank, enhancing quality of HR and IT resources in the banks on the lines required by RBI, work to raise the standards of corporate governance by putting in place certain minimum fit and proper criteria for members to be eligible for seeking election for the post of director, institute special audit by Chartered Accountants, the cost of which may be borne by the RBI, and furnish reports of the findings within a given time frame, introduce long form audit reports for conducting statutory audit, modify its audit rating models to bring it on par with the gradation system of RBI, conduct statutory audit only through external Chartered Accountants in respect of banks with deposits over a specified minimum level etc. The draft MoU is given in Annexure—I. The TAFCUBs would be set up in states that sign the MoUs with the RBI. In respect of the states that sign the MoU but do not fulfil the commitments therein, the TAFCUB would cease to function and RBI would be at liberty to initiate appropriate corrective action.

8. Proposed Operating Framework

The entities in the sector display a high degree of heterogeneity in terms of their deposit/asset base, area of operations and nature of business. A system of differentiated regulatory and supervisory regime as opposed to a 'one size fits all' approach may be more appropriate, keeping in view the vastly differentiated entities comprising the sector. The broad principles governing RBI regulation over UCBs could largely follow the principles as under:

(a) *Unit Banks (Simplified regulatory regime)*: Unit banks, in particular, the smaller among them, essentially capture the basic concept and spirit of cooperative banking since they function from a single office/branch and cater to the clientele in and around their place of business. As such, they have a natural ability to relate to the customer, have the local feel and flavour and consequently modulate their business strategy to meet the local aspirations. Since small unit banks with deposits below, say, ₹ 50 crore epitomize the basic tenets of cooperative banking, less stringent regulations could be considered for such banks. For example, CRAR could be replaced by the simpler form of minimum capital requirement, viz., Net Owned Funds to NDTL ratio which is easier to compute for the small banks while serving the purpose adequately. At the same time, keeping in view their ability to assess and absorb risks, appropriate limitations like a lower level of single and group exposure limit could be prescribed for these banks to contain their concentration risk. Similarly, the exposure by such banks to sensitive sector should be checked, as these banks lack the wherewithal, in terms of expertise, technology and financial strength to sustain exposure to capital market/real estate etc. As such, keeping in view the nature and size of their operations, appropriate relaxations like a lower prescribed minimum investment in G-Sec (in view of their inability to access market) and restrictions necessary to insulate them

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from systemic shocks may be introduced for such banks. Ideally the unit banks should work within a small geographical area and accordingly the Unit banks to be eligible for the simplified regulatory regime shall conform to this requirement by rolling back their business in far-off locations. The suggested simplified regulatory prescriptions are given in Annexure—II.

(b) *All banks (other than unit banks with deposits less than ₹50 crore)*

Regulatory prescriptions, as applicable to commercial banks should be applicable in all respects to banks falling in this category. However, for these banks the extant relaxations for UCBs could remain in force for the period already prescribed. Further, it is suggested that as a matter of principle, there should not be any unscheduled Multi-State Bank. This could be operationalized through the Central Registrar of Cooperative Societies, which could ensure that a bank is scheduled before it is granted registration under the Multi-State Cooperative Societies Act. In order to ensure that all scheduled banks are also, as far as possible, strong enough to support themselves and a few smaller UCBs around them, the RBI could prescribe appropriate norms for scheduling of cooperative banks.

Further, banks in this category which comply with the prescribed regulatory requirements can be extended facilities and privileges as are presently available to the commercial banks of comparable size.

The existing scheduled banks, both under Multi-State and State Cooperative Societies Act, which do not meet the prescribed criteria and do not comply with the prudential and regulatory regimen akin to that of commercial banks, could be excluded from the second schedule to the RBI Act through a time bound corrective action framework As a corollary, the existing non-scheduled Multi-State Banks could also be required to close their branches/withdraw from any business outside the principal state of their activity.

9. Supervision

The number of unit banks with deposits under ₹50 crore constitute 33 per cent of UCBs and account for less than 6 per cent of deposits of the sector. These banks, limited by their size/type of operations, pose lower systemic risks and could be supervised by a combination of simplified off-site surveillance system of the RBI and on-site audit by the state governments. Based on these reports, Reserve Bank of India, at its discretion, could conduct inspection of such banks, which, however would not be normally covered under its regular schedule of inspection. The increased dependence on off-site surveillance of RBI and on-site supervision by RCS in respect of the small unit banks would provide increased flexibility to the RBI to deploy its supervisory resources to the larger and more risky banks.

10. Developmental Role of RBI

The Reserve Bank may have to provide assistance to the UCBs, more particularly the smaller ones, in improving their skill levels. Since the College of Agricultural

Banking is already providing training facilities to the UCBs, this institution could be used as the forum for doing so. Keeping in view the financial implications for banks, for providing quality training, the cost of training programmes could be largely subsidized by the Reserve Bank for the Unit banks falling under Tier I.

The Reserve Bank has been encouraging the UCBs to invest in government securities by stipulating that a portion of the SLR investments are held in the form of these securities. There is an inherent advantage in holding a part of the SLR investments in G-Secs as otherwise the banks are required to keep their entire SLR in higher tier cooperative banks, the financial position of which may itself be uncertain. At the same time it would be necessary to ensure that the UCBs are not put to any difficulty in buying and selling the securities. To address this issue Reserve Bank may, through its Regional Directors, liaise with the network of Primary Dealers to put in place an appropriate arrangement in this regard.

Conclusion

Every authority concerned with Cooperative sector will have to play its part in ensuring that the aspirations of the Urban Cooperative Banking sector are nurtured in a manner that depositor interest and the public interest at large is protected. The role of RBI could, thus, be to frame a regulatory and supervisory regime that is multi-layered to capture the heterogeneity of the sector and implement policies that would provide adequate elbowroom for the sector to grow in a non-disruptive manner.

The State and Central Governments could recognize that the UCBs are not just cooperative societies but they are essentially banking entities whose management structure is that of a cooperative.

They should recognize the systemic impact that inefficient functioning of the entities in the sector could have. Consequently, it would be in the interest of the sector if they support, facilitate and empower the RBI to put in place mechanisms and systems that would enable these UCBs to perform their banking functions in a manner that is in the overall interest of the depositor and the public at large.

Appendix to Urban Coop. Banks

Draft terms of reference of the TAFCUB

1. To categorize the UCBs in the state under the two-tiers of regulatory regime.
2. To identify banks, which are viable, potentially viable and unviable.
3. To recommend the various conditions, including the nature and extent of funds required to be infused, in each UCB identified as potentially viable, the source thereof, changes in management where necessary and the time frame for achieving viability. In doing so, the TAFCUB may assign responsibility to different agencies for facilitating the turn-around.
4. To set up milestones for evaluation of progress made under the rehabilitation plan.

5. To recommend the future set up of the existing unlicenced banks whose applications are pending with Reserve Bank of India.
6. To recommend the manner and time frame for exit of the unviable banks, which could be in the form of merger/amalgamation, conversion into a credit society and liquidation.

   The proposals for merger/amalgamation recommended by the TAFCUB shall conform to the guidelines issued in this regard.
7. To arrive at a threshold limit of deposits that would make a depositor automatically eligible to become a member.
8. To recommend on the management aspects of a bank which is placed under the revival plan.
9. Any other issues as may be referred to it by the Reserve Bank of India.

Tier II (All other banks)

For all banks, other than unit banks with deposits upto ₹50 crore, all regulations as applicable to commercial banks should be applied, However, for these banks the extant relaxations for UCBs could remain in force for the period already prescribed. Further, facilities and opportunities available to commercial banks should, as far as possible, be also made available to such banks to enable them to grow and compete with commercial banks. Banks that do not comply with the regulations should either reduce their operations to qualify for the relaxed regulations applicable for unit banks with deposits less than ₹ 50 crore or may be required to convert into cooperative societies

As per the terms of the document, until 2008, 28 state governments and Central Government (in case of multi-state UCBs) have signed the Memoranda of Understanding (MoUs) with the RBI covering 98.6 per cent of the total number of UCBs representing 99.2 per cent of deposits of the sector. As a part of the MoU, the State Level Task Force for Cooperative Urban Banks (TAFCUBs) have been set up to identify the potentially viable and non-viable UCBs in the State and to chart out the revival path and non-disruptive exit route for the two sets of banks, respectively. These measures instilled confidence in the sector which is evident from the increase in deposits for three successive years, i.e., from 2005–06 to 2007–08.

During 2007–08, the RBI continued with its policy of encouraging states to sign MoUs to establish a co-ordinated supervisory/regulatory structure, by further adding incentives the scheme in the form of additional business opportunities, opening of new ATMs and conversion of exchange counters into branches, among others. The process of consolidation through mergers of UCBs progressed further in 2007–08 with a total of 61 mergers being effected upon the issue of statutory orders by the Central Registrar of Cooperative Societies/Registrar of Cooperative Societies (CRCS/RCS) concerned. Further, as on 31 March 2008, 268 UCBs were under various stages of liquidation. All these measures appear to have positive impact on the performance of UCBs as a whole.

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Urban Cooperative Banks' Policy Developments

The cumulative mechanism adopted by the RBI for regulation and supervision of the UCBs in line with the framework suggested in the Vision Document through signing of MoUs helped strengthen the sector. Furthermore, the RBI guidelines on merger/amalgamation of UCBs just prior to commencement of MoU process, helped phase out non-viable banks through a non-disruptive exit route. Both of these mechanisms progress well and help the UCB sector to strengthen further. Besides, RBI continues with its policy of relaxed regulatory norms for Tier I UCBs, i.e., smaller UCBs with deposit base of less than ₹100 crore and having branches limited to a single district. Moreover, the RBI also made available a number of facilities to UCB s in those states that have signed MoU with the RBI.

Regulatory and Supervisory Framework

The performance of the cooperative banking sector has been a cause for concern in recent years in the context of financial sector reforms. Financial and managerial weaknesses of cooperatives have been in evidence. It has been, therefore, felt necessary to extend the essential spirit of the regulatory and supervisory measures to the cooperative banks as well, with necessary adaptations to suit the circumstances in which cooperative banks operate. It may be repeated in this connection that among the rural cooperative banks, only the State Cooperative Banks and Central Cooperative Banks are covered under the scope of the Banking Regulation Act. The RBI is the regulatory authority for such banks while their supervision has been entrusted to NABARD, which has concurrent power for the same.

High Power Committee on Urban Cooperative Banks

In order to make a comprehensive review of activities and regulatory framework pertaining to UCBs, a High Power Committee was constituted by the RBI in May 1999 (Chairman being Shri K. Madhava Rao), to focus on the following issues:

(i) to evolve objective criteria to determine the need and potential for organizing urban cooperative banks; review the existing entry point norms and examine the relevance of special dispensations for less/least developed areas;

(ii) to review the existing policy pertaining to branch licensing and area of operation of urban cooperative banks;

(iii) to consider measures for determining the future set up of weak/unlicensed banks;

(iv) to examine the feasibility of introducing capital adequacy norms for urban cooperative banks;

(v) to examine the need for conversion of cooperative credit societies into primary cooperative banks and

(vi) suggest necessary legislative amendments to Banking regulation Act and Cooperative Societies Acts of various States for strengthening the urban banking movement. The committee submitted its report in November 1999 in which very useful recommendations have been made with regard to revision of licencing policy for new PCBs, branch licencing policy, extension of areas of operation, dealing with unlicensed and weak PCBs, application of capital adequacy norms, conversion of cooperative societies into PCBs and reforms in State Cooperative Acts, Multi-State Cooperative Societies Act and Banking Regulation Act. The recommendations were aimed at:

(i) reducing systemic risk to the financial system;

(ii) putting in place strong regulatory norms at the entry level so as to sustain and improve the operational efficiency of urban cooperative banks in a competitive environment;

(iii) evolving measures to strengthen the existing structure, particularly in the context of ever increasing number of weak banks and

(iv) aligning the PCB sector with other segments of the banking sector in the context of application of prudential norms and removing the irritants of dual control regime.

Major Recommendations

The major recommendations of the High Power Committee on Urban Cooperative Banks are as under:

(a) Licensing Policy of New UCBs:

The regulator should prescribe the twin criteria for entry i.e., a strong start-up capital and requisite norms for promoters' eligibility. The existing quantitative criteria for viability standards should be replaced by qualitative norms like CRAR, tolerance limit of NPAs and operational efficiency. The committee prescribed five grades (depending on population size of centre) of entry point norms (EPN) based on centre-wise capital and membership.

(b) Corporate Governance:

At least two directors with suitable banking experience or relevant professional background should be present on the Boards of UCBs and the promoters should not be defaulters to any financial institution or banks and should not have any association with chit fund/NBFC/cooperative bank or commercial bank in the capacity of Director on the Board of Directors.

(c) Branch Licensing Policy and Area of Operation:

The Reserve Bank should extend to the UCBs the same freedom and discipline as is applicable to commercial banks in opening branches, if a UCB complies with the broad norms relating to capital adequacy, provisioning, net NPAs, profitability and priority sector advances. Further, it should not be in default of any of the provisions of the B.R. Act or RBI Act or Directives issued by the Reserve Bank. Every UCB must submit to the Reserve Bank an Annual Action Plan (AAP). Scheduled UCBs which satisfy the eligibility criteria would be given freedom to

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open new branches under the AAP. Non-scheduled UCBs should continue to obtain prior approval of the Reserve Bank after complying with the eligibility criteria.

(d) Extension of Area of Operation:

New UCBs can extend their area of operation to the entire district of their registration and adjoining districts. When the UCB desires to open a branch in a district in a state other than the district in which it is registered, it must have a net worth which is not less than the EPN prescribed for the highest category centre in that state. If a UCB desires to open a branch in a state other than the state in which it is registered, it must have a net worth of not less than ₹50 crore.

(e) Policy on Unlicensed Banks:

Under the provisions of Section 5 (ccv) of B.R. Act, a primary credit society with paid-up capital and reserves of ₹1 lakh and with main objective of carrying on banking business, automatically secures status of an urban bank. The committee, therefore, recommended amendment to the Act so as to prevent such automatic transformation of primary credit societies into UCBs. The committee also recommended that the licence should be given to a bank if it—

(i) attains minimum level of CRAR prescribed by the regulator;
(ii) has net NPAs not in excess of 10 per cent;
(iii) has made profits during each of the last 3 years and
(iv) has complied with the statutory framework of B.R.Act/Directive issued by the Reserve Bank.

(f) Policy on Weak/Sick Banks:

Separate objective criteria—based on CRAR, net NPA and history of losses—have been recommended for identification of weak and sick banks.

(g) Application of CRAR to UCBs:

UCBs should be subject to CRAR discipline in a phased manner with initially lower CRAR norms prescribed for non-scheduled UCBs as compared to scheduled UCBs. The committee has recommended uniform CRAR as applicable to commercial banks for scheduled UCBs and 9 per cent in case of non-scheduled UCBs by March-end 2003.

(h) Conversion of Cooperative Credit Societies into UCBs:

Such of the credit societies whose net worth is not less than the entry point capital prescribed for new banks in that given centre, which have been posting profits during each of the last 3 years, which have earned 'A' audit rating and whose methods of operation are not detrimental to the interests of the depositors, may be allowed to convert themselves into UCBs.

