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(A State University Established by the Government of Tamilnadu)



**KARAIKUDI – 630 003**

**DIRECTORATE OF DISTANCE EDUCATION**

**B.B.A**

**Second Year – Third Semester**

**104 33**

**Banking Theory**

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Work Order No.AU/DDE/DE12/III Sem/ PCM /2021 Dated 27.08.2021 Copies – 800

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## Banking Theory

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# UNIT – I INTRODUCTION TO BANKING

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*Introduction to Banking*

## **Structure**

- 1.0 Introduction
- 1.1 Objectives
- 1.2 Definition of Bank
- 1.3 Kinds of Banks
- 1.4 Credit Creation and Balance Sheet
- 1.5 Answers to Check Your Progress Questions
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## **NOTES**

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### **1.0 INTRODUCCION**

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A bank is a financial establishment and a financial intermediary that accepts deposits and ways those deposits into lending activities, either directly by loaning or indirectly through capital markets.

A bank may be defined as an institution that accepts deposits, makes loans, pays checks, and provides financial services. A bank is a financial intermediary for the safeguarding, transferring, exchanging, or lending of money. A primary role of banks is connecting those with funds, such as investors and depositors, to those seeking funds, such as individuals or businesses needing loans. A bank is the connection between customers that have capital deficits and customers with capital surpluses.

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### **1.1 OBJECTIVES**

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

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

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### **1.2 DEFINITION OF BANK**

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Banking shows an essential role in modern trade and commerce. Banks execute the twin functions of accepting deposits from the public and

## NOTES

making loans to needy and deserving people in society. Deposits become liabilities and loans appear on the assets side of their balance sheets. Banks provide money to different categories of borrowers. The interest received on those loans becomes their chief source of revenue and the interest on deposits constitutes the main item of outflow for a bank.

The Banking Regulation Act, 1949 which regulate the all the banks in India. The settlement 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.'

In 1901, Justice Holmes wrote, in an Irish case (Re Shields Estate): "The real business of the banker is to obtain deposits of money which he may use for his own profit by lending it out again."

In United Dominions (1966), Lord Denning deferred to these words to define a bank: "An establishment for the custody of money received from, or on behalf of, its customers. Its essential duty is to pay their drafts on it: its profits arise from the use of money left unemployed by them."

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### 1.3 KINDS OF BANKS

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In India, Banks are classified into the various categories in aspects of their functions, which are as follows:

- Central Bank
  - Commercial Banks
  - Development Banks
  - Cooperative Banks
  - Specialized Banks
  - Regional Rural Banks
  - Exchange Banks
  - Indigenous Bankers -
  - Savings Bank-
- 
- **Central Bank (Reserve Bank of India or RBI)** - The central bank is the apex bank in banking structure of any country. The Central Bank controls the flow of currency in the economy. It regulates the other banks in the country. It also works as a banker to the government. The central bank plays a very important role in the economy of the country. It helps stimulate growth and control inflation in the country. It does so by controlling the flow of money in the economy. When other banks are in a problem, they approach the Central Bank for assistance. Hence it is also called as a banker's bank.
  - **Commercial banks-** Commercial banks are the banks which do the banking business with the aim of earning profits.

### There are three types of commercial banks-

(a) Public sector banks- These are banks where the majority of the shares are held by the Government or the Reserve Bank of India. For example, State Bank of India

(b) Private sector banks- These are the banks where the majority of shares are held by private individuals/entities. Example, HDFC Bank.

(c) Foreign banks- These are the banks which are registered outside of India but have their branches in India. Example, Citibank.

- **Development Banks** - These banks provide financial assistance to various industries for the purchase of machinery and equipment, modernization and expansion. For example, IFCI (Industrial Finance Corporation of India and SFCs (State Financial Corporations)
- **Co-operative banks** - Co-operative banks are the banks whose main objective is to provide financial assistance to economically weaker sections of the society. Example, The New India Cooperative Bank.

### There are three types of cooperative banks-

(a) Primary Credit Societies- These institutions are formed at village level or town level. The operations of such banks are limited to a very small area.

(b) District Central Cooperative Banks- These banks operate at the district level. They act as a link between primary credit societies and state cooperative banks.

(c) State Cooperative Banks- State Cooperative Banks are biggest forms of cooperative banks. They operate at the state level. Some of State Cooperative banks operate in multi States.

#### Check Your Progress

1. List different types of banking systems.
2. What is a bank?
3. Name two main functions of a bank

- **Specialized Banks**- These banks specialize in providing financial assistance to a particular industry or sector. For example, EXIM Bank, SIDBI, NABARD etc.

(a) EXIM Bank stands for Export-Import Bank. This Bank specializes in providing financial assistance to import and export sector.

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## NOTES

(b). SIDBI stands for Small Industries Development Bank of India. SIDBI specializes in providing financial assistance to small industries.

(c) NABARD stands for National Bank for Agricultural and Rural Development. NABARD specializes in providing financial support to the agricultural sector in the rural areas.

- **Regional Rural Banks-** The main aim of Regional Rural Banks (RRBs) is to provide banking services in rural areas.
- **Exchange Banks.** These banks are mainly concerned with the financing of foreign trade. The main function of such banks is to provide a facility for transfer of money from one country to another. Example, Bank of America
- **Indigenous Bankers -** These are private lenders who charge a very high rate of interest on loans given by them
- **Savings Bank-** The main aim of the Savings Bank is to cultivate a habit of saving among people. For example, Post Office savings bank

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### 1.4 CREDIT CREATION AND BALANCE SHEET

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Credit creation or money creation refers to the strength of the banks to expand or contract demand deposits through the process of more loans, advances and investments. It will be seen that the most important function of a commercial bank is the formation of credit money—a function which overshadows all other banking functions. Sometimes a bank could never lend more than the amount deposited by the depositors; this may be partially true. But it is also true that whatever is lent out by a bank may come back by way of new deposits, which may be lent out again and so on, a deposit becoming a loan which again returns to the bank as a deposit and becomes the basis for a new loan and so on.

A commercial bank, therefore, has been aptly described as a 'factory of credit', which is able to multiply loans and investments and hence deposits. With a little cash at the disposal they are able to create additional purchasing power to a considerable degree. It is in this sense that banks create credit. An increase in bank credit will, therefore, mean multiplication of bank deposits.

There are mainly two ways of creating credit money by a commercial bank:

- By giving a loan, and
- By purchase of securities.

**By giving a loan:**

Assume an inaccessible community will not have any foreign trade relations and only one bank where everybody keeps an account; further no cash distributed and transactions are made by cheques. Bankers know that all the currency that depositors withdraw earlier returns to the bank. They also know that all depositors will not withdraw all deposits at real time. From experience they have learnt that if they just keep about 20% of their total demand deposits in cash reserves, they will have enough to meet all demands for cash.

Suppose a casual borrower goes to the bank for a loan of Rs. 5,000. After being convinced of the capable of the borrower and the safety of the loan in their hands, the bank will advance a loan of Rs. 5,000 not by handing over cash or gold to the borrower, but by opening an account in his name. If the borrower, already has an account, he will be allowed an overdraft to the extent of Rs. 5,000.

Thus, the most common method of making a loan is merely to credit the account of the borrower with Rs. 5,000. The borrower will then draw cheques on the bank while making purchases. Those who receive the cheques deposit them with the banks in their own accounts. Therefore, a bank loan of Rs. 5,000 has resulted in deposits of Rs. 5,000. The point to be noted and understand is that loans are made by creating a deposit.

When a person deposits Rs. 5,000 with a bank, the bank does not keep the entire cash but only a certain percentage (say 20%) of it to meet the day-to-day cash obligations. Thus, the bank keeps Rs. 1000 and lends to another person B, Rs. 4000 by opening a credit account in their respective names. Again, keeping 20% to meet B's obligations, the bank advances the rest Rs. 3200 to C ; further keeping 20% to meet C's obligations the bank advances Rs. 2560 to D and so on, till Rs. 5,000 are completely exhausted.

Thus, an original deposit of Rs. 5,000 leads to additional deposits of Rs. 4000 plus Rs. 3200 plus Rs. 2560 plus Rs. 2045, plus Rs. 1640 and so on. By adding up all the deposits we get total Rs. 10,000. It is clear, therefore, that the total amount of credit creation will be the reverse of the cash reserve ratio. Here cash reserve ratio has been assumed to be 20% or 1/2, therefore, the credit is Rs. 10,000 i.e., five times the original deposit of Rs. 5,000. Although, we have assumed one bank, yet the credit creation will take place when there are many banks.

It is clear that the main limitation on credit creation is the reserve ratio of cash to credit. Therefore, the amount of credit that a system of banking can create depends upon the reserve ratio. The banks can multiply a given amount of cash to many times of credit. If the public would demand no cash, credit would go on expanding indefinitely. But the reserve ratio is a sort of leakage from the Stream of credit creation.

We can, thus, think of a credit creation multiplier. The higher the reserve ratio, the smaller is the credit creation multiplier. In our example

**NOTES**

above, with an original deposit of Rs. 5,000 the bank was in a position to create credit of Rs. 10,000. The credit creation multiplier is obviously  $10(Rs\ 10,000/Rs,5,000)$ .

In general, the credit creation multiplier is related to the reserve ratio in the following way:

$$1/1-(1-\text{reserve ratio}) = 1/\text{reserve ratio}$$

## NOTES

If the reserve ratio is  $1/3$ , credit creation multiplier is 3 a reserve ratio of  $1/5$  will give us a higher value 5.

### **By purchase of securities:**

Making loan is not the only way in which deposits can be created. Sometimes, banks buy securities at the Stock Exchange and also buy real assets. When the bank does so, it does not pay the sellers in cash, rather it credits the amount of the price of the security or assets to the accounts of the sellers. The bank, therefore, creates a deposit with it.

It does not matter whether the seller of securities or property is a customer of the purchasing bank or not, as the seller is bound to deposit the cheques he receives in one of the banks. The purchase of security by any banker is bound to increase the deposits either of his own bank or of some other bank, in any case, the deposits of the banking system as a whole.

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## **1.5 Answers to Check Your Progress Questions**

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1. Define the term 'bank'. What are the primary functions of a commercial bank?
2. Explain the secondary functions and general utility services of commercial banks.
3. Explain the different kinds of banks.
4. Explain the concepts creation of credit, liquidity, profitability and safety.
5. What is credit creation? Explain how bank scan create credit. What arc the limitations of credit creation?

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## **1.6 Summary**

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Banking plays a pivotal role in modern trade and commerce.

- Banks working in two directions of functions of accepting deposits from the public and making loans to needy.
- 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 with drawable by cheque, draft, order or otherwise.'



- Banks in India are classified into Central Bank, Commercial Banks, Development Banks, Cooperative Banks and Specialized Banks.
- 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.

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### 1.7 Key Words

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**Balance:** the amount of money you have in your bank account.

**Bank Draft:** an order to pay someone that is sent from one bank to another bank, usually in a different country.

**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.

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### 1.8 Self Assessment Questions and Exercises

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#### Short-Answer Questions

1. What are the two main functions of Bank?
2. Define of bank.
3. W are the different Classification of banks in India?

#### Long-Answer Questions

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

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**1.9 Further Reading**

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## **UNIT – II BANKING VS BRANCH BANKING AND COMMERCIAL BANK**

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*Reserve Bank of India*

### **Structure**

- 2.0 Introduction
- 2.1 Objectives
- 2.2 Definition of Unit Banking
- 2.3 Definition of Branch Banking
- 2.4 Basic Difference between the Unit Banking and Branch Banking
- 2.5 Type of Commercial Banks
- 2.6 Functions of Commercial Bank
- 2.7 Credit Creation by Commercial Banks and It's Limitations
- 2.8 Some of the limitations of credit creation by commercial banks
- 2.9 The Balance Sheet of a Commercial Bank
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- 2.15 Further Readings

### **NOTES**

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### **2.0 INTRODUCTION**

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Banking refers to a business activity in which the entity accepting deposits from the customers, safeguards it and lends it to those who need it, and earns a profit. Different countries of the world adopt different types of the banking system . Basically there are two types of banking system prevalent in most of the countries, which are unit banking and branch banking. A unit banking is a banking system in which one bank, generally a small independent bank that renders banking services to its local community.

On the other hand, a branch banking, as the name suggests, is one in which a bank has more than one office in a country or outside at different locations and renders banking services to the customers of that area.

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## 2.1 OBJECTIVES

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In this chapter, you may find all the important differences between unit banking and branch banking.

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## 2.2 DEFINITION OF UNIT BANKING

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Unit Banking implies a banking practice wherein the banking operations are carried out by only one office, which is situated in a specified location. It is managed by its own governing body or the Board members. It has an independent existence, as it is not under the control of any other individual, bank, or body corporate.

A unit bank has no branches at all and for the purpose of providing facilities related to remittance and collection of funds, a unit bank takes recourse of the correspondent banking system. A correspondent bank refers to a financial institution, which enters into an agreement with another bank to render services to the customers as a representative of the latter.

The unit bank serves a limited area, and so it possesses an expert knowledge of the problems and basic needs of the localities and aims at resolving them.

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## 2.3 DEFINITION OF BRANCH BANKING

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Branch Banking implies a banking system wherein a banking organization, through its wide network of branches provides banking services to its customers throughout the country and even in abroad.

It has a central office called as the head office and other offices which are set up at different locations to serve the customers are called as branches. The branches are controlled and coordinated by the head office, with the help of their regional or zonal offices.

The bank is under the control of the Board of Directors (BOD) and it is owned by shareholders. Each bank branch has a manager who looks after the management of the concerned branch of which he/she is the incharge, as per the policies and instructions laid down from time to time by the head office.

For the purpose of financial reporting at the end of the financial year, the assets and liabilities of all the branches and the head office are summed up.

### **Key Differences Between Unit Banking and Branch Banking**

1. The points given below explain the difference between unit banking and branch banking in detail:
2. Unit banking is a type of banking system adopted in many countries wherein there is a single independent small bank that caters a particular locality. On the other hand, branch banking can be defined as a banking

- practice wherein a bank has several branches that operate throughout the country and even in foreign countries, to provide services to its customers.
3. While unit banks are not influenced by ups and downs of the local economy, branch banks remain unaffected by the ups and downs of the local economy, however, they are hit by the changes in the national economy.
  4. A unit bank has more independence of operations, as compared to the branch bank.
  5. When it comes to supervision cost, it is higher in case of a unit bank than a branch bank.
  6. A branch bank has a large pool of financial resources, at its disposal. Conversely, in a unit banking system, the financial resources are limited to the particular unit only.
  7. If we talk about competition, there is a high level of competition between the bank branches to sell its products and provide services to the customers. On the contrary, in the unit banking system, the competition hardly exists within the bank.
  8. In the unit banking system, the rate of interest is not fixed as the unit bank has its own policies and guidelines. As against, in a branch banking, the interest rate is decided by the head office, as per the directions of the central bank.
  9. As a unit bank is an independent one, it does not need to rely on any other body for taking important decisions. In contrast, in a branch banking system, the decision making is time-consuming, as it has to rely on the head office.

## NOTES

### 2.4 BASIC DIFFERENCE BETWEEN THE UNIT BANKING AND BRANCH BAKING

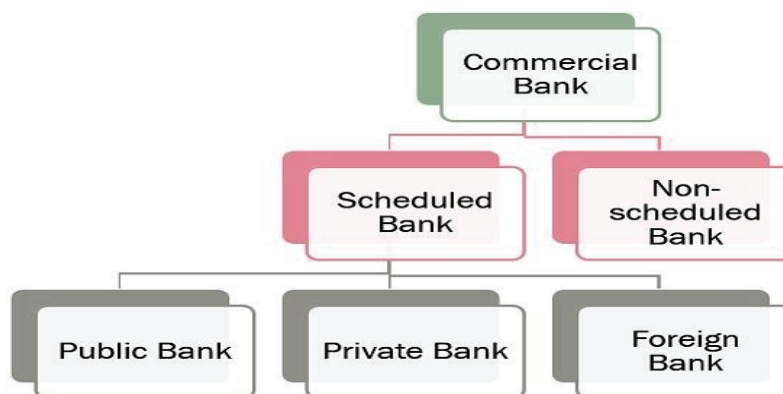
BASIS FOR COMPARISON	UNIT BANKING	BRANCH BANKING
Meaning	Unit banking is that system of banking in which there is a single small banking company, that provides financial services to the local community.	Branch banking is a banking method wherein a bank operates in more than one place to provide banking services to customers, through its branches.
Local economy	Affected by the ups and downs of the local economy.	It is not affected by the ups and downs of the local economy.
Independence of operations	More	Comparatively less
Supervision Cost	Low	Comparatively high

## NOTES

Financial Resources	Limited financial resources	Large pool of financial resources
Competition	No or little within the bank	Exist between the bank branches
Rate of interest	Not fixed, as the bank has its own policies and norms.	Fixed by the head office, and directed by the central bank.
Decision making	Quick	Time Consuming

Commercial Bank can be described as a financial institution, that offers basic investment products like a savings account, current account, etc to the individuals and corporate. Along with that, it provides a range of financial services to the general public such as accepting deposits, granting loans and advances to the customers. It is a profit making company, which pays interest at a low rate to the depositors and charges higher rate of interest to the borrowers and in this way, the bank earns the profit.

## 2.5 TYPE OF COMMERCIAL BANKS



Commercial banks are classified into two categories i.e. scheduled commercial banks and non-scheduled commercial banks. Further, scheduled commercial banks are further classified into three types:

**Private Bank:** When the private individuals own more than 51% of the share capital, then that banking company is a private one. However, these banks are publicly listed companies in a recognized exchange.

**Public Bank:** When the Government holds more than 51% of the share capital of a publicly listed banking company, then that bank is called as Public sector bank.

**Foreign Bank:** Banks set up in foreign countries, and operate their branches in the home country are called as foreign banks.

Non-scheduled commercial banks refer to the banks which are not covered in the Reserve Bank of India's second schedule. The paid-up capital of such banks is not more than Rs. 5 lakhs.

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## 2.6 FUNCTIONS OF COMMERCIAL BANK

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*Reserve Bank of India*

### 1. Primary functions

**Accepting Deposits:** The primary function for which the commercial banks were established is to accept deposits from the general public, who possess surplus funds and are willing to deposit them so as to earn interest on it. There are various products offered by the bank to the customers for the deposit of their money, which includes savings account, current account, fixed deposit and recurring deposit.

**Advancing Loans:** Next important function performed by the commercial bank is lending money to the individuals and companies. The banks make loans to the customers in the form of term loans, cash credit, overdraft and discounting of bills of exchange.

### 2. Secondary functions

**Agency Services:** There are some facilities provided by the commercial banks in which they act as an agent of the customers. Such services are:

- Collection and payment of rent, interest and dividend.
- Collection and payment of cheques and bills.
- Buying and selling securities.
- Payment of insurance premium and subscriptions.

**General Utility Services:** Commercial banks provide general utility services to the customers and charges a fee for the same. It covers services like:

- Safekeeping of valuables, documents etc, in locker or vault.
- ATM card, credit card and debit card facility.
- Issue of demand draft, pay order and traveller's cheque.
- Internet and mobile banking
- Sale of application forms of competitive exams.

**Transfer of funds:** Banks assist in the transfer of funds from one person to another or from one place to another through its credit instruments.

**Credit Creation:** The commercial banks are authorized to create credit, by granting more loans than the amounts deposited by the customers.

A commercial bank offers an array of facilities such as internet banking, mobile banking, ATM facility, credit card facility, NEFT, RTGS and so forth for which it charges a definite sum as a fee for providing these facilities.

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## 2.7 CREDIT CREATION BY COMMERCIAL BANKS AND IT'S LIMITATIONS

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### NOTES

A central bank is the primary source of money supply in an economy through circulation of currency.

It ensures the availability of currency for meeting the transaction needs of an economy and facilitating various economic activities, such as production, distribution, and consumption.

However, for this purpose, the central bank needs to depend upon the reserves of commercial banks. These reserves of commercial banks are the secondary source of money supply in an economy. The most important function of a commercial bank is the creation of credit.

Therefore, money supplied by commercial banks is called credit money. Commercial banks create credit by advancing loans and purchasing securities. They lend money to individuals and businesses out of deposits accepted from the public. However, commercial banks cannot use the entire amount of public deposits for lending purposes. They are required to keep a certain amount as reserve with the central bank for serving the cash requirements of depositors. After keeping the required amount of reserves, commercial banks can lend the remaining portion of public deposits.

According to Benham's, "a bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits."

Let us learn the process of credit creation by commercial banks with the help of an example.

Suppose you deposit Rs. 10,000 in a bank A, which is the primary deposit of the bank. The cash reserve requirement of the central bank is 10%. In such a case, bank A would keep Rs. 1000 as reserve with the central bank and would use remaining Rs. 9000 for lending purposes.

The bank lends Rs. 9000 to Mr. X by opening an account in his name, known as demand deposit account. However, this is not actually paid out to Mr. X. The bank has issued a check-book to Mr. X to withdraw money. Now, Mr. X writes a check of Rs. 9000 in favor of Mr. Y to settle his earlier debts.

The check is now deposited by Mr. Y in bank B. Suppose the cash reserve requirement of the central bank for bank B is 5%. Thus, Rs. 450 (5% of 9000) will be kept as reserve and the remaining balance, which is Rs. 8550, would be used for lending purposes by bank B.

Thus, this process of deposits and credit creation continues till the reserves with commercial banks reduce to zero.

From Table-1, it can be seen that deposit of Rs. 10,000 leads to a creation of total deposit of Rs. 50,000 without the involvement of cash.



**The process of credit creation can also be learned with the help of following formulae:**

Total Credit Creation = Original Deposit \* Credit Multiplier Coefficient

Credit multiplier coefficient =  $1 / r$  where  $r$  = cash reserve requirement also called as Cash Reserve Ratio (CRR)

Credit multiplier co-efficient =  $1/10\% = 1 / (10/100) = 10$

Total credit created =  $10,000 * 10 = 100000$

If CRR changes to 5%,

Credit multiplier co-efficient =  $1/5\% = 1 / (5/100) = 20$

Total credit creation =  $10000 * 20 = 200000$

Thus, it can be inferred that lower the CRR, the higher will be the credit creation, whereas higher the CRR, lesser will be the credit creation. With the help of credit creation process, money multiplies in an economy. However, the credit creation process of commercial banks is not free from limitations.

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## **2.8 SOME OF THE LIMITATIONS OF CREDIT CREATION BY COMMERCIAL BANKS**

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The limitations of credit creation process (as shown in Figure-3) are explained as follows:

### **(a) Amount of Cash:**

Affects the creation of credit by commercial banks. Higher the cash of commercial banks in the form of public deposits, more will be the credit creation. However, the amount of cash to be held by commercial banks is controlled by the central bank.

The central bank may expand or contract cash in commercial banks by purchasing or selling government securities. Moreover, the credit creation capacity depends on the rate of increase or decrease in CRR by the central bank.

### **(b) CRR:**

Refers to reserve ratio of cash that need to be kept with the central bank by commercial banks. The main purpose of keeping this reserve is to fulfill the transactions needs of depositors and to ensure safety and liquidity of commercial banks. In case the ratio falls, the credit creation would be more and vice versa.

## **NOTES**

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**(c) Leakages:**

Imply the outflow of cash. The credit creation process may suffer from leakages of cash.

The different types of leakages are discussed as follows:

**(i) Excess Reserves:**

Takes place generally when the economy is moving towards recession. In such a case, banks may decide to maintain reserves instead of utilizing funds for lending. Therefore, in such situations, credit created by commercial banks would be small as a large amount of cash is resented.

**(ii) Currency Drains:**

Imply that the public does not deposit all the cash with it. The customers may hold the cash with them which affects the credit creation by banks. Thus, the capacity of banks to create credit reduces.

**(d) Availability of Borrowers:**

Affects the credit creation by banks. The credit is created by lending money in form of loans to the borrowers. There will be no credit creation if there are no borrowers.

**(e) Availability of Securities:**

Refers to securities against which banks grant loan. Thus, availability of securities is necessary for granting loan otherwise credit creation will not occur. According to Crowther, “the bank does not create money out of thin air; it transmutes other forms of wealth into money.”

**(f) Business Conditions:**

Imply that credit creation is influenced by cyclical nature of an economy. For example, credit creation would be small when the economy enters into the depression phase. This is because in depression phase, businessmen do not prefer to invest in new projects. In the other hand, in prosperity phase, businessmen approach banks for loans, which lead to credit creation.

In spite of its limitations, we can conclude that credit creation by commercial banks is a significant source for generating income.

The essential conditions for creation of credit are as follows:

- Accepting the fresh deposits from public
- Willingness of banks to lend money
- Willingness of borrowers to borrow.

**Check Your Progress**

- i List the commercial banks
- ii What is private bank
- iii What is public bank

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## 2.8 THE BALANCE SHEET OF A COMMERCIAL BANK

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The balance sheet of a commercial bank provides a picture of its functioning. It is a statement which shows its assets and liabilities on a particular date at the end of one year.

The assets are shown on the right- hand side and the liabilities on the left-hand side of the balance sheet. As in the case of a company, the assets and liabilities of a bank must balance. The balance sheet which every commercial bank in India is required to publish once in a year.

### **The Distribution of Assets:**

The assets of a bank are those items from which it receives income and profit. The first item on the assets side is the cash in liquid form consisting of coins and currency notes lying in reserve with it and in its branches. This is a certain percentage of its total liabilities which it is required to keep by law. Cash reserves do not yield income to the bank but are essential to satisfy the claims of its depositors.

The second item is in the form of balances with the central bank and other banks. The commercial banks are required to keep a certain percentage of their time and demand deposits with the central bank. They are the assets of the bank because it can withdraw from them in cash in case of emergency or when the seasonal demand for cash is high.

The third item, money at call and short notice, relates to very short-term loans advanced to bill brokers, discount houses and acceptance houses. They are repayable on demand within fifteen days. The banks charge low rate of interest on these loans. The fourth item of assets relates to bills discounted and purchased.

The bank earns profit by discounting bills of exchange and treasury bills of 90 days duration. Some bills of exchange are accepted by a commercial bank on behalf of its customers which it ultimately purchases. They are a liability but they are included under assets because the bank can get them rediscounted from the central bank in case of need.

The fifth item, investments by the bank in government securities, state bonds and industrial shares, yields a fixed income to the banks. The bank can sell its securities when there is need for more cash. The sixth item relating to loans and advances is the most profitable source of bank assets as the bank charges interest at a rate higher than the bank rate.

The bank makes advances on the basis of cash credits and overdrafts and loans on the basis of recognised securities. In the seventh item are included liabilities of the bank's customers which the bank has accepted and endorsed on their behalf. They are the assets of the bank because the liabilities of customers remain in the custody of the bank.

## NOTES

## NOTES

The bank charges a nominal commission for all acceptances and endorsements which is a source of income. The eighth item relates to the value of permanent assets of the bank in the form of property, furniture, fixtures, etc. They are shown in the balance sheet after allowing for depreciation every year. The last item includes profits retained by the bank after paying corporation tax and profits to shareholders.

### **The Distribution of Liabilities:**

The liabilities of commercial banks are claims on it. These are the items which form the sources of its funds. Of the liabilities, the share capital of the bank is the first item which is contributed by its shareholders and is a liability to them. The second item is the reserve fund. It consists of accumulated resources which are meant to meet contingencies such as losses in any year.

The bank is required to keep a certain percentage of its annual profits in the reserve fund. The reserve fund is also a liability to the shareholders. The third item compresses both the time and demand deposits. Deposits are the debts of the bank to its customers.

They are the main source from which the bank gets funds for investment and are indirectly the source of its income. By keeping a certain percentage of its time and demand deposits in cash the bank lends the remaining amount on interest. Borrowings from other banks are the fourth item.

The bank usually borrows secured and unsecured loans from the central bank. Secured loans are on the basis of some recognised securities, and unsecured loans out of its reserve funds lying with the central bank. The fifth item bills payable refer to the bills which the bank pays out of its resources. The sixth items relates to bills for collection.

These are the bills of exchange which the bank collects on behalf of its customers and credits the amount to their accounts. Hence it is a liability to the bank. The seventh item is the acceptance and endorsement of bills of exchange by the bank on behalf of its customers. These are the claims on the bank which it has to meet when the bills mature.

The eighth item contingents liabilities relate to those claims on the bank which are unforeseen such as outstanding forward exchange contracts, claims on acknowledge debts, etc. In the last item, profit and loss, are shown profits payable to the shareholders which are a liability on the bank.

The various items of the balance sheet shown in Table 1 are a rough indicator of the assets and liabilities of commercial banks. The balance sheet of a particular bank showed its financial soundness. By studying the balance sheets of the major commercial banks of a country, one can also know the trend of the monetary market. "The bank balance sheet reflects bank credit extension on its asset side in loans and investments, and on the liabilities side reflects the bank's operations as an

intermediary in time deposits and its role as an element in the nation's monetary system in demand deposits.”

**Table 1. Form of Balance Sheet:**

<b>Liabilities</b>	<b>Assets</b>
1. Share Capital	1. Cash
2. Reserve Fund	2. Balances with the Central Bank and other banks.
3. Deposits	3. Money at call and Short-Notice
4. Borrowings from other banks	4. Bills Discounted and Purchased.
5. Bills Payable	5. Investments
6. Bills for collection	6. Loans, Advances, Cash Credits and Overdrafts.
7. Acceptances. Endorsements and other obligations	7. Liabilities of Customer for Acceptances. Endorsements and other Obligations.
8. Contingent Liabilities	8. Property, Furniture, Fixtures less Depreciation
9. Profit and Loss	9. Profit and Loss.

**NOTES**

**2.9 INVESTMENT POLICY OF A COMMERCIAL BANK**

The main function of a commercial bank is to accept deposits. It is a institution which do business with the money provided by the depositors. The bank makes investment of such funds in different sectors of the economy and thus a bank should take into consideration the main factors while investing its funds. The following principles followed as regard the investment policy of a commercial bank :

**1. Profitability** – Bank is a profit earning institution. Thus, it makes investment of its funds in the securities which are profitable to the bank. Thus, the principles of profitability is an important consideration for investment of a bank.

**2. Safety** – The bank funds are generally the amount of savings done by general public which are deposited in the different accounts. In this way bank are trustee of a public money. So, it is necessary the bank should be in position to repay deposit whenever demanded by the depositors. It is the responsibility of the bank to provide safety of the fund generated from public money. The bank thus make investment of funds in those securities which are safe and secured. In this connection the banks make investment

## NOTES

in the securities. Thus, the principle of safety is a important consideration while making investment of funds by commercial bank.

**3. Diversification** – This is an important principle of investment policy of commercial bank. According to this principle, the bank should diversify the risks involve in investment of fund by making investment in different types of securities of different companies. This principle is based on the logic that “ All eggs should not be kept in the same basket.” If the bank invests its fund in different securities of different companies the risks of loss involved in one securities may be covered up by the profits earn from investment in other securities. When investment is made according to this policy there will be low risk in investment of fund by the bank.

**4. Liquidity** – Another important consideration in investment of funds by the bank is that investment should be made in such securities which can be easily converted into cash. So that depositors easily withdraw their money whenever need of money arise. Thus, liquidity is an important consideration by banks while investing its funds.

**5. Stability** – A commercial bank make investment in share, debenture and other securities issued by companies, financial institutions and government. The prices of these securities fluctuates. When there is greater fluctuations of prices of securities in the market there will be greater risk involved in such investment. Thus the bank considers the stability in the prices of securities as important factors while making investment of its funds.

**6. Productivity of investment** – Bank should invest its funds in such a company which is engaged in manufacturing business. It is necessary from safety point of view.

In this way a commercial bank takes into the consideration the above mentioned factors while investing its funds. Besides, the above mentioned principles or consideration the commercial bank also takes into account some other factors such as national interest, transfer of securities, tax concession and government policy while making investment of its funds.

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## 2.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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1. Define the Commercial Bank
2. What is schedule Bank?
3. What are the main functions of commercial bank?
4. What is CRR?

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## 2.11 SUMMARY

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- 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.
- General utility services are those in which the bank's position is not that of an agent for his customer.
- 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

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## 2.12 KEY WORDS

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- 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
- 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.
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## 2.13 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. What is leakage in banking
2. What is CRR
3. What is SLR

### Long-Answer Questions

4. Explain the type of commercial bank
5. Explain the balance sheet of commercial bank
6. Describe the investment policy of commercial bank
7. What is unit banking?
8. What is Branch banking?

### Long Answer Question

1. What is branch banking? Explain its advantages and disadvantages.
2. Explain the concept of 'unit banking'. What are the merits and demerits of unit banking system? Suggest measures to overcome the demerits of unit banking system.
3. Explain the concept of Branch banking'. What are the merits and demerits of Branch banking system? Suggest measures to overcome the demerits of Branch banking system.
4. How does Branch banking differ from the unit banking?

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## 2.14 FURTHER READINGS

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# UNIT – III RESERVE BANK OF INDIA (RBI)

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*Reserve Bank of India*

## **Structure**

- 3.0 Introduction
- 3.1 Objectives
- 3.2 Besides it has other objectives, which can be listed out as below.
- 3.3 Function of the Reserve Bank of India
- 3.4 Important Methods adapted by RBI to Control Credit Creation
- 3.5. Quantitative Method:
- 3.6 Qualitative Method:
- 3.7 Indian Money Market
- 3.8 Answers to Check Your Progress Questions
- 3.9 Summary
- 3.10 Key Words
- 3.11 Self Assessment Questions and Exercises
- 3.12 Further Readings

## **NOTES**

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## **4.0 INTRODUCTION**

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The Reserve Bank of India (RBI) was established in the year 1935 in accordance with the Reserve Bank of India Act, 1934. The Reserve Bank of India is the central Bank of India entrusted with the multidimensional role. It performs important monetary functions from issue of currency note to maintenance of monetary stability in the country. Initially the Reserve Bank of India was a private share holder's company which was nationalized in 1949. Its affairs are governed by the Central Board of Directors appointed by the Government of India. Since its inception the Reserve Bank of India had played an important role in the economic development and monetary stability in the country.

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## **3.1 OBJECTIVES**

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- To Understand the meaning and objectives of Reserve Bank of India
- Discuss the functions of Reserve Bank of India
- To know about the control of credit by Reserve Bank of India
- Brief about the Indian money market

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### **Objectives of the Reserve Bank of India**

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as:

*to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.*

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### **3.2 BESIDES IT HAS OTHER OBJECTIVES, WHICH CAN BE LISTED OUT AS BELOW.**

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1. To remain free from political influence and be in successful operation for maintaining financial stability and credit.
2. To discharge purely central banking functions in the Indian money market, such as acting as the note-issuing authority, bankers' bank and banker to Government, and to promote the growth of the economy.
3. To assist the planned process of development of the Indian economy.

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### **3.3 FUNCTION OF THE RESERVE BANK OF INDIA**

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#### 1. Issuer of Currency Notes

It is responsible for issuing currency notes. It brings uniformity in notes issue thus making it easier to control and regulate credit in accordance with the requirements in the economy. This also helps in keeping the faith of the public in the paper currency.

#### 2. Banker to the Government

As banker to the government the Reserve Bank manages the banking needs of the government. It maintains and operates the government's deposit accounts. It collects receipts of funds and makes payments on behalf of the government. It represents the Government of India as the member of the IMF and the World Bank.

#### 3. Custodian of Cash Reserves of Commercial Banks

The commercial banks hold deposits in the Reserve Bank and the latter has the custody of the cash reserves of the commercial banks. The institution is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. It decides policy rates and reserve ratios.

### 3. Custodian of Country's Foreign Currency Reserves

The Reserve Bank has the custody of the country's reserves of international currency, and this enables the Reserve Bank to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

### 5. Lender of Last Resort

The commercial banks approach the Reserve Bank in times of emergency to tide over financial difficulties, and the Reserve bank comes to their rescue though it might charge a higher rate of interest.

### 6. Central Clearance and Accounts Settlement

Since commercial banks have their surplus cash reserves deposited in the Reserve Bank, it is easier to deal with each other and settle the claim of each on the other through book keeping entries in the books of the Reserve Bank. The clearing of accounts has now become an essential function of the Reserve Bank

### 7. Controller of Credit

Since credit money forms the most important part of supply of money, and since the supply of money has important implications for economic stability, the importance of control of credit becomes obvious. Credit is controlled by the Reserve Bank in accordance with the economic priorities of the government.

Banking Government Exams MBA Exams Free Mock Tests Free Exam Preparation Free tests Mock Tests All India Mock Tests SBI PO Exam IBPS PO Exams Bank Logo Bank Logos Banking Sector Oliveboard Quiz Daily Quiz Fun Quiz

### 8. Detection of Fake Currency

Reserve Bank is expected to unearth black money held in cash. As the new currency notes (demonetization) have added security features, they would help in curbing the menace of fake currency.

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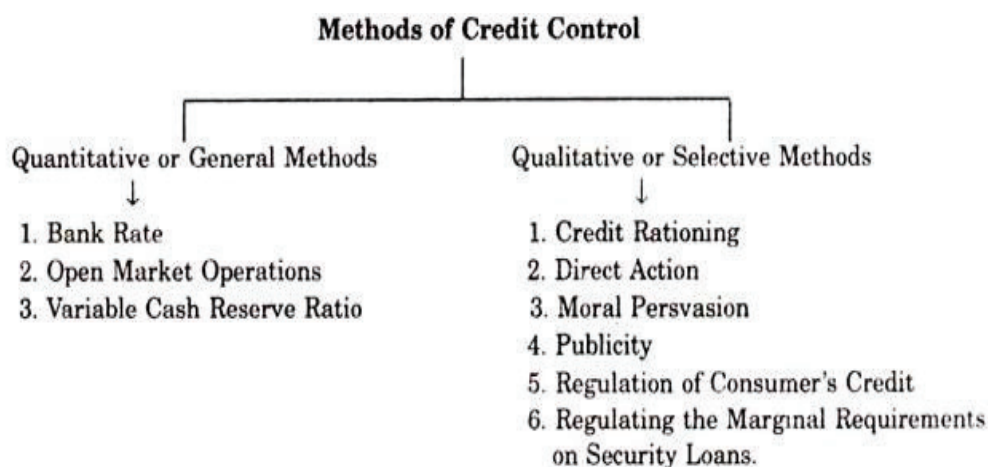
## 3.4 IMPORTANT METHODS ADAPTED BY RBI TO CONTROL CREDIT CREATION

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The various methods employed by the RBI to control credit creation power of the commercial banks can be classified in two groups, viz., quantitative controls and qualitative controls. Quantitative controls are designed to regulate the volume of credit created by the banking system qualitative measures or selective methods are designed to regulate the flow of credit in specific uses.

## NOTES

## NOTES



Quantitative or traditional methods of credit control include banks rate policy, open market operations and variable reserve ratio. Qualitative or selective methods of credit control include regulation of margin requirement, credit rationing, regulation of consumer credit and direct action.

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### 3.5. QUANTITATIVE METHOD:

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#### (i) Bank Rate:

The bank rate, also known as the discount rate, is the rate payable by commercial banks on the loans from or rediscounts of the Central Bank. A change in bank rate affects other market rates of interest. An increase in bank rate leads to an increase in other rates of interest and conversely, a decrease in bank rate results in a fall in other rates of interest.

A deliberate manipulation of the bank rate by the Central Bank to influence the flow of credit created by the commercial banks is known as bank rate policy. It does so by affecting the demand for credit the cost of the credit and the availability of the credit.

An increase in bank rate results in an increase in the cost of credit; this is expected to lead to a contraction in demand for credit. In as much as bank credit is an important component of aggregate money supply in the economy, a contraction in demand for credit consequent on an increase in the cost of credit restricts the total availability of money in the economy, and hence may prove an anti-inflationary measure of control.

Likewise, a fall in the bank rate causes other rates of interest to come down. The cost of credit falls, i. e., and credit becomes cheaper. Cheap credit may induce a higher demand both for investment and consumption purposes. More money, through increased flow of credit, comes into circulation.

A fall in bank rate may, thus, prove an anti-deflationary instrument of control. The effectiveness of bank rate as an instrument of control is, however, restricted primarily by the fact that both in inflationary and recessionary conditions, the cost of credit may not be a very significant factor influencing the investment decisions of the firms.

### **(ii) Open Market Operations:**

Open market operations refer to the sale and purchase of securities by the Central bank to the commercial banks. A sale of securities by the Central Bank, i.e., the purchase of securities by the commercial banks, results in a fall in the total cash reserves of the latter.

A fall in the total cash reserves leads to a cut in the credit creation power of the commercial banks. With reduced cash reserves at their command the commercial banks can only create lower volume of credit. Thus, a sale of securities by the Central Bank serves as an anti-inflationary measure of control.

Likewise, a purchase of securities by the Central Bank results in more cash flowing to the commercial banks. With increased cash in their hands, the commercial banks can create more credit, and make more finance available. Thus, purchase of securities may work as an anti-deflationary measure of control.

The Reserve Bank of India has frequently resorted to the sale of government securities to which the commercial banks have been generously contributing. Thus, open market operations in India have served, on the one hand as an instrument to make available more budgetary resources and on the other as an instrument to siphon off the excess liquidity in the system.

#### **Check your progress**

- i What is credit control?
- ii List the quantitative or general methods of credit control
- iii List the qualitative or selective methods of credit control

### **(iii) Variable Reserve Ratios:**

Variable reserve ratios refer to that proportion of bank deposits that the commercial banks are required to keep in the form of cash to ensure liquidity for the credit created by them.

A rise in the cash reserve ratio results in a fall in the value of the deposit multiplier. Conversely, a fall in the cash reserve ratio leads to a rise in the value of the deposit multiplier.

A fall in the value of deposit multiplier amounts to a contraction in the availability of credit, and, thus, it may serve as an anti-inflationary measure.

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A rise in the value of deposit multiplier, on the other hand, amounts to the fact that the commercial banks can create more credit, and make available more finance for consumption and investment expenditure. A fall in the reserve ratios may, thus, work as anti-deflationary method of monetary control.

The Reserve Bank of India is empowered to change the reserve requirements of the commercial banks.

The Reserve Bank employs two types of reserve ratio for this purpose, viz. the Statutory Liquidity Ratio (SLR) and the Cash Reserve Ratio (CRR).

The statutory liquidity ratio refers to that proportion of aggregate deposits which the commercial banks are required to keep with themselves in a liquid form. The commercial banks generally make use of this money to purchase the government securities. Thus, the statutory liquidity ratio, on the one hand is used to siphon off the excess liquidity of the banking system, and on the other it is used to mobilise revenue for the government.

The Reserve Bank of India is empowered to raise this ratio up to 40 per cent of aggregate deposits of commercial banks. Presently, this ratio stands at 25 per cent.

The cash reserve ratio refers to that proportion of the aggregate deposits which the commercial banks are required to keep with the Reserve Bank of India. Presently, this ratio stands at 9 percent.

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### 3.6 QUALITATIVE METHOD:

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The qualitative or selective methods of credit control are adopted by the Central Bank in its pursuit of economic stabilisation and as part of credit management.

#### (i) Margin Requirements:

Changes in margin requirements are designed to influence the flow of credit against specific commodities. The commercial banks generally advance loans to their customers against some security or securities offered by the borrower and acceptable to banks.

More generally, the commercial banks do not lend up to the full amount of the security but lend an amount less than its value. The margin requirements against specific securities are determined by the Central Bank. A change in margin requirements will influence the flow of credit.

A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security.

**(ii) Credit Rationing:**

Rationing of credit is a method by which the Central Bank seeks to limit the maximum amount of loans and advances and, also in certain cases, fix ceiling for specific categories of loans and advances.

**(iii) Regulation of Consumer Credit:**

Regulation of consumer credit is designed to check the flow of credit for consumer durable goods. This can be done by regulating the total volume of credit that may be extended for purchasing specific durable goods and regulating the number of installments through which such loan can be spread. Central Bank uses this method to restrict or liberalise loan conditions accordingly to stabilise the economy.

**(iv) Moral Suasion:**

Moral suasion and credit monitoring arrangement are other methods of credit control. The policy of moral suasion will succeed only if the Central Bank is strong enough to influence the commercial banks.

In India, from 1949 onwards, the Reserve Bank has been successful in using the method of moral suasion to bring the commercial banks to fall in line with its policies regarding credit. Publicity is another method, whereby the Reserve Bank makes direct appeal to the public and publishes data which will have sobering effect on other banks and the commercial circles.

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**3.7 INDIAN MONEY MARKET**

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Money market is a market for short-term funds. We define the short-term as a period of 364 days or less. In other words, the borrowing and repayment take place in 364 days or less. The manufacturers need two types of finance: finance to meet daily expenses like purchase of raw material, payment of wages, excise duty, electricity charges etc., and finance to meet capital expenditure like purchase of machinery, installation of pollution control equipment etc.

The first category of finance is invested in the production process for a short-period of time. The market where such short-time finance is borrowed and lent is called 'money market'. Almost every concern in the financial system, be it a financial institution, business firm, a corporation or a government body, has a recurring problem of liquidity management, mainly because the timing of the expenditures rarely synchronize with that of the receipts.

The most important function of the money market is to bridge this liquidity gap. Thus, business and finance firms can tide over the mismatches of cash receipts and cash expenditures by purchasing (or selling) the shortfall (or surplus) of funds in the money market.

## NOTES

In simple words, the money market is an avenue for borrowing and lending for the short-term. While on one hand the money market helps in shifting vast sums of money between banks, on the other hand, it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used (at a cost) by banks, corporations and other institutions which need short-term money.

A supplier of funds to the money market can be virtually anyone with a temporary excess of funds. The government bonds, corporate bonds and bonds issued by banks are examples of money market instruments, where the instrument has a ready market like the equity shares of a listed company. The money markets refer to the market for short-term securities (one year or less in original maturity) such as treasury bills, certificates of deposits, commercial paper etc. Money market instruments are more liquid in nature.

The money market is a market where money and highly liquid marketable securities are bought and sold. It is not a place like the stock market but an activity and all the trading is done through telephones. One of the important features of the money market is honour of commitment and creditworthiness.

The money market form an important part of the financial system by providing an avenue for bringing equilibrium of the surplus funds of lenders and the requirements of borrowers for short periods ranging from overnight up to a year. Money market provides a non-inflationary way to finance government deficits and allow governments to implement monetary policy through open market operations and provide a market based reference point for setting interest rate.

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### 3.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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1. Why the credit control is necessary to the Banking sector
2. What are the Selective methods of Credit control
3. What are the Quantitative methods of Credit control

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### 3.9 SUMMARY

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- 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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### 3.10 KEY WORDS

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**Currency:** is a medium of exchange for goods and services. In short, it's money, in the form of paper or coins, usually issued by a government and generally accepted at its face value as a method of payment.

**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.

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### 3.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short Answer Question

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?

### Long Answer Question

1. Discuss the important constituents of Indian money market.
2. What are the important features of the guidelines for the issue of CDs? Discuss.
3. Discuss Ready Forward Contracts and Money Market Mutual Funds in detail.

### NOTES

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### 3.12 FURTHER READINGS

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# UNIT – IV INTRODUCTION TO MONEY

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*Introduction to Money*

## Structure

- 4.01 Introduction
- 4.02 Type of money
- 4.03 Money Promotes Productivity and Economic Growth:
- 4.04 Money and Investment in Quick-Yielding Projects:
- 4.05 Monetization and Economic Growth:
- 4.06 Demand for Money:
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- 4.08 Types of Monetary Standards: Metallic and Paper Standard
- 4.09 Methods of Note Issue
- 4.10 Answers to Check Your Progress Questions
- 4.11 Summary
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- 4.13 Self Assessment Questions and Exercises
- 4.14 Further Readings

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### 4.01 INTRODUCTION

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Money is a commonly accepted medium of exchange therefore economic exchanges without the arbitration of money are called barter exchanges. Barter exchanges become extremely difficult in large economies because of the high costs people would have to incur looking for suitable persons to exchange their surpluses with it. Money also acts as a convenient unit of account. The value of all goods and services can be expressed in monetary units. It is not perishable and its storage costs are also considerably lower. It is also acceptable to anyone at any point of time. Thus money can act as a store of value for individuals. Any asset other than money can also act as a store of value. For example, real estate, precious metals, livestock, stock, etc.