(i) Legislative Reforms in Central and States Statutes:

The application of certain provisions of B.R. Act, 1949 to UCBs in 1966 initiated a regime of dual control resulting in the absence of clear cut demarcation between the functions of the state governments and the Reserve Bank. Hence, the State Government Acts should be so amended as to categorize the banking-related functions and the functions of the state governments separately. Accordingly, Multi-State Cooperative Societies Act, 1984, State Cooperative Societies Acts and Banking Regulation Act should be amended.

Licensing Norms

Licensing policy for UCBs was revised in August 2000, in consonance with the recommendations of the High Power Committee. The thrust of the new policy is on strong start-up capital, professionalization of boards of management and corporate governance. The revised entry point norms are based on population criterion. According to the new norms, UCBs should have minimum capital of ₹4 crore and membership of at least 3,000 if the population of the place where the UCB is being established is more than 10 lakh. For population between 5–10 lakh, the minimum share capital and membership requirements are ₹2 crore and 2,000, respectively. For population between 1–5 lakh the corresponding minimum requirements are ₹1 crore and 1,500, respectively. For towns with population less than 1 lakh, the corresponding minimum requirements are ₹25 lakh and 500, respectively. The number of licensed UCBs increased from 1,849 to 1,937 between March-end 2000 and March-end 2001. Between July 2000 and June 2001, licenses under Section 22 of the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies (AACS)) were issued to 18 new banks and 17 existing unlicensed UCBs.

Recent Regulatory Measures

During March 2001, certain UCBs faced liquidity and insolvency problems. A major factor behind the problem had been non-adherence by these UCBs to prudential norms prescribed by the Reserve Bank, such as lending to stockbrokers, exceeding prudential exposure to single party/group and the limit on unsecured advances and failure to meet inter-bank payment obligations. At the centre of the problem was a multi-state scheduled UCB, which witnessed a sudden withdrawal of deposits.

The Reserve Bank felt that in the interest of financial stability, it was important to take measures to strengthen the regulatory framework for the cooperative sector. Issues such as removal of 'dual' control of the UCBs, laying down of clear-cut guidelines for their management structure, enforcement of further prudential standards in respect of access to uncollateralized funds, lending by the UCBs against volatile assets, etc., were considered in this context. The Reserve Bank identified the following areas for immediate regulatory response:

(a) the extent of access of the UCBs to call/notice money markets;

(b) the asset-liability management system of the UCBs;

(c) inter-bank exposure of the UCBs in the form of deposits maintained by one UCB with another and

(d) the maintenance of SLR portfolio by the UCBs.

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In order to address these issues, the Reserve Bank has announced a series of measures relating to UCBs in the April 2001 monetary and credit policy statement. The salient features of these measures are given below.

(a) Lending to Stock Markets:

It is important to point out that even before the policy changes were initiated in April 2001, cooperative banks were neither permitted to invest directly in stock markets nor to lend to stock brokers. They could, however, lend to individuals against pledge of shares up to a certain limit. Available information revealed that a few UCBs ignored these guidelines and established a nexus with certain stockbrokers in order to operate in the stock market. In order to prevent any possible misuse in the future, Reserve Bank had put a stop on lending by UCBs directly or indirectly against also advised to unwind existing lending to stockbrokers or direct investment in shares on the contracted dates. In response to representations received from UCBs and their federations, the October 2001 mid-term review proposed to allow UCBs to grant loans to individuals against security of shares, subject to certain conditions.

(b) Access to Call/Notice Money Markets:

In order to reduce the excessive reliance of some UCBs in the call money market, it was announced that their borrowings in the call/notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at March-end of the previous financial year. The freedom to lend in the call/notice money market, however, continues.

(c) Inter-UCB Term Deposits:

As parking of funds by UCBs with other UCBs may pose a systemic risk, as a safety precaution, UCBs were advised not to increase their term deposits with other UCBs. The outstanding deposits with other UCBs as on 19 April 2001 have to be unwound before end of June 2002. UCBs may maintain current account balances at their discretion with other UCBs to meet their day-to-day clearing and remittance requirements.

(d) Maintenance of SLR:

UCBs are required to maintain their SLR equivalent to 25.0 per cent of net demand and time liabilities (NDTL). They can maintain it in the form of investments in government and other approved securities or as deposits with StCBs/CCBs. In the April 2001 policy statement, it was announced that with effect from 1 April 2003 all scheduled UCBs would need to maintain their entire SLR assets of 25.0 per cent of NDTL only in government and other approved securities and that compliance with CRR requirements on par with scheduled commercial banks would be prescribed in

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due course. All scheduled UCBs and non-scheduled UCBs with deposits of ₹25 crore and above now have to maintain investments in government securities only in Subsidiary General Ledger (SGL) Accounts with Reserve Bank or in constituent SGL Accounts with public sector banks, Primary Dealers (PDs), scheduled commercial banks, state cooperative banks and depositories. Non-scheduled UCBs with deposits of less than ₹25 crore would have the facility of maintaining government securities in physical or scrip form. The UCBs were required to achieve certain higher proportion of their SLR holding in the form of government and other approved securities as a percentage of their NDTL by 31 March 2002. In response to the representations received from UCBs and their federations it has been proposed to modify the time-frame for achieving the prescribed levels of SLR holding.

Apart from initiating the policy changes, the Reserve Bank has also addressed the issue of dual control of UCBs. At present, three authorities are involved in regulatory and promotional aspects concerning the UCBs—the Central Government (in case of banks having multi-state presence), state governments and the Reserve Bank. Doing away of dual control entails amendments to the Constitution of India, which can be a long drawn legislative process. In view of this, the Reserve Bank felt that one of the options that deserves to be seriously considered is setting up of a new apex supervisory body which can take-over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs. This apex body could be under the control of a separate high-level supervisory board consisting of representatives of the Central Government, state governments, the Reserve Bank as well as acknowledged experts in the areas of cooperative banking, etc. The body may be given the responsibility of inspection and supervision of UCBs and ensuring their conformity with prudential, capital adequacy and risk-management norms laid down by the Reserve Bank.

Much before the incidence of irregularities in the UCBs discussed above, the Reserve Bank had appointed a High Power Committee (Chairman being Shri. K. Madhava Rao), 1999, to review the performance of the UCBs and to suggest necessary measures to strengthen this sector. The committee submitted its report in the same year. The major recommendations of the committee were given earlier.

Structural Initiatives

Vision Document

A significant proposal of the Vision Document was to address the problem of dual control of UCBs by signing of MoU between the Reserve Bank and the respective state governments, and establishing a consultative forum for supervision of the banks. Accordingly, the Reserve Bank approached the states having a large network of UCBs for signing MoUs. Since June 2005, MoUs have been signed with 23 state governments (upto 20 October 2008) and with the Central Government in respect of multi-state UCBs and TAFCUBs have been constituted in all such states. The mechanism of TAFCUBs has been able to restore the confidence in the UCB sector (Box.IV.1).

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Two-tier Regulatory Structures—Definition Amended

The definition of Tier I bank was amended with effect from 7 March 2008. Banks falling under the following categories are classified as Tier I banks: (i) unit banks, i.e., banks having a single branch/head office. MoU and TAFCUBs—Impact and Progress

In order to ensure greater convergence of regulatory and supervisory policies between the two regulators in the urban cooperative banking sector, viz., state governments (Central Government in case of multi-state UCBs) and the Reserve Bank, the latter pursued a policy of encouraging the state governments to sign a Memorandum of Understanding (MoU) in this regard. Pursuant to this policy, as on 20 October 2008, 23 States, viz., Gujarat, Andhra Pradesh, Karnataka, Madhya Pradesh, Uttarakhand, Rajasthan, Chhattisgarh, Goa, Maharastra, Haryana, National Capital Territory of Delhi, West Bengal, Assam, Tripura, Punjab, Uttar Pradesh, Manipur, Meghalaya, Himachal Pradesh, Kerala, Mizoram, Tamil Nadu and Sikkim have signed MoUs with the Reserve Bank. The MoU has also been signed with Central Government in respect of multi-state UCBs. As on 20 October 2008, the MoU has covered 1,746 UCBs out of 1,770 which accounts for 98.6 per cent of total number of UCBs and 99.2 per cent of total deposits as well as advances of the sector. As per the arrangements under MoU, the Reserve Bank constitutes state level Task Force for Cooperative Urban Banks (TAFCUB) comprising representatives of the Reserve Bank, the state government and the UCB sector. Accordingly, TAFCUBs have been constituted in all states that have signed MoUs. A Central TAFCUB has also been constituted for the multi-state UCBs. TAFCUBs identify potentially viable and non-viable UCBs in the states and suggest revival path for the viable and non-disruptive exit route for the non-viable ones. The exit of non-viable banks could be through merger/amalgamation with stronger banks, conversion of them into societies or liquidation, as the last option. TAFCUBs, since its inception, have examined the position of 949 UCBs (Including cases of banks reviewed more than once) and taken decision on finalising merger with respect to 14 banks. Orders of directions by the Reserve Bank were imposed on 37 banks and licences were cancelled for 40 banks.

Consolidation and Strengthening of the UCB Sector

Weak financial position of a number of UCBs has been the major concern in the UCB sector for decades. The dual regulatory control over the sector contributed a lot to the weak financial position of this sector. To address this issue, the Reserve Bank of India in March 2005 prepared a vision document and based on that a Medium-Term Framework (MTF), which envisaged regulatory coordination between the two main regulatory authorities of the urban cooperative banking sector, viz., the Reserve Bank of India and the respective state governments (central government for multi-state UCBs) through signing of a Memorandum of Understanding (MoU) in each state within the existing legal framework.

MoUs have been entered into with the central government and all the 28 states having presence of UCBs, thus covering the entire UCB sector. Task Force for Cooperative Urban Bank (TAFCUBs) have been constituted in all these states and a central TAFCUB has also been constituted for the multi-state UCBs. The supervisory actions taken on the basis of the recommendations of TAFCUBs include cancellation of licenses or rejection of license applications of unviable UCBs, supersession of errant Board of Directors, and placing/modification of operational restrictions/directions on the banks. Other important policy measures that were implemented based on a consensus in the TAFCBUs were Guidelines on ‘Fair Practice Code for Lenders’ and issue of guidelines on ‘Fit and Proper Criteria’ for appointment of CEOs of UCBs. Further, TAFCUBs identify the potentially viable UCBs and suggest solutions for their revival while formulating non-disruptive exit strategies for non-viable banks. The exit of non-viable banks could be through merger/amalgamation with stronger banks, conversion into societies or liquidation, as the last option. With a view to facilitating consolidation, and non-disruptive and orderly resolution of weak/unviable entities in the UCB sector, the Reserve Bank of India had framed in February 2005 guidelines for merger/amalgamation of UCBs. In terms of these guidelines, the acquirer bank has to protect deposits of the acquired bank on its own or with upfront financial assistance from the state government. In order to give a fillip to the process of mergers and consolidation of the sector and to address the legacy cases of UCBs with negative net worth as on 31 March 2007, the Reserve Bank of India issued in January 2009 additional guidelines for merger/amalgamation of UCBs which provided for DICGC support to the extent and in the manner prescribed under Section 16 (2) of the DICGC Act, 1961, financial contribution by the acquirer bank and sacrifice of a portion of their deposits by large depositors.

As an additional option for resolution of weak UCBs, where proposals for mergers are not forthcoming from within the UCB sector, guidelines were issued by the Reserve Bank of India in February 2010 for sanction of a scheme of transfer of assets and liabilities of UCBs (including branches) to commercial banks with DICGC support, in legacy cases of banks with negative net worth. These guidelines provide for 100 per cent protection to all depositors and DICGC support is restricted to the amount provided under Section 16 (2) of the DICGC Act, 1961. UCBs which had negative net worth as on 31 March 31 2007 or earlier and continue to have negative net worth as on the date of transfer would be considered eligible under the scheme.

As an incentive, the Reserve Bank of India would permit the transferee (Commercial) bank to take over branches of the transferor bank (UCB) with the prior approval of the Reserve Bank of India. The shifting/relocation of branches of the transferor bank may also be permitted by the Reserve Bank of India subject to banking facilities being made available to customers through the existing/relocated branches of the transferor/transferee bank.

10.2.1 Rural Cooperatives: Short-Term and Long-Term Structure

Rural cooperative credit institutions include state cooperative banks (StCBs), district central cooperative banks (DCCBs), primary agricultural credit societies (PACs), state cooperative agriculture and rural development banks (SCARDBs) and primary cooperative agriculture and rural development banks (PCARDBs). Recognising the wide outreach of rural cooperative credit institutions, particularly among the rural and vulnerable segments of the society, and their role in purveying rural credit and deposit mobilization, efforts are being made to restore operational viability and financial health of those institutions. The financial performance of rural cooperative credit institutions is characterized by several weaknesses such as high NPAs, poor recovery and accumulated losses. As on 31 March 2007, four out of 31 StCBs, 97 out of 371 DCCBs, 48,078 out of 97,224 PACs, eight out of 20 reporting SCARDBs and 342 out of reporting 697 reporting PCARDBs incurred losses, which together amounted to ₹1,524 crore (excluding PACSs).

As at end-March 2010, there were a total of 95,765 rural cooperative institutions operating in the country. Out of the total number of rural cooperatives, short-term cooperatives constituted a majority while only 1 per cent of the total cooperatives operating in the country were long-term in nature. Within the short-term structure, while StCBs and DCCBs carry on profitable operations, PACS are incurring huge losses. The financial positions of long-term cooperatives are weaker than the short-term cooperatives with both SCARDBs and PCARDBs reporting losses as at end-march 2010. StCBs and DCCBs are heavily dependent on deposits for their resources whereas borrowings constitute a major part of total assets in case of PACS, SCARDBs and POCARDBs. The short-term cooperatives (except PACS) are better placed as compared to their long-term counterparts in terms of asset quality and recovery performance. The NPA ratio is higher in the case of long-term cooperatives. Within the short-term structure, the PACS have the highest NPA ratio, indicating poor asset quality of these grass root level cooperatives.

Rural Cooperatives—Short-term Structure

The short-term structure of rural cooperatives comprises of StCBs operating as the apoex institutions in each state, DCCBs operating at the district level and PACS operatying at a more granular level.

Rural Cooperative Banks—Long-term Structure

The long-term structure of rural cooperatives consists of SCARDBs operating at the state level and PCARDBs operating at district/block level. As at end-March 2010, the long term co-operative credit structure consisted of 20 SCARDBs and 697 PCARDBs. In those States which do not have the long-term structure, separate sections of StCBs look after the long-term credit requirements as well.

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Primary Agricultural Credit Societies (PACSs)

PACSs deal directly with individual farmers, provide short and medium-term credit, supply agricultural inputs, distribute consumer articles and also arrange for the marketing of products of its members through a cooperative marketing society. PACSs lie at the lowest level of the short-term structure of rural cooperative credit institutions. A large number of them, however, face severe financial problems primarily due to erosion of own funds, deposits and low recovery rates. Various policy initiatives have been taken to improve the financial health of PACSs in recent years. NABARD has been providing support for developing the infrastructure in PACSs out of Cooperative Development Fund (CDF). The number of PACSs stood at 94,647 at end March 2010. The total membership stood at 126 million and the number of borrowing members stood at 48 million at March-end 2007. For the country as a whole, as at March-end 2007, one PAC on an average covered seven villages.

The process of implementation of the recommendations of the Task Force on revival of short-term cooperative credit structure (Chairman being Prof. A Vaidyanathan) started with the announcement of a package by the Government of India. Twenty five states have signed MoUs with the Government of India and NABARD. At end-March 2010, 80,639 PACs completed the required special audit. Common Accounting System (CAs) and Management Information System (MIS) were introduced along with several Human Resources Development (HRD) initiatives. Recapitalization of eligible PACs has been initiated.