The main functions of money are:

- 1) It must act as a medium of exchange;
- 2) It must act as a unit of account;
- 3) It must be a store of value;
- 4) It must be a standard of deferred payment.

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**Medium of exchange**

Money act as a medium of exchange when it is used to intermediate the exchange of goods and services.

**Measure of value**

For determining the market value of a good, service or any other transaction a unit of account is a necessity which acts as a standard of numerical monetary unit of measurement. It is also known as a “measure” or “standard” of relative worth of goods and services and deferred payment. A unit of account is a necessary prerequisite to formulate commercial agreements involving debt.

For carrying out trade, money acts as a standard measure and common denomination, and is necessary for efficient accounting.

**Store of value**

Money acts as a store of value since it can reliably be saved, stored and retrieved and is also predictably usable as a medium of exchange whenever retrieved.

To summarise money is any item or verifiable record that fulfils all the functions mentioned above.

**Standard of deferred payment**

In simple terms a "standard of deferred payment" (i.e. payments which are withheld until a specific time) is an accepted way of settling a debt. Money is used for settling debts. So debts and their settlement can be denominated in terms of money.

Various kinds of money are there varying in their liquidity, liability and strength. Society has modified money at different times and in the process several types of money has come into existence. In earlier times there was ample availability of metals which were cheap then, and as a result metal money came into existence. As the value of metals increased metal money slowly became infeasible and thus was substituted by the paper money. Several commodities have been used as the medium of exchange at different times. Therefore, it can be said that according to the needs and availability of means, the kinds of money has changed.

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**4.02 TYPE OF MONEY**

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There are 4 major types of money:

- 1) Commodity Money
- 2) Fiat Money
- 3) Fiduciary Money
- 4) Commercial Bank Money

## **Commodity Money**

Commodity money is the simplest kind of money used in barter system in which valuable resources fulfil the functions of money. The value of the resources and the purpose determines the value of this kind of money and is only limited by the scarcity of resources. The parties involved in the exchange process of goods and services determine the value of this kind of money.

As commodity is used for the purpose of exchange, the commodity becomes equivalent to the money and is thus called commodity money. Certain types of commodity are used as commodity money.

Among them are precious metals such as gold, silver, copper, etc. In many parts of the world seashells (also known as cowrie shells), tobacco and many other items were used as a type of money & medium of exchange. Example: gold coins, bronze coins, beads, shells, pearls, stones, tea, sugar, metal, etc.

## **Fiat Money**

The meaning of the word fiat is “command of the sovereign” (i.e. command of authority holding supreme power). Fiat currency does not have any intrinsic value and it cannot be converted into valuable resource. Government by order determines the value of Fiat Money thereby making it a legal tender/instrument for all transaction purposes in areas within the jurisdiction of that government.

Fiat money needs to be controlled, because it’s misuse may adversely affect the economy of an entire country. All modern money systems today are based on Fiat Money. Market forces of demand and supply determine the real value of Fiat Money. Example: Paper currency, Coins.

## **Fiduciary Money**

The meaning of the word fiduciary is “involving trust”, and today’s monetary system is highly fiduciary i.e. based upon trust. If a bank assures the customers payment in different types of money and if the customer can also sell these promises (legal tenders) or transfer them to somebody else, it is known as fiduciary money.

Generally gold, silver or paper money is generally used for payments as fiduciary money. Bank notes and cheques also are the examples of fiduciary money as both of them are kind of tokens/legal tenders which are used as money and carry the same value.

## **Commercial Bank Money**

Demand deposits or commercial bank money are claims against financial institutions that can be used for the purchase of goods and services. A demand deposit account allows the owner to withdraw funds at any time by the means of cheque or cash withdrawal without giving the

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bank or financial institution any prior notice. Banks are legally obligated to return the funds to the owner of a demand deposit account immediately upon demand (i.e. at call). One can perform demand deposit withdrawals in person, via cheques or bank drafts, using ATMs (Automatic Teller Machines), or by the means of online banking.

There are some other types of money too, like the Credit money, Electronic money, Coin and Paper money, Fractional money and Representative money which are discussed below:

### **Credit Money**

Any future monetary claim against an individual that can be used to buy goods and services is known as Credit money. There are many forms of credit money, such as bonds, money market accounts, IOUs etc. Any form of financial instrument that matures after a certain period of time or cannot be repaid immediately is considered as credit money.

### **Electronic Money**

The money which exists only in banking computer systems and is not held in any physical form or rather is present in electronic form is known as Electronic money. In USA and many other developed countries, only a small fraction of the currency or money in circulation actually exists in physical form. Most of the money in such countries are in electronic form. Need of physical currency is on the decline as more and more citizens use electronic alternatives to physical currency. Example: Bitcoins, etc.

### **Plastic Money**

The term Plastic money is used predominantly to refer to the hard plastic cards we use everyday in place of actual paper money/bank notes. There are many different forms of plastic money such as credit cards, debit cards, cash cards, pre-paid cash cards and store cards.

### **Coins**

Coins are manufactured by stamping metals into particular weight and sizes. Throughout human history various precious metals like gold, silver, copper, bronze, etc. have been used to make coins. Governments authorize and control the minting of coins.

### **Paper Money**

Paper money does not have any intrinsic value by itself and it is a fiat money which is approved by the order of the government to be treated as legal tender to act as a medium of exchange of value. Paper money is printed by the government according to requirements which is tightly controlled as it's usage and supply have effects upon the economy of the country.

### **Fractional Money**

Fractional money is a kind of hybrid money. It has a dual character. It is partly backed by a commodity and it also has a fiat money transaction purpose. When the commodity loses its value, the Fractional money converts into Fiat money.

### **Representative Money**

It is the representation of a claim on a certain commodity and it can be redeemed for that commodity at a bank, financial institution or commercial institution such as a shop, or department store etc. It is kind of token or currency that can be exchanged for a fixed quantity of commodity without the payment of money to the limit of the value of the Representative money. Its value is dependent upon the commodity it backs. Example: gift cards, etc. Role of Money in Economic Development of Developing Countries!

Economic development is generally believed to be dependent on the growth of real factors such as capital accumulation, technological progress, and increase in quality and skills of labour force. This view does not adequately stress the role of money in the process of economic development.

### **Significance of Money**

It is said that money is a mere veil and intrinsically unimportant. What matters is the real goods and productive factors which money buys. However, this extreme view about the unimportance of money as such is no longer believed. Not only is money an important factor without which modern complex economic organisation is impossible, but it is also an important factor for promoting economic development. We discuss below the importance of money in the process of economic development.

In the economy today money performs several functions. Money serves as a standard of value in which other values are measured. Money is a store of value, that is, the means in which wealth can be held. It acts as a standard for deferred payments.

However, the most important function of money which distinguishes it from other goods is that it serves as a medium of exchange. That is, money is a means of payment for goods and services. It is this use of money that distinguishes a monetary economy from a barter economy. A monetary economy is one in which goods are sold for money and money is used to buy goods.

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### **4.03 MONEY PROMOTES PRODUCTIVITY AND ECONOMIC GROWTH:**

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Barter system was full of difficulties of exchanging goods and services between individuals. In the absence of easy exchange of goods

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and services the barter system worked as an obstacle to the division of labour and specialisation among individuals which is an important factor for increasing productivity and economic growth. Further, the process of economic growth leads to the expansion of production of goods and services and consequential rise in incomes of the people.

In the developed countries in times of depression when idle productive capacity exists, the increase in investment made possible by creation of new money by the Government or banks would lead to the increase in aggregate demand for goods and services. In such times the supply of goods and services is elastic due to the existence of excess capacity. Therefore, increase in aggregate demand generated by the investment financed by created money brings about expansion in output of goods and services and thereby causes an increase in the level of employment.

In developing countries, the created money can play a useful role in promoting economic development. Rapid economic development can be achieved by stepping up the rate of investment or capital formation. But additional resources are required to increase the rate of investment. But in a country where a majority of the people are living at the bare subsistence level, voluntary savings, taxation.

Government borrowing cannot by themselves provide sufficient investible resources for development. The government therefore attempts to increase the volume of investible resources beyond what is possible on the basis of current level of savings through creating new money. The newly created money can be spent on investment projects both in the industrial and agricultural fields which would lead to the increase in output, income and employment.

**Check your progress**

- i What is plastic money?
- ii What is money?
- iii What is barter system?

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**4.04 MONEY AND INVESTMENT IN QUICK-YIELDING PROJECTS:**

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It is widely believed that any increase in the supply of money in developing countries would lead to the rise in prices or to the emergence of inflationary pressures. However, this is not always true. A reasonable amount of newly created money helps the development of the economy by raising the level of investment. In the developing economies a lot of natural and human resources lie un-utilised and underutilized which can be employed for productive purposes.



If the newly created money is used for investment in those projects such as small irrigation works, land reclamation schemes, flood control and anti-soil erosion measures, cottage industries which yield quick returns, then the danger of inflation will not be there. These quick-yielding projects will increase the production of essential consumer goods in the short run and will therefore prevent the rise in prices.

Further, if development strategy is such that a higher priority is assigned to agriculture and other wage goods industries and further that organisational and institutional reforms are undertaken to provide all farmers with irrigation facilities, fertilizers and high-yielding varieties, agricultural output can be raised in the short period. In this framework, new money can be created to increase the level of investment without much adverse effect on prices.

## NOTES

### **4.05 MONETIZATION AND ECONOMIC GROWTH:**

Further, as is well known, most underdeveloped countries have a large non-monetised (i.e. barter) sector where production is for the purpose of subsistence only. To break the subsistence nature of economic activity and thus generate new forces for economic growth, its monetisation is required. The introduction of money helps in bringing it in contact with the modern sector. This contact of the subsistence sector with the modern sector will lead to the expansion of its output.

In order to obtain the products of the modern industrial sector, the people engaged in the subsistence sector will make efforts to raise their output. Thus, a surplus of output over their self-consumption will be generated in this way which will ultimately break their subsistence nature.

It is supported by the past history of the developing countries. During the colonial period, the monetisation of the peasant sector led to the expansion in exports in exchange for the imported industrial products. This stepped up their agricultural development to a good extent.

Similar to the growth of production for exports the introduction of money in the subsistence agricultural sector and its contact with the modern sector, would lead to the increase in marketable surplus of food-grains and other agricultural products which is an important factor in economic development.

If some rise in agricultural prices occurs as a result of increase in investment financed by the created money, as is likely the case, it would serve as an incentive to produce more food grains and supply it the market. The rise in agricultural incomes will increase demand for industrial products and would therefore accelerate their growth.

Further, the monetisation of the subsistence sector will also help in raising the volume of savings. Monetisation will bring this sector in contact with

the financial institutions such as commercial and cooperative banks and insurance companies.

The opportunities of earning more income through interest on saving will raise the propensity to save of the people in the present-day subsistence sector. If proper monetary policies are pursued, then instead of consuming or hoarding all their therefore incomes, these people can deposit a part of them in the financial intermediaries.

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### **4.06 DEMAND FOR MONEY:**

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The old idea about the demand for money was that money was demanded for completing the business transactions. In other words, the demand for money depended on the volume of trade or transactions. As such the demand for money increased during boom period or when the trade was brisk and it decreased during depression or slackening of trade.

The modern idea about the demand for money was put forward by the late Lord Keynes, the famous English economist, who gave birth to what has been called the Keynesian Economics. According to Keynes, the demand for money, or liquidity preference as he called it, means the demand for money to hold.

Broadly speaking, there are three main motives on account of which money is wanted by the people by the people, viz:

- (i) Transactions motive
- (ii) Precautionary motive
- (iii) Speculative motive

Now a word about each one of them.

(i) Transactions Motive:

This motive can be looked at:

- (a) From the point of consumers who want income to meet the household expenditure which may be termed the income motive, and
- (b) From the point of view of the businessmen, who require money and want to hold it in order to carry on their business, i.e., the business motive.

**(a) Income Motive:**

The transactions motive relates to the demand for money or the need for cash for the current transactions of individual and business exchanges. Individuals hold cash in order “to bridge the interval between the receipt of income and its expenditure.” This is called the income Motive’.

Most of the people receive their incomes by the week or the month, while the expenditure goes on day by day. A certain amount of ready money, therefore, is kept in hand to make current payments. This amount will depend upon the size of the individual's income, the interval at which the income is received and the methods of payments current in the locality.

**(b) Business Motive:**

The businessmen and the entrepreneurs also have to keep a proportion of their resources in ready cash in order to meet current needs of various kinds. They need money all the time in order to pay for raw materials and transport, to pay wages and salaries and to meet all other current expenses incurred by any business of exchange.

Keynes calls it the 'Business Motive' for keeping money. It is clear that the amount of money held, under this business motive, will depend to a very large extent on the turnover (i.e., the volume of trade of the firm in question). The larger the turnover, the larger in general, will be the amount of money needed to cover current expenses.

**(c) Precautionary Motive:**

Precautionary motive for holding money refers to the desire of the people to hold cash balances for unforeseen contingencies. People hold a certain amount of money to provide for the risk of unemployment, sickness, accidents and other more uncertain perils. The amount of money held under this motive will depend on the nature of the individual and on the conditions in which he lives.

**(d) Speculative Motive:**

The speculative motive relates to the desire to hold one's resources in liquid form in order to take advantage of market movements regarding the future changes in the rate of interest (or bond-prices). The notion of holding money for speculative motive is a new typically Keynesian idea. Money held under the speculative motive serves as a store of value as money held under the precautionary motive does. But it is a store of money meant for a different purpose.

The cash held under this motive is used to make speculative gains by dealing in bonds whose prices fluctuate. If bond prices are expected to rise, which in other words means that the rate of interest is expected to fall, businessmen will buy bonds to sell when the price actually rises.

If however, bond prices are expected to fall, i.e., the rate of interest is expected to rise, businessmen will sell bonds to avoid capital losses. Nothing being certain in this dynamic world, where guesses about the future course of events are made on precarious bases, businessmen keep cash to speculate on the probable further changes in bond prices (or the rate of interest) with a view to making profits.

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Given the expectations about the changes in the rate of interest in future, less money will be held under the speculative motive at a higher current or prevailing rate of interest and more money will be held under this motive at a lower current rate of interest.

The reason for this inverse correlation between money held for speculative motive and the prevailing rate of interest is that at a lower rate of interest less is lost by not lending money or investing it, that is by holding on to money; while at a higher rate, holders of cash balances would lose more by not lending or investing.

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### 4.07 SUPPLY OF MONEY:

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We have described the demand for money as the demand for the stock (not flow) of money to be held. The flow is over a period of time and not at a given moment. In the case of commodity, it is a flow. Goods are being continually produced and disposed of. This is the essential difference between the demand for money and the demand for a commodity.

Similarly, the supply of money conforms to the 'stock' concept and not the 'flow' concept. Just as the demand for money is the demand for money to hold, similarly, the supply of money means the supply of money to hold. Money must always be held by someone, otherwise it cannot exist. Hence, the supply of money means the sum total of all the forms of money which are held by a community at any given moment.

The stock of money, which constitutes the supply of it, consists of (a) metallic money or coins, (b) currency notes issued by the currency authority of the country whether the Central bank or the government, and (c) chequable bank deposits. In old times, the coins formed the bulk of money supply of the country. Later, the currency notes eclipsed the metallic currency and now the bank deposits in current account withdraw-able by cheques have overwhelmed all other forms of money.

Thus, money supply means total volume of monetary media of exchange available to the community for use in connection with the economic activity of the country. Broadly speaking, money supply in a country is composed of two main elements, viz., (a) currency with the public; and (b) deposit money with the public.

In order to arrive at the total amount of currency with the public, we add: (i) currency notes in circulation; (ii) circulation of rupee notes and coins; and (iii) circulation of small coins; and from the total deduct- 'Cash in hand with banks' The bulk of the currency with the public (over 95 per cent) is in the form of currency notes issued by the Reserve Bank of India. Next in importance are the rupee notes issued by the Government of India.

Besides currency, money supply with the public includes the deposit money, i.e., the bank balances held in current accounts of the banks. In underdeveloped countries, the currency, and not the bank deposits, occupies a dominant position, because in such countries the bulk of

commercial dealings are done through cash as a medium of exchange and not through cheques as in advanced countries. Deposit money with the public in India consists of two items, viz., net demand deposits of bank and 'other deposits' with the Reserve Bank of India.

By adding total currency with the public and the total demand deposits, we get the total money supply with the public.

It is also worth nothing here that in India the deposit money with the public has now come to exceed, albeit slightly, the total currency money with the public. Compare with it the position in 1950-51, when deposit money with the public was not even one-half of the currency in circulation among the public.

This shows that the banking habit has steadily been growing in the country and the time will not be far off when deposit money will far outstrip the currency money.

The total amount of bank deposits in the country is determined by the monetary policy of the central bank of the country. When the central bank wants to give a boost to the economy of the country, it follows a cheap money policy, lowers the bank rate, which is followed by lower rates of interest charged by the commercial banks, thus helping credit creation by the banks.

There are times, however, when in the interest of economic stability, the central bank follows a policy of credit squeeze by raising the bank rate and purchasing securities through open market operations and adopting other credit control measures.

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#### **4.08 TYPES OF MONETARY STANDARDS: METALLIC AND PAPER STANDARD**

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There are two types of monetary standards: A. Metallic Standard B. Paper Standard.

##### **A. Metallic Standard:**

Under metallic standard, the monetary unit is determined in terms of some metal like gold, silver, etc. Standard coins are made out of the metal. Standard coins are full-bodied legal tender and their value is equal to their intrinsic metallic worth. The important thing to note is that to be on a metallic standard a country must keep – (a) its monetary unit at a constant value in terms of the selected metal, and (b) its various types of money convertible into the selected metal at constant values.

Metallic standard may be of two types:

1. Monometallism
2. Bimetallism.

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**1. Monometallism:**

Monometallism refers to the monetary system in which the monetary unit is made up or convertible to only one metal. Under monometallic standard, only one metal is used as standard money whose market value is fixed in terms of a given quantity and quality of the metal.

**Types of Monometallism:**

Monometallism can be of two types:

**a. Silver Standard:**

Under silver standard, the monetary unit is defined in terms of silver. The standard coins are made of silver and are of a fixed weight and fineness in terms of silver. They are unlimited tender. There is no restriction on the import and export of silver. The silver standard remained in force in many countries for a long period.

India remained on silver standard from 1835 to 1893. During this period, Rupee was the standard coin and its weight was fixed at 180 grains and fineness 11/12. The coinage of the Rupee was free and people can get their silver converted into coins at the mint. Similarly, silver coins could be melted into bullion.

Silver standard lacks universal recognition as compared to gold standard. There is greater instability of both internal and external values of money under silver standard because silver price fluctuates more than that of gold. Thus, as far as the metal is concerned, gold is preferred to silver in most of the countries.

**b. Gold Standard:**

Gold standard is the most popular form of monometallic standard; the monetary unit is expressed in terms of gold. The standard coins possess a fixed weight and fineness of gold. The gold standard remained widely accepted in most of the countries of the world during the last quarter of the 19th century and the first quarter of the 20th century.

The U.K. was the first country to adopt the gold standard in 1816. She was also the first to abandon this standard in 1931. Germany adopted the gold standard in 1873, France in 1878 and the U.S.A. in 1900. Gradually, gold standard disappeared from different countries and finally it was completely abandoned by the world by 1936.

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Gold standard has been defined differently by different monetary economists. According to D.H. Robertson, “Gold standard is a state of affairs in which a country keeps the value of its monetary unit and the value of a defined weight of gold at equality with one another.” According to Coulborn, “The gold standard is an arrangement whereby the chief piece of money of a country is exchangeable with a fixed quantity of gold of a specific quality.”

In the words of Kemmerer, “a gold standard is a monetary system in which the unit of value, in which price and wages are customarily expressed, and in which the debts are usually contracted, consists of the value of a fixed quantity of gold in an essentially free gold market.”

## **2. Bimetallism:**

Bimetallism is a monetary system which attempts to base the currency on two metals. According to Chandler, “A bimetallic or double standard is one in which the monetary unit and all types of a nation’s money are kept at constant value in terms of gold and also in terms of silver.” Under bimetallism two metallic standards operate simultaneously.

Two types of standard coins from two different metals (say gold and silver) are minted. Both the types of standard coins become unlimited legal tender and a fixed ratio of exchange based on mixed ratio of exchange based on mint parity is prescribed for them. Provisions for unlimited purchase, sale and redeem-ability are extended to both metals.

## **B. Paper Standard:**

Paper standard refers to a monetary standard in which inconvertible paper money circulates as unlimited legal tender. Under paper money standard, although the standard money is made of paper, both currency and coins serve as standard money for purpose of payment. No gold reserves are required either to back domestic paper currency or to facilitate foreign payments.

The paper standard is known as managed standard because the quantity of money in circulation is controlled and managed by the monetary authority with a view to maintain stability in prices and incomes within the country. It is also called fiat standard because paper money is inconvertible in gold and still regarded as full legal tender. After the general breakdown of gold standard in 1931, almost all the countries of the world shifted to the paper standard.

To ensure a good note issue system, two principles of note issue have been advocated:

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(1) Currency principle and

(2) Banking principle.

1. Currency Principle:

The currency principle is advocated by the 'currency school' comprising Robert Torrens, Lord Overstone, G. W. Norman and William Ward. Currency principle is based on the assumption that a sound system of note issue should command the greatest public confidence. This requires that the note issue should be backed by 100 per cent gold or silver reserves. Or in other words, paper currency should be fully convertible into gold or silver.

Thus, according to the currency principle, the supply of paper currency is subjected to the availability of metallic reserves and varies directly with the variations in the metallic reserves.

**2. Banking Principle:**

The banking principle is advocated by the 'banking school', the important members of which are Thomas Tooke, John Fullarton James, Wilson and J.W. Gilbart. The banking principle is based on the assumption that the common man is not much interested in getting his currency notes converted into gold or silver.

Therefore 100 per cent metallic reserves may not be necessary against note issue. It is sufficient to keep only a certain percentage of total paper currency in the form of gold or silver reserves. The banking principle of note issue is derived from the practice of the commercial banks to keep only a certain proportion of cash reserves against their total deposits.

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#### **4.09 METHODS OF NOTE ISSUE:**

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Different countries have adopted various methods of note-issue in different periods.

Important methods of note-issue are discussed below:

**1. Simple Deposit System:**

Under the simple deposit system, the paper currency notes are fully backed by the reserves of gold or silver or both. This system is based on the currency principle of note issue. This method involves no danger of over-issue of currency and commands maximum degree of public confidence. But, this system has never been practised because it is very costly and has no elasticity of money supply.



## **2. Fixed Fiduciary System:**

Under the fixed fiduciary system, the central bank is authorised to issue only a fixed amount of currency notes against government securities. All notes issued in excess of this limit should be fully backed by gold and silver reserves. Fiduciary issue means the issue of currency notes without the backing of gold and silver. This system was first introduced in England under the Bank Charter Act of 1844 and still prevails there. India followed this system between 1862 to 1920.

## **3. Proportional Reserves System:**

Under the proportional reserve system, certain proportion of currency notes (40%) are backed by gold and silver reserves and the remaining part of the note issue by approved securities. India adopted this method on the recommendation of Wilton Young Commission.

According to the Reserve Bank of India Act 1933, not less than 40 per cent of the total assets of the Issue Department should consist of gold bullion, gold coins and foreign securities, with the additional provision that gold coins and gold bullion were not at any time to be less than Rs. 40 crores. The proportional reserve system was later replaced by the minimum reserve system by the Reserve Bank of India (Amendment) Act, 1956.

## **4. Minimum Fiduciary System:**

Under the minimum fiduciary system, the minimum reserves of gold against note issue that the authority is required to maintain are fixed by law. Against these minimum reserves, the monetary authority can issue as much paper currency as is considered necessary for the economy. There is no upper limit fixed for the issue of currency.

## **5. Maximum Reserve System:**

Under this system, the government fixes the maximum limit upto which the monetary authority can issue notes without the backing of metallic reserves. The monetary authority cannot issue notes beyond this limit. The maximum limit is not rigid and may be revised from time to time according to the changing needs of the economy.

This system was followed by France and England upto 1928 and 1939 respectively. Under this system, the Central bank is given the power to determine the maximum limit and thus an element of elasticity is introduced in the system of note issue. The system, however involves the dangers of over-issue and loss of public confidence when the maximum limit is raised and additional currency is circulated without the backing of metallic reserves.

## **NOTES**

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## 4.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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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).

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## 4.11 SUMMARY

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- 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.
- 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 learnable 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.

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## 4.12 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.
- Coin: are manufactured by stamping metals into particular weight and sizes

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### **4.13 SELF ASSESSMENT QUESTIONS AND EXERCISES**

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#### **Short-Answer Questions**

1. What is money market?
2. What do you understand by bill market?
3. What is the supply of money?

#### **Long-Answer Questions**

1. What are the features of a developed market?.
2. Discuss the different approaches to the supply of money.
3. Write a detailed note on the monetary standards in India.

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### **4.14 FURTHER READINGS**

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- E. Gordon, K. Natarajan.2014. Banking Theory, Law and Practice, Himalaya publishing house, Hyderabad.
- Parameswaran, R. 2001. Indian Banking. S. Chand Publishing. New Delhi.
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- Iyenger, Vijayaragavan. 2009. Introduction to Banking. Excel Books. New Delhi.

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## UNIT – V THE FOREIGN EXCHANGE MARKET

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- 5.1 Introduction
- 5.2 Purchasing Power Parity (Inflation) Theorem
- 5.3 Balance Of Payments Position
- 5.4 Direct And Indirect Quotes
- 5.5 Spot Rate, Forward Rate, Cash Rate And Tom Rate
- 5.6 International Credit Instruments
- 5.7 Bills Of Exchange
- 5.8 Answers to Check Your Progress Questions
- 5.9 Summary
- 5.10 Key Words
- 5.11 Self Assessment Questions and Exercises
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### 5.1 INTRODUCTION

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The participants in the foreign exchange market include central banks, commercial banks, brokers etc. The central banks monitor market movements and sentiments and intervene according to government policy. The function of buying and selling of foreign currencies in India is performed by authorized dealers / moneychangers appointed by the RBI. The foreign exchange department of the major banks are linked across the world on a 24 hour basis. Major commercial centers are London, Amsterdam, Frankfurt, Milan, Paris, New York, Toronto, Bahrain, Tokyo, Hong Kong and Singapore.

#### **Functions of a foreign exchange market**

Purchasing power is transferred across different countries which will enhance the feasibility of international trade and overseas investments. The foreign exchange market acts as a central focal point wherein prices of various currencies are discovered. Enables the investors to hedge or minimize their risks. Enables the traders to arbitrage any inequalities. Provides an investment / trading avenue to entities who are willing to expose themselves to this risk.

## Foreign currency and foreign exchange

In the context of India, any currency other than Indian rupees is foreign currency. Foreign exchange includes currency, drafts, bills, letters of credits and traveller cheques which are denominated and ultimately payable in foreign currency.

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## 5.2 PURCHASING POWER PARITY (INFLATION) THEOREM DETERMINANTS OF EXCHANGE RATE

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Difference in inflation rates between two countries is considered as the most important factor for variations in exchange rates. If domestic inflation is high, it means domestic goods are costlier than foreign goods. This results in higher imports creating more demand for foreign currency, making it costlier. (In other words the value of domestic currency will decline). If a basket of goods cost Rs470 in India and \$10 in US then it is quite natural that the exchange rate should be Rs47/\$1

PPP theory can be expressed by the formula:

$$PPP_r = \text{Spot rate} \frac{(1+r_h)}{(1+r_f)}$$

where  $r_h$  is inflation rate at home;  $r_f$  is the inflation rate of foreign country

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## 5.3. BALANCE OF PAYMENTS POSITION

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The BOP position has a big impact on the value of a nation's currency. A big or consistent deficit would mount a pressure on the currency of a nation as deficits require payments in foreign currency. In the case of a fixed currency rate scenario – the local currency would be devalued thereby making imports costlier and exports cheaper. However in the free rate scenario a big or consistent deficit would be a forewarning for depreciation of a nations currency

### Government intervention

At times the government would intervene by purchasing or selling foreign exchange to control pressures on the nation's currency.

### Market expectation

Market expectation as regards interest rates, inflation, taxes, BOP positions etc would affect the foreign exchange rates.

### Overseas investment

E.g. if US investments in India increases there would be dollar inflows putting downward pressure on dollar in India.

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### Speculation

Speculators including treasury managers of banks, by virtue of their buying and selling, tend to influence the rates.

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## 5.4 DIRECT AND INDIRECT QUOTES

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### Direct quotes

No of units of the domestic currency per unit of foreign currency. E.g. 1\$ = Rs 49.50 is a dollar direct quote of an Indian rupee in India. However the same quote when quoted in US is not a direct quote for an American.

### Indirect quotes

No of units of a foreign currency per fixed number of domestic currency; E.g. Rs 100 = \$0.2245

### Two way quotes

#### Bid price and offer price

Bid is the price at which a dealer is willing to buy another currency and offer is the rate at which he is willing to sell the currency.

E.g. a quote of Rs /\$ is Rs42,50 / 42.55 it means that the dealer will buy \$ at Rs 42.50 and sell dollar at 42.55

### Spreads

Spread is the difference between the bid rate and the offer rate and usually represents the profit margins that a dealer expects to make.

### Cross currency rates

In India all buy and sell transactions are routed through the US \$. Hence all deals involving any other currency would necessarily involve converting in US\$ and then converting the US\$ into INR. Thus if an Indian importer wishes to buy Yen he would first have to sell rupees and

buy dollar; then he would sell dollar and buy yen. The banker would obtain the Yen / \$ rate from Singapore or Tokyo and then apply the Rs /\$ rate to determine the amount of rupees required to buy the desired Yen.

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## 5.5 SPOT RATE, FORWARD RATE, CASH RATE AND TOM RATE

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**Spot rate:** Rate quoted for transactions that will settled two business days from the transaction date (T+2)

**Forward rate:** Rate quoted for transactions that will be settled beyond two business days at a mutually agreed rate and date.

**Cash rate:** Rate quoted for transactions that will settled on the same day (T+0)

**Tom rate:** Rate quoted for transactions that will be settled in one business day from the date of transaction (T+1)

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## **5.6 INTERNATIONAL CREDIT INSTRUMENTS**

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International credit instruments play an important role in settling of international transactions

### **Telegraphic or cable transfers**

Used for remittance of foreign exchange. Mode of transfer is telegraphic transfer. Sender of money pays the money to be transferred to Authorized dealer. The authorized dealer is requested to make the payment in foreign currency to the ultimate receiver of the money. Code numbers used for verifying authenticity of remittances. Authorized dealer charges for this service. Payment received by the receiver on the same day.

### **TT Buying and selling rates**

TT buying rates applicable for transactions where the Banks nostro account has already been credited or will be credited without delay. Nostro Accounts are foreign currency account maintained at foreign centers with correspondent banks to facilitate receipt and payment of foreign currency. TT selling rates are applicable where bank does not have to handle any documents/ bills

### **Bankers draft and bankers cheques**

The payer obtains a bankers draft or a cheque drawn by a foreign bank on its correspondent bank. The receiver of the draft presents it for collection through his banker. More time consuming than Mail transfer and not a very preferred mode of transfer of funds.

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## **5.7 BILLS OF EXCHANGE**

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### **Bill buying and selling rates**

Bill buying rates is applied where the bank has to handle documents. A good example

of a situation where buying rates is applied is when export bills for collection. Bill selling rates is applied where the bank has to handle documents in a transaction like payment of export bill.

### **Letters of credit**

Preferred form of payment for making trade payments. The importer banks requests his banker (issuing bank) to open an letter of credit. The letter of credit is issued through the correspondent bank which in turn will advise the beneficiary bank (advising bank)

## **NOTES**

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### **International Money orders**

Issued by post offices of respective countries. MO are issued in the currency of the issuing post office. The domestic post office will then convert the currency (charge a nominal fee) and pay the same to the addressee.

### **TC Buying and selling rates**

The rates at which TCs are purchased and sold by the bank Euro currency. New currency of 11 out of 15 members of EU . Britain, Denmark, Sweden and Greece are not a part of it.

Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands,

Portugal and Spain are part of it. Euro is an international currency without the backing of bullion. European Central Bank (ECB) controls euro and it has erased national boundaries

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## **5.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

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- 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.
- Exchange control 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.
- 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.

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## **5.9 SUMMARY**

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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'.
- 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.

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### 5.10 KEY WORDS

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- 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.

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### 5.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. How is the rate of exchange determined under the inconvertible paper currency system?
2. What are the three possible objects of exchange control?
3. 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

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### 5.12 FURTHER READINGS

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- E. Gordon, K. Natarajan. 2014. Banking Theory, Law and Practice, Himalaya publishing house, Hyderabad.
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## **UNIT – VI THE BANKING REGULATION ACT 1949**

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### **Structure**

- 6.1 Introduction
- 6.2 HISTORY, SOCIAL CONTROL AND APPLICABILITY
- 6.3 Banking Companies and the Reserve Bank of India
- 6.4 The Banking Companies (Amendment) Act, 1960
- 6.5 The Banking Companies (Second Amendment) Act, 1960
- 6.6 The Banking Companies (Amendment) Act, 1961
- 6.7 Banking Companies (Amendment) Act, 1962
- 6.8 The Banking Regulation Act 1949 in Applicable to Banking Companies
- 6.9 The Banking Regulation (Co-operative Societies) Rules, 1966
- 6.10 Answers to Check Your Progress Questions
- 6.11 Summary
- 6.12 Key Words
- 6.13 Self Assessment Questions and Exercises
- 6.14 Further Readings

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### **6.1 INTRODUCTION**

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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.

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### **6.2 HISTORY, SOCIAL CONTROL AND APPLICABILITY**

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

- i 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 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.

- ii 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.
- iii 3. The Act lays down certain important provisions regarding the minimum paidup 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 paidup 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.
- iv 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 paidup 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.
- v 4. Certain unscrupulous banks used to mislead the ignorant public by showing large figures of authorized capital as against very fractional

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amount of paidup capital. Also, by calling only a small portion of the subscribed capital, the promoters of banking companies used to persuade persons to purchase 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 paidup 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.

- vi 5. 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.
- vii 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.
- viii 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.
- ix 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.
- x 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.
- xi 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.

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### **6.3 Banking Companies and the Reserve Bank of India**

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

- i 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.
- ii 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.
- iii 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

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- 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.
- iv 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.
  - v 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.
  - vi The Reserve Bank may, if it thinks necessary, apply to the High Court for the winding up of any banking company.
  - vii 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.
  - viii 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.

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### **6.4 THE BANKING COMPANIES (AMENDMENT) ACT, 1960**

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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.

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 Regulation Act 1949*

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## **6.5 THE BANKING COMPANIES (SECOND AMENDMENT) ACT, 1960**

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

### **NOTES**

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.

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## **6.6 THE BANKING COMPANIES (AMENDMENT) ACT, 1961**

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Subsequent to the failure of two scheduled banks in 1960, the Reserve Bank hadaken 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

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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 shall vest in the transferee bank and the liabilities of the transferor bank shall be taken over by the transferee bank.

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### **6.7 BANKING COMPANIES (AMENDMENT) ACT, 1962**

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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.

### **(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:

- a. Statutory reserve balance required to be maintained under Section 42 of the Reserve Bank of India Act and

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b. 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**

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.

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### **(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

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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.

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### **6.8 THE BANKING REGULATION ACT 1949 IN APPLICABLE TO BANKING COMPANIES**

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1. Save as hereinafter provided, no company shall carry on banking business in India unless it holds a license issued in that behalf by the Reserve Bank and any such license may be issued subject to such conditions as the Reserve Bank may think fit to impose.] .

2. Every banking company in existence on the commencement of this Act, before the expiry of six months from such commencement, and every other company before commencing banking business 11 [in India], shall apply in writing to the Reserve Bank for a license under this section:

3. Before granting any license under this section, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that 56[\*\*\*] the following conditions are fulfilled, namely:-

(a) that the company is or will be in a position to pay its present or future depositors in full as their claims accrue;

(b) that the affairs of the company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors;

(c) that the general character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors;

(d) that the company has adequate capital structure and earning prospects;

(e) that the public interest will be served by the grant of a license to the company to carry on banking business in India;

(f) that having regard to the banking facilities available in the proposed principal area of operations of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors the grant of the license would not be

prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;

(g) any other condition, the fulfillment of which would, in the opinion of the Reserve Bank, be necessary to ensure that the carrying on of banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.]

3 A. Before granting any license under this section to a company incorporated outside India, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that the conditions specified in sub-section (3) are fulfilled and that the carrying on of banking business by such company in India will be in the public interest and that the government or law of the country in which it is incorporated does not discriminate in any way against banking companies registered in India and that the company complies with all the provisions of this Act applicable to banking companies incorporated outside India.]

4. The Reserve Bank may cancel a license granted to a banking company under this section:

(i) if the company ceases to carry on banking business in India; or

(ii) if the company at any time fails to comply with any of the conditions imposed upon it under sub-section (1); or

(iii) if at any time, any of the conditions referred to in sub-section (3) 15 [and sub-section (3A)] is not fulfilled:

5. Any banking company aggrieved by the decision of the Reserve Bank cancelling a license under this section may, within thirty days from the date on which such decision is communicated to it, appeal to the Central Government.

6. The decision of the Central Government where an appeal has been preferred to it under sub-section (5) or of the Reserve Bank where no such appeal has been preferred shall be final.

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## **6.9 THE BANKING REGULATION (CO-OPERATIVE SOCIETIES) RULES, 1966**

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Banking Regulation Act, 1949: Application of the Act to Cooperative Banks -- Important Provisions

Banking Regulation Act came into being in 1949. Prior to that, certain provisions of the Companies' Act, 1913 were applicable to Banking Companies. The need for the Act was felt with many banks in poor

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financial health due to poor management of loan/investment portfolio and non-maintenance of adequate liquidity. This was also further complicated by mushroom growth of banks and closure and failure of some banks

The objectives of the Banking Regulation Act broadly are:

- to safeguard the interests of depositors;
- to develop banking institutions on sound lines; and
- to attune the monetary and credit system to the larger interests and priorities of the nation.

In 1966, the Act was made applicable to cooperative banks by incorporating Section 56 therein. The important provisions of Banking Regulation Act, 1949 (as applicable to cooperative banks) are given below:

### Section-3

- the Act shall not apply to (a) a primary agricultural credit society and (b) a cooperative land development bank.

### Section- 5 Interpretations

#### Section 5(b)

- banking means the accepting for the purpose of lending or investments of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft or otherwise;
- banking Company means a Company which does business of banking;
- mere function of giving loans does not make a banking company;
- Power of receiving money or deposits from customers and honouring their cheques is essential characteristic of banking.

### Section - 6 - Forms of business which banking companies may engage in.

A bank is prohibited from doing any business other than those mentioned in Section 6. The businesses a bank may carry on are summarised into three categories:

- main business of banking i.e., borrowing, taking or lending money, dealing in Bills of Exchange, Bills of lading and Debentures, issuing letters of credit, buying/selling foreign exchange etc.,
- allied business: Acting as agent/trustee/administrator, carrying on guarantee business, providing safe custody;
- dealing in property is restricted to (i) property coming in satisfaction of claims or as security and (ii) property necessary for its own sake.

The Government of India has specified hire purchase, equipment leasing and insurance as new forms of business for cooperative banks to be engaged in. Reserve bank as empowered by the act, issues guidelines periodically for the conduct of these types of business.

Section 6(1) gives an elaborate list of forms of business in addition to normal business of banking that a banking company may engage in.

Section 6(2): - No banking company shall engage in any form of Business other than those referred to in SS 6(1).

Section 11 - Requirement as to minimum paid-up capital and reserves

No cooperative bank shall commence or carry on the business of banking in India unless the aggregate value of its paid-up capital and reserves is not less than one lakh rupees. Value means "Real or Exchangeable Value" as approved by RBI/NABARD during the inspection of the bank. The real or exchangeable value of the bank could be calculated as Realizable Assets less Outside Liabilities or Owned Funds less Erosion

Section-18 - Cash reserve

- every cooperative bank, not being a scheduled SCB, shall maintain
- by way of cash reserve with itself, or
- by way of balance in current account with RBI or SCB of the state concerned, or by way of net balance in current account a sum equivalent to at least 3 % of its demand and time liabilities (DTL) as on last Friday of the second preceding fortnight;
- Shall submit to the RBI before 15th day of every month a return showing the amounts held on alternate Fridays during a month with particulars of its DTL on such Fridays.

Scheduled cooperative banks will have to maintain CRR as per RBI Act. The scheduled cooperative banks, governed by section 42 (1) of Reserve Bank of India Act 1934 under which they have to maintain a minimum CRR 3% with Reserve Bank of India, which can be increased to 20% of Net Demand and Time Liabilities(NDTL).

Liabilities in India shall not include:-

- paid-up capital, reserves, or any credit balance in the PL account;
- any advances taken from a State Govt., RBI, IDBI, EXIM Bank, NHB, SIDBI, NCDC, NABARD
- in case of an SCB or a CCB, deposits representing reserve funds by any cooperative society within its area of operation; in case of a CCB, any advance taken from the concerned SCB.

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- in case of any cooperative bank which has granted an advance against any balance maintained with it, such balance to the extent of the amount outstanding in respect of such advance
- in case of any cooperative bank, the amount of any advance or other credit arrangement drawn and availed of against any approved securities

### Section 19- Restriction on holding shares in other cooperative societies

No cooperative bank shall hold shares in other cooperative societies except to such extent and subject to such conditions as RBI may specify.

Not applicable for:

- shares acquired through funds provided by the State Govt. on that behalf;
- DCCBs to hold shares of affiliated SCB.

### Section 20 - Restriction on loans and advances

No cooperative bank shall:

- make loans and advances on the security of its own shares;
- grant unsecured loans or advances to any of its directors;
- any firm or private company in which the director has interest.

This above clause shall not apply to grant of unsecured loans or advances made by a cooperative bank

- against bills for supplies or services made or rendered or bill of exchange arising out of bona fide commercial or trade transactions;
- trust receipts furnished to the cooperative bank;

If on examination of any return submitted by the bank, it appears that any loans or advances are being granted to the detriment of the interest of the depositors of the cooperative bank, RBI by order in writing, prohibit the cooperative bank from granting such further loans, or impose such other restrictions as it thinks fit.

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## 6.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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- 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. NOTES Self-Instructional Material 133 Banking Regulation Act, 1949



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

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### 6.11 SUMMARY

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- 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.

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### 6.12 KEY WORDS

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- **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.

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- Amendment: An amendment is a formal or official change made to a law, contract, constitution, or other legal document.

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### **6.13 SELF ASSESSMENT QUESTIONS AND EXERCISES**

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#### **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?

#### **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.

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### **6.14 FURTHER READINGS**

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# UNIT – VII INDIAN BANKING SYSTEM

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*Indian Banking System*

## **Structure**

- 7.1 Introduction
- 7.2 Objectives
- 7.3 RBI – Reserve Bank of India
- 7.4 NABARD
- 7.5 State Bank of India
- 7.6 EXCHANGE BANKS: FUNCTIONS, WORKING AND DEFECTS
- 7.7 Commercial Bank: Definition, Function, Credit Creation and Significances
- 7.8 Indigenous Bankers
- 7.9 Cooperative Banking
- 7.10 Answers to Check Your Progress Questions
- 7.11 Summary
- 7.12 Key Words
- 7.13 Self Assessment Questions and Exercises
- 7.14 Further Readings

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## **7.1 INTRODUCTION**

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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.

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## **7.2 OBJECTIVES**

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

- Know the management of the RBI

- Discuss the organisation and structure of the RBI
- know about NABARD, Commercial Banks, Indigenous Banks and Cooperative Banks

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### 7.3 RBI – RESERVE BANK OF INDIA

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The Reserve Bank of India (RBI) is India's central bank, also known as the banker's bank. The RBI controls monetary and other banking policies of the Indian government. The Reserve Bank of India (RBI) was established on April 1, 1935, in accordance with the Reserve Bank of India Act, 1934. The Reserve Bank is permanently situated in Mumbai since 1937.

#### **Establishment of Reserve Bank of India**

The Reserve Bank is fully owned and operated by the Government of India.

- The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:
- Regulating the issue of Banknotes
- Securing monetary stability in India

Modernising 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 Official

## Organisation Structure

Indian Banking System



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### Objectives

The primary objectives of RBI are to supervise and undertake initiatives for the financial sector consisting of commercial banks, financial institutions and non-banking financial companies (NBFCs).

### Some key initiatives are:

1. Restructuring bank inspections
2. Fortifying the role of statutory auditors in the banking system

### Legal Framework

The Reserve Bank of India comes under the purview of the following Acts:

- Reserve Bank of India Act, 1934
- Public Debt Act, 1944
- Government Securities Regulations, 2007
- Banking Regulation Act, 1949
- Foreign Exchange Management Act, 1999
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- Credit Information Companies(Regulation) Act, 2005

- Payment and Settlement Systems Act, 2007

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### 7.4 NABARD

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The National Bank for Agricultural and Rural Development commonly known by the acronym NABARD is a leading development oriented bank in India, which has its headquarters in Mumbai, the country's financial capital. With branches all across the country dedicated to improving the lot of the rural populace, the bank is expected to play a key role in ensuring development and implementation of the government's financial inclusion policy. To that effect, this leading rural development bank has joined hands with the broader Alliance for Financial Inclusion. The vision of NABARD is to play a leading role in a range of matters that deal with policy, planning as well as operations that are related to the broad area of agriculture credit. Another key role of NABARD is to provide financial assistance to various areas apart from agriculture to spearhead the development of villages in India through financing of key economic activities.

#### **Brief History of NABARD**

The history of the National Bank for Agricultural and Rural Development harks back to year 1981, the time of the B.Sivaraman Committee. This committee was established by the 61st ACT of the Parliament of India in the year 1981 to investigate and provide recommendations on how to improve the lot of the rural masses that then comprised close to 80% of India's overall population.

NABARD was formed as per the recommendations of the committee and it came into being on the 12th of July in the year 1982. Its formation was based on the tenets of the National Bank for Agriculture and Rural Development Act of 1981. The newly formed NABARD at inception, took over the roles earlier played by the Agriculture Credit Department (ACD) and the RPCC (Rural Planning and Credit Cell) of the RBI (Reserve Bank of India) as well as the tasks then performed by the ARDC (Agricultural Refinance and Development Corporation).

Following the formal introduction of NABARD, the ARDC, RPCC and ACD ceased to exist and were completely replaced. At the time of inception, NABARD was provided an initial corpus of Rs.100 crores and over the subsequent period, its composition was revised multiple times. As recorded in the month of March in the year 2015, NABARD's total paid up capital was estimated at Rs. 5000 crore with RBI's share standing at Rs. 20 crores, while the rest Rs. 4980 crores being controlled by the Indian Government. This resulted after RBI sold the major portion of its stake in NABARD to the Government of India.

At present, the National Bank for Agriculture and Rural Development (NABARD) has various international partnerships including leading global organizations and World Bank-affiliated institutions that are breaking new ground in the fields of rural development as well as agriculture. These international partners play a key consultant's role in providing advisory services as well as financial assistance designed to ensure uplifting of rural peoples as well as optimization of various agricultural processes.