Central Cooperative Banks (CCBs)

Central Cooperative Banks form the middle tier of cooperative credit institutions. CCBs are independent units in as much as the State Cooperative Banks have no control to control or supervise their affairs. They are of two kinds, viz., 'pure' and 'mixed'. Those banks the membership of which is confined to cooperative organizations only are included in the 'pure' type, while those banks the membership of which is open to cooperative organizations as well as to individuals are included in the 'mixed' type. The pure type of central banks can be seen in Kerala, Bombay, Orissa, etc., while the mixed type can be seen in Andhra Pradesh, Assam, Tamil Nadu, etc. The pure type of banks is based on strict cooperative principles. However, the mixed type has an advantage over the pure type in so far as they can draw their funds from the non-agricultural sector too. But by allowing individuals to hold shares, loan facilities are necessarily extended to them. While in some of them happen to be middlemen, who may utilize the proceeds of the loans to carry on their trading operations, then it would be a hard blow on the very basic principle of cooperation, which strive for the elimination of the middlemen.

The CCBs draw their funds from share capital, deposits, loans from the State Cooperative Banks and where state banks do not exist from the RBI, NABARD and commercial banks. Deposits constitute the major component of sources of funds, followed by borrowings. The main function of CCBs is to finance the primary credit societies. In addition, they carry on commercial banking activities like acceptance of deposits, granting of loans and advances on the security of first class gilt-edged securities, fixed deposit receipts, gold, bullion, goods and documents of title to goods, collection of bills, cheques, etc., safe custody of valuables and agency services. They also act as 'balancing centres', making available excess funds of one primary to another which is in need of them.

State Cooperative Banks (StCBs)

State Cooperative Banks are at the apex of the three-tier cooperative structure dispensing mainly short/medium-term credit. A StCB is the principal society in a state which is registered or deemed to be registered under the Government Societies Act, 1912, or any other law for the time being in force in India relating to cooperative societies and the primary object of which is the financing of the other societies in the state which are registered or deemed to be registered. In addition to such a principal society in a state or where there is no such principal society in a state, the state government may declare any one or more cooperative societies carrying on business in that state to be a State Cooperative Bank (or, banks). StCBs being the apex institutions in the short-term structure of rural cooperatives, their financial health has strong influence in the overall financial health of short-term rural cooperatives. Particularly given the fact that the ground level cooperatives or PACS incurred huge losses in recent years, StCBs' ability to provide assistance to PACS depends on the financial soundness of their own.

As in the case of CCBs, State Cooperative Banks may be 'pure' in which case it will be a federation of CCBs only, or 'mixed' in which case it will be a federation of both CCBs and individual members. The StCBs receive current and fixed deposits from its constituent banks as well as savings, current and fixed deposits from the general public and from local boards, other local authorities, etc. Further, they receive loans from commercial banks and seasonal loans from the RBI and NABARD. The state governments contribute a certain portion of their working capital.

The principal function of StCBs is to assist the CCBs and to balance excesses and deficiencies in the resources of CCBs. This function of the apex bank to act as a 'balancing centre' is important since direct lending is not allowed among the CCBs. The connection between the StCBs and the primary cooperative societies is not direct. The CCBs are acting as intermediaries between the StCBs and primary societies. Of course, in the absence of a CCB, the StCB may act as a CCB and in that case its connection with primary societies will be direct.

State Cooperative Agriculture and Rural Development Banks (SCARDBs)

State Cooperative Agriculture and Rural Development Banks constitute the upper-tier of long-term cooperative credit structure. Though long-term credit cooperatives

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have been allowed to access public deposits under certain conditions, such deposits constitute a relatively small proportion of their total liabilities. SCARDBS are mostly dependent on borrowings for on-lending. As on 31 March 2002, as against deposits of ₹536 crore, outstanding borrowings of SCARDBS were ₹14,888 crore. On the same date, their loans outstanding were ₹14,000 crore.

Primary Cooperative Agriculture and Rural Development Banks (PCARDBs)

Primary Cooperative Agriculture and Rural Development Banks are the lowest layer of long-term credit cooperatives. As in the case of SCARDBS, PCARDBS are primarily dependent on borrowings for their lending business. As on 31 March 2002, deposits and borrowings of PCARDBS were at ₹251 crore and ₹9,077 crore, respectively, while loans extended by them were of the order of ₹8,960 crore.

Revitalization of Rural Cooperative Banks

Cooperative credit institutions play a significant role in the deployment of credit for agriculture and rural sector and account for 45 per cent of the total credit for the rural sector. These institutions, however, lack professionalism, sound management system and autonomy in decision-making. Low volume of business/ low resource base, low borrowing membership, high incidence of overdues, and dual control have adversely affected the health of cooperative credit institutions. In addition, poor recovery performance has affected the ability of these institutions to cater to the credit needs of new and non-defaulting members and resulted in low paid-up share capital. The vital link in the short-term cooperative credit system, viz., the PACS at the grassroot level is weak. Their size is small and uneconomical and many of them are dormant. Cooperatives need to augment their resource base, especially the capital base and pay greater attention to specialization and diversification of loan business, non-fund business, efficient financial intermediation, risk management and reduction in NPAs. In recognition of the importance of cooperative banks in the development process of the rural economy and the need for its revitalization so as to make them efficient and cost effective instruments for delivery of rural credit, a task force (Chairman being Shri Jagdish Capoor) was constituted in April 1999 to study the cooperative credit system and suggest measures for its strengthening. The terms of reference of the task force were:

(i) to review the functioning of the cooperative credit structure and suggest measures to rationalise and improve and to make cooperatives as member-driven and professional business enterprises;

(ii) to study aspects relating to costs, spreads and effectiveness at various tiers of cooperative credit structure;

(iii) to study the financial performance of the cooperative banks with a view to improving their financial health so that they can become efficient and cost effective in the delivery of rural credit and

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(iv) to review the existing supervisory and regulatory mechanism for cooperative credit institutions and suggest measures for strengthening the arrangements.

Major Recommendations of the Task Force

The task force submitted its report to the Central Government on 24 July 2000. The major recommendations of the task force are given below. The implementation of these recommendations will go a long way towards re-energising the cooperative sector.

(a) Resource Base

In view of the limited resources of cooperative banks, the task force has emphasised the need for strengthening the resource base, especially the capital.

(b) Regulation and Control

The report recognized the need for reducing government control over cooperatives, giving them maximum autonomy and making them 'member driven'. The report encouraged state governments to adopt Model Cooperative Societies Act or dovetail the essential features of the Model Act in their respective State Cooperative Societies Acts so as to reflect the spirit of democratization and self-reliance enshrined in the Model Act. Specific action plans need to be prepared to remove the overlapping of controls and endow functional autonomy and operational freedom to cooperatives. The duality of control between the state governments on the one hand and the Reserve bank/NABARD on the other, has adversely affected the working of cooperative banks. In view of this, the bank-related functions should be exclusively brought under the purview of the BR Act, 1949 and regulated by the Reserve Bank.

(c) Professionalism in Cooperative Banks

The cooperative banks should work like professional organizations on sound managerial systems. The banks' boards should be professional and accountable ones. Cooperative banks will have to evolve sound personnel policies encompassing proper manpower planning and assessment. Banks should have objective and transparent policies for recruitment of staff.

(d) Business Diversification

The task force emphasized diversification of business products as the prime need at all levels in the cooperative credit institutions. The diversified avenues may include, inter alia, housing loans, consumer loans, consortium financing, financing of services sector, distribution of insurance products, etc. Banks should upgrade their skills and technology to provide efficient and affordable services. The task force recommended that the cooperative banks may be permitted to lend up to 10 per cent of their deposits outstanding as at the end of the previous year for commercial and technology intensive projects outside the cooperative fold.

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(e) Costs, Margin and Funds Management

In the view of the task force, to ensure viability, cooperative banks will have to necessarily charge such rates of interest on their loans and advances as will cover the cost of raising funds, transaction and risk costs, and ensure a positive net rate of return. Interest rates offered by cooperative banks on deposits need to be market driven. No unremunerative business should be thrust upon the PACS and they should be allowed the discretion to accept or otherwise any non-credit business such as participation in Public Distribution System. Further, institution-specific investment policies need to be evolved taking into account, inter alia, composition of funds, maturity pattern of assets and liabilities, availability of money market instruments, exposure limits and efficient monitoring and control mechanism.

(f) De-layering in Cooperative Banks

The task force is of the view that continuance of the existing three-tier structure in the short-term cooperative credit structure in bigger states is generally necessary. However, measures should be taken to strengthen cooperatives, if necessary, by voluntary amalgamation/merger based on economies of scale, particularly in areas where CCBs are unviable and are not in a position to ensure uninterrupted credit flow to agriculture. Further, the integration of ST and LT structures into a 'single window' organization may be an advantageous proposition. In case a merger is not possible, both types of institutions may be allowed to handle long-term as well as short-term credit.

(g) Revitalization Package

The task force expressed an urgent need to initiate measures for the rehabilitation of potentially viable cooperative banks. Strengthening of base level institutions would be the key for strengthening the entire structure. The revitalization package for cooperative banks consists of a four-dimensional programme encompassing financial, operational, organizational and systemic aspects. The state of the Central Governments need to take the lead in formulating the rehabilitation package, which should be unit-specific and not across the board and should be taken-up after studying its viability and possibility of turnaround in five to seven years. Given the need to progressively reduce the control of the state governments over the cooperatives, the financial assistance from the state governments should be by way of loans and not in the form of equity. The financial burden of rehabilitation will be shared by members contributing 20 per cent of the costs by mobilising additional share capital. The balance amount will be equally provided by the Central and respective state governments by way of interest bearing bonds to be redeemed in a phased manner. In case of long-term structure, the members' contribution will be 10 per cent and balance amount will be shared equally by the Central and concerned state governments.

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(h) Cooperative Rehabilitation and Development Fund

A Cooperative Rehabilitation and Development Fund may be set up at NABARD by an initial contribution of ₹500 crore from the Central Government for implementation of the rehabilitation package in states which fulfil the necessary pre-conditions for such plans, and also for certain other purposes.

(i) Mutual Assistance Fund

Furthermore, Mutual Assistance Fund may be set up at the state level by contributions from cooperative institutions in the state for rendering assistance and providing soft loans to weak primary units to enable them to overcome temporary difficulties.

(j) Capital Adequacy

The cooperative banks need to move in the direction of strengthening their capital base and conform to the applicable norms over a period of time.

(k) Recovery Management

The task force suggests that the provisions of the existing DRT may be made applicable to cooperative banks also where loan size is more than ₹1 lakh so as to expedite recovery of chronic overdues. There is a need to evolve compromise/settlement procedure for closing of long pending overdue loans. The government should support the cooperative banks in their recovery efforts and desist from providing across the board interest subsidy and making loan waiver announcements.

(l) Internal Checks, Control and Audit

Lack of appropriate internal control systems like inspections, internal and concurrent audit and periodic branch visits by the higher tier officials in cooperative banks is a matter of increasing supervisory concern. This has led to poor MIS in these banks. These banks should strengthen their internal checks and controls and MIS so that supervision over these banks could be more effective. Audit of cooperative institutions should be conducted on a regular basis and the criteria for the audit classification should be uniform in all the states and be transparent. NABARD may formulate suitable guidelines for this purpose. The task force is of the view that audit at all levels may be entrusted to the firms of Chartered Accountants.

(m) Branch Licensing of CCBs

Branch licensing of CCBs needs to be brought under the provisions of the Banking Regulations Act, 1949.

(n) Transparency and Disclosure Norms

The apex cooperative banks and CCBs may be advised to disclose certain critical information in their balance sheets like movements in NPAs, provisions, return on assets, business per employee, profit per employee, etc.

Supervisory Framework for StCBS and CCBs

NABARD is the supervisory authority for State Cooperative Banks and Central Cooperative Banks. NABARD conducts inspection of these institutions under the provisions of the Banking Regulation Act. In addition, it has also been undertaking periodic inspections of state level institutions such as SCARDBS, Apex Weavers' Societies, Marketing Federations, etc., on a voluntary basis. Such inspections help in assessing the managerial and financial strength of a bank so as to ensure the protection of the interests of depositors as well as the bank's compliance with statutory regulations.

A Technical Group constituted in 1996 to review the inspection strategy adopted by NABARD had recommended adoption of CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Controls) approach for a sharper focus of NABARD's inspections. In order to have a further refinement in the inspection strategy, an Expert Committee to Review the Supervisory Role of NABARD was constituted in January 1998. The committee submitted its report in April 1998. The major recommendations of the committee are given in the next section.

The Expert Committee, while advocating the adoption of CAMELS approach, emphasized the need for adoption of timely and adequate compliance to inspection reports also as a criterion for judging the performance of banks. Accordingly, it recommended CAMELSC (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Controls, and Compliance) approach for inspections. As per the recommendations, the guidelines for on-site supervision of cooperative banks were revised in August 1998 since 1998–99. In order to effect continuous monitoring over banks, a system of off-site surveillance through a set of returns, both statutory and non-statutory, has been introduced.

Periodic on-site inspections may throw-up the need for in-depth scrutiny of certain aspects of operations. The Expert Committee has, therefore, recommended the on-site examinations to be supplemented by additional instruments like systems study, portfolio inspection, commissioned audit and monitoring visits. Necessary guidelines have already been developed to undertake such supplementary appraisals. As regards the recommendation relating to constitution of state level audit committees to bring about improvement in the quality and content of the audit, NABARD is pursuing the matter with the state governments. Further, to make the system of supervision meaningful and effective, NABARD is laying necessary emphasis on the timely and adequate compliance of the inspection findings by the institutions concerned.

Another recommendation which has already been implemented is the setting up of the Board of Supervision in NABARD in November 1999. The Board of Supervision, set up as an internal committee of the Board of Directors, is entrusted with, inter alia, the work of framing policy guidelines on matters relating to supervision and inspection, reviewing the inspection findings on cooperative banks (as also RRBs), and suggesting appropriate measures, identifying the emerging issues in the functioning of these cooperative banks and suggesting measures for strengthening the supervisory system in NABARD. The board meets frequently to review the working of banks especially those whose owned funds have been eroded due to high level of accumulated losses, provisions for NPAs, etc. With a view to giving special focus on the cooperative banking structure in individual states, the Board of Supervision has decided to make a state-wise review of the working of the cooperative banks for identifying the state's specific problems and taking-up the matter with the concerned state government. As per the recommendations of the Expert Committee, the on-site inspections of StCBs and SCARDBS are being decentralized in a phased manner.

In one area where most of the cooperative banks are found to be deficient is in respect of internal control system. Thus, NABARD has laid special emphasis on strengthening the internal control systems in banks, particularly the inspection of branches and affiliates and on effecting reconciliation of long pending entries and balancing of books. The banks have also been advised to introduce/update operational manuals for improving the internal checks and control systems. Exhaustive guidelines have been provided by NABARD to the cooperative banks in proper record maintenance. As internal audit and external audit are interrelated, bank managements were advised to strengthen their audit systems. To facilitate this, NABARD has been organizing the conference of Chief Cooperative Audit Officers of the state governments every year. The conference discusses arrangements for audit of cooperative credit institutions, measures needed for improving the audit systems and strategies for ensuring compliance to audit findings.