### **The Role of NABARD**

The National Bank for Agriculture and Rural Development has been pivotal in introducing social enterprises as well as innovations across the vast rural areas of India. The institution currently works with an estimated 4000 partner companies that are leading innovators and key players in various rural projects. Some of the key areas of focus for NABARD currently include crop productivity initiatives, soil and water conservation, initiatives to maintain tribal heritage/way of life in remote rural areas as well as SHG-Bank Linkage initiatives. In spite of being involved in these roles, NABARD is still one of the biggest contributors to the national exchequer featuring among the leading 50 tax paying companies consistently.

Any and all profits generated by NABARD are in fact reinvested in its numerous development projects designed for the betterment of the rural communities. The National Bank for Agriculture and Rural Development is well known globally as an organization with unmatched commitment to finding answers as well as solutions for the overall betterment of those who reside in rural areas of India. Close to 30 years of working in these areas is one of the key reasons why NABARD is held in such high regard and esteem not just in India but all over the world.

The following is a short list of some of the key achievements and actions that NABARD has achieved or is carrying out in India:

Development of the cottage industry – India's traditional manufacturing systems had been in disarray since the time of Independence and its cottage industry needed to be reorganized requiring substantial reinvestment. As a majority of cottage or small scale industries in India are based in rural areas, NABARD has played a pivotal role in redeveloping India's cottage industry such that these rural industries have become a key driver of growth and change in the rural areas.

The rural economy is only part of the overall national economy and it cannot be treated as a separate silo which is completely independent from the other portions of the country's economy. With this in mind, NABARD has historically reached out to numerous allied economies such as fertilizer manufacturers, pesticide producers, manufacturers of farm equipment and more in order to create a virtuous cycle which not only benefits the rural economy but the overall economy of the country as a whole.

### **NOTES**

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This unique institution also serves as the supreme agency that is involved in financing a range of organizations that are involved in the disbursement of credit to rural regions for carrying out a range of development activities. Additionally, NABARD also funds other companies that are involved in providing development support to rural industries all over the country.

NABARD is also a leading organization involve in taking measures towards building of new agencies and institutions involved in creating credit delivery systems specifically targeted at Indian villages and their residents. These measures include end to end overview of monitoring, rehabilitation centre formulation, credit institution restructuring, training new personnel and much more.

This agency also operates as a co-coordinator of various rural financing activities across the complete range of organizations that work at the grassroots level. Apart from financing such institutions, NABARD also acts as a liaison for a these institutes with the Indian Government, state level governing bodies, the Reserve Bank of India (RBI) as well as any other institutions that operate at a national level and are engaged in the formulation of rural policies.

The bank also plays a noteworthy role in both the monitoring as well as evaluation of any and all projects that NABARD has in the past or is currently refinancing. This includes all financial institutions engaged in financing activities in the rural sector be it agriculture, manufacturing, infrastructure development or any others.

In terms of enhancing the rural development opportunity, NABARD also engages in ensuring the development of organizations that can help the rural economy. To ensure that these develop in the correct direction, NABARD is also engaged in keeping a check on its various client institutions.

Co-operative banks are the backbone of the rural economy and the National Bank for Agriculture and Rural Development is engaged in regulating these banks while also providing training facilities for the personnel employed with these banks as well as other financial institutions operating in the rural areas of the farthest reaches of India.

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## 7.5 STATE BANK OF INDIA

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The State Bank of India, popularly known as SBI, is one of the leading banks in India. The bank traces its origin to the first decade of the 19th century. Later on, it was merged with the Imperial Bank. In the year 1955, the Government of India nationalized the Imperial Bank along with the Reserve Bank of India. Ever since that time, the bank acquired its present name that is SBI.

The State Bank of India is India's largest commercial bank. The bank has been striving sincerely to adhere to the efforts of providing



utmost customer satisfaction to the best possible extent. The SBI has presence all over India with 16,000 branches. Not only this, the bank has made its roots secured internationally as well. At present, SBI has 131 branches in 32 countries all over the world.

SBI created a unique method of serving its customers even on a holiday. One can find a floating SBI ATM on a boat in the backwaters of Kerala. This caters to the needs of the customers by providing service round the clock. Besides, the customers can also avail the facilities of online banking and transactions.

### State Bank of India Services

State Bank of India Services are most varied and innovative amongst all its contemporaries. State Bank of India Services includes a host of products and services to suit all types of consumers.

Banking Subsidiaries- State Bank of Bikaner and Jaipur (SBBJ), State Bank of Hyderabad (SBH), State Bank of Indore (SBIr), State Bank of Mysore (SBM), State Bank of Patiala (SBP), State Bank of Saurashtra (SBS) and State Bank of Travancore (SBT).

Foreign Subsidiaries - State bank of India International (Mauritius) Ltd., State Bank of India (California), State Bank of India (Canada) and INMB Bank Ltd, Lagos.

Non- banking Subsidiaries - SBI Capital Markets Ltd (SBICAP), SBI Funds Management Pvt Ltd (SBI FUNDS), SBI DFHI Ltd (SBI DFHI), SBI Factors and Commercial Services Pvt Ltd (SBI FACTORS) and SBI Cards & Payments Services Pvt. Ltd. (SBICPSL)

#### Check Your Progress

- i What is the full form of NABARD?
- ii Why the SBI was formed?

## 7.6 EXCHANGE BANKS: FUNCTIONS, WORKING AND DEFECTS

### Functions of Exchange Banks:

Exchange banks perform the following functions in India:

#### 1. Financing Exports:

The exchange banks facilitate the payment of goods exported. This is done through Document against Acceptance (D.A.) Bill which the Indian exporter draws against the importer. This bill is sent to the importer through the exchange bank. The importer returns it to the exporter after acceptance and the latter discounts it from his exchange bank.

## NOTES

## NOTES

### **2. Financing Imports:**

The exchange banks also facilitate the financing of imports. When an Indian importer imports goods, he receives through the exchange bank on the basis of the Document Against Payment (D.P.) Bill drawn by the foreign exporter.

### **3. Financing Internal Trade:**

The exchange banks finance the internal trade of the country. They finance the movement of goods from one commercial centre to another. They advance loans to traders and discount their bills of exchange.

### **4. General Banking Functions:**

The exchange banks perform general banking functions like Indian banks such as accepting deposits, advancing loans, agency services, credit remittance facility, locker facility, stock invest facility, card facility, etc.

### **5. Encourage Foreign Investments:**

The exchange banks encourage the flow of foreign investments into India. Foreign investors usually rely on their banker's judgement for overseas investment. Exchange banks are an important medium for projecting the country's image abroad. They provide Indian corporations access to foreign collaborators as well as introduce foreign companies to Indian corporations.

### **6. Access to International Capital Markets:**

The exchange banks help in providing Indian corporations and government agencies access to international capital markets.

### **7. Develop Expertise and Innovations:**

The exchange banks help in developing expertise and innovations in several areas such as trade, finance, payment systems, currency and interest rate risk management and financial engineering. To the extent these help in improving the efficiency of Indian banks, competitiveness improves.

### **8. Mobilising Funds from Non-Resident Indians:**

The exchange banks help in mobilising deposits from non-resident Indians (NRI) abroad through their network of branches located in foreign countries.

### **9. Canalising Agent:**

The exchange banks play the role of canalising agents for foreign currency credits for major projects. For example, Grindlays helped in arranging credits for the HBJ gas pipeline.

### **10. Revival of Sick Industries:**

The exchange banks help in the revival of Indian sick industries by putting their Indian clients in touch with NRIs who might be willing to invest in the equity of firms in question, and also facilitate the transfer of technology.

### **11. Cover the Risks of Exchange Rate:**

The exchange banks cover the risks of exchange rate movements by booking forward contracts.

### **Working of Exchange Banks in India**

The number of exchange banks, better known as foreign banks, operating in India at present is 36. They have a network of 204 branches. Among the biggest foreign banks in India are: Citi Bank, ANZ Grindlays Bank, Standard Chartered Bank, Hong Kong Bank, American Express Bank, Bank of America, British Bank of Mideast, Bank of Tokyo, and Deutsche Bank.

For operating in India, every foreign bank is required to obtain a licence from the RBI. The licence is given with the condition that there should not be any discrimination against any Indian bank operating in that country to which the foreign bank belongs.

A foreign bank is required to bring in \$ 10 million for the first branch it sets up, \$ 10 million for the second and \$ 5 million for the third. It is also required to deposit with the RBI either in cash or in the form of unencumbered approved securities or both an amount equal to the amount specified above.

Every foreign bank operating in India is also required to deposit with the RBI at the end of each calendar year 20 per cent of its profits earned in India. Every foreign bank is further required to keep 12 per cent of the total of its time and demand liabilities with the RBI as CRR (Cash Reserve Ratio) which is interest free.

In addition to the CRR, it is required to maintain in cash, gold or unencumbered securities, known as Statutory Liquidity Ratio (SLR) up to the level of its outstanding net demand and time liabilities equal to 25 per cent with effect from 13 April, 1996. Every foreign bank is required to maintain its assets equivalent to not less than 85 per cent of its demand and time liabilities in India at the close of business on the last Friday of every quarter. Foreign banks operating in India are required to comply with the capital adequacy norm of 8 per cent from 1 April, 1993 which they have achieved.

## **NOTES**

## NOTES

The foreign banks operating in India are required to provide a minimum of 32 per cent of their net outstanding advances to the priority sector in India every year. It is inclusive of the sub-targets of 10 per cent each in respect of credit for exports and small scale industries, the shortfall, if any, in the overall target as well as sub-targets has to be made good by placing deposits with the Small Industries Development Bank of India (SIDBI) at a rate of 8 per cent with effect from March 1995.

For opening a new branch or to change the location of an existing branch, a foreign bank is required to take prior permission of the RBI. With effect from 22 April, 1992, they have been permitted to expand branches on considerations of national advantage from the viewpoint of facilitating exports and investment, with no change in other conditions.

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### **7.7 .COMMERCIAL BANK: DEFINITION, FUNCTION, CREDIT CREATION AND SIGNIFICANCES**

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#### **Meaning of Commercial Banks:**

A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit.

In fact, commercial banks, as their name suggests, are profit-seeking institutions, i.e., they do banking business to earn profit.

They generally finance trade and commerce with short-term loans. They charge high rate of interest from the borrowers but pay much less rate of interest to their depositors with the result that the difference between the two rates of interest becomes the main source of profit of the banks. Most of the Indian joint stock Banks are Commercial Banks such as Punjab National Bank, Allahabad Bank, Canara Bank, Andhra Bank, Bank of Baroda, etc.

The difference between the rates is called 'spread' which is appropriated by the banks. Mind, all financial institutions are not commercial banks because only those which perform dual functions of (i) accepting deposits and (ii) giving loans are termed as commercial banks.

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### **7.8 INDIGENOUS BANKERS**

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Indigenous bankers are private firms or individuals who operate as banks and as such both receive deposits and give loans. Like banks, they are also financial intermediaries. They should be distinguished from professional moneylenders whose primary business is not banking but money lending.

A pure moneylender lends his own funds an indigenous banker raises a part of his loanable funds from the public in deposits or other forms. A moneylender conducts his transactions in cash, while a large part

of die transactions of an indigenous banker are based on dealings in short term credit instruments like hundis and commercial bills.

The system of indigenous banking in India dates back to ancient times. Until the middle of the nineteenth century the indigenous financial agencies constituted the bulk of the Indian financial system. They provided credit not only to traders and producers but also to the governments of the day.

The advent of the British had an adverse impact on their business. The European bankers began to enjoy state patronage and prestige. The foreign (exchange) banks took over the financing of external trade. In metropolitan areas and important commercial centres the setting up of modern commercial banks took away more and more the business of indigenous financial agencies who, were gradually pushed to the financing of internal trade.

With the growth of commercial and co-operative banking geographically as well as functionally, especially since the mid 1950s, the area of operations of these agencies has contracted further. Still there are thousands of family firms, especially in the western and southern parts of India, who continue to operate as traditional-style bankers. Many of these firms have continued in this business for several hundred years. Indigenous bankers are, by and large, urban-based. Their business, besides being hereditary, is confined to a few castes and communities.

The size of the indigenous banking class and the volume of their credit operations are not known with certainty. The Banking Commission (1972) had estimated their number to be in the neighbourhood of 2,000 to 2,500. Timberg and Aiyar (1980) have placed this number at a minimum of 20, 000 leaving out Central India and Eastern India outside Calcutta. They have further estimated that in late 1970s the total credit extended by these bankers was in the neighbourhood of Rs. 1,500 crores, which was equal to 10 per cent of the total commercial bank credit in the year 1977-8.

Indigenous bankers do not constitute one homogeneous category. The Banking Commission (1972) had grouped them under four main sub-groups Gujarati shroffs, Shikarpuri or Multani shroffs, Chettiars of the South, and Marwari Kayas of Assam. Timberg and Aiyar (1980) do not cover Assam and so leave out Marwari Kayas. But they have found that Rastogi bankers numbering about 500 are also an important sub-group serving craftsmen and traders in the Oudh area of U.P. and providing about Rs. 100 crores of credit.

The Gujarati shroffs are active in the industrial and trading centres of Gujarat, Bombay, and Calcutta, joined by the Marwari shroffs in Bombay and Calcutta. The Shikarpuris operate mainly in the metropolitan areas of Bombay and Madras and elsewhere in the South where the Chettiars are also active. The Marwari's operate also in the tea gardens of Assam and other parts of North-East India.

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## NOTES

Thus, the major concentration of indigenous bankers is in the West and South. According to Timberg and Aiyar (1980), the Chettiar bankers, numbering about 2,500, extended credit of about Rs. 380 crores (in late 1970s) at rates ranging between 18 and 30 per cent per annum. They have further estimated that about 40,000 Chettiar pawnbrokers extended credit (of an incredibly large amount) of Rs. 1,250 crores.

Of the four main types of indigenous bankers, the Gujarati shroffs are the most important. In recent years Shikarpuri shroffs have lost more and more their old character of indigenous bankers and taken on the role of 'commercial financiers', who mainly lend out of their owned funds. We study only about these two types. This will also throw light on the main functions performed by other types of indigenous bankers as bankers, once we remember that none of them performs all these functions, and that there are differences in the methods of operation of various types of indigenous bankers.

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## 7.9 COOPERATIVE BANKING

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### Meaning of Cooperative Bank:

Cooperative bank is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks, the cooperative banks are founded by collecting funds through shares, accept deposits and grant loans.

The cooperative banks, however, differ from joint stock banks in the following manner:

- (i) Cooperative banks issue shares of unlimited liability, while the joint stock banks issue shares of limited liability.
- (ii) In a cooperative bank, one shareholder has one vote whatever the number of shares he may hold. In a joint stock bank, the voting right of a shareholder is determined by the number of shares he possesses.
- (iii) Cooperative banks are generally concerned with the rural credit and provide financial assistance for agricultural and rural activities. Joint stock companies are primarily concerned with the credit requirements of trade and industry.
- (iv) Cooperative banking in India is federal in structure. Primary credit societies are at the lowest rung. Then, there are central cooperative banks at the district level and state cooperative banks at the state level. Joint stock banks do not have such a federal structure.
- (v) Cooperative credit societies are located in the villages spread over entire country. Joint stock banks and their branches mainly concentrate in the urban areas, particularly in the big cities.

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## 7.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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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:
3. Official Directors – The governor who is appointed/nominated for a period of four years along with four Deputy Governors
4. Non-Official Directors – Ten Directors from various fields and two government Officials
5. The full form of NABARD is National Bank for Agricultural and Rural Development.

### NOTES

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## 7.11 SUMMARY

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- The Reserve Bank is fully owned and operated by the Government of India.
- State Bank of India (SBI) is an Indian multinational, public sector banking and financial services company.
- By far the most important constituent of the bazaar 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.

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## 7.12 KEY WORDS

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- 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

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### **7.13 SELF ASSESSMENT QUESTIONS AND EXERCISES**

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#### **Short-Answer Questions**

1. What are indigenous banks?
2. What do you understand by NABARD?
3. 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. Discuss the management and functions of NABARD.

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### **7.14 FURTHER READINGS**

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- Parameswaran, R. 2001. Indian Banking. S. Chand Publishing. New Delhi.
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## UNIT – VIII STATE BANK OF INDIA

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*State Bank of India*

- 8.1 Introduction
- 8.2 Objectives
- 8.3 State Bank of India Organisation
- 8.4 Objectives and Functions of State Bank of India:
- 8.5 Financial Resources of SBI
- 8.6 The Procedure Followed In The Decision Making Process,
- 8.7 The Norms Set By The State Bank Of India
- 8.8 Answers to Check Your Progress Questions
- 8.9 Summary
- 8.10 Key Words
- 8.11 Self Assessment Questions and Exercises
- 8.12 Further Readings

### NOTES

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### 8.1 INTRODUCTION

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The State Bank of India is the biggest commercial bank and holds a special position in the modern commercial banking system in India. It came into existence on July 1, 1955 after the nationalisation of Imperial Bank of India. The Imperial Bank of India was established in 1921 by amalgamating the three Presidency Banks of Madras, Bombay and Bengal.

Until the establishment of the Reserve Bank of India in 1935, the Imperial Bank of India, in addition to its normal commercial banking functions had been performing certain central banking functions. It used to act as the banker to the government, as banker's bank and as the clearing house.

After the establishment of the Reserve Bank of India, the Imperial Bank of India left its central banking functions, but continued to serve as the agent of the Reserve Bank in the areas where the latter did not have its branches. In 1955, on the recommendations of the Rural Credit Survey Committee, the Imperial Bank of India was nationalised and renamed as the State Bank of India through the State Bank of India Act 1955.

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### 8.2 OBJECTIVES

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

- Know the history of the State Bank of India
- Discuss the management of the State Bank of India

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

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### 8.3 STATE BANK OF INDIA ORGANISATION

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#### NOTES

The organisation of the State Bank of India can be discussed under the following heads:

#### **i. Capital:**

The state Bank of India has an authorised capital of Rs. 20 crore which has been divided into 20 lakh shares of Rs. 100 each. The issued capital of the State Bank is Rs. 5.6 crore. The shares of the State Bank are held by the Reserve Bank, insurance companies and the general public. At the end of March 2001, the paid-up capital and the reserves of the State Bank were Rs. 13461 crore.

#### **ii. Management:**

The management of the State Bank of India is under the control of a Central Board of Directors consisting of 20 members.

The break-up of the Central Board is as given below:

- (a) A Chairman and a Vice-Chairman are to be appointed by the Central Government in consultation with Reserve Bank.
- (b) Two Managing Directors are to be appointed by the Central Board with the approval of the Central Government,
- (c) Six directors are to be elected by the private shareholders.
- (d) Eight directors are to be nominated by the Central Government in consultation with the Reserve Bank to represent territorial and economic interests. Not less than two of them should have special knowledge in the working of cooperative institutions and of the rural economy,
- (e) One director is to be nominated by the Central Government,
- (f) One director is to be nominated by the Reserve Bank.

#### **iii. Subsidiary Banks:**

Through the State Bank of India (Subsidiary Banks) Act, 1959, major state- associated banks were converted into subsidiary banks of State Bank of India.

At present, there are seven subsidiary banks of the State Bank of India:

- (a) The State Bank of Bikaner and Jaipur;
- (b) The State Bank of Hyderabad;
- (c) The State Bank of Mysore;
- (d) The State Bank of Patiala;
- (e) The State Bank of Saurashtra;
- (f) The State Bank of Travancore; and
- (g) The State Bank of Indore.

The State Bank of India holds not less than 55 per cent of the issued capital of each subsidiary bank.

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#### **8.4 OBJECTIVES AND FUNCTIONS OF STATE BANK OF INDIA:**

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The main objectives and functions of the State Bank of India are given below:

**Objectives:**

The State Bank of India has been established to operate on the normal commercial principles, with the only difference that, unlike other commercial banks in the country, it takes into consideration and responds in a progressively liberal manner the financial requirements of cooperative institutions and small scale industries, particularly in the rural areas of the country.

**The main objectives of the State Bank are:**

- (i) To act in accordance with the broad economic policies of the government;
- (ii) To encourage and mobilise savings by opening branches in rural and semi-urban areas and to promote rural credit;
- (iii) To establish government partnership in the provision of cooperative credit;
- (iv) To extend financial help for the establishment of licensed warehouses and cooperative marketing societies;

**NOTES**

(v) To provide financial help to the small scale and cottage industries;

(vi) To provide remittance facilities to the banking institutions.

The State Bank of India acts as an agent of the Reserve Bank in all those places where the latter does not have its branches.

## NOTES

**As an agent of the Reserve Bank, the State Bank performs the following functions:**

(i) It acts as the government's bank, i.e., it collects money and makes payments on behalf of the government and manages public debt.

(ii) It acts as the bankers' bank. It receives deposits from and gives loans to commercial banks. It also acts as the clearing house for the commercial banks, rediscounts the bills of exchange of the commercial banks and provides remittance facilities to the commercial banks.

### **Ordinary Banking Functions:**

The State Bank of India performs all kinds of commercial banking functions:

(i) It receives deposits from the public.

(ii) It gives loans and advances against eligible securities including goods, bills of exchange, promissory notes, fully paid shares of companies, immovable property or documents of title, debentures, etc.

(iii) It invests its surplus funds in government securities, railway securities and securities of corporations and treasury bills.

### **Other Functions:**

The State Bank of India also performs the following other functions:

(i) It buys and sells gold and silver.

(ii) It acts as agent of cooperative banks.

(iii) It underwrites issues of stocks, shares, debentures, and other securities in which it is authorised to invest funds.

(iv) It administers, singly or jointly, estates for any purpose as executor, trustee or otherwise.

(v) It draws bills of exchange and grants letters of credit payable out of India.

(vi) It buys bills of exchange payable out of India with the approval of the Reserve Bank; it subscribes buys, acquires, holds and sells shares in the capital of banking companies.

*State Bank of India*

### **Prohibited Functions:**

The State Bank of India has been prohibited from doing certain businesses by the State Bank of India Act:

(i) The State Bank cannot grant loans against stocks and shares for a period more than six months.

(ii) It can purchase no immovable property other than its own offices.

(iii) It can neither rediscount nor offer loans against the security of exchange bills whose maturity period exceeds six months.

(iv) It cannot rediscount bills which do not carry at least two good signatures.

(v) It can neither discount bills nor grant credit to individuals or firms above the sanctioned limit.

## **NOTES**

### **Check Your Progress**

1. Which is the oldest and the largest commercial bank in India?
2. When was the Reserve Bank of India established?

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## **8.5 FINANCIAL RESOURCES OF SBI**

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The SBI was the first public sector bank that captured the domestic capital market in 1994 to shore up its capital base. In the year 1994, the bank raised an amount of Rs. 22,104 million through the issue of unsecured redeemable subordinate floating bonds. During the year 2000-01, the bank augmented its TIRE-II capital by private placement of unsecured, redeemable, subordinated bonds aggregating to Rs. 25 billion. The Reserve Bank of India is the single largest shareholder of the bank. The SBI's shares and bonds are listed for trading on all the major Indian stock exchanges

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## **8.6 THE PROCEDURE FOLLOWED IN THE DECISION MAKING PROCESS, INCLUDING CHANNELS OF SUPERVISION AND ACCOUNTABILITY IN STATE BANK OF INDIA**

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There is a well defined system in the Bank regarding the decision making process. Financial decisions are taken at various levels by different

## NOTES

officials depending upon their positions and also through committee approach. Centralized credit processing cells are being formed at certain centres for sanction of personal segment loans and loans under SIB segment. Branches will source the applications and forward them to the respective credit processing cells, for their consideration. Further, there is a well defined organisational structure and a clear system of accountability and control system, which also take into account the RBI / CVC guidelines.

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### **8.7 THE NORMS SET BY THE STATE BANK OF INDIA FOR THE DISCHARGE OF ITS FUNCTIONS**

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- The Bank functions with the following core values / norms
- Excellence in customer service
- Profit orientation
- Fairness in all dealing and relations
- Risk taking and innovation
- Integrity

Transparency and discipline in policies and systems

Regarding the core functions of the Bank i.e. accepting deposits and sanction of loans, the interest rates for deposits / advances and different deposit as well as loan products, are displayed in the Bank's website and also made available at all the Branches.