Supervisory Framework for UCBs

Duality/multiplicity of control of the credit cooperatives comes in the way of effective regulation and supervision of cooperative banks. The major issue in this context is the overlapping jurisdiction of the state governments and the RBI. Successive committees have recommended that there should be clear demarcation of areas of regulatory responsibilities between the state governments and the RBI. It has also been recommended that the RBI should regulate and supervise the banking operations of UCBs. Although the RBI has concurred with such recommendations and advised the state governments to undertake suitable legislative amendments, the issue has not been resolved so far. Given the serious implications of the lack of clear-cut jurisdiction over regulation of cooperative banks, it has been proposed by the RBI to rationalize this system by establishing a unified regulatory authority for UCBs with representatives of Centre, states and other interested parties. The Central Government, in turn, view that the issue be resolved through appropriate amendments in the Banking Regulation Act rather than through amendment of respective State Cooperative Societies Acts. Subsequently, RBI has submitted a draft bill which is under consideration of the government. In any case, if immediate

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measures are not taken to remove duality of control, it will be difficult to make the supervisory system effective.

Inspection

The on-site inspection cycle for scheduled UCBs and weak UCBs is once a year, while well managed non-scheduled UCBs are inspected once in three years. All other UCBs are inspected once in two years. The mechanism for evaluating performance on the basis of supervisory ratings based on CAMELS parameters are already in place for commercial banks. A similar rating system has been finalized for UCBs. Initially, such supervisory ratings would be made applicable to scheduled UCBs and the same would be extended to other UCBs in a phased manner. This would be implemented on trial basis for scheduled UCBs from March 2003.

Due to increased number of UCBs, the existing on-site inspection has come under severe strain. Consequently, a system of continuous off-site supervision has been put in place through a set of periodical prudential returns for UCBs. The returns cover asset and liability position, profitability, non-performing assets, details on credit portfolio and large exposures, etc. During the first phase of implementation of off-site supervision, scheduled UCBs were advised to submit quarterly returns commencing with their financial position as on 31 March 2001. It has been observed that in the past, some UCBs developed serious financial problems soon after they received licences. Various measures such as close monitoring of the submission of statutory returns by the banks, special scrutiny of their books of account in case of default in maintaining CRR/SLR, etc., have been initiated to step-up supervisory efforts towards such banks.

Financial audit is a key supervisory tool for monitoring implementation of various prudential norms including accounting, income recognition, asset classification, provisioning, etc. For UCBs, however, supervision of audit function falls within the purview of the respective state governments. A committee was set up in 1995 to review the system and procedures associated with audit of UCBs. The recommendations of the committee included professionalization of audit, mandatory concurrent audit of large banks, mandatory setting-up of audit committees for all UCBs, conduct of statutory audit by chartered accountants rather than government officials, etc. The RBI has accepted the recommendations and advised the state governments to implement them. To review the supervisory framework of UCBs on a regular basis and to recommend suitable steps to strengthen the existing system, a task force has also been formed headed by an Executive Director of the RBI.

Check Your Progress

1. Mention the act under which Union Cooperative Banks are registered.
2. What does rural cooperative credit include?

10.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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1. Urban cooperative banks are registered under Cooperative Societies Acts of the respective state governments.
2. Rural cooperative credit institutions include state cooperative banks (StCBs), district central cooperative banks (DCCBs), primary agricultural credit societies (PACs), state cooperative agriculture and rural development banks (SCARDBs) and primary cooperative agriculture and rural development banks (PCARDBs).

10.4 SUMMARY

- Urban cooperative banks are registered under Cooperative Societies Acts of the respective state governments.
- The High Power Committee on Urban Cooperative Banks (1999) made a number of recommendations concerning the regulatory aspects in relation to UCBs.
- The urban co-operative banking sector comprises a number of institutions which vary in terms of their size, nature of business and geographic spread.
- Urban cooperative banks form a heterogeneous group in terms of geographical spread, area of operation, size or even in terms of individual performance
- Licensing policy for UCBs was revised in August 2000, in consonance with the recommendations of the High Power Committee.
- NABARD is the supervisory authority for State Cooperative Banks and Central Cooperative Banks. NABARD conducts inspection of these institutions under the provisions of the Banking Regulation Act.

10.5 KEY WORDS

- **Fund:** A *fund* is a source of money that is allocated for a specific purpose.
- **Ivestment:** An *investment* is the purchase of goods that are not consumed today but are used in the future to create wealth.
- **Subsidy:** A sum of money granted by the state or a public body to help an industry or business keep the price of a commodity or service low is called subsidy.

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10.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are urban cooperative banks?
2. Mention the difference between Tier I and Tier II banks.
3. What is the role of high power committees in the working of urban cooperatives?
4. What are the functions of cooperative banks?

Long-Answer Questions

1. What is the Draft Vision Document for urban cooperatives?
2. What are the major recommendations of the high power committee on urban cooperatives? Discuss.
3. Discuss the working of Central Cooperative banks and State Cooperative banks?
4. Discuss the role of regional and rural banks.

10.7 FURTHER READINGS

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UNIT 11 PLACE OF PRIVATE SECTOR BANKS

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Structure

11.0 INTRODUCTION

Following the recommendations of the Narasimham Committee (I), there were recommendations that there shall be no barriers to new banks being set up in the private sector and in recognition of the need to introduce greater competition with a view to achieving higher productivity and efficiency of the banking system, the banking system was liberalized during the early 1990s. This unit discusses the role and functions of private sector banks in India.

11.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the role of private sector banks in India
- Discuss the functions of private sector banks in India
- Learn about the revised guidelines for private sector banks in India

11.2 ROLE AND FUNCTIONS IN INDIA

The Reserve Bank issued a set of guidelines in January 1993 for the entry of new private sector banks which are as follows:

(i) **Formation of Banks**—(a) Such a bank shall be registered as a public limited company under the Companies Act, 1956. (b) The decision of the Reserve Bank with regard to licensing under the Banking Regulation Act, 1949 (B.R.Act, 1949) and inclusion in the Second Schedule to the Reserve Bank of India Act, 1934 shall be final. (c) While granting a license, preference may be given to those banks the headquarters of which are proposed to be

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located in a centre which does not have the headquarters of any other bank. (d) Voting rights of an individual shareholder shall be governed by the ceiling of one per cent (since raised to 10 per cent in February 1994). However, exception may be granted under Section 53 of the said Act to public financial institutions. (e) The new bank shall not be allowed to have as a director any person who is a director of any other banking company and not more than three directors from companies which among themselves are entitled to exercise voting rights in excess of 20 per cent of the total voting rights of all the shareholders of the banking company as laid down in the B.R.Act, 1949. (f) The bank will be governed by the provisions of the Reserve Bank of India Act, 1934, the B.R.Act, 1949 and other relevant statutes. It would be subject to the directives, instructions, guidelines and advices given by the Reserve Bank. It would be expected to concentrate on core banking activities initially.

(ii) **Capital**—(a) The minimum paid-up capital for such a bank shall be ₹100 crore and the promoters' contribution shall be 25 per cent or 20 per cent in case the capital exceeds ₹100 crore. NRI participation in the primary equity of a new bank shall be to the extent of 40 per cent. In the case of a foreign company or foreign finance company as a technical collaborator or a co-promoter, equity participation shall be restricted to 20 per cent.

(b) The shares of the bank should be listed on stock exchanges. (c) A new bank shall be subject to prudential norms in respect of banking operations, accounting and other policies, norms for income recognition, asset classification and provisioning as well as capital adequacy of eight per cent of the risk weighted assets which will be applicable to such new bank from the beginning so also will be single borrower and group exposure limits.

(iii) **Operations**—(a) The bank shall have to observe priority sector lending targets as applicable to other domestic banks. However, some modifications in the composition of the priority sector lending may be considered by the Reserve Bank for an initial period of three years. (b) Such a bank will have to comply with Reserve Bank instructions in respect of export credit and may be issued an authorized dealer's licence when applied for. (c) The new bank shall not be allowed to set up a subsidiary or mutual fund for at least three years after its establishment. (d) The holdings of such a bank in the equity of other companies shall be governed by the existing provisions applicable to other banks, i.e., (i) 30 per cent of the bank's or the investee company's capital funds, whichever is less, and (ii) 1.5 per cent of the bank's incremental deposits during a year. The aggregate of such investments in other companies shall not exceed 20 per cent of the bank's own paid-up capital and reserves. (e) Such a bank shall have to lay down its loan policy within the overall policy guidelines of the Reserve Bank and shall specifically provide prudential norms covering related party transactions. (f) Such other conditions as the Reserve Bank may prescribe from time to time.

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(iv) **Opening of Branches**—Branch licensing shall be governed by the existing policy whereby banks are free to open branches at various centres including urban/ metropolitan centres without the prior approval of the Reserve Bank once they satisfy the capital adequacy and prudential accounting norms. However, a new bank will be required to open rural and semi urban branches also, as may be laid down by the Reserve Bank.

Revised Guidelines

Following the recommendations of the working group to review the licensing policy for setting-up of new private sector banks, in consultation with the Reserve Bank, guidelines were issued in January 2001 for entry of new banks in the private sector. The guidelines retained certain existing conditions on the entry of new banks such as promoters' capital share at 40 per cent, opening of new branches, etc. The proposed bank needs to observe the prescribed targets in respect of priority sector lending (40 per cent of net bank credit) as applicable to other domestic banks. The major changes in the revised guidelines are:

(i) The minimum paid-up capital for a new bank should be ₹200 crore, which shall be increased to ₹300 crore in subsequent three years after commencement of business.

(ii) The guidelines enable a non-banking financial company (NBFC) to convert into a commercial bank, if it satisfies the prescribed criteria of: a) minimum net worth of ₹200 crore; b) a credit rating of not less than AAA (or its equivalent) in the previous year; c) capital adequacy of not less than 12 per cent; d) net non-performing assets not more than 5 per cent.

(iii) A large industrial house should not promote any new bank. Individual companies, directly or indirectly connected with large industrial houses may, however, be permitted to participate in the equity of a new private sector bank up to a maximum of 10 per cent, but would not have controlling interest in the bank. The bank shall not extend any credit facilities to the promoters and companies investing up to 10 per cent of the equity.

(iv) Preference would be given to promoters with expertise of financing priority areas and in setting-up banks specializing in the financing of rural and agro-based industries.

The guidelines also prescribed 31 March 2001 as the last date for receipt of applications. At the first stage, the applications were screened by the Reserve Bank to ensure prima facie eligibility of the applicants. Thereafter, the applications were referred to a high level advisory committee, which submitted its recommendations to the Reserve Bank on 29 June 2001.

During the brief period of their existence, which started operations in April 1995, the performance of the new private sector has been impressive. It may be noted in this connection that they have the inherent advantage of strong capital base, lean and specialized manpower, customer orientation, control over operating expenses, access to latest technology and innovative services. Another important advantage which they have is that they are not straddled with non-performing assets which a chronic problem for the older banks as a result of accumulating these over the years.

Check Your Progress

1. What did the Narasimham Committee recommend?
2. When did the Reserve Bank of India issue a ser of giudelines for the entry of new private sector banks?

11.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Narasimham Committee recommended that there shall be no barriers to new banks being set up in the private sector.
2. The Reserve Bank issued a set of guidelines in January 1993 for the entry of new private sector banks.

11.4 SUMMARY

- Following the recommendations of the Narasimham Committee (I), there were recommendations that there shall be no barriers to new banks being set up in the private sector.
- The decision of the Reserve Bank with regard to licensing under the Banking Regulation Act, 1949 (B.R.Act, 1949) and inclusion in the Second Schedule to the Reserve Bank of India Act, 1934 shall be final.
- The minimum paid-up capital for such a bank shall be ₹100 crore and the promoters' contribution shall be 25 per cent or 20 per cent in case the capital exceeds ₹100 crore.
- The bank shall have to observe priority sector lending targets as applicable to other domestic banks.
- Following the recommendations of the working group to review the licensing policy for setting-up of new private sector banks, in consultation with the Reserve Bank, guidelines were issued in January 2001 for entry of new banks in the private sector.
- The guidelines also prescribed 31 March 2001 as the last date for receipt of applications.

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11.5 KEY WORDS

- **Operations**: The action of functioning or the fact of being active or in effect.
- **Capital:** Capital refers to wealth in the form of money or other assets owned by a person or organization or available for a purpose such as starting a company or investing.
- **Fund:** A fund refers to a sum of money saved or made available for a particular purpose.

11.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What is the role of private sector banks in India?
2. Mention any two recommendations of the new guidelines issued by the Reserve Bank of India in January 1993 for the entry of new private sector banks.
3. How have private sector banks contributed to banking sector in India?

Long-Answer Questions

1. What are the new guidelines issued by the Reserve Bank of India in January 1993 for the entry of new private sector banks?
2. What are the major recommendations of the new guidelines issued by the Reserve Bank of India in January 2001 for the entry of new private sector banks?
3. What are the major functions of private sector banks in India? Discuss.

11.7 FURTHER READINGS

Somashekar, NT. 2009. *Banking.* NewAge International. New Delhi.

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BLOCK - IV
BANKER AND CUSTOMER SYSTEM

UNIT 12 BANKERS AS BORROWERS

NOTES

Structure

12.0 INTRODUCTION

The modern banking requires that a constituent should either be known to the banker or should be properly introduced. The bank owed a duty to make enquiries directed to discover whether a new constituent might use the account for any fraudulent purposes. The underlying object of the bank insisting on producing reliable reference is only to find out, if possible, whether the new constituent is a genuine party or an impersonator or a fraudulent rogue … (however) the burden of establishing good faith and absence of negligence is on the defendant. The bank has to establish that they acted without negligence not only in the receipt of the payment of the cheque amount but even earlier at the time of opening the account.

This unit discusses the precautions to be taken before opening accounts and discusses the significance of fixed deposit receipts.

12.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the precautions to be taken before opening accounts
- Discuss the significance of fixed deposits
- Know about the KYC norms
- Learn about the benefits of other deposits

12.2 PRECAUTIONS TO BE TAKEN BEFORE OPENING ACCOUNTS

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Before opening an account, the banker should obtain references from respectable parties as to the proposed customer's integrity and respectability. By allowing a person to open an account without satisfactory reference, the banker would be inviting unpleasant consequences. In the first place, by obtaining possession of a cheque book, a dishonest person may use it for nefarious purposes. Secondly, he may happen to be undischarged bankrupt in which case the banker would be facing serious consequences. Thirdly, the banker may inadvertently allow an overdraft, which can be realized only if the customer is a solvent party. Fourthly, omission to make enquiries regarding a customer before opening an account in that person's name is likely to make the banker guilty of negligence. In this connection, the observations made by Justice Bailhache in Ladbroke vs Todd are of considerable importance. According to these observations, the bank acted negligently, for they did not make ordinary enquiries which ordinary, reasonable people should make in opening an account. It is true that in Bapulal Premchand vs Nath Bank Ltd, it was held by Justice Chagla that it was not obligatory upon a bank to make enquiries as to the respectability of a customer in order to avail itself of the protection given under Section 131 of the Negotiable Instruments Act. However, in the more recent case of Union of India vs National Overseas and Grindlays Bank (1978), the Court observed:

In short, the safer course for the banker would be to obtain references as to the respectability and integrity of a proposed customer before opening an account. As a matter of fact, it is customary for the banks in India to insist on the introduction by an existing customer of the branch before opening a new account. They also insist on the Permanent Account Number (PAN) supplied by the Income Tax Department, wherever applicable, and two copies of the passport size photographs of the new customer.