Regarding sanction of loans, each officer of the Bank will consider loan proposals and take a decision in terms of the scheme of delegation of powers, on the merits of the proposals. All the officers of the Bank are expected to discharge their duties and responsibilities with integrity and due diligence.

Public can also refer to the captions " Interest rates', ' code of ethics' & ' citizens charter' of the Bank's website for any further information. They can also refer to the following captions of the Bank's website, for detailed information on related products.

- Personal Banking
- Agricultural / Rural
- NRI Services
- International
- Corporate Banking
- Services
- Government Agencies
- SME

The rules and regulations, instructions, manuals and records held by the Bank/ used by its employees for discharging its functions

*State Bank of India*

There are quite a number of documents like manuals, book of instructions, codified circulars, scheme of delegation of powers, proceedings of the board etc and also the periodical circulars used by the employees for discharging various functions.

A statement of the categories of documents that are held by the Bank or under its control.

These are mainly register of Shareholders/Record of the proceedings of the AGMs, Board Meetings and various Committee meetings, documents executed by customers/borrowers/guarantors, contracts with third parties etc.

The particulars of any arrangement that exists for consultation with, or representation by, the members of the public in relation to the formulation of its policy or implementation thereof in SBI.

As per the present arrangement, the Shareholders can raise issues concerning policies and in the Annual General Meetings which can relate to the policy of the Bank.

Further, the Banks quarterly results and annual results / reports are published in the bank's website periodically for information of public as well as shareholders which would give an idea about the policies of the bank and implementation thereof. Further, the Central Board the apex management body of the bank is constituted with members who are leaders from different interest groups and professions such as Industrialists ,Bankers from Apex Institutions, Chartered Accountants, Economists and Workmen representatives

Public can also refer to the captions financial results / consolidated financial statement / annual report / shareholders information of the Bank's website, for further information.

Bank has appointed various committees for different purposes. Following are some of the important Committees managing the key affairs of the Bank :

- Risk Management Committee
- Credit Risk Management committee
- Asset Liability Management committee
- Operational Risk Management committee
- Audit Committee
- Central Management Committee

### **Central as well as Local Boards**

Public are not entitled to participate on the above committee meetings and minutes are not accessible to public.

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Public can also refer to the caption Annual report for various committees more particularly the " corporate governance" link under the Annual report for more information about the committees.

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## 8.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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- The State Bank of India is the oldest and the largest commercial bank in India. comment
- The Reserve Bank of India was established in 1935. Comment

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## 8.9 SUMMARY

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- 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.
- 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

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## 8.10 KEY WORDS

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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.

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## 8.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. Write a short note on the State Bank of India.
2. Give a short description of the information technology policy of the State Bank of India.



### **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 risk governance structure of the State Bank of India.

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### **8.12 FURTHER READINGS**

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*State Bank of India*

### **NOTES**

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## **UNIT – IX REGIONAL RURAL BANKS**

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- 9.1 Introduction
- 9.2 Objectives
- 9.3 Reasons for establishing the RRBs
- 9.4 Various problems of RRBs
- 9.5 Current government's policy
- 9.6 Cooperative Banking
- 9.7 History
- 9.8 Extent of Cooperative Banking in India
- 9.9 Significant features of Cooperative Banking in India
- 9.10 Problems faced by Cooperative Banks in India
- 9.11 Evaluation of Cooperative Banking
- 9.12 Importance of Cooperative Banks
- 9.13 Weaknesses of Cooperative Banking
- 9.14 Answers to Check Your Progress Questions
- 9.15 Summary
- 9.16 Key Words
- 9.17 Self Assessment Questions and Exercises
- 9.18 Further Readings

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### **9.1 INTRODUCTION**

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The banks which are present in India are divided into 3 major groups namely, Central Bank (RBI), Scheduled Banks & Non-Scheduled Banks. This means other than RBI, every bank will be either a scheduled bank or a non-scheduled bank. Based on the functions, there are five categories of Banks in India viz. Central Bank (RBI), Commercial Banks, Development Banks, and Cooperative Banks & Specialized Banks.

Further Scheduled banks are classified into scheduled commercial banks & scheduled cooperative banks. The basic difference b/w them are in their holding pattern. Regional Rural Banks comes under scheduled commercial banks.

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### **9.2 OBJECTIVES**

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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

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### **9.3 REASONS FOR ESTABLISHING THE RRBS**

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Even after nationalisation, there were cultural concerns which made it difficult for commercial banks even under the ownership of government, to lend to farmers. So Regional Rural Banks were started to work in rural perspectives & they can lend to more & more farmers, who are in real need of money. To provide them constitutional background, a separate act was passed.

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### **9.4 VARIOUS PROBLEMS OF RRBS:-**

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RRBs were considered as a low-cost organisation having a rural philosophy, local touch & pro-poor focus. Each bank was to be funded by a 'Public Sector Bank' (PSU), though; they were planned as the self-sustaining credit institutions which were able to refinance their core resources in themselves & were expected from the statutory pre-emptions. There were 196 RRBs in India in 1990. This has reduced to 56 (as of mar-2014) after mergers & amalgamations.

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### **9.5 CURRENT GOVERNMENT'S POLICY**

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The Modi govt. has put the hold on further mergers of the RRBs. The government is focusing on improving the performance of RRBs & to explore new opportunities in the same. At present, there is a bill pending to make some amendments in the RRB act which is aiming to increase the pool of investors to tap capital for RRBs.

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### **9.6 COOPERATIVE BANKING**

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A cooperative bank is jointly owned enterprise in which same people are its customers who are also its owners. Therefore, the basic difference b/w scheduled commercial banks & a scheduled cooperative bank is in their holding pattern. These are registered under Cooperative societies Act. The cooperative banks work agreeing to the principles of mutual assistance. These cooperative structures are one of the largest networks in the world comprising of more than 200million members.

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### **9.7 HISTORY**

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Hermann Schulze & Friedrich Wilhelm Raiffeisen gave the idea of cooperative banking for the first time. In India, the history of cooperatives begins from 1904 when the cooperative credit societies act, 1904 led to the

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formation of societies in both rural & urban zones. The act was recommended by Sir Friedrich Nicholson (1899) & Sir Edward Law (1901).The cooperative societies act of 1912, further gave recognition to the formation of non-credit societies & the central cooperative organisations.

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### **9.8 EXTENT OF COOPERATIVE BANKING IN INDIA**

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Further, it is divided into 2 broad categories namely, Urban Cooperative Banks & Rural Cooperative Banks.

Urban cooperatives have been further divided into scheduled & non-scheduled. Both categories are again divided into multi-state & single-state. The majority of these comes under no- scheduled & single-state category. All the activities of urban cooperatives are monitored by RBI. whereas; it is regulated by RBI & NABARD for rural cooperative banks.

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### **9.9 SIGNIFICANT FEATURES OF COOPERATIVE BANKING IN INDIA:-**

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These are small financial institutions governed by Banking Regulations Act, 1949 & Banking Laws cooperative Societies Act, 1965. Owned by its members. Involved in community development. Bringing banking to the doorstep of the lowest section of the society Profits obtained will be combined to form some reserves while some amount is distributed to members. Some sections of banking regulation act are not applicable to cooperative banks

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### **9.10 PROBLEMS FACED BY COOPERATIVE BANKS IN INDIA:-**

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The state partnership has resulted in excessive state control & interference. Inactive membership has made them declining as there is the lack of dynamic & professional attitude. Credit retrieval is weak, especially in rural areas.

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### **9.11 EVALUATION OF COOPERATIVE BANKING:**

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Progress of Cooperative Credit:

As a result of effective steps taken by the government and the Reserve Bank of India, the cooperative banking system in India made tremendous progress after independence. The cooperative credit which was only 3.1 per cent of the total rural credit in 1951-52, rose to 15.5% in 1961-62 and to 22.7 per cent in 1970-71.

The total amount of short-term credit granted by the cooperatives increased from Rs. 23 crore in 1951-52 to Rs. 203 crore in 1961-62 and further to Rs. 1425 crore in 1979-80. Thus, during the period of about two decades (i.e., 1960-61 to 1979-80), the short-term and medium-term loans increased by more than seven times.

Cooperative credit increased significantly from Rs. 3874 crore in 1985-86 to Rs. 10479 crore in 1995-96, and further to Rs. 24296 crore in 2002-03. Short-term cooperative credit increased from Rs. 2787 crore in 1985-86 to Rs. 8331 crore in 1995-96 and to Rs. 20247 crore in 2002-03. Medium-term and long-term cooperative loans increased from Rs. 1087 crore in 1985-86 to Rs. 2148 crore in 1995-96 and to Rs. 4049 crore in 2002-03.

During 10th Five Year Plan (2002-03 to 2006-07), agricultural credit from cooperative banks increased from Rs. 23716 crore (34%) to Rs. 33174 crore (22%). In 2009-10, it was **Rs. 32925 crore (20%)**.

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### **9.12 IMPORTANCE OF COOPERATIVE BANKS:**

The cooperative banking system has to play a critical role in promoting rural finance and is specially suited to Indian conditions.

Various advantages of cooperative credit institutions are given below:

#### **I. Alternative Credit Source:**

The main objective of cooperative credit movement is to provide an effective alternative to the traditional defective credit system of the village money lender. The cooperative banks tend to protect the rural population from the clutches of money lenders. The money lenders have so far dominated the rural areas and have been exploiting the poor people by charging very high rates of interest and manipulating accounts.

#### **II. Cheap Rural Credit:**

Cooperative credit system has cheapened the rural credit both directly as well as indirectly:

- (a) Directly, because the cooperative societies charge comparatively low interest rates, and
- (b) Indirectly, because the presence of cooperative societies as an alternative agency has broken money lender's monopoly, thereby enforcing him to reduce the rate of interest.

#### **III. Productive Borrowing:**

An important benefit of cooperative credit system is to bring a change in the nature of loans. Previously the cultivators used to borrow for consumption and other unproductive purposes. But, now, they mostly

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borrow for productive purposes. Cooperative societies discourage unproductive borrowing.

### **IV. Encouragement to Saving and Investment:**

Cooperative credit movement has encouraged saving and investment by developing the habits of thrift among the agriculturists. Instead of hoarding money the rural people tend to deposit their savings in the cooperative or other banking institutions.

### **V. Improvement in Farming Methods:**

Cooperative societies have also greatly helped in the introduction of better agricultural methods. Cooperative credit is available for purchasing improved seeds, chemical fertilizers, modern implements, etc. The marketing and processing societies have helped the members to purchase their inputs cheaply and sell their produce at good prices.

### **VI. Role of Cooperative Banks before 1969:**

Till the nationalisation of major commercial banks in 1969, cooperative societies were practically the only institutional sources of rural credit. Commercial banks and other financial institutions hardly provided any credit for agricultural and other rural activities. Cooperative credit to the agriculturists as a percentage of total agricultural credit increased from 3.1 per cent in 1951-52 to 15.5 per cent in 1961-62 and further to 22.7 per cent in 1970-71.

On the other hand, the agricultural credit provided by the commercial banks as a percentage of total agricultural credit remained almost negligible and fell from 0.9 percent in 1951-52 to 0.6 percent in 1961-62 and then rose to 4 per cent in 1970-71.

### **VII. Role of Cooperative Banks after 1969:**

After the nationalisation of commercial banks in 1969, the government has adopted a multi-agency approach. Under this approach, both cooperative banks and commercial banks (including regional rural banks) are being developed to finance the rural sector.

But, this new approach also recognised the prime role to be played by the cooperative credit institutions in financing rural areas because of the following reasons:

(a) Co-operative credit societies are best suited to the socio-economic conditions of the Indian villages.

(b) A vast network of the cooperative credit societies has been built over the years throughout the length and breadth of the country. This network can neither be duplicated nor be surpassed easily.

(c) The cooperative institutions have developed intimate knowledge of the local conditions and problems of rural areas.

### **VIII. Suitable Federal Structure of Cooperative Banking System:**

Cooperative banking system has a federal structure with- (a) primary agricultural credit societies at the village level, (b) higher financing agencies in the form of central cooperative and state cooperative banks, (c) land development banks for providing long- term credit for agriculture. Such a banking structure is essential and particularly suited for effectively meeting the financial requirements of the vast rural areas of the country.

Considering the great importance of cooperative banks, particularly in the rural areas, it is not surprising that every committee or commission, that has examined the working of the cooperative banking system in India, has expressed the common view that “cooperation remains the best hope of rural India.”

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### **9.13 WEAKNESSES OF COOPERATIVE BANKING:**

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Various committees, commissions and individual studies that have reviewed the working of the cooperative banking system in India have pointed out a number of weaknesses of the system and have made suggestions to improve the system.

Major weaknesses are given below:

#### **I. General Weaknesses of Primary Credit Societies:**

Organisational and financial limitations of the primary credit societies considerably reduce their ability to provide adequate credit to the rural population.

The All India Rural Credit Review Committee pointed out the following weaknesses of the primary credit societies:

- (a) Cooperative credit still constitutes a small proportion of the total borrowings of the farmers,
- (b) Needs of tenants and small farmers are not fully met.
- (c) More primary credit societies are financially weak and are unable to meet the production-oriented credit needs,
- (d) Overdues are increasing alarmingly at all levels,
- (e) Primary credit societies have not been able to provide adequate and timely credit to the borrowing farmers.

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## II. Inadequate Coverage:

Despite the fact that the cooperatives have now covered almost all the rural areas of the country, its rural household membership is only about 45 per cent. Thus, 55 per cent of rural households are still not covered under the cooperative credit system.

In fact, the borrowing membership of the primary credit societies is significantly low and is restricted to a few states like Maharashtra, Gujrat, Punjab, Haryana, Tamil Nadu and to relatively rich land owners.

### Criteria of determining borrowing membership include:

- (a) Borrowing members as a proportion of rural households,
- (b) The average amount of loan issued per borrowing member, and
- (c) The proportion of loans going to weaker sections.

The banking Commission 1972 has brought out the following reasons for the low borrowing membership cooperative societies:

- (a) Inability of the people to provide the prescribed security;
- (b) Lack of up-to-date land records;
- (c) Ineligibility of certain purposes for loans;
- (d) Inadequacy of prescribed credit limits;
- (e) Onerous conditions prescribed for loans such as share capital contribution at 10 or 20 per cent of loans outstanding and compulsory saving deposits; and
- (f) Default of members to repay loans.

## III. Inefficient Societies:

In spite of the fact that the primary agricultural credit societies in most of the states have been reorganised into viable units, their loaning business has not improved. As the Seventh Plan has observed that out of 94089 primary agricultural credit societies in the country in 1982-83, only 66000 societies had full time paid secretaries. About 34000 societies were running at loss.

## IV. Problem of Overdues:

A serious problem of the cooperative credit is the overdue loans of the cooperative institutions which have been continuously increasing over the years. In 1991-92, percentage of overdues to demand at the level of



land development banks was 57, at the level of central cooperative banks was 41 and at the level of primary agricultural credit societies was 39.

The overdues in the short-term credit structure are most alarming in North-Eastern States. In the long-term loaning sector, the problem of overdues has almost crippled the land development banks in 9 states, viz., Maharashtra, Gujarat, Madhya Pradesh, Bihar, Karnataka, Assam, West Bengal, Orissa and Tamil Nadu.

Large amounts of overdues restrict the recycling of the funds and adversely affect the lending and borrowing capacity of the cooperative societies.

The Banking Commission 1972 pointed out the following reasons for the overdue loans:

- (a) Indifferent management or mismanagement of primary societies;
- (b) Unsound lending policies resulting in over-lending or lending unrelated to actual needs, diversions of loans for other purposes;
- (c) Vested interests and group politics in societies and willful defaulters;
- (d) Inadequate supervision over the use of loans and poor recovery efforts;
- (e) Lack of adequate control of central cooperative banks over primary societies;
- (f) Lack of proper links between credit and marketing institutions;
- (g) Failure to take quick action against willful defaulters; and
- (h) Uncertain agricultural prices.

#### **V. Regional Disparities:**

There have been large regional disparities in the distribution of cooperative credit. According to the Seventh Plan, the eight states of Andhra Pradesh, Gujarat, Haryana, Kerala, Madhya Pradesh, Maharashtra, Punjab and Rajasthan account for about 80 per cent of the total credit disbursed. The per hectare short-term credit disbursed varied from Rs. 4 in Assam to Rs. 718 in Kerala.

#### **VI. Benefits to Big Land Owners:**

Most of the benefits from the cooperatives have been covered by the big land owners because of their strong socio-economic position. For instance, in 1984-85 the farmers having holdings less than two hectares got only 38.8 per cent of the total loans granted by the primary agricultural credit societies, whereas the land owners with holdings of more than 2 hectare received 55 per cent. The share of the poorest rural population (i.e. tenants, share croppers and landless labours) was only 6.2 per cent.

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**VII. Lack of Other Facilities:**

Besides the provision of adequate and timely credit, the small and marginal farmers also need other facilities in the form of supply of inputs (i.e., better seeds, fertilisers, pesticides, etc), extension and marketing services.

These facilities will enable them to utilise the borrowed credit in a proper way. Therefore, the credit societies should be reorganised into multi-purposes cooperatives.

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**9.14 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)

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**9.15 SUMMARY**

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- 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

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**9.16 KEY WORDS**

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- Fund: A fund is a source of money that is allocated for a specific purpose.
- Investment: 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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## 9.17 SELF ASSESSMENT QUESTIONS AND EXERCISES

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*Regional Rural Banks*

### Short-Answer Questions

1. What are urban cooperative banks?
2. What are the functions of cooperative banks?

### Long-Answer Questions

1. What are the major recommendations of the high power committee on urban cooperatives? Discuss.
2. Discuss the working of Central Cooperative banks and State Cooperative banks?
3. Discuss the role of regional and rural banks.

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## 9.18 FURTHER READINGS

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- E. Gordon, K. Natarajan. 2014. Banking Theory, Law and Practice, Himalaya publishing house, Hyderabad.
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## **UNIT – X PRIVATE SECTOR BANKS**

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- 10.1 Introduction and Concept of Private sector banks
- 10.2 Objectives
- 10.3 History and Evolution
- 10.4 Performance Evaluation of Private Sector Banks
- 10.5 Types of Private sector banks:
- 10.6 Role of Regulators in Private Banking in India
- 10.7 Answers to Check Your Progress Questions
- 10.8 Summary
- 10.9 Key Words
- 10.10 Self Assessment Questions and Exercises
- 10.11 Further Readings

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### **10.1 INTRODUCTION AND CONCEPT OF PRIVATE SECTOR BANKS**

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The private-sector banks in India represent part of the Indian banking sector that is made up of both private and public sector banks. The "private-sector banks" are banks where greater parts of stake or equity are held by the private shareholders and not by government. Banking in India has been dominated by public sector banks since the 1969 when all major banks were nationalised by the Indian government. However since liberalisation in government banking policy in 1990s, old and new private sector banks have re-emerged. They have grown faster and bigger over the two decades since liberalisation using the latest technology, providing contemporary innovations and monetary tools and techniques. The private sector banks are split into two groups by financial regulators in India, old and new. The old private sector banks existed prior to the nationalisation in 1969 and kept their independence because they were either too small or specialist to be included in nationalisation. The new private sector banks are those that have gained their banking license since the liberalisation in the 1990s.

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### **10.2 OBJECTIVES**

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

- Discuss the role of private sector banks in India
- Understand the functions of private sector banks in India
- Learn about the revised guidelines for private sector banks in India

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## 10.3 HISTORY AND EVOLUTION

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Private-sector banks have been functioning in India since the very beginning of the banking system. Initially, during 1921, the private banks like bank of Bengal, bank of Bombay and bank of Madras were in service, which all together formed Imperial Bank of India.

Reserve Bank of India (RBI) came in picture in 1935 and became the centre of every other bank taking away all the responsibilities and functions of Imperial bank. Between 1969 and 1980 there was rapid increase in the number of branches of the private banks. In April 1980, they accounted for nearly 17.5 percent of bank branches in India. In 1980, after 6 more banks were nationalised, about 10 percent of the bank branches were those of private-sector banks. The share of the private bank branches stayed nearly same between 1980 and 2000.

Then from the early 1990s, RBI's liberalisation policy came in picture and with this the government gave licences to a few private banks, which came to be known as new private-sector banks.

There are two categories of the private-sector banks: "old" and "new".

The old private-sector banks have been operating since a long time and may be referred to those banks, which are in operation from before 1991 and all those banks that have commenced their business after 1991 are called as new private sector banks. Housing Development Finance Corporation Limited was the first private bank in India to receive license from RBI as a part of the RBI's liberalization policy of the banking sector, to set up a bank in the private-sector banks in India.

Historically, the private sector banks played a crucial role in the growth of joint stock banking in India. The first half of the 20th century witnessed phenomenal growth of private sector banks. As a result in 1951, there were 566 private banks of which 474 were non-scheduled and 92 scheduled classified on the basis of their capital size. The role of private sector banking started declining when the Government of India entered banking business with the establishment of State Bank of India in 1955 and subsequently two rounds of bank nationalization one in July 1969 (14 major banks), another in April 1980 (takeover of 6 banks). Consequently, the presence of public sector banks has increased. At present, there are 32 private banks comprising of 24 old banks, which existed prior to 1993-94 and eight new private banks, which were established during 1993- 94 and onwards after the RBI announced guidelines in January 1993 for establishment of new banks in private sector following the recommendations of Narasimham Committee-I (1991). Compared to New private sector banks, the old banks are smaller in size. For example, at end March 2000, the average net worth of the 24 Old Private Banks (OPBs) was Rs.179.67 Crore per OPB compared to that of the New Private Bank (NPB) at Rs. 479.88 Crore per NPB. The OPBs are essentially regional in

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character although some of them have scattered presence in areas other than in and around the areas of their origin. The number of branches of the NPBs was 999 at end March 2003, while those of OPBs 3491. The NPBs are extremely cautious in expanding their branch network and business because their managers, mostly drawn from the public sector banks know very well the ills of unbridled expansion of branches by public sector banks in the post-nationalization era.

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The Narasimham Committee-I, that advocated competition in the banking industry, made unequivocal recommendation to allow private and foreign banks into the industry. Acting on the recommendations of the committee, the RBI laid down guidelines for the establishment of the private sector banks on January 1993. The guidelines prescribed that the private banks should be established as public limited companies under the Indian Companies Act: 1956. The paid-up capital shall not be less than Rs. 100 Crore. The new guidelines issued in 2001 raised the minimum paid-up capital to Rs. 200 Crore, which shall be enhanced to Rs. 300 Crore within three years after the commencement of business. The promoters' share shall not be less than 40 per cent and the voting right of a shareholder shall not exceed 10 per cent. The new banks should avoid shortcomings such as unfair concentration of credit, cross-holding of industrial groups, etc. Those banks which intent to establish main office in a centre where no banking is having such office is to be preferred. These banks are required to observe priority sector lending targets as applicable to other domestic banks. The guidelines aim at ensuring that the new entrants are ab initio financially viable and technologically up-to-date While granting approvals for OPBs, one of the considerations before the RBI was that the new banks would start functioning in a professional manner giving clear signals to the effect that would improve the image of commercial banking system and give confidence to the depositing public.

Accordingly, nine banks were set-up in private sector including some by development financial institutions. Prominent among them are ICICI Bank, GTB, HDFC and IDBI bank. Another interesting development was merger of some banks. Bareilly Corporation Ltd merged with Bank of Baroda in 1999, Times Bank merged with HDFC Bank in 1996, Bank of Madura Ltd merged with ICICI bank in 2001 and Nedungadi Bank Ltd merged with Punjab National Bank in 2003. With regard to branch expansion, banks attaining capital adequacy norms and prudential accounting standards can set up new branches without the prior approval of RBI.