KYC (Know Your Customer) Norms

A brief mention on the KYC norms may not be out of place in this connection. Restricting money laundering and terrorist financing was the main objective of KYC norms when it was introduced during the late 1990s in the USA. Following the USA Reserve Bank of India directed all banks to implement KYC guidelines for all new bank accounts in 2002. The Bank directed all banks to put in place a policy framework to know their customers before opening any account. This involved verifying customers' identity and address by requiring them to furnish documents which are accepted as relevant proof. Proof of identity and proof of residence are the mandatory requirements required under KYC norms. Passport, Voters ID Card, PAN Card and driving license are accepted as proof of identity while proof of residence can be a ration card, an electricity/telephone bill or a letter from the employer or any recognised public authority certifying the address. Verification by an existing account holder is also required in some cases. While the standard documents which are accepted as proof of identity and proof of residence are the same for all banks, some deviations are permitted which differ from bank to bank.

All documents shall be checked against bank's requirements in order to ascertain whether they match before initiating an account opening process.

After satisfying himself as to the respectability and integrity of the customer, the banker must obtain his/her specimen signature. This should be kept in such a manner as to facilitate quick references.

The customer's full name, address and occupation should be written above his account in the ledger. If the customer is allowed to overdraw, particulars regarding the same should also be recorded. In the case of joint accounts or partnerships or limited companies, etc., the name of the person/persons authorized to operate on the account should be clearly stated.

The banker should get from his customer a mandate, if the customer intends to operate on his account by another person. The mandate should specify the power delegated to the mandatory. It should be noted here that an authority to draw and endorse cheques does not imply the authority to overdraw the account. Specimen signature/s of the person/s authorized to operate on the account should also be given in the mandate. These particulars should be entered on the ledger.

12.3 SIGNIFICANCE OF FIXED DEPOSIT RECEIPTS

In addition to accepting money on current/savings bank accounts, bankers receive money on deposit accounts undertaking to repay the amounts on the expiry of a specified period, or subject to a notice. Bankers generally prefer deposits which are repayable after the expiry of a specified period. Such deposits are known as 'fixed deposits'.

When a person deposits money with the banker on a fixed deposit, a 'Deposit Receipt' is given to him by way of an acknowledgment of the amount deposited. This document is usually marked 'not negotiable' which means that it can not be transferred by mere endorsement and delivery. It was held in Evans vs National Provincial Bank of England that payment to a person wrongfully dealing with even a signed deposit receipt was no discharge to the bank, unless the depositor was stopped by his conduct from disputing such payment.

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However, the deposit receipt can be assigned provided due notice of assignment is given to the banker. But it may be noted here that the banker would be entitled to recover from the deposit amount any money owing to him from the depositor at the time of the receipt of such a notice.

In some cases, the banker may make the signing of the deposit receipt a condition precedent to the withdrawal of money. In such cases, it is necessary to produce the deposit receipt duly signed at the time of withdrawal. Nevertheless, the banker can not refuse payment in the case of loss of deposit receipt. He can pay the amount safely after obtaining an ordinary indemnity from the customer. It may be noted here that the deposit receipt not being a negotiable instrument, any holder other than the customer will not get a valid title.

A deposit receipt has been held to be a good subject of donation mortis causa (i.e., a gift made in contemplation of death and to take effect only in the event of death).

A depositor is not legally entitled to draw cheques against fixed deposits. But in the case of deposit accounts repayable on demand, there is a conflict of judicial opinions. In Hopkins vs Abbot, it was held that cheques could be drawn against deposit accounts repayable on demand. On the other hand, according to Dr H.L. Hart and Sir John Paget, a depositor is probably not entitled to draw cheques against deposit accounts repayable on demand. Some banks have a cheque form printed at the back of the deposit receipt. This, however, does not change the nature of the deposit account.

A fixed deposit is attachable by a garnishee order as the order attaches funds due or accruing due.

In the case of insolvency of a depositor, the amount should go to the Official Assignee. In the case of the death of the depositor, the amount should go to his personal representatives.

Fixed deposit accounts may be opened in the name of minors and they can give a valid discharge for the deposit amount repaid to them.

Fixed deposit accounts may be opened in the name of joint parties. Here, all the parties should combine in withdrawal. In the case of death of one or more of the parties, the property passes on to the survivor/s whom the banker can safely pay. When the deposit is in the joint names of husband and wife, as mentioned earlier, this rule does not apply. On the death of the husband, the property does not pass on to the widow unless it can be proved that the husband opened the account with the deliberate intention of making a provision for his wife in case of his untimely death. In Nagarajamma vs State Bank of India, it was held that a fixed deposit in the joint names of a husband and wife payable to either or survivor would not, on the death of the husband, constitute a gift by the husband to his wife. The decision was followed in Guru Datta vs Ram Datta. If, however, the wife dies first, in the absence of any express instruction to the contrary, the property passes on to the husband.

Deposit receipts given by bankers are exempted from stamp duty.

In the case of a fixed deposit account, the law of limitation begins to run from the expiry of the fixed period. If the account is a deposit account repayable after the expiry of a specified period's notice of withdrawal, the law of limitation begins to operate immediately after the money is due to be repaid. If the account is a deposit account repayable on demand, the law begins to operate from the date when a demand for repayment has been made by the depositor.

Check Your Progress

1. What was the main objective of KYC norms when it was introduced during the late 1990s in the USA?
2. What are Fixed Deposits?

12.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Restricting money laundering and terrorist financing was the main objective of KYC norms when it was introduced during the late 1990s in the USA.
2. Bankers generally prefer deposits which are repayable after the expiry of a specified period. Such deposits are known as 'fixed deposits'.

12.5 SUMMARY

- Before opening an account, the banker should obtain references from respectable parties as to the proposed customer's integrity and respectability.
- By allowing a person to open an account without satisfactory reference, the banker would be inviting unpleasant consequences. In the first place, by obtaining possession of a cheque book, a dishonest person may use it for nefarious purposes.
- The modern banking requires that a constituent should either be known to the banker or should be properly introduced.
- A brief mention on the KYC norms may not be out of place in this connection. Restricting money laundering and terrorist financing was the main objective of KYC norms when it was introduced during the late 1990s in the USA.
- All documents shall be checked against bank's requirements in order to ascertain whether they match before initiating an account opening process.
- The customer's full name, address and occupation should be written above his account in the ledger.

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- In addition to accepting money on current/savings bank accounts, bankers receive money on deposit accounts undertaking to repay the amounts on the expiry of a specified period, or subject to a notice.
- Bankers generally prefer deposits which are repayable after the expiry of a specified period. Such deposits are known as 'fixed deposits'.
- When a person deposits money with the banker on a fixed deposit, a 'Deposit Receipt' is given to him by way of an acknowledgment of the amount deposited.
- In the case of a fixed deposit account, the law of limitation begins to run from the expiry of the fixed period.

12.6 KEY WORDS

- **Fixed Deposit:** A fixed deposit (FD) is a financial instrument provided by banks or NBFCs which provides investors a higher rate of interest than a regular savings account, until the given maturity date
- **Ledger:** Ledger refers to a book or other collection of financial accounts.
- **Nominee:** Nominee refers to a person or company, not the owner, in whose name a stock, bond, or company is registered.

12.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are the precautions to be taken before opening a bank account?
2. Why is it important to insist on the introduction by an existing customer of the branch before opening a new account in India?

Long-Answer Questions

1. 'The modern banking requires that a constituent should either be known to the banker or should be properly introduced.' Comment on the statement with reference to the text.
2. What are the Know Your Customer (KYC) norms of a bank?
3. What is the significance of Fixed Deposits?
4. What is the procedure of applying for a Fixed Deposit in a bank?

12.8 FURTHER READINGS

NOTES

Somashekar, NT. 2009. *Banking.* NewAge International. New Delhi.

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UNIT 13 BANKER AND CUSTOMER: RELATIONSHIP

NOTES

Structure

13.0 INTRODUCTION

Under Section 5(1) of the Banking Regulation Act, 1949, a banking company is defined as 'any company which transacts the business of "banking"'. Under Section 5 (1) (b) 'banking'—means the accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the definition of banker and customer
- Discuss the relationship between banker and customer
- Learn about the agency services

13.2 DEFINITIONS OF THE TERMS BANKER AND CUSTOMER

Let us understand the definitions of the terms 'banker' and 'customer'.

The Banker

There has been much controversy regarding the definition of the term 'banker.' According to Macleod:

The essential business of a 'Banker' is to buy money and debts, by creating other debts. A banker is therefore essentially a dealer in debts, or credit.

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But this definition is not considered a satisfactory one since it does not make any distinction between a banker and a moneylender. A moneylender is also a dealer in credit. He lends money on the credit of the borrowers or on their securities. A better definition is that of Dr H.L. Hart. According to him:

A banker or a bank is a person or a company carrying on the business of receiving moneys, and collecting drafts, for customers subject to the obligation of honouring cheques drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts.

According to this definition, the essential function of a banker is the acceptance of deposits of funds withdrawable on demand. Sir John Paget states that no one can be a banker who does not take deposit accounts, take current accounts, issue and pay cheques, crossed and uncrossed, for his customers. He further adds that if the banking business carried on by any person is subsidiary to some other business, he can not be regarded as a banker.

Section 3 of the Negotiable Instruments Act, 1881 corresponding with Section 2 of the Bills of Exchange Act 1882, states that the term 'banker' includes persons or a corporation or a company acting as bankers. But this definition is not at all a satisfactory one because the Act does not state as to who can act as bankers.

The Customer

The term 'customer' also presents some difficulty in the matter of definition. There is no statutory definition of the term either in India or in England. However, the legal decisions on the matter throw some light on the meaning of the term. Thus, in Great Western Railway Company vs London and County Banking Company, a customer was defined as a person who has some sort of an account, either deposit or current account, or some similar relation with a banker. It implies that any person or corporate body may become a customer by opening a deposit account or current account, or by negotiating an advance on current or loan account.

According to Sir John Paget, to constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business. As far as the condition that the transaction should be in the nature of regular banking business is concerned, there is unanimity. A casual transaction like the encashment of a cheque cannot be considered to constitute a person as a customer of a bank. But it is difficult to reconcile with the idea of Sir John Paget when he states that there must be some recognizable course or habit of dealing in order to constitute a person as a customer of a bank. According to this view, a single transaction will not constitute a customer.

A more acceptable view is expressed in Ladbroke vs Todd. According to the Judge:

'The relation of banker and customer begins as soon as the first cheque is paid in and accepted for collection. It is not necessary that the person should have drawn on any money or even that he should be in a position to draw any money'.

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Therefore, neither the number of transactions nor the period during which business has been conducted between the parties is material in determining whether or not a person is a customer. The same view was expressed in the case of Commissioners of Taxation vs English, Scottish and Australian Bank Ltd. The Judge observed:

'The word 'customer' signifies a relationship in which duration is not of essence. A person whose money has been accepted by the bank on the footing that they undertake to honour cheques up to the amount standing to his credit is a customer of the bank in the sense of the statute irrespective of whether his connection is of long or short standing. The contrast is not between a habitual and a newcomer, but between a person for whom the bank performs a casual service, e.g., cashing a cheque for a person introduced by one of their customers, and a person who has an account of his own at the bank'.

To sum up, the mere opening of an account will constitute a person a customer of a bank, irrespective of whether his connection is of long or short standing.

Check Your Progress

1. Define banker.
2. What is the essential business of a banker?

13.3 RELATIONSHIP, FUNCTIONS, SUBSIDIARY AND AGENCY SERVICES

The true relationship between a banker and a customer is that of a debtor and a creditor. The banker, when he receives money from a customer, does not hold the money in a fiduciary capacity. Money left with him is at his disposal, subject to the obligation to honour cheques of the customer up to the amount of any credit balance in his account or up to the limit of any overdraft which the banker has agreed to allow. The observations made in Foley vs Hill bring out clearly the relationship between the banker and the customer. According to the Judge:

'Money when paid into a bank ceases altogether to be the money of the principal; it is then the money of the banker, who is bound to return an equivalent amount by paying a similar sum to the depositor when he is asked for it. The money paid into the bank is money known by the principal to be placed there for the purpose of being under the control of the banker; it is then the banker's money; he is known to deal with it as his own, he makes what profit he can, which profit he retains to himself; paying back only the principal, according to the custom of the bankers in some places, or the principal and a small rate of interest, according to the custom of bankers in other places. That being established to be the relative

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situations of banker and customer, the banker is not an agent or factor, but he is a debtor.'

A Debt By a Banker vis-à-vis an Ordinary Commercial Debt

A debt due by a banker differs from an ordinary commercial debt in one important respect, namely that it is not due unless demanded. In the case of an ordinary commercial debt, a request by the creditor for payment is unnecessary. In the Jochimson case, it was held that, it is necessarily a term of such contract that the bank is not liable to pay the customer the full amount of the balance until he demands payment from the bank at the branch at which the account is kept.

Law of Limitation and a Debt by a Banker

Based on the decision in the Joachimson case, the limitation period, in the case of a current or savings bank account, does not begin to run until the customer has made a demand for repayment which has not been complied with by the banker irrespective of whether or not interest has been credited to the account.

In the case of deposit accounts repayable on demand, the law of limitation does not begin to run until demand has been made for repayment. It has been held in the Jammu and Kashmir Bank Ltd vs Chandra Prakash that as far as money of a customer in the hands of a banker payable on demand is concerned, the period of limitation would run from the date of demand for repayment and not from the date of refusal. In the case of deposit accounts subject to notice, the law does not begin to run until the expiry of the stipulated notice of withdrawal given by the customer.

In the case of a fixed deposit, the law of limitation begins to run from the date at which the depositor is entitled to be repaid. It should be remembered here that the law does not apply so long as interest is being paid on it or so long as the deposit receipt is renewed. If it is a condition precedent to the withdrawal of money that the receipt must be returned to the banker, the law will run only from the date on which the receipt is produced.

Cases where the Banker is a Trustee and an Agent

Under certain circumstances, bankers enter into fiduciary relations with their customers. For instance, when a banker receives valuables for safe custody he acts as a trustee. The property in them does not pass on to the banker. Again, when he buys or sells securities on behalf of his customer he acts as an agent.

Special Features of the Relationship

Appropriation of Payments

When money is paid in by the customer, or when the banker receives money from third parties for the credit of the customer, the customer has a right to say that it should be placed to a particular account, or should be applied in payment of a particular debt or in meeting certain cheques or bills. The banker is bound to appropriate it accordingly, irrespective of the state of accounts between them. But if the customer does not make any specific appropriation, the banker can appropriate, and apply the payment even to a statute-barred debt. When the method of appropriation is communicated to the customer, it becomes irrevocable.

In case there is a current account, and neither the banker nor the customer makes any specific appropriation, then any successive payments will be appropriated in accordance with the Rule in Clayton's Case. According to this rule, it is the first sum paid in that is first paid out. Thus, it is the first item on the debit side that is discharged or reduced by the first item on the credit side. It should be noted that the rule applies only to a current or running account.

Banker's Right of Set-off

As far as the banker's right of set-off is concerned, there is a conflict of judicial opinions. In Garnett vs Mckervan, it was held that , in the absence of a special agreement to the contrary, a banker might set-off a customer's credit balance against a debt due to him from the customer and that there was no legal obligation on a bank to give notice to a customer about its intention to combine accounts. But in Greenhalgh and Sons vs Union Bank of Manchester, the Judge observed:

'If the banker agrees with his customer to open two accounts or more; he has not in my opinion, without the assent of the customer, any right to move either assets or liabilities from one account to the other; the very basis of his agreement with his customer is that the two accounts shall be kept separate.'

Again, in Jinda Ram vs Central Bank of India Ltd, it was held that where there are two separate partnership firms and these firms have two distinct and separate accounts, the bank is entitled to appropriate monies belonging to one of the firms for the repayment of an overdraft of another firm. The Court observed that although two separate firms were involved they were not separate legal entities.

In view of these conflicting judicial opinions, the banker can be on the safer side by taking an agreement from the customer authorizing him to combine the accounts at any time without notice and to return cheques which, as a result of his having taken such an action, would overdraw the combined account.

However, in such cases as the death or bankruptcy of the customer, the banker can exercise the right of set-off without notice even in the absence of an agreement, in order to ascertain the net amount owing to him.

At the same time, it may be noted that the right of set-off cannot be exercised by the banker if he has made some agreement, express or implied, to keep the accounts separate. This has been laid down in Halesowen Presswork and Assemblies Ltd, vs Westminster Bank Ltd.

Another point to be noted in this connection is that the banker cannot exercise his right of set-off if the accounts are not in the same right. For instance, the

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banker cannot set-off the credit balance on a partner's account against a debt due on the partnership firm's account and vice versa.

Further, the banker cannot combine a trust account with the personal account of the customer.

Again, the right of set-off applies only to existing debts and not to contingent liabilities. Thus in Jeffryes vs Agra and Masterman's Bank Ltd, the Judge observed:

'You cannot retain a sum of money which is actually due against a sum of money which is only becoming due at a future date.'

Also, the right of set-off does not apply where the customer has deposited an amount taking a loan from a third party on condition that the money is repayable if not used for a particular purpose, the bank having notice of the condition attached to the loan and where the customer is unable to utilize the loan due to liquidation as was decided in Quistclose Investments Ltd vs Rolls Razor Ltd and others (in voluntary liquidation) .

Banker's Obligation to Honour the Customer's Cheques

Section 31 of the Negotiable Instruments Act, 1881 imposes a statutory obligation upon the banker to honour the cheques of his customer drawn against his current account so long as his balance is sufficient to allow the banker to do so, provided the cheques are presented within a reasonable time after their ostensible date of issue. The section runs as follows:

'The drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheque must pay the cheque when duly required so to do and in default of such payment must compensate the drawer for any loss or damage, caused by such default'.

The statutory obligation may be extended by an agreement, express or implied, to the amount of overdraft agreed upon. But after giving sufficient notice, a banker can withdraw any overdraft limit already granted. In Mohammed Hussain vs Chartered Bank, the Court referred to the decision in Rouse vs Bradford Banking Company. Wherein it was held that it may be that an overdraft does not prevent the bank who have agreed to give it, from at any time giving notice that it is no longer to continue and they must be paid their money'. But if the bankers 'have agreed to give an overdraft, they cannot refuse to honour cheques, or drafts, within the limit of that overdraft, which have been drawn and put into circulation before any notice is given to the customer that the limit is withdrawn. The circumstances under which a banker is justified in dishonouring his customer's cheques are discussed elsewhere.

Before dishonouring a cheque of his customer, the banker must make it certain that circumstances permit him to do so. Otherwise, he will be liable to pay damages to the customer for injuring his credit. A businessman can recover substantial damages without pleading and proving actual damage as was held in Robin vs Steward. But in the case of a non-trading customer, only nominal damages

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will be awarded unless the damages are alleged and proved as special damages as was held in Gibbons vs Westminster Bank Ltd. In this connection it may be mentioned that the wrongful dishonour of a cheque for a small amount usually constitutes greater damage to the credit of the customer than the dishonour of a cheque for a larger amount as was held in Davidson vs Barclays Bank Ltd.

As observed earlier, when computing the customer's balance, the banker need only to take into account his credit balance at the branch on which the cheque is drawn. In Mohammed Hussain vs Chartered Bank, the court observed that though the bank had the right to combine several accounts of the customer, the customer had no right to require the bank to combine the different accounts in determining whether a cheque on an account may be dishonoured. The Court cited the following passage from Halsbury's Laws of England.

'Unless precluded by agreement, express or implied from the course of business, the bank is entitled to combine different accounts in his own right even though at different branches of the same bank, and to treat the balance, if any, as the only amount standing to his credit… . The customer, however, has not the equivalent right, and cannot utilize a credit balance at one branch for the purpose of drawing cheques on another branch where he has no account or where his account is overdrawn.'

In the absence of an express or implied agreement giving the customer a right to draw cheques against uncleared items, the banker is entitled to return such cheques with the answer 'effects not cleared' as was held in Underwood vs Barclays Bank Ltd. Here it should be remembered that an implied agreement would arise from some established course of business. Thus, if the banker has been following the practice of honouring his customer's cheques drawn against uncleared items, he cannot, without reasonable notice, return cheques with the answer 'effects not cleared'.

The duty of the banker to honour the cheques of his customer, unless improperly drawn, does not apply to bills of exchange accepted by the customer and made payable by the banker. Here also, an implied agreement would arise from some established course of business.

The liability of a banker for wrongful dishonour of acheque is only to the drawer and not the payee of the cheque. In Meghaji Malsee Ltd vs P.C. Ommen, one of the points which arose for consideration was whether the plaintiff company, which was the holder of the cheque, could hold the drawee bank liable. The Court referred to Section 31 of the Negotiable Instruments Act which deals with the liability of the drawee of a cheque and observed that the said section referred to the liability of the drawee to the drawer and not to the payee of the cheque. The Court also referred to the following observations of the Supreme Court in Jagjivan Mavji vs Ranchhoddas Meghaji:

'There is no provision in the Act that the drawee is as much liable on the instrument, the only exception being under Section 31 in the case of a drawee of a cheque having sufficient funds of the customer in his hands, and even then, the liability is only towards the drawer and not the payee. This is elementary law… .'

Banker's Duty to Maintain Secrecy of the Customer's Account

Because of the peculiarly private character of the transactions between the banker and the customer, the banker should not divulge to third parties the state of the customer's account except on reasonable and proper occasions. If the banker fails in his duty, he will be liable for damages which may be substantial in case the credit of the customer has suffered serious injury. According to Sir John Paget, this duty of the banker to maintain secrecy does not end even with the closing of the customer's account. Further it has been laid down in Tournier vs National Provincial Bank of England that this secrecy applies not only to information derived by the banker from the customer himself or from his account but also to information concerning the customer's credit that may come into the banker's possession in his capacity as a banker. In the instant case, a customer of the National Provincial Bank drew a cheque in favour of Tournier who, in turn, endorsed it in favour of a third party who had an account with another bank. On return of the cheque to the National Provincial Bank, the manager of the bank enquired as to who the person to whom the cheque was paid. The manager was told that the person was a book-maker. Tournier sued against the National Provincial Bank on the ground that the manager disclosed information that Tournier was a book-maker to outsiders. The Court held that the disclosure constituted a breach of duty on the part of the National Provincial Bank to Tournier.

However, the duty to maintain secrecy is not absolute, but qualified. The following qualifications have been cited as examples by the Judge in the above quoted Tournier case.

- Where disclosure is under compulsion of law.
- Where there is a duty to the public to disclose.
- Where the interests of the bank require disclosure.
- Where the disclosure is made in accordance with an express or implied consent of the customer.

In addition to the above qualifications, there is a practice among bankers of giving opinion to one another concerning the creditworthiness of customers. In such cases, the banker should confine himself to general statements and should not disclose the details of the account, unless specifically authorized to do so.

It is also important that the banker should not make statements which may make him liable for defamation or fraudulent misrepresentation. If the banker makes any statement knowing it to be false and if any third party suffers a loss for having relied on the statement, the banker will be held liable to such third party to whom the information is given.

It may be noted in this connection that till recently it was believed that as far as a banker's liability to a third party was concerned, he could not be held liable

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for any false information given negligently since there was no contractual relationship between the banker and a non-customer. But the decision in Hedley Byrne and Co. Ltd, vs Heller and Partners Ltd, indicates that action for professional negligence may arise if financial loss is suffered by third parties through their reliance on the professional skill and judgment of persons with whom they are not in contractual or fiduciary relationship. According to the facts of this case, before entering into a transaction with A, the plaintiffs sought a reference to A's standing from A's bankers. The bankers provided the reference, stating therein that they accepted no responsibility for its accuracy. The reference proved to be misleading and the bankers had been negligent. As a result of the loss suffered by the plaintiffs, they sued the bankers for negligence. The House of Lords held:

(a) that the bankers could be held liable for negligence contained in a reference; but

(b) that the disclaimer of liability in the reference exonerated them from liability on the particular facts of the case.

The banker should decline to give any information in response to enquiries from an outsider who is not a banker, in the absence of an express authority from the customer concerned. While declining to give information, care should be taken to see that he does not state anything which is likely to injure his customer's credit.

Banker's Lien

Another feature of the relationship between the banker and the customer is the banker's right of lien over such of his customer's securities as may come into his possession in the ordinary course of business. A 'lien' may be defined as the right to retain property belonging to a debtor until he has discharged a debt due to the retainer of the property.

A distinction may be made between a 'general lien' and a 'particular lien'. A 'particular lien' confers a right to retain the goods in respect of a particular debt involved in connection with a particular transaction. A 'general lien' confers a right to retain goods not only in respect of debts incurred in connection with a particular transaction but also in respect of any general balance arising out of the general dealing between the two parties.

Banker's lien is a general lien. It has been held in Brandao vs Barnett that bankers have a general lien on all securities deposited with them as bankers by a customer, unless there is an express contract, or circumstances that show an implied contract, inconsistent with the lien.

Further, in the same judgment, a banker's lien has been defined as an implied pledge. An ordinary lien does not imply a power of sale; but a pledge does. But a banker's right of sale is generally regarded as extending to only fully negotiable securities. It is not clear whether the banker's right of sale extends to securities which are not fully negotiable. Most cases concerning lien have applied to negotiable securities and, in the absence of legal decision on the matter, it seems advisable to regard a banker's lien on non-negotiable securities as conferring only a right to retain them until his demands have been satisfied.

Section 171 of the Indian Contract Act has specifically conferred upon the banker the right of general lien. In terms of this section, a banker has a general lien on cash, cheques, bills of exchange and securities deposited with him in his character of a banker for any money due to him as banker.

Cases where the Banker Cannot Exercise His Right of Lien

1. In the case of securities deposited with the banker for safe custody only, the banker is acting as a bailee and has no lien over such articles.
2. In the case of funds and securities specifically appropriated, the banker cannot exercise his right of lien because there is an express contract inconsistent with the lien as was held in Krishna Kishore Kar vs Uco Bank.
3. A bank has no right of lien in respect of money deposited by a customer or a credit balance earmarked by the customer for a specific purpose, although the right of lien applies where the bank has no express or implied notice of the purpose of the deposit.
4. Right of lien is not exercisable where documents or valuables are left in the hands of the banker inadvertently. But where the securities are left in the hands of the banker even after the loan for which the securities were given as collateral is repaid, right of lien is exercisable over them. By leaving the securities with the banker, the customer is supposed to have re-deposited them with the banker as was held by the House of Lords in the case of London and Globe Finance Corporation. The position was endorsed in India by the Supreme Court in Syndicate Bank vs Vijay Kumar. In the instant case, certain fixed deposit receipts held by the bank to cover a guarantee issued by the bank were allowed to be retained by the bank as general lien even after the discharge of the guarantee. The decision was followed in State Bank of India vs Deepak Maviya. The decision by the National Consumer Disputes Redressal Commission in State Bank of India vs Jawaharlal was also similar.
5. A general lien cannot arise in respect of property of a customer pledged as security for a particular debt.
6. The banker cannot exercise his right of lien in respect of property coming into his hands by mistake, or which is placed in his hands to cover an advance that is not granted as was held in Lucas vs Dorrien.
7. No lien arises until the due date in respect of an advance of a specific amount for a definite period.
8. No lien arises in case the credit and liability do not exist in the same right. Thus, the banker cannot exercise his right of lien over the securities or funds of a partner in respect of a debt due from the partnership firm.

9. The banker cannot exercise his right of lien in respect of a separate account maintained by the customer which is known to the banker as a Trust Account.
10. No lien arises over properties on which the customer has no title.

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Banker's Right to Charge Interest and Commission

A banker is entitled to charge interest on loans, either by express agreement or by right of custom or usage of trade. He is also allowed to charge compound interest unless there is an agreement to the contrary.

In the absence of an express agreement, or without due notice, a banker is not entitled to debit his charges at any other than the customary dates. And if the banker dishonours his customer's cheques owing to lack of funds by reason of his having done so, he may be held liable for unjustifiable dishonour.

The banker is also entitled to charge commission for services rendered to his customer.

Garnishee Orders

A 'garnishee order' is an order of the Court, obtained by the judgment creditor attaching funds in the hands of a third party who owes judgment creditor money, warning the third party (the Garnishee) not to release money attached until directed by the Court to do so. For instance, if A obtains judgment in respect of a debt due to him from B, A may apply to the Court for a garnishee order attaching funds in B's bank account.

Before issuing an absolute garnishee order, a garnishee order nisi is issued to the banker. In the case of a garnishee order nisi, although the order attaches funds in the hands of the banker (the garnishee), an opportunity is given to him to show cause why the funds should not be handed over to the judgment creditor. On the banker failing to show sufficient cause, the order is made absolute. The banker should not pay over funds until the order is made absolute as he has no authority for payment under an order nisi.

When a garnishee order is served on a banker, he should attach all funds due or accruing due. The term 'accruing due' means debts already incurred, but payable on a future date. It does not include debts not existing at the time the order is served. In the case of a current or savings bank account, although it might appear that it is not a debt due until a demand for repayment is made, the garnishee order itself operates as a demand for repayment sufficient to render money in that account immediately repayable as was held in the Joachimson Case.

Thus, a current/savings bank account is attachable by a garnishee order. So also a deposit account repayable on demand is attachable by a garnishee order. Further, the following kinds of deposits are attachable:

1. A deposit repayable on fixed notice, provided the notice has been given before the order is received. However, under Section 38 of the Administration of Justice Act, 1956, a deposit account in England is

attachable by a garnishee order, notwithstanding any condition as to return of the receipt or the absence of a notice.

2. A deposit repayable on a fixed date. In this case it is a debt accruing due.

Therefore, when the banker is served with a garnishee order, he should stop operations on the accounts of the customer. It must remain dormant until the order is discharged. Nevertheless, the banker can open a new account and operate it during the garnishee proceedings. The new account is not attachable by the garnishee order as it attaches only debts due or accruing due at the date when the order is served and not future debts. Further, in the case of a limited garnishee order (where the sum attachable is specified), the banker can transfer any credit balance to a new account with the consent of the customer, and this new account can be allowed to be operated freely.

Before paying the amount in accordance with a garnishee order, a banker is entitled to deduct from the customer's credit balance all debts due to him at the date of the order. For this purpose, he can combine all the accounts of his customer. But he is not entitled to retain moneys against contingent liabilities. Nor is he entitled to transfer the balance in the current account to a loan account to defeat a garnishee order.