Banks have the freedom to rationalize their existing branch network by relocating branches, opening of specialized branches, spinning off business, setting up of controlling offices, etc. In terms of size, there are Goliaths and Davies among the banks. On one extreme, there is the omnipresent big bank like the SBI (Public Sector Bank) with 9017 branches. On other extreme, there is the small private sector bank; the Ganesh Bank of Kurundwad Ltd. located in an obscure town in

Maharashtra operating with only 30 branches. The youngest bank is the United Bank of India established in 1950. It has been struggling to improve its market share. The Benares State Bank Ltd. is the oldest Bank established in 1871 in the holy city of Varanasi. It remained smaller in size compared to the youngest NPBs. The Bharat Overseas Bank Ltd, which came into being in 1973's is the only private bank having a branch abroad. Between the two extremes, there are 21 banks, which are regional in character and operate with different levels of efficiency.

The New Private Sector Banks started publishing balance sheets since 1995-96. In that year the share of OPBs in total assets was 6.2 per cent while that of NPBs was 1.4 per cent. The NPBs had improved their market share to 5.3 per cent by 1999-2000 at the cost of PSBs. The share of private sector banks in the total number of branches in 1992-93 was only 8.33 percent. In 2002-03, the share of private sector banks in total bank branches is 8.75 percent.

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### 10.4 PERFORMANCE EVALUATION OF PRIVATE SECTOR BANKS

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The performance of 16 Old Private Banks (OPBs) and 8 New Private Banks (NPBs) is evaluated during the reform period. The 8 new private banks as has already been stated, came into existence after 1992-93 and the financial results of these banks are published from 1995-96. Hence, their performance analysis rebates to the period 1995-96 to 2002-03. Only 16 old private sector banks are considered for the analysis, leaving those banks, which are merged with others, Bank of Mathura Ltd. (2001), Bareilly The Nedungadi Bank Ltd. (2003) and those banks whose total assets are less than Rs. 100 Crore. The New Private Banks which are included for evaluation are Bank of Punjab Ltd., Centurion Bank Ltd., Global Trust Bank Ltd., HOFC Bank Ltd., ICICI Bank Ltd., OBI Bank Ltd., Industrial Bank Ltd' and UTI Bank Ltd.(now AXIS Bank Ltd ).

A. The parameters elected for evaluation of efficiency of PBs are:

- Business per Branch,
- Operating expenses per Branch,
- Profit per Branch,
- Business per Employee,
- Establishment expenses per Employee, and
- Profit per Employee

B. The parameter selected for profitability analysis are:

- Return on Assets,
- Return on Equity,
- Net interest Margin as a percentage of working funds,

- Non-Interest Income as a percentage of Total Income, and
- Credit-Deposit Ratio.

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### 10.5 TYPES OF PRIVATE SECTOR BANKS:

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Private sector banking is a type of banking process that involves financial institutions which are primarily owned and operated by private individuals and business organizations rather than by a government entity. This is in contrast with public sector banking, in which the banking enterprise is owned and operated by the state in some manner. In many nations that are supportive of free enterprise, private sector banking is the most common form of banking available. While a government may not actually control banks and other financial institutions that engage in this form of banking, private sector institutions do typically have to comply with governmental regulations that apply to banking in general.

It is not unusual for private sector banking to play a major role in the economy of a given nation. Since this form of banking along with other private sector business enterprises tends to account for a large portion of the money that moves through an economy, financial analysts will pay close attention to what is happening in the private sector. In some nations, a government bank may sometimes set the standard for issues such as interest rates, with banks in the private sector following the example. Since so much of the economy depends on the activities occurring within the private sector, the current policies and procedures that govern private sector banking within a given nation can often help to slow and eventually reverse an unfavourable economic trend, such as a recession.

Another benefit of private sector banking is the support that the mechanism provides to the free enterprise system within a number of economies. Assuming that the banks associated with the private sector are working in harmony with other private sector businesses and concerns, the potential for growing the economy at a consistent and prudent pace is possible. Banking of this tends to make it easier for companies to obtain funds for expansion projects, the launching of stock offerings, and other vital activities that ultimately benefit both the banks and the companies, as well as consumers in general.

#### Check your progress

- i) Type of private sector bank
- ii) Performance evaluation of private sector bank

While private sector banking does provide a wide range of benefits, this form of banking has to comply with governmental regulations that are in effect in the nation where the banks are located. This helps to provide a



basis or foundation for the operation, allowing all banking concerns to have the opportunity to compete for customers. Typically, the regulations also help to establish guidelines for the creation of financial products that are offered to individual and commercial customers, while still allowing each bank to offer value-added benefits that help them to stand out among the different choices open to those potential customers.

There are types of Private banks in India;

- Old generation private banks.
- New generation private banks
- Foreign banks operate in India
- Co-operative banks

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### 10.6 ROLE OF REGULATORS IN PRIVATE BANKING IN INDIA

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Due to its nature, PB in India has to deal with multiple regulators whose policies influence the working of the sector at different levels. Thus, apart from the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI), private banking products and services are also influenced by the Forwards Markets Commission (FMC) and the Insurance Regulatory and Development Authority (IRDA).

At the beginning of the 21st century, the biggest banks in the industrial world have become complex financial organizations that offer a wide variety of services to international markets and control billions of dollars in cash and assets. Supported by the latest technology, banks are working to identify new business niches, to develop customized services, to implement innovative strategies and to capture new market opportunities. With further globalization, consolidation, deregulation and diversification of the financial industry, the banking sector will become even more complex.

Although, the banking industry does not operate in the same manner all over the world, most bankers think about corporate clients in terms of the following:

**Commercial banking** - banking that covers services such as cash management (money transfers, payroll services, bank reconciliation), credit services (asset-based financing, lines of credits, commercial loans or commercial real estate loans), deposit services (checking or savings account services) and foreign exchange.

**Investment banking** - banking that covers an array of services from asset securitization, coverage of mergers, acquisitions and corporate restructuring to securities underwriting, equity private placements and placements of debt securities with institutional investors.

## NOTES

Over the past decade there has been an increasing convergence between the activities of investment and commercial banks, because of the deregulation of the financial sector. Today, some investment and commercial banking institutions compete directly in money market operations, private placements, project finance, bonds underwriting and financial advisory work.

Furthermore, the modern banking industry has brought greater business diversification. Some banks in the industrialized world are entering into investments, underwriting of securities, portfolio management and the insurance businesses. Taken together, these changes have made banks an even more important entity in the global business community.

As a result, the market place has been redefined with new rules of the game. Banks are transforming to universal banking, adding new channels with lucrative pricing and freebies to offer. New channels squeezed spreads, demanding customers better service, marketing skills heightened competition, defined new rules of the game pressure on efficiency. Need for new orientation diffused customer loyalty. Bank has led to a series of innovative product offerings catering to various customer segments, specifically retail credit.

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### 10.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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- Narasimham Committee recommended that there shall be no barriers to new banks being set up in the private sector.
- The Reserve Bank issued a set of guidelines in January 1993 for the entry of new private sector banks.

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### 10.8 SUMMARY

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- 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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## 10.9 KEY WORDS

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- 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

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## 10.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. What is the role of private sector banks in India?
2. 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 functions of private sector banks in India? Discuss.

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## 10.11 FURTHER READINGS

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

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## NOTES

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## UNIT – XI BANKER-BORROWER

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### NOTES

- 11.1 Introduction
- 11.2 Objectives
- 11.3 Expectations from bankers
- 11.4 Expectations from the borrowers
- 11.5 Answers to Check Your Progress Questions
- 11.6 Summary
- 11.7 Key Words
- 11.8 Self Assessment Questions and Exercises
- 11.9 Further Readings

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### 11.1 INTRODUCTION

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Shri A.C. Mahajan, Chairman, BCSBI; Shri M. Narendra, Chairman, Assocham National Council for Banking & Finance; Shri Ashvin Parekh, MD APAS LLP; other dignitaries on the dais; colleagues from the banking fraternity; members of Assocham; representatives of the print and electronic media; ladies and gentlemen! Let me begin by complimenting ASSOCHAM for flagging an issue that is so relevant and contemporaneous for the banking industry. Banks face immense challenges in the area of management of loans and advances in view of the mounting non-performing assets. These challenges exist in spite of the normal rigors that are specified by the regulator and banks' own Head and controlling offices. An increasing number of enabling statutes and enactments coupled with fair practice lending codes make the job of a lender extremely challenging and open to scrutiny. It is against this backdrop that the bankers borrowers 'love-hate' relationships need to be analysed. It seems to be an imaginative idea on part of ASSOCHAM to invite the banking supervisor to inaugurate the session in a bid to arbitrate between the banker and borrower and invite the wrath of both! On a more serious note, a determining aspect of the banker-borrower relationship is built on trust and understanding. It is also important that these relationships neither get too cosy nor do they get too strained as either would have deleterious consequences for the sector and the larger economy. The banking regulations in a way set the ground rules for bank-borrowers relationship, while the supervisory process ensures that this relationship remains healthy. Based on my own practical experience in the field- first as a commercial banker and now as the banking supervisor, I intend to highlight some of the behavioral practices that RBI expects from the bankers and the borrowers. I would also emphasize some regulatory/supervisory concerns that currently exist and could arise from unhealthy relationships between the two.

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## 11.2 OBJECTIVES

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*Banker - Borrower*

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

- Know the precautions to be taken before opening accounts
- Learn the significance of fixed deposits
- Know about the KYC norms
- Learn about the benefits of other deposits

Banker-borrower relationship: Built on foundation of trust and understanding

Relationships demand honest discharge of certain responsibilities by the parties concerned and that alone leads to development of mutual trust and respect. This is equally applicable to a banker-borrower relationship as well. A non-receptive banker or a truant borrower is a malady that the credit system can ill-afford. The banker-borrower relationship is essentially symbiotic as both need each other. Both have certain expectations from the other and when these don't get fulfilled on account of a malafide or fraudulent intent the part of either of them, the relationship gets strained.

Recent spurt in instances of forensic audit being conducted by bankers on their borrowers signifies a breakdown in the implicit trust. There has also been an increase in incidence of suits filed against defaulters and cases of wilful default- an unwillingness to pay, despite an ability to pay. These problems could have their genesis in a failure to exercise the right amount of prudence and due diligence on part of the banker or an *ab initio* intent of the borrower to defraud the bank. This, however, is not a one-way street. The bankers have also been known to be indifferent and negligent of the genuine needs or problems of the borrowers in many cases. More often than not, it is due to a lack of basic understanding of the borrowers' business. At times it is due to factors which are beyond the borrowers' control. In fact, both extremes- excessive and too little trust and due diligence can prove detrimental to banking business. A middle course perhaps would be the most ideal mix with the bankers following the right regulatory rigor and the borrowers following a model code of conduct in their dealings.

Having set out the broader realm of the banker-borrower relationship; let me now turn to some specifics insofar as the expectations from bankers and the borrowers are concerned and non-observance of which can vitiate the relationship between the two.

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## 11.3 EXPECTATIONS FROM BANKERS

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**i) Timely sanctioning and disbursal of the loans** – Borrowers approach the banks because they need finance. The business needs varying quantum of money at different stages. I do not need to go into the details

## NOTES

## NOTES

but what is of essence is observing timeliness by the banks in sanctioning the loans and disbursing as per the needs of the borrower. The borrower would have his commitments to its creditors, suppliers etc. and if these are not met his projections can go haywire. This issue is of far greater significance in case of small borrowers like MSMEs. Unlike large corporate they do not have multiple sources of finance and they could quickly go out of business. The banks also need to provide handholding support to the borrowers, especially in times of stress.

**ii) Adequacy of finance-** A related issue is to ascertain how much finance should the bank give when the borrower approaches. It is at this stage that the efficacy of the credit appraisal process of the bank comes under scrutiny. The bankers should be able to appreciate the business prospects of the borrower and be able and willing to logically reason with the borrower about the projections and assumptions. Excessive financing might result in funds being siphoned off for other purposes and inadequate finance could mean stalled projects and idling of resources. The lending decisions cannot, however, be made alone on an idiosyncratic analysis of the riskiness of the project/business that the borrowers seeks funds for. A very important dimension to contend for the banks is risk of concentration in a particular segment. There is a need to eschew the urge to lend to a sunrise sector following the herd mentality. Concentration risk can hurt the banks badly as has been the case in past in lending to steel, mining, gems and jewellery and infrastructure sector. Exposure concentration in one sector in a geographical area (eg. Exposure to sugar mills in UP) also suffers from political risk.

**iii) Pricing of loan-** An aspect related to adequacy of finance is the pricing of loan. Not only does the finance need to be adequate but also the price charged to the borrower. Bestowing finer pricing of loans on an inferiorly rated or an unrated borrower does raise red flags from the banking supervisor. Loan pricing needs to be risk-based, fair and transparent. If the interest rate being charged is too coercive, the borrower would be squeezed; the business would suffer with banks being forced to take the ultimate hit.

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### 11.4 EXPECTATIONS FROM THE BORROWERS:

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**i) Refrain from Q to Q existence-** The pressure from shareholders tends to drive many imprudent business managers and owners to look for short-term wins. This is reflected in their approach whereby they look to report better financial results than the preceding quarter. In the process, they end up diluting their own internal norms such as extending larger credits than normal and also extending credit for longer periods etc. It must be understood that while the business managers may be temporary, the businesses themselves are going concerns and they cannot be expected to perform miracles even under unfavourable business environment. The efforts to appease the shareholders by all means 'Fair or foul' must end.

**ii) Focus on core competencies** – Rather than looking to make quick bucks by diversifying into so-called ‘hot’ but unrelated activities, the businesses must focus on their core competencies. Diversification, if at all, must be a well-considered and long-term measure rather than ‘quick-fix’ decision. Another trend that has caught the attention of the borrowers is taking a view on the movement of exchange rates and keep unhedged positions. The disturbing part is that even businesses with no earnings/expenses in foreign currency are taking such bets and are likely to burn their fingers. Taking a view on currency is a job of the domain experts and the businesses having no core competency in the area & hence should resist the temptation as wrong -way bets can potentially obliterate a firm overnight.

**iii) Over leverage** - Excessive leverage run up by the Indian corporate is a matter of great concern. Over-leveraging is like having blood pressure-too low or too high, both are detrimental to the health. While banks need to do proper due diligence taking into account a consolidated balance sheet of the group; on their part the borrowers and the large business houses must end over-reliance on borrowed funds for achieving extraordinary growth rates. Operating with too little equity in the enterprise is like treading on thin ice. Too much leverage dilutes promoter’s responsibility and has implications for banks’ ability to recover loans. Double leveraging, where promoters pledge their own shares for funding their other companies needs to be viewed with caution. This, then denigrates to a possibility where the promoter is responsible only to the extent of such shares pledged with banks while funds solicited on the strength of such securities finds its way to the books of SPVs floated or the company’s subsidiaries. I am sure that responsible corporate borrower behaviour and banks’ mechanisms to counter the same will be given due thought in this seminar.

**iv) Diversion of funds-** There are several instances of borrowers diverting money to real estate or capital market for short term gains without deploying them for purposes borrowed. Rather than de-risking the balance sheet, such short-term misadventures often prove very costly.

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## 11.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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- Restricting money laundering and terrorist financing was the main objective of KYC norms when it was introduced during the late 1990s in the USA.
- Bankers generally prefer deposits which are repayable after the expiry of a specified period. Such deposits are known as ‘fixed deposits’.

## NOTES

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## 11.6 SUMMARY

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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.
- The modern banking requires that a constituent should either be known to the banker or should be properly introduced. 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

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## 11.7 KEY WORDS

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- 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.

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## 11.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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### Short-Answer Questions

1. What are the precautions to be taken before opening a bank account?

### Long-Answer Questions

1. What are the Know Your Customer (KYC) norms of a bank?
2. What is the significance of Fixed Deposits?
3. What is the procedure of applying for a Fixed Deposit in a bank?

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## 11.9 FURTHER READINGS

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*Banker - Borrower*

## **NOTES**

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## UNIT – XII BANKER AND CUSTOMER

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### NOTES

- 12.1 Introduction
- 12.2 Objectives
- 12.3 Definition of a ‘BANKER’
- 12.4 Who is a ‘Customer’?
- 12.5 ‘Know Your Customer’ Guidelines and Customer:
- 12.6 Banker-Customer Relationship:
- 12.7 Classification of Relationship:
- 12.8 Definition of Lessor, lessee, premium and rent:
- 12.9 Functions Of Commercial Banking
- 12.10 Answers to Check Your Progress Questions
- 12.11 Summary
- 12.12 Key Words
- 12.13 Self Assessment Questions and Exercises
- 12.4 Further Readings

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### 12.1 INTRODUCTION

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The relationship between a banker and a customer depends on the activities; products or services provided by bank to its customers or availed by the customer. Thus the relationship between a banker and customer is the transactional relationship. Bank’s business depends much on the strong bondage with the customer. “Trust” plays an important role in building healthy relationship between a banker and customer.

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### 12.2 OBJECTIVES

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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

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### 12.3 DEFINITION OF A ‘BANKER’

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The Banking Regulations Act (B R Act) 1949 does not define the term ‘banker’ but defines what banking is? As per Sec.5 (b) of the B R Act “Banking’ means 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.”

As per Sec. 3 of the Indian Negotiable Instruments Act 1881, the word “banker includes any person acting as banker and any post office savings bank”.

According to Sec. 2 of the Bill of Exchange Act, 1882, ‘banker includes a body of persons, whether incorporated or not who carry on the business of banking.’

Sec.5(c) of BR Act defines "banking company" as a company that transacts the business of banking in India. Since a banker or a banking company undertakes banking related activities we can derive the meaning of banker or a banking company from Sec 5(b) as a body corporate that:

- (a) Accepts deposits from public.
- (b) Lends or
- (c) Invests the money so collected by way of deposits.
- (d) Allows withdrawals of deposits on demand or by any other means.

Accepting deposits from the ‘public’ means that a bank accepts deposits from anyone who offers money for the purpose. Unless a person has an account with the bank, it does not accept deposit. For depositing or borrowing money there has to be an account relationship with the bank. A bank can refuse to open an account for undesirable persons. It is banks right to open an account. Reserve Bank of India has stipulated certain norms “Know Your Customer” (KYC) guidelines for opening account and banks have to strictly follow them. In addition to the activities mentioned in Sec.5 (b) of B R Act, banks can also carry out activities mentioned in Sec. 6 of the Act.

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## 12.4 WHO IS A ‘CUSTOMER’?

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The term Customer has not been defined by any act. The word ‘customer’ has been derived from the word ‘custom’, which means a ‘habit or tendency’ to-do certain things in a regular or a particular manner’s .In terms of Sec.131 of Negotiable Instrument Act, when a banker receives payment of a crossed cheque in good faith and without negligence for a customer, the bank does not incur any liability to the true owner of the cheque by reason only of having received such payment. It obviously means that to become a customer account relationship is must. Account relationship is a contractual relationship.

It is generally believed that any individual or an organisation, which conducts banking transactions with a bank, is the customer of bank. However, there are many persons who do utilize services of banks, but do not maintain any account with the bank.

Thus bank customers can be categorized in to four broad categories as under:

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Those who maintain account relationship with banks i.e. Existing customers.

Those who had account relationship with bank i.e. Former Customers

Those who do not maintain any account relationship with the bank but frequently visit branch of a bank for availing banking facilities such as for purchasing a draft, encashing a cheque, etc. Technically they are not customers, as they do not maintain any account with the bank branch.

Prospective/ Potential customers: Those who intend to have account relationship with the bank. A person will be deemed to be a 'customer' even if he had only handed over the account opening form duly filled in and signed by him to the bank and the bank has accepted the it for opening the account, even though no account has actually been opened by the bank in its books or record.

The practice followed by banks in the past was that for opening account there has to be an initial deposit in cash. However the condition of initial cash deposit for opening the account appears to have been dispensed with the opening of 'No Frill' account by banks as per directives of Reserve Bank of India. 'No Frill' accounts are opened with 'Nil' or with meager balance.

The term 'customer' is used only with respect to the branch, where the account is maintained. He cannot be treated as a 'customer' for other branches of the same bank. However with the implementation of 'Core Banking Solution' the customer is the customer of the bank and not of a particular branch as he can operate his account from any branch of the bank and from anywhere. In the event of arising any cause of action, the customer is required to approach the branch with which it had opened account and not with any other branch.

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### **12.5 'KNOW YOUR CUSTOMER' GUIDELINES AND CUSTOMER:**

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As per 'Know Your Customer' guidelines issued by Reserve Bank of India, customer has been defined as:

- a) A person or entity that maintains an account and/or has a business relationship with the bank;
- b) One on whose behalf the account is maintained (i.e. the beneficial owner);
- c) Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and

d) Any person or entity connected with a financial transaction, which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

*Banker and Customer*

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## **12.6 BANKER-CUSTOMER RELATIONSHIP:**

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Banking is a trust-based relationship. There are numerous kinds of relationship between the bank and the customer. The relationship between a banker and a customer depends on the type of transaction. Thus the relationship is based on contract, and on certain terms and conditions.

These relationships confer certain rights and obligations both on the part of the banker and on the customer. However, the personal relationship between the bank and its customers is the long lasting relationship. Some banks even say that they have generation-to-generation banking relationship with their customers. The banker customer relationship is fiducial relationship. The terms and conditions governing the relationship is not be leaked by the banker to a third party.

## **NOTES**

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## **12.7 CLASSIFICATION OF RELATIONSHIP:**

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The relationship between a bank and its customers can be broadly categorized in to General Relationship and Special Relationship. If we look at Sec 5(b) of Banking Regulation Act, we would notice that bank's business hovers around accepting of deposits for the purposes of lending. Thus the relationship arising out of these two main activities are known as General Relationship. In addition to these two activities banks also undertake other activities mentioned in Sec.6 of Banking Regulation Act. Relationship arising out of the activities mentioned in Sec.6 of the act is termed as special relationship.

### **General Relationship:**

1. Debtor-Creditor: When a 'customer' opens an account with a bank, he fills in and signs the account opening form. By signing the form he enters into an agreement/contract with the bank. When customer deposits money in his account the bank becomes a debtor of the customer and customer a creditor. The money so deposited by customer becomes bank's property and bank has a right to use the money as it likes. The bank is not bound to inform the depositor the manner of utilization of funds deposited by him. Bank does not give any security to the depositor i.e. debtor. The bank has borrowed money and it is only when the depositor demands, banker pays. Bank's position is quite different from normal debtors.

Banker does not pay money on its own, as banker is not required to repay the debt voluntarily. The demand is to be made at the branch where the account exists and in a proper manner and during working days and working hours.

## NOTES

The debtor has to follow the terms and conditions of bank said to have been mentioned in the account opening form. {Though the terms and conditions are not mentioned in the account opening form, but the account opening form contains a declaration that the terms and conditions have been read and understood or has been explained. In fact the terms and conditions are mentioned in the passbook, which is issued to the customer only after the account has been opened.}

In the past while opening account some of the banks had the practice of giving a printed handbill containing the terms and conditions of account along with the account opening form. This practice has since been discontinued. For convenience and information of prospective customers a few banks have uploaded the account opening form, terms and conditions for opening account, rate charge in respect of various services provided by the bank etc., on their web site.

While issuing Demand Draft, Mail / Telegraphic Transfer, bank becomes a debtor as it owes money to the payee/ beneficiary.

2. Creditor–Debtor: Lending money is the most important activities of a bank. The resources mobilized by banks are utilized for lending operations. Customer who borrows money from bank owns money to the bank. In the case of any loan/advances account, the banker is the creditor and the customer is the debtor. The relationship in the first case when a person deposits money with the bank reverses when he borrows money from the bank. Borrower executes documents and offer security to the bank before utilizing the credit facility.

In addition to opening of a deposit/loan account banks provide variety of services, which makes the relationship more wide and complex. Depending upon the type of services rendered and the nature of transaction, the banker acts as a bailee, trustee, principal, agent, lessor, custodian etc.

### **Special Relationship:**

1. Bank as a Trustee: As per Sec. 3 of Indian Trust Act, 1882 ‘ A "trust" is an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner.’ Thus trustee is the holder of property on behalf of a beneficiary.

As per Sec. 15 of the ‘Indian Trust Act, 1882 ‘A trustee is bound to deal with the trust-property as carefully as a man of ordinary prudence would deal with such property if it were his own; and, in the absence of a contract to the contrary, a trustee so dealing is not responsible for the loss, destruction or deterioration of the trust-property.’ A trustee has the right to reimbursement of expenses (Sec.32 of Indian Trust Act.).