In England, the Court, by issuing a writ, commands the sheriff to seize the goods and bring them to the court. In India, the Court levies attachment by issuing a prohibitory order, which basically restricts or restraints the alienation of the attached property. Therefore, in England, as soon as the garnishee order is served, the attaching creditor becomes a secured creditor. But in India, that would not be so merely on the serving of a garnishee order. However, the position of law in India would not be unlike that prevailing in England when pursuant to the order of attachment or by the coercive process, the moneys attached are actually brought into the Court as was held in Rikhabchand Mohanlal Surana vs the Sholapur Spinning and Weaving Co. Ltd. In the instant case, the High Court opined that, although so long as the attachment order is of a prohibitory nature, the creditor may not have any rights or security in the property. Once the money is brought into the Court, the attaching creditor is entitled to insist that that money should be handed over to him in satisfaction of his decree. The High Court agreed with the statement in Halsbury's Laws of England that the judgment creditor is entitled to insist on payment to himself by the garnishee. The High Court observed that the attaching creditor, having taken steps to obtain payment against the decree, can not be told that the Court is holding moneys not for him but for the debtor, more so when the garnishee obtains complete discharge by making payment in the Court. In the result, the attaching creditor was held to be secured creditor.

Where Funds are not Attached by a Garnishee Order

1. In the case of funds coming into the banker's hands subsequent to the receipt of the garnishee order, they are not attached. This is because a garnishee

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order attaches funds due or accruing due as on the date of the garnishee order. It may be noted here that the date of attachment and not the date on which the application for attachment is made that is material. In other words, the attachment of the debt due to the judgment debtor is not illegal because application for attachment is made before it became due as was held in Nandikatta Anjana and others vs Bandi Ramakrishna and others. In this case, it was not disputed that the application for attachment was made before the debt fell due for payment though the attachment was actually levied after the debt became due. It was contended that the application having been made prior to date on which the debt became due, the attachment order should be deemed to be one in respect of a contingent debt and was, therefore, bad. The High Court, however, rejected this contention and observed that the date of attachment and not the date on which the application for attachment was made that was material. If the debt was due by the date on which the attachment was effected, there could not be any valid objection against the same, simply because the application for its attachment was made before it became due.

2. In the case of a joint account, it is not attached by a garnishee order, provided the order is issued against only one of the account holders. Here again, reference may be made to the decision in Nandikatta Anjana and others vs Bandi Ramakrishna and others mentioned above. It has been held that the attachment of a debt jointly due to a judgment debtor with another is illegal. The High Court referred to the decision in Macdonald vs Tacquash Gold Mines Co., in which a view was taken that a debt, legal or equitable, owing by a garnishee to a judgment debtor, should not be a debt due to him jointly with another person. Observing that this view was approved by the Indian Courts, the High Court referred to the decision in Batcha vs Sulaiman Sahib in which it was held that under Order 21, Rule 46 of the Civil Procedure Code, the attachment could be made of a debt due to a judgment debtor alone and not a debt due to the judgment debtor and another.
3. In the case of a partnership firm's account, it is not attached by a garnishee order provided the order is issued against only one of the partners.
4. In the case of an overdrawn account of a customer, the garnishee order will not attach funds even though the customer has not reached the agreed limit of overdraft when the order is served.
5. In the case of a garnishee order which does not correctly designate the judgment debtor and the account which he has with the bank, funds are not attached.
6. In the case of amounts credited as cash in respect of uncleared items, it is doubtful whether they are attached by a garnishee order. In Jones vs Coventry, it was held that they were attached by a garnishee order. However, in view of a later decision in Underwood vs Barclays Bank, the earlier

decision does not appear to hold good. The later decision recognized the banker's right to return cheques drawn against uncleared items in the absence of a contract, express or implied, to the contrary. A still more recent decision in Fern vs Bishop & Co. Ltd and another upheld the decision in Underwood vs Barclays Bank. In this case, a garnishee order was served on the debtor's bank for an amount of £806. The debtor's credit balance was £4,998, including an item of £4,700 representing a cheque paid in for collection but not collected. The bank, having deducted bank charges due to it, opened a new account for the £4,700 and left £218 to meet the judgment debt. The Judge stated that the question was whether at the time the garnishee order was served, the sum of £4,700 constituted a debt owed by the bank to the judgment debtor, that is whether the bank was holding the cheque in question as a holder for value. It was held in Underwood vs Barclays Bank that for a bank to become a holder for value there had to be a contract between the banker and the customer, express or implied, that the latter might draw against cheques which were not cleared. Applying that to the instant case, there was no evidence of such a contract. As to the burden of proving such a contract, if there were an express agreement the bank would be under a duty when served with a garnishee order nisi to disclose the fact to the judgment creditor. But if such an agreement were to be implied from a course of conduct, it would be wrong for a banker to offer details of a customer's banking transactions to any judgment creditor, who could use the machinery of discovery under the control of the Court. In the instant case this had not been done. Thus, the garnishee order was made absolute in the sum of £218.

7. Until recently it was considered that a garnishee order could not attach a debt owing in a foreign currency. But the decision in Choice Investments Ltd, vs Jemnimon : Midland Bank Ltd, indicates that a garnishee order could attach even a credit balance maintained in a foreign currency. In this case the question was whether the garnishee order issued against the bank could attach funds in a US$ Deposit Account maintained by the judgment debtor in England. The Judge outlined the procedure to be followed as follows,

> '…as soon as the garnishee order nisi it operates to "freeze" the sum in the hands of the bank, in this way; the must, as soon as reasonably practicable, in the ordinary course of business, put a 'stop order' in the requisite amount of US dollars. It should be such a number of dollars as, if realized at the time of the stop order, would realize the amount of the sterling judgment—at the buying rate of sterling ruling at the time of the stop order. The bank should not make a transfer into sterling at that stage. But, if and when the garnishee order is made absolute, the bank should exchange that stopped amount from dollars into sterling so far as is necessary to meet the sterling judgment debt and pay over that amount to the judgment creditor. But if and so far

as the stopped amount (owing to exchange fluctuations) is more than enough to meet the judgment debt, the bank must release the balance from the stop order and have it available to the customer on demand. If the stopped amount is, when the garnishee order is made absolute, by virtue of exchange fluctuations, insufficient to satisfy the judgment, remaining funds with the banks are not affected…..'

Banker–Customer Relationship in the context of Bankers

Book Evidence Act

As observed earlier, a banker has to disclose the state of a customer's account under an order from a Court of Law. Before the enactment of the Bankers' Book Evidence Act, 1891, a banker had to produce the actual books of accounts whenever he was summoned to do so by any of the parties to the suit. But the Bankers' Books Evidence Act provides that, a certified copy of any entry in a banker's book shall in all legal proceedings be received as prima facie evidence of such entry, and of the matters, transactions and accounts therein recorded. In terms of Section 4 of the Act:

'A certified copy of any entry in a banker's book shall in all legal proceedings be received as prima facie evidence of the existence of such entry, and shall be admitted as evidence of the matters, transactions and accounts therein recorded in every case where, and to the same extent as, the original entry itself is now by law admissible, but not further or otherwise.'

Further, Section 5 of the Act provides that a banker or officer shall not in any legal proceedings to which the bank is not a party be compellable to produce any banker's book the contents of which can be proved under the Act, or to appear as a witness to prove the matters, transactions and accounts therein recorded, unless by the order of the Court or a Judge made for a special cause. At the same time, if the bank is not a party in the action and if the Court is not satisfied that the certified copies produced are true copies of the accounts maintained by the bank, it is open to the Court to direct the bank authorities to produce the original books.

A 'certified copy' has been defined by the Act as a copy of any entry in the books of a bank together with the certificate written at the foot of such copy that it is the true copy of such entry, that such entry is contained in one of the ordinary books of the banker, and that such book is still in the custody of the bank. The term 'Bankers' Books' includes ledgers, day books, cash books, accounts books and all other books used in the ordinary business of the bank.

A Court or Judge may also give any party to a legal proceeding leave to inspect and take copies of any entries in a banker's books. The relevant provision is contained in Section 6 of the Act in terms of which:

1. On the application of any party to a legal proceeding, the court or Judge may order that such party be at liberty to inspect and take copies of any

entries in a banker's books for any of the purposes of such proceeding, or may order the bank to prepare and produce, within a time to be specified in the order, certified copies of all such entries are to be found in the books of the bank relevant to the matters in issue in such proceeding, and such further certificate shall be dated and subscribed in a manner hereinbefore directed in reference to certified copies.

2. An order under this or the preceding section may be made either with or without summoning the bank, and shall be served on the bank three clear days (exclusive of bank holidays) before the same is to be obeyed, unless the Court or Judge shall otherwise direct.
3. The bank may at any time before the time limited for obedience to any such order as aforesaid either offer to produce their books at the trial or give notice of their intention to show cause against such order, and thereupon the same shall not be enforced without further order.

It may be noted here that although the Court is bestowed with such wide powers, no Court would grant such an order except on the clearest evidence of its necessity. It has been held in Satyanarain JhunJhunuwala vs Punjab National Bank that an application under the Bankers' Book Evidence Act for an order upon a bank to supply a certified copy of the entries in respect of one of its customers for a particular period could not be allowed because it being a third party document, the same ought not to be allowed to be produced by this process unless very special circumstances are shown. The Court quoted with approval the observations in Central Bank of India Ltd vs P D Shamdasani wherein Beaumont, C.J. has said:

'The Legislature has endowed the Courts with wide powers of ordering production of documents necessary for the determination of matters before the Court, and for directing inspection of those documents but it must always be borne in mind that an order directing a person to produce or give inspection of the books in a dispute to which he is not a party involves a serious inroad upon his normal rights as a citizen and the Courts have always set their faces against anything in the nature of a roving or fishing commission to inspect documents… . If the Courts were to make orders for inspection of books merely on an allegation that certain facts are not true, the practice would be open to an unscrupulous person to make a false charge, possibly against a business rival, and then get inspection of that business rival's books.'

It may carefully be noted here that if the bank is a party in the action, it can be compelled to produce its actual books under sub-poena.

The exemption granted to bankers from producing their books under the Act in any legal proceeding to which the bank is not a party, however, does not hold good in case of a police investigation. In terms of the decision in A.F.G. Price vs Emperor, it is not the intention of the Legislature to exempt banks from the operation of Section 94 of the Indian Criminal Procedure Code under which an officer in charge of a police station can, by a written order, call upon a person to

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produce any documents which the police officer thinks relevant to the investigation he is carrying on. In other words, a police investigation is not a legal proceeding in the sense in which the term is employed in Section 5 of the Bankers' Book Evidence Act on the ground that a police investigation has nothing to do with evidence in its legal sense, which is the essence of legal proceeding.

Another important point to be noted here is that a certified copy of an entry in a banker's books is only a prima facie evidence, and not a conclusive evidence. The observations made by the Judge in Chandradhar Goswami and others vs Gauhati Bank Ltd, are pertinent in this connection. According to these observations, while the bankers Book Evidence Act recognizes certified copies admissible as evidence, such admissibility is only to the same extent as the original entry itself would be admissible by law, not further or otherwise. By reason of Section 34 of the Evidence Act, the original entries alone would not be sufficient by themselves to charge any person with liability and so copies produced under Section 4 of the Bankers' Book Evidence Act cannot by themselves are sufficient to charge any person with liability.

Check Your Progress

3. What is the true relationship between a banker and a customer?
4. Define a lien.

13.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A banker is therefore essentially a dealer in debts, or credit.
2. The essential business of a 'Banker' is to buy money and debts, by creating other debts.
3. The true relationship between a banker and a customer is that of a debtor and a creditor.
4. A 'lien' may be defined as the right to retain property belonging to a debtor until he has discharged a debt due to the retainer of the property.

13.5 SUMMARY

- The essential business of a 'Banker' is to buy money and debts, by creating other debts. A banker is therefore essentially a dealer in debts, or credit.

- Section 3 of the Negotiable Instruments Act, 1881 corresponding with Section 2 of the Bills of Exchange Act 1882, states that the term 'banker' includes persons or a corporation or a company acting as bankers.
- The term 'customer' also presents some difficulty in the matter of definition. There is no statutory definition of the term either in India or in England. However, the legal decisions on the matter throw some light on the meaning of the term.
- The true relationship between a banker and a customer is that of a debtor and a creditor. The banker, when he receives money from a customer, does not hold the money in a fiduciary capacity.
- As far as the banker's right of set-off is concerned, there is a conflict of judicial opinions.
- The drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheque must pay the cheque when duly required so to do and in default of such payment must compensate the drawer for any loss or damage, caused by such default.
- Because of the peculiarly private character of the transactions between the banker and the customer, the banker should not divulge to third parties the state of the customer's account except on reasonable and proper occasions.
- Another feature of the relationship between the banker and the customer is the banker's right of lien over such of his customer's securities as may come into his possession in the ordinary course of business.
- A 'lien' may be defined as the right to retain property belonging to a debtor until he has discharged a debt due to the retainer of the property.
- A banker is entitled to charge interest on loans, either by express agreement or by right of custom or usage of trade.
- A 'garnishee order' is an order of the Court, obtained by the judgment creditor attaching funds in the hands of a third party who owes judgment creditor money, warning the third party (the Garnishee) not to release money attached until directed by the Court to do so.

13.6 KEY WORDS

- **Banker:** An individual that is employed by a banking institution and participates in various financial transactions is called a banker.
- **Trustee:** A trustee is an individual person or member of a board given control or powers of administration of property in trust with a legal obligation to administer it solely for the purposes specified.
- **Debt:** Debt refers to a sum of money that is owed or due.

13.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short-Answer Questions

1. How does a debt due by a banker differs from an ordinary commercial debt?
2. What do you understand by law of limitation?
3. What are the cases when a banker cannot exercise his right of lein?
4. What are garnishee orders?

Long-Answer Questions

1. Who is a banker? Disuss the major functions of a banker.
2. 'The relation of banker and customer begins as soon as the first cheque is paid in and accepted for collection.' Comment on the statement with reference to the text.
3. Mention the cases in which a banker is a trustee and not an agent.
4. What are the special features of the relationship between a banker and a customer?

13.8 FURTHER READINGS

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UNIT 14 RECENT TRENDS IN INDIAN BANKING SYSTEM

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Structure

14.0 INTRODUCTION

As a rule, banking systems are adapted to the structure and needs of the particular economy they exist in. Indian economic policy has been founded on the philosophy of economic growth with social justice. It is against this background that we have to assess the steps taken by the Indian banking system during the recent past which marks a significant departure from the beaten track of traditional banking.

14.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the recent trends in the Indian banking system
- Discuss the developments in the field of branch banking
- Learn the importance of banking habitat
- Know about money lending

14.2 RECENT TRENDS: AN OVERVIEW

The concept of banking has undergone a dynamic change in keeping with the need to achieve rapid socio-economic progress although the achievements have not been without cost and shortcomings.

The most striking feature is its reach. Banks are no longer confined to metropolitan cities and large towns. The branch network is extensive and these branches are now spread out into the remote corners of our country. In terms of the number of branches, Indian banking system is one of the largest, if not the largest, in the world today. An equally important achievement is the close association of our banks with the country's developmental efforts. The diversification and development of our economy, and the acceleration of the growth process, are in no small measure as a result of the critical role which our banks have played in financing economic activities in various sectors.

From Security Orientation to Purpose Orientation

According to traditional banking theory, the creditworthiness of a person is based on the basis of the tangible assets owned by him. The result is that people who have money can get more money from the banks. This concept does not fit in the social concept which enjoins that it is not enough that only people of means are given bank finance. What is more important is that bank finance should go to make people creditworthy, through productive efforts on their part, and to turn them into people of means. Basic to this new concept of banking, a shift in the approach to lending from security orientation to purpose orientation is necessary. In fact, technical competence of the borrower, operational flexibility and economic viability of the project rather than the security which the borrower can offer are gradually becoming popular among the banking community in evaluating a loan proposal.

The identification of the priority sectors for the purpose of financing by banks has given a new orientation to the Indian banking system. The measures taken by the banks in this regard, which are primarily aimed at furthering the welfare of the common man, have already been highlighted at an earlier point. It may briefly be mentioned here that the change in the pattern of banks' business has taken the form of a much enlarged quantum of credit to the hitherto neglected, or more positively, the new priority sector. From a mere ₹307 crore which represented about an eighth of the total bank credit in December 1966 and ₹504 crore which represented 15 per cent of the total bank credit in June 1969, the share of public sector banks in the priority sector was ₹1,46,546 crore as at the end of March 2001. As a share of net bank credit, this constituted 43 per cent. Agricultural credit has risen from under ₹200 crore in June 1969 to ₹53,685 crore in March 2001 with its share at 15 per cent. An important point worth noting here is that this large increase has been reasonably well distributed as is evident from the fact that the total number of borrowal accounts from the banking system which stood at 1.64 lakh in June 1969 increased manifold in the case of agricultural borrowers alone. The overall picture of the priority sectors is still more impressive. On the side of bank credit, there were barely 4 lakh accounts in the priority sectors in June 1969. By 2002, the number of such accounts has risen to nearly 40 million. The importance of the priority sectors in our economy can be gauged from their contribution to the national income generation, the creation of employment opportunities and the diffusion of economic power. Prior to social control and nationalization, the banking system was negligent in its attitude to these sectors. It was social control and the guidelines of the erstwhile National Credit Council which brought the first stirrings towards a major meaningful sectoral deployment of credit in favour of these areas of activity and, as was only to be expected, banks operated in the margin in the sense that the incremental ratio of the new credit to these sectors went up sharply. Also, the internationalization of the new philosophy was quickly reflected in the new orientation given to policies and programmes of the various banks and innovations introduced by them in their schemes.

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Correction of Regional Imbalances:

Developments in the Field of Branch Banking

The increasing realization of the banking system to fall in line with the socio-economic objectives necessitated the expansion of the network of branches to the underbanked areas of the country. In December 1966, there were little under 6,600 branches and by June 1969, this figure reached to about 8,260. Between June 1969 and end-April 1976, the number of all commercial banks in the country increased by 12,555, bringing down the average population served per bank office from 65,000 to 26,000. By June 2002, there were 66,186 branches of commercial banks. The average population per bank office had come down to 15,000 at the end of June 2002. Such a pace of expansion has few, if any, parallels in the history of banking development anywhere in the world. Most of the branch expansion has occurred in the rural and semi-urban areas, reflecting the concern to achieve a more balanced spatial distribution of credit, and today there is a bank office in almost all the 5,000 odd development blocks in the country. As at the end of June 2002, rural branches accounted for 49.1 per cent of all the branches. Thus, the branch expansion of banks has been aimed at correcting the regional imbalances in banking development. Branches of a bank are a means, an essential means, to the end we are seeking, namely, a greater involvement of banks with decentralized activity. The new branches in the rural areas are expected to increase the flow of credit to rural occupations in general and agriculture in particular, and to mobilize the savings generated in the rural sector.

The 'area approach' is another method adopted by the banking system to correct the regional imbalances in development. The 'Lead Bank Scheme' is the main instrument of this aspect of banking policy. The Lead Banks are engaged in preparing credit plans based on bankable schemes which are expected to assist in the economic development of the rural areas of the country and to bring about a more systematic involvement of banks in grassroot level development.

Development of Banking Habit

As a natural corollary to the development in the field of branch banking, development of banking habits in India during the last few decades has been at an unparalleled pace. Obviously, the banking system in the country has made a significant contribution to ensure such progress. Sustained efforts have been made by banks to induce people to keep a part of their savings as bank deposits, and to expand and diversify their lending portfolio to cover a considerably large number of borrowers than ever before. A good measure to the development of banking habit is provided by the growth in the volume of banking transactions in relation to gross domestic product. In 1969, deposits amounted to 13 per cent of GDP and advances 10 per cent. By 2002, deposits as a proportion of GDP has risen to around 50 per cent and advances to well above 25 per cent, indicating the extent to which the banking system has been instrumental in spreading the banking habits in the country. An idea of the extent to which the banking system has been able to spread banking habits in the rural areas is indicated by the fact that the growth of deposits of rural branches has been much faster than that of total deposits. The rapid development of banking habits is also evidenced by the considerable increase in the use of cheques in recent years. Another important parameter which is a symbolic indicator of the growing banking habits is the growth in bank credit.

Attitudinal Change on the Part of Bankers

A welcome change in the philosophy and techniques, particularly in the field of bank lending, is taking place. This relates to the attitudes on the part of banks. As observed by the former governor of the Reserve Bank of India:

'Commensurate with the growth of branch banking in the rural areas and the larger involvement of banks with agricultural and small industrial clients, we have had an attitudinal change on the part of bankers, a change symbolized by banking going retail instead of its erstwhile wholesale character and the system itself shedding its elitist image to become more truly an operation for the masses rather than for the classes. Social control sought to break the link between those who owned the banks and the satisfaction of their credit needs. It was realized that a system where the grant of credit was a matter of privilege had to be replaced by one where the requirements of credit were assessed on the basis of genuine production need and on impersonal norms… .'

Emergence of Retail Banking

During the recent past, the retail character of banking operations has become more predominant, especially among the new private sector banks. Retail banking or mobilizing deposits from individuals and providing loan facilities to them in the form of home loans, auto loans, credit cards, etc., is becoming popular. This used to be considered by the banks as a tough proposition because of the volume of operations involved. But during the last few years, banks seem to have realized that the only sustainable way to increase deposits is to look at small and middle class consumer retail deposit and not the price sensitive corporate depositors. With financial sector reforms gathering momentum, the banking system is facing increasing competition from non-banks and the capital market. More and more companies are tapping the capital market directly for finance. This is one of the main reasons for the banks to focus vigorously on the much ignored retail deposits. Margins in corporate banking are also shrinking. In corporate lending, the margins are generally 1 to 2 per cent above the prime rate. In retail they are 3–4 per cent.

In addition, it is reported that the Indian retail market has the potential to be second only to the US. National Readership Survey 5 puts Indian households with monthly income of over ₹5,000 at 4.5 million. According to the survey, the category of households with annual income of ₹2 lakh and above is growing at the rate of 30 per cent per annum. This obviously indicates the enormous potential of the retail market. No wonder, banks with vision and insight are trying to woo this market through a series of innovative additions to their products, services, technology and marketing methods. Fixed and Unfixed Deposits (i.e., Cluster Deposits which can be broken up into smaller units to help meet depositors needs without breaking it up entirely), centralized database for 'any branch banking' (whereby a customer can access his account in any of the branches irrespective of the branch where the account is maintained), room service (whereby the customers are visited at their residences/offices to enable them to open their accounts), automatic teller machines, telebanking network, extended banking time, courier pick-up for cheques and documents, etc., are some of the privileges extended to the customers by the banks in their eagerness to cultivate the retail market. In short, in the bold new world of retail banking, the customer is crowned as king.

Breakthrough in Virtual Banking

Closely allied to the above point is the emergence of virtual banking. Going by the latest indications, virtual banking is catching up in the Indian banking system. ATMs (Automated Teller Machines) have been installed by almost all the major banks in major metropolitan cities and even rural areas. The Shared Payment Network System (SPNS) has already been installed in Mumbai. The operationalization of the Very Small Aperature Terminal (VSAT) is expected to provide a thrust to the development of Indian Financial Network (INFINET) which will further facilitate connectivity within the financial sector. Electronics Funds Transfer (EFT) mechanism has been initiated by major banks. As on 30 September 2001, the scheme, which is operated by the Reserve Bank, is available for funds transfer across thirteen major cities in the country. The scheme was originally intended for small value transactions. However, with effect from 1 October 2001, even large value transactions (as high as ₹2 crore) have also been permitted.

It may be recalled here that the EFT system was introduced in India in the light of the recommendations of the Shere Committee, which had pointed out the legal impediments to the establishment of the system and had advised the Reserve Bank of India on what was to be done. The committee, while recommending a single national level inter-bank and intra-bank funds transfer system to be introduced immediately, said that all commercial banks in public and private sector and co-operative banks satisfying certain criteria with particular regard to capital adequacy, sufficiently high level of computerization and willingness to abide by the rules and regulations should be admitted in the EFT system as participants. Regarding the fixation of responsibilities and liabilities of the participants and bank customers, the committee recommended that the Reserve Bank of India might be empowered to frame the relevant regulations. The committee, after considering the various legal implications of the system, recommended that there was the need for a new

EFT Act in the long run although in the short run an EFT system might be adopted on a combination of regulatory and contractual models. While Section 17 (6) of the Reserve Bank of India Act empowered the Bank to operate a remittance system for transfer of funds, Section 58 (2) (P) of the Act empowered the Bank to make regulations in this regard. India was lagging behind in this technological field. But the way is now clear for electronics funds transfer which will go a long way in curing the corporate sector's headaches of cash management in multiple locations. The system is a path-breaking technology that will ultimately pave the way for paperless banking.

While technology has resulted in facilities such as 'Total Branch Automation', 'Single Window Service' and other accounts related functions in the recent past, the thrust areas of the present relate to the use of technology for providing centralized systems for banks where centralized data exists with decentralized access to branches and their constituents. This would result in the customer being treated as a customer of a bank as a whole rather than of a particular branch. The area of Payment and Settlement Systems, which is at the core of banking activities, has also got a shot in the arm, thanks to emerging technologies.

Thus, the banking institutions are now in a position to provide an enlarged range of services to the customers more rapidly and accurately at their convenience without direct physical access to bank branches.

Move towards Universal Banking: 'Financial Services Supermarkets'

A recent trend in the Indian banking system has been the diversification of the activities of the banks by providing a length of financial services within the banks themselves or through the subsidiary route, thereby converting themselves into 'financial services supermarkets'. Thus, many have entered themselves into the field of merchant banking services, factoring services, asset management services, insurance services, etc. In keeping with the liberalization process in the financial system, in February 1994, banks have been allowed to undertake para banking activities like equipment leasing, hire purchase financing and factoring. Banks have been advised to select certain branches to undertake these activities. They can now undertake such activities subject to an overall exposure ceiling of 15 per cent of the bank's capital funds to an individual borrower and 40 per cent to a group of borrowers. It may be noted in this connection that a major step towards universal banking has been the merger of ICICI with ICICI Bank Ltd.

From Moneylending to Development Banking

As an extension to the above, it may be noted that from being dispensers of short-term credit, banks are now actually helping industrial development of the country by providing access to capital market and long-term savings of the economy. The transformation of banks from being moneylenders to development bankers is a recent phenomenon in the Indian banking system.

Establishment of Specialized Branches

Another recent trend visible in the banking system, especially with the onset of liberalized branch licensing policy of the Reserve Bank, has been the establishment of specialized branches to cater to the needs of specific segments of the clientele. The following are the main types of such specialized branches:

NRI Branches	—	to cater to the needs of NRI clientele.
Industrial Finance Branches	—	to cater to the needs of industrial clients exclusively.
Overseas Branches	—	to specifically concentrate on export-import business.
Small-scale Industries Branches	—	to deal with small-scale industries exclusively.
Professional Branches	—	to cater to the needs of professionals such as engineers, doctors, chartered accountants, lawyers, contractors, etc.
Agricultural Finance Branches	—	to cater to the needs of high-tech agriculture, agro exports and corporate clients dealing with agri-business.
Recovery Branches	—	to exclusively concentrate on recovery of non-performing assets.

Customer Focus

Growing expectations of the bank customers is a marked feature of the current banking environment. Forces of competition and growth of technology are mainly responsible for this change. At the same time, however hard a bank may try to meet customer expectations, there will be occasions for customer complaints. Hence, the Banking Ombudsman Scheme instituted by the Reserve Bank, discussed in detail elsewhere, is a welcome step in the right direction. It may briefly be pointed out here that the main objective of the scheme is to create a forum for the speedy redressal of customers' grievances and also to receive unresolved complaints about the provision of banking services, as well as to facilitate the settlement or withdrawal of such grievances.

Conclusion

The above analysis clearly indicates that it is being increasingly realized by our banks that banking is no more a deposit taking and moneylending institution, making profits on the differential, nor is a bank an institution which could be run by bankers whose only qualifications were high integrity, intuitive shrewdness, certain degree of impassivity; but not necessarily high intellect. The last few years have witnessed profound changes in Indian banking.

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Since the days of social control and the nationalization of major commercial banks, the progress towards aligning the banking system's operations to the needs of our developing economy has been truly remarkable. The financial sector reforms initiated during the recent past can rightly be considered as the second banking revolution paving way for the development of superior foundations and positioning the banking system strategically to meet the challenges and brace the opportunities of the future. Of course, one is acutely aware that given the tasks and problems before the banking system, there is still much to be done but it would be less than charitable not to pay tribute to the progress achieved so far.

Check Your Progress

1. What has given a new orientation to the Indian banking system?
2. What is a good measure to the development of banking habitat?

14.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The identification of the priority sectors for the purpose of financing by banks has given a new orientation to the Indian banking system.
2. A good measure to the development of banking habit is provided by the growth in the volume of banking transactions in relation to gross domestic product.

14.4 SUMMARY

- As a rule, banking systems are adapted to the structure and needs of the particular economy they exist in Indian economic policy has been founded on the philosophy of economic growth with social justice.
- Banks are no longer confined to metropolitan cities and large towns.
- The branch network is extensive and these branches are now spread out into the remote corners of our country.
- According to traditional banking theory, the creditworthiness of a person is based on the basis of the tangible assets owned by him.
- The identification of the priority sectors for the purpose of financing by banks has given a new orientation to the Indian banking system.
- The increasing realization of the banking system to fall in line with the socio-economic objectives necessitated the expansion of the network of branches to the underbanked areas of the country.
- The 'area approach' is another method adopted by the banking system to correct the regional imbalances in development.

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- As a natural corollary to the development in the field of branch banking, development of banking habits in India during the last few decades has been at an unparalleled pace.
- During the recent past, the retail character of banking operations has become more predominant, especially among the new private sector banks.
- Another recent trend visible in the banking system, especially with the onset of liberalized branch licensing policy of the Reserve Bank, has been the establishment of specialized branches to cater to the needs of specific segments of the clientele.

14.5 KEY WORDS

- **Finance :** Finance is a field that is concerned with the allocation (investment) of assets and liabilities over space and time, often under conditions of risk or uncertainty.
- **Cheque:** A cheque is an order to a bank to pay a stated sum from the drawer's account, written on a specially printed form.
- **Ombudsman:** The ombudsman is an independent official who has been appointed to investigate complaints.

14.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What is the most striking feature of the Indian banking system?
2. What do you understand by traditional banking theory?
3. Mention some of the recent developments in the field of branch banking.
4. What is area approach?
5. How has retail banking emerged in the past?

Long-Answer Questions

1. What are the recent trends in the Indian banking system? Discuss.
2. 'The identification of the priority sectors for the purpose of financing by banks has given a new orientation to the Indian banking system.' Comment on the statement with reference to the text.
3. How has banking habitat developed in the recent past? Explain.
4. What is virtua banking? How has virtual banking facilitated the banking structure?

14.7 FURTHER READINGS

NOTES

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