In case of trust banker customer relationship is a special contract. When a person entrusts valuable items with another person with an

intention that such items would be returned on demand to the keeper the relationship becomes of a trustee and trustier. Customers keep certain valuables or securities with the bank for safekeeping or deposits certain money for a specific purpose (Escrow accounts) the banker in such cases acts as a trustee. Banks charge fee for safekeeping valuables

2. Bailee – Bailor: Sec.148 of Indian Contract Act, 1872, defines "Bailment" "bailor" and "bailee". A "bailment" is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them.

The person delivering the goods is called the "bailor". The person to whom they are delivered is called, the "bailee".

Banks secure their advances by obtaining tangible securities. In some cases physical possession of securities goods (Pledge), valuables, bonds etc., are taken. While taking physical possession of securities the bank becomes bailee and the customer bailor. Banks also keeps articles, valuables, securities etc., of its customers in Safe Custody and acts as a Bailee. As a bailee the bank is required to take care of the goods bailed.

3. Lessor and Lessee: Sec.105 of 'Transfer of property Act 1882' defines lease, Lessor, lessee, premium and rent. As per the section "A lease of immovable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms."

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### **12.8 DEFINITION OF LESSOR, LESSEE, PREMIUM AND RENT:**

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- (1) The transferor is called the lessor,
- (2) The transferee is called the lessee,
- (3) The price is called the premium, and
- (4) The money, share, service or other thing to be so rendered is called the rent."

Providing safe deposit lockers is as an ancillary service provided by banks to customers. While providing Safe Deposit Vault/locker facility to their customers bank enters into an agreement with the customer. The agreement is known as "Memorandum of letting" and attracts stamp duty.

The relationship between the bank and the customer is that of lessor and lessee. Banks lease (hire lockers to their customers) their immovable

### **NOTES**

## NOTES

property to the customer and give them the right to enjoy such property during the specified period i.e. during the office/ banking hours and charge rentals. Bank has the right to break-open the locker in case the locker holder defaults in payment of rent. Banks do not assume any liability or responsibility in case of any damage to the contents kept in the locker. Banks do not insure the contents kept in the lockers by customers.

4. Agent and Principal: Sec.182 of 'The Indian Contract Act, 1872' defines "an agent" as a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called "the Principal".

Thus an agent is a person, who acts for and on behalf of the principal and under the latter's express or implied authority and the acts done within such authority are binding on his principal and, the principal is liable to the party for the acts of the agent.

Banks collect cheques, bills, and makes payment to various authorities viz., rent, telephone bills, insurance premium etc., on behalf of customers. . Banks also abides by the standing instructions given by its customers. In all such cases bank acts as an agent of its customer, and charges for these services. As per Indian contract Act agent is entitled to charges. No charges are levied in collection of local cheques through clearing house. Charges are levied in only when the cheque is returned in the clearinghouse.

5. As a Custodian: A custodian is a person who acts as a caretaker of something. Banks take legal responsibility for a customer's securities. While opening a dmat account bank becomes a custodian.

6. As a Guarantor: Banks give guarantee on behalf of their customers and enter in to their shoes. Guarantee is a contingent contract. As per sec 31,of Indian contract Act guarantee is a " contingent contract ". Contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen.

It would thus be observed that banker customer relationship is transactional relationship.

Termination of relationship between a banker and a customer:

The relationship between a bank and a customer ceases on:

- (a) The death, insolvency, lunacy of the customer.
- (b) The customer closing the account i.e. Voluntary termination
- (c) Liquidation of the company
- (d) The closing of the account by the bank after giving due notice.



(e) The completion of the contract or the specific transaction.

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## **12.9 FUNCTIONS OF COMMERCIAL BANKING**

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Commercial banks perform various functions to serve the people. It is because of this that they are considered as the nerve center of the modern world. The functions performed by commercial banks can be classified into primary functions secondary functions and subsidiary functions. Read this article to know in detail.

### **NOTES**

#### **Primary functions of a bank**

The primary functions are the main functions of commercial banks. It includes (1.) Accepting deposits (2) Advancing loans and (3) Transferring bank deposits.

1. Accepting Deposits: The most important functions of commercial bank is that of accepting deposits. Deposits are broadly classified primary deposits like fixed deposits, current deposits and saving deposits. Derived deposits are those deposits which banks secure when it gives loans to its customers.

Fixed deposits or time deposits: In the case of fixed deposits banks pay money after the expiry of fixed period with the predetermined interest. Money is accepted by banks for a specific period say one, two five or more years Money cannot be withdrawn before the expiry of the period and interest rate is usually high for such deposits

Current or demand deposit: Businessmen keep their money as current deposit on which no interest is paid by the bank. This can be withdrawn at any time without any notice by using cheques. So they are known as current deposits.

Savings deposits: Savings deposits belong to small savers and middle class people. They stand midway between current deposits and fixed deposits. The rate of interest to them is less than that is allowed to fixed deposits. Some restrictions are also imposed on the withdrawals of savings deposits.

#### **Check your progress**

i Who is customer?

ii Who is banker?

iii List the relationship of them.

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2. Advancing Loans: Another important function performed by commercial bank is the granting of loans to its customers. The money accepted commercial banks from its customers are used to give loans at slightly higher rates of interest. The difference between the lending rate and the deposit rates constitute the margin of profit for the banks.

The following are the principal types of loans advanced by commercial banks.

Loans and advances: Advances are granted for short periods to customers while loans are granted for longer periods against security like gold, property or other valuables.

Cash credit: The bank advances loans to manufacturers and businessmen against certain specific securities like raw materials or finished products.

3. Transferring bank deposits: Commercial banks transfer money from one name to another in the same place or another place. Suppose a person in Chennai wants to make a payment to another person in Trivandrum he may send his cheques or bank draft to the person in Trivandrum.

### Secondary function

Discounting bills of exchange: This is another method of lending money. Discounting commercial papers, bills and promissory notes are the most acceptable form of lending by commercial banks. If a borrower holds genuine trade bills and requires money immediately the banks provides him with money by discounting the bills of exchange before the due date. When the bill matures the bank will collect money from the drawer of the bill.

Overdrafts: Banks grant overdraft facilities to its business customers. This means that the customers will be permitted to draw in excess of their deposit amount subject to a maximum prescribed by the bank.

### Subsidiary function

Subsidiary functions Modern commercial banks render many other functions apart from the traditional functions. These services are done to attract more customers to the bank. However it should be noted that banks are not legally bound to undertake these functions.

These services are grouped under

- Agency services
- General Utility services
- Overseas Trading services
- Information and other services

Agency services: Commercial banks nowadays provide a large number of agency services to its customers. The following are the agency services done by the banks. A. Collecting cheques, bills and promissory notes. B. Collecting dividends on the shares of the customers. C. Paying premium to the insurance companies on behalf of the customer. D. Collecting and paying rent, interest and telephone bills. Etc. E. Collecting salary pensions Etc

General utility services: Banks undertake certain utility services to its customers. These services are a) Using travellers cheques b) Issuing demand draft c) Acting as a trustee of the customer's property. Providing safe custody measures for valuable articles like jewelry.

As a conclusion we can say that the services rendered by modern commercial banks are innumerable. It mobilizes the scattered savings of innumerable people and redistributes them to useful channels. It constitutes the very life blood of the modern society.

## NOTES

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### 12.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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- A banker is therefore essentially a dealer in debts, or credit.
- The essential business of a 'Banker' is to buy money and debts, by creating other debts.
- The true relationship between a banker and a customer is that of a debtor and a creditor.

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### 12.11 SUMMARY

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- 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.

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### 12.12 KEY WORDS

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- 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.

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### 12.13 SELF ASSESSMENT QUESTIONS AND EXERCISES

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#### Short-Answer Questions

1. What do you understand by law of limitation?
2. What are the cases when a banker cannot exercise his right of lien?
3. What are garnishee orders?

#### Long-Answer Questions

1. Who is a banker? Discuss the major functions of a banker.
2. Mention the cases in which a banker is a trustee and not an agent.
3. What are the special features of the relationship between a banker and a customer?

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### 12.4 FURTHER READINGS

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E. Gordon, K. Natarajan. 2014. Banking Theory, Law and Practice, Himalaya publishing house, Hyderabad.

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

Gupta, H.R. 2011. Practical Banking in India. Gyan Publishing House. New Delhi.

Iyenger, Vijayaragavan. 2009. Introduction to Banking. Excel Books. New Delhi.

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## UNIT – XIII BANKER AGENCY SERVICE

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*Banker Agency Service*

- 13.1 Introduction
- 13.2 Objectives
- 13.3 Function of Banker as a Agency
- 13.4 Answers to Check Your Progress Questions
- 13.5 Summary
- 13.6 Key Words
- 13.7 Further Readings
- 13.8 Self Assessment Questions and Exercises

### NOTES

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### 13.1 INTRODUCTION

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Banking & Finance Industry is discovering the immense capabilities and is increasingly adopting Mobile, POS & similar Hand-Held Devices to take banking services to the common man or better serve the existing customers.

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### 13.2 OBJECTIVES

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To understand the Banker and its Agency services

The bank performs a number of secondary functions, also called as non-banking functions.

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### 13.3 FUNCTION OF BANKER AS A AGENCY

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These important secondary functions of banks are explained below.

#### 14.3.1 Agency Functions

The bank acts as an agent of its customers. The bank performs a number of agency functions which includes :-

- Transfer of Funds
- Collection of Cheques
- Periodic Payments
- Portfolio Management
- Periodic Collections
- Other Agency Functions

#### a. Transfer of Funds

## NOTES

The bank transfer funds from one branch to another or from one place to another.

### **b. Collection of Cheques**

The bank collects the money of the cheques through clearing section of its customers. The bank also collects money of the bills of exchange.

### **c. Periodic Payments**

On standing instructions of the client, the bank makes periodic payments in respect of electricity bills, rent, etc.

### **d. Portfolio Management**

The banks also undertakes to purchase and sell the shares and debentures on behalf of the clients and accordingly debits or credits the account. This facility is called portfolio management.

### **e. Periodic Collections**

The bank collects salary, pension, dividend and such other periodic collections on behalf of the client.

### **f. Other Agency Functions**

They act as trustees, executors, advisers and administrators on behalf of its clients. They act as representatives of clients to deal with other banks and institutions.

### **14.3.2 General Utility Functions**

The bank also performs general utility functions, such as :-

- Issue of Drafts, Letter of Credits, etc.
- Locker Facility
- Underwriting of Shares
- Dealing in Foreign Exchange
- Project Reports
- Social Welfare Programmes
- Other Utility Functions

#### **a. Issue of Drafts and Letter of Credits**

Banks issue drafts for transferring money from one place to another. It also issues letter of credit, especially in case of, import trade. It also issues travellers' cheques.

#### **b. Locker Facility**

The bank provides a locker facility for the safe custody of valuable documents, gold ornaments and other valuables.

*Banker Agency Service*

**c. Underwriting of Shares**

The bank underwrites shares and debentures through its merchant banking division.

**d. Dealing in Foreign Exchange**

The commercial banks are allowed by RBI to deal in foreign exchange.

**e. Project Reports**

The bank may also undertake to prepare project reports on behalf of its clients.

**f. Social Welfare Programmes**

It undertakes social welfare programmes, such as adult literacy programmes, public welfare campaigns, etc.

**g. Other Utility Functions**

It acts as a referee to financial standing of customers. It collects creditworthiness information about clients of its customers. It provides market information to its customers, etc. It provides travellers' cheque facility.

**NOTES**

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**13.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

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- Different function of banker as agency

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**13.5 SUMMARY**

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- A banker is entitled to charge interest on loans, either by express agreement or by right of custom or usage of trade.
- 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 '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.

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### 13.6 KEY WORDS

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**Banker** A person who is doing banking business is called a banker

**Portfolio** a range of investments held by a person or organization.

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### 13.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

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- Explain the different function of agency as a banker
- 

### 13.8 FURTHER READINGS

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E. Gordon, K. Natarajan.2014. Banking Theory, Law and Practice, Himalaya publishing house, Hyderabad.

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

Gupta, H.R. 2011. Practical Banking in India. Gyan Publishing House. New Delhi.

Iyenger, Vijayaragavan. 2009. Introduction to Banking. Excel Books. New Delhi.

### NOTES



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## UNIT – XIV RECENT TRENDS IN INDIAN BANKING SYSTEM

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*Banker Agency Service*

- 14.1 Introduction
- 14.2 Objectives
- 14.3 Top Trends in Banking and Financial Services in India
- 14.4 Few Trends in Banking and Financial Services in India
- 14.5 Answers to Check Your Progress Questions
- 14.6 Summary
- 14.7 Key Words
- 14.8 Self Assessment Questions and Exercises
- 14.9 Further Readings

### NOTES

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#### 14.1 INTRODUCTION

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The Banking industry and financial institutions are vital sectors of any economy. Development of these two sections of the economy can impact the growth of the country in an incredible way. In the era of “Digital India”, the banking and financial services in India have undergone a massive evolution and the phenomenon continues. The change can be attributed to various components like new regulatory policies and customer expectations. However, the one element that has affected banking and financial services the most is technological advancement.

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#### 14.2 OBJECTIVES

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

- Understand the recent trends in the Indian banking system
- Learn the developments in the field of Technological banking
- Learn the importance of banking habitat
- Know about money lending

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#### 14.3 TOP TRENDS IN BANKING AND FINANCIAL SERVICES IN INDIA

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The emergence of innovative financial technology has revolutionized financial services in India as well as the banking sector. It has resulted in the introduction and advancement of several technology trends that have contributed to the radical transformation, growth, and advancement of these industries. The alliance between the innovative technologies of the financial sector and banking services has changed the conventional systems of handling money, and this collaboration is expected to create a massive shift with emerging trends in financial services.

The rise of Fintech companies, internet banking, and mobile banking are some of the classic examples of emerging trends in the banking sector and financial services. In addition to the betterment of traditional systems, these banking and financial services industry trends are a few steps toward creating a cashless society, complete digital transformation, and the rise of Fintech. In this time of change, the only thing that is constant is change.

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## **14.4 FEW TRENDS IN BANKING AND FINANCIAL SERVICES IN INDIA THAT ARE CHANGING THE ENTIRE SCENARIO**

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### **1. Digitization**

With the rapid growth of digital technology, it became imperative for banking and financial services in India to keep up with the changes and innovate digital solutions for the tech-savvy customers. Besides the financial institutions, insurance, healthcare, retail, trade, and commerce are some of the major industries that are experiencing the enormous digital shift. To stay competitive, it is necessary for the banking and financial industry to take the leap on the digital bandwagon.

In India, it all began not earlier than the 1980s when the banking sector introduced the use of information technology to perform basic functions like customer service, book-keeping, and auditing. Soon, Core Banking Solutions were adopted to enhance customer experience. However, the transformation began in the 1990s during the time of liberalization, when the Indian economy exposed itself to the global market. The banking sector opened itself for private and international banks which is the prime reason for technological changes in the banking sector. Today, banks and financial institutions have benefitted in many ways by adopting newer technologies. The shift from conventional to convenience banking is incredible.

Modern trends in banking system make it easier, simpler, paperless, signatureless and branchless with various features like IMPS (Immediate Payment Service), RTGS (Real Time Gross Settlement), NEFT (National Electronic Funds Transfer), Online Banking, and Telebanking. Digitization has created the comfort of “anywhere and anytime banking.” It has resulted in the reduced cost of various banking procedures, improved revenue generation, and reduced human error. Along with increased customer satisfaction, it has enabled the customers creating personalized solutions for their investment plans and improve the overall banking experience.

### **2. Enhanced Mobile Banking**

#### **Mobile Banking technology**

Mobile banking is one of the most dominant current trends in banking systems. As per the definition, it is the use of a smartphone to

perform various banking procedures like checking account balance, fund transfer, and bill payments, without the need of visiting the branch. This trend has taken over the traditional banking systems. In the coming years, mobile banking is expected to become even more efficient and effortless to keep up with the customer demands. Mobile banking future trends hint at the acquisition of IoT and Voice-Enabled Payment Services to become the reality of tomorrow. These voice-enabled services can be found in smart televisions, smart cars, smart homes, and smart everything. Top industry leaders are collaborating to adopt IoT-connected networks to create mobile banking technologies that require users' voice to operate.

## NOTES

### 3. UPI (Unified Payments Interface):

UPI or Unified Payments Interface has changed the way payments are made. It is a real-time payment system that enables instant inter-bank transactions with the use of a mobile platform. In India, this payment system is considered the future of retail banking. It is one of the fastest and most secure payment gateways that is developed by National Payments Corporation of India and regulated by the Reserve Bank of India. The year 2016 saw the launch of this revolutionary transactions system. This system makes funds transfer available 24 hours, 365 days unlike other internet banking systems. There are approximately 39 apps and more than 50 banks supporting the transaction system. In the post-demonetization India, this system played a significant role. In the future, with the help of UPI, banking is expected to become more "open."

### 4. Block Chain

Blockchain is the new kid on the block and the latest buzzword. The technology that works on the principles of computer science, data structures and cryptography and is the core component of cryptocurrency, is said to be the future of banking and financial services globally. Blockchain uses technology to create blocks to process, verify and record transactions, without the ability to modify it.

### 5. Artificial Intelligence Robots

#### Artificial Intelligence robot

Several private and nationalized banks in India have started to adopt chatbots or Artificial intelligence robots for assistance in customer support services. For now, the use of this technology is at a nascent stage and evolution of these chatbots is not too far away. Usage of chatbots is among the many emerging trends in the Indian banking sector that is expected to grow.

More chatbots with the higher level of intelligence are forecasted to be adopted by the banks and financial institutions for improved customer interaction personalized solutions. The technology will alleviate the chances of human error and create accurate solutions for the customers.

## NOTES

Also, it can recognize fraudulent behavior, collate surveys and feedback and assist in financial decisions.

### **6. The rise of Fintech Companies:**

Previously, banks considered Fintech companies a disrupting force. However, with the changing trends in the financial services sector in India, fintech companies have become an important part of the sector. The industry has emerged as a significant part of the ecosystem. With the use of financial technology, these companies aim to surpass the traditional methods of finance. In the past few decades, massive investment has been made in these companies and it has emerged into a multi-billion-dollar industry globally.

#### **Rise of fintech technologies**

Fintech companies and fintech apps have changed the way financial solutions are provided to the customers. Besides easy access to financial services, fintech companies have led to a massive improvement in services, customer experience, and reduced the price paid. In India, the dynamic transformation has been brought upon by several important elements like fintech startups, established financial institutions, initiatives like “Start-Up India” by Government of India, incubators, investors, and accelerators. According to a report by National Association of Software and Services Companies (NASSCOM), the fintech services market is expected to grow by 1.7 times into an \$8 billion market by 2020.

### **7. Digital-Only Banks:**

It is a recent trend in the Indian financial system and cannot be ignored. With the entire banking and financial services industry jumping to digital channels, digital-only banks have emerged to create paperless and branchless banking systems. This is a new breed of banking institutions that are overtaking the traditional models rapidly. These banks provide banking facilities only through various IT platforms that can be accessed on mobile, computers, and tablets. It provides most of the basic services in the most simplified manner and gives access to real-time data. The growing popularity of these banks is said to be a real threat to traditional banks.

ICICI Pockets is India’s first digital-only bank. These banks are attractive to the customers because of their cost-effective operating models. At the same time, though virtually, they provide high-speed banking services at very low transaction fees. In today’s fast lane life, these banks suit the customer needs because they alleviate the need of visiting the bank and standing in a queue.

### **8. Cloud Banking:**

Cloud technology has taken the world by storm. It seems the technology will soon find its way in the banking and financial services

sector in India. Cloud computing will improve and organize banking and financial activities. Use of cloud-based technology means improved flexibility and scalability, increased efficiency, easier integration of newer technologies and applications, faster services and solutions, and improved data security. In addition, the banks will not have to invest in expensive hardware and software as updating the information is easier on cloud-based models.

## 9. Biometrics:

### Biometric payment

Essentially for security reasons, a Biometric Authentication system is changing the national identity policies and the impact is expected to be widespread. Banking and financial services are just one of the many other industries that will be experiencing the impact. With a combination of encryption technology and OTPs, biometric authentication is forecasted to create a highly-secure database protecting it from leaks and hackers attempts. Financial services in India are exploring the potential of this powerful technology to ensure sophisticated security to customers' account and capital.

## 10. Wearables:

With smartwatch technology, the banking and financial services technology is aiming to create wearables for retail banking customers and provide more control and easy access to the data. Wearables have changed the way we perform daily activities. Therefore, this technology is anticipated to be the future retail banking trend by providing major banking services with just a click on a user-friendly interface on their wearable device.

These are some of the recent trends in the banking and financial sector of India and all these new technologies are predicted to reshape the industry of business and money. The future is going to bring upon a revolution of sorts with historical changes in traditional models. The massive shift in the landscape has few challenges. Nonetheless, the customers are open to banking innovations and the government is showing great support with schemes like "Jan Dhan Yojana," which aims at proving a bank account to every citizen. Meanwhile, the competition from the foreign and private sector banks have strained the government regulators, nationalized banks and financial institutions to adopt new technology in order to stay relevant in the race.

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## 14.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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- The identification of the priority sectors for the purpose of financing by banks has given a new orientation to the Indian banking system.

## NOTES

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- 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.

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#### 14.6 SUMMARY

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- 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 socioeconomic objectives necessitated the expansion of the network of branches to the under banked areas of the country.

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#### 14.7 KEY WORDS

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- Ombudsman: The ombudsman is an independent official who has been appointed to investigate complaints.
- Blockchain is the new kid on the block and the latest buzzword
- Unified Payments Interface has changed the way payments are made. It is a real-time payment system that enables instant inter-bank transactions with the use of a mobile platform.

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#### 14.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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##### Short answer Question

1. What is biometric system
2. What is green card
3. Advantage of mobile banking

##### Long Answer Question

1. What do you understand by traditional banking theory?
2. Mention some of the recent developments in the field of banking.
3. How has retail banking emerged in the past?

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## 14.9 FURTHER READINGS

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E. Gordon, K. Natarajan.2014. Banking Theory, Law and Practice, Himalaya publishing house, Hyderabad.

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

Gupta, H.R. 2011. Practical Banking in India. Gyan Publishing House. New Delhi.

Iyenger, Vijayaragavan. 2009. Introduction to Banking. Excel Books. New Delhi.

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### NOTES

Distance Education – CBCS- (2018-19 Academic year onwards)  
Question Paper Pattern – Theory

Time: 3 Hrs  
Maximum: 75 Max

**NOTES**

Part – A (10 x 2 = 20 Marks)  
Answer all Questions

1. Define Central Bank.
2. What is Automated Teller Machine?
3. What is Credit card?
4. What is insurance Premium?
5. Define promissory note.
6. Define General Crossing.
7. Who is Beneficiary?
8. What is meant by RTGS?
9. What is base rate?
10. What do you understand by the term 'banker'?

Part- B (5 x 5 = 25 Marks)  
Answer all questions choosing either (a) or (b)

11. a. Discuss the modern functions of commercial banks.  
(OR)  
b. What are the different types of cheque?
12. a. What are the types of negotiable instruments?  
b. What is Debit card? Explain different types of Debit card.
13. a. Enumerate the advantage of fixed deposit account.  
(OR)  
b. What is endorsement? Explain the liability of an endorser.
14. a. State the utility services offered by commercial bank  
(OR)  
b. What are the various types of Deposits?
15. a. Explain the procedure for opening a joint account.  
(OR)  
b. How does the Unit Banking differ from the Branch Banking?

Part – C (3 x 10 = 30 Marks)  
(Answer any 3 out of 5 questions)

16. Describe the functions of Commercial Banks
17. Explain the popular services covered under E- Banking.
18. Explain the role and importance of banks in economic development.
19. Describe the function of Reserve Bank of India.
20. Explain briefly the function of NABARD.