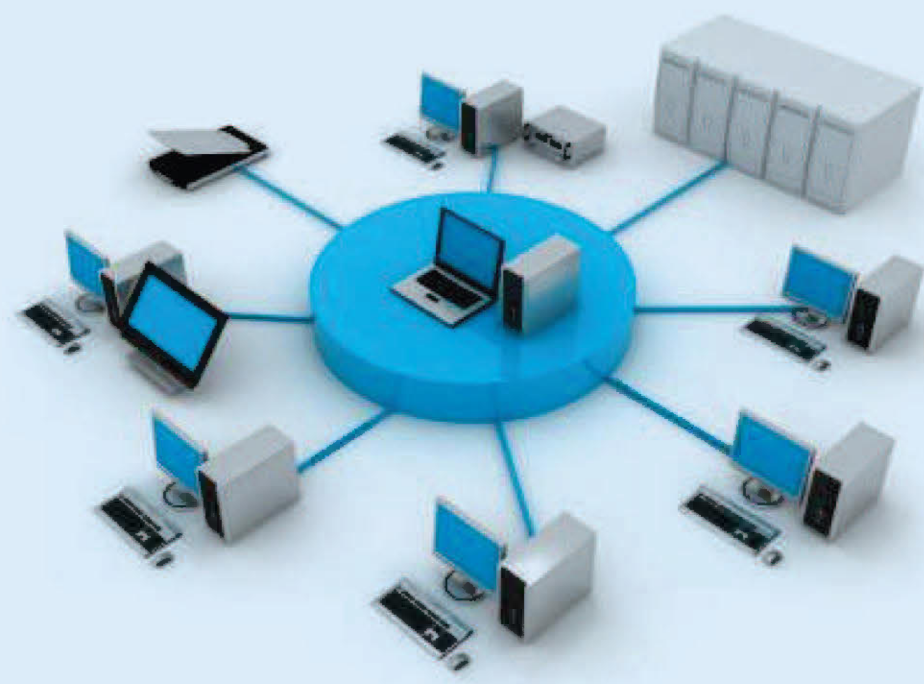

Dr. C.V. Raman University
Kargi Road, Kota, BILASPUR, (C. G.),
Ph. : +07753-253801, +07753-253872
E-mail : info@cvru.ac.in | Website : www.cvru.ac.in

Banking & Insurance Practices

Institute of Open and Distance Education

Faculty of Management

Banking & Insurance Practices

3BBA3

DR. C.V. RAMAN UNIVERSITY

Chhattisgarh, Bilaspur

A STATUTORY UNIVERSITY UNDER SECTION 2(F) OF THE UGC ACT

3BBA3

Banking and Insurance Practices

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Compiled, reviewed and edited by Subject Expert team of University

1. Dr. Priyanka Bose

(Assistant Professor, Dr. C. V. Raman University)

2. Dr. Supriya Singh

(Assistant Professor, Dr. C. V. Raman University)

3. Dr. Abhinav Awasthi

(Assistant Professor, Dr. C. V. Raman University)

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Dr. C.V. Raman University

Kargi Road, Kota, Bilaspur, (C. G.),

Ph. +07753-253801,07753-253872

E-mail: info@cvru.ac.in

Website: www.cvru.ac.in

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1 Bank and Banking Practices

NOTES

The Unit Include:

- Introduction
- Origin of the word
- Definition
- Banking in India
- History
- Post-Independence
- Nationalization
- Liberalization
- Early phase from 1786 to 1969 of Indian Banks:
- Adoption of banking technology
- Evolution of Commercial Banks in India
- Functions of Commercial Bank
- Competitive Landscape of Banks In India
- Banking Structure in India
- RBI as Bankers' Bank:
- Chapter Summary
- Test Yourself

Learning Objectives:

After going through this chapter, you should be able to:

- Define what banks are.
- Describe the importance of banks.
- Discuss issues and concerns involved.
- Understand gross working concept.

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Introduction

A **bank** is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly or through capital markets. A bank connects customers that have capital deficits to customers with capital surpluses.

Due to their critical status within the financial system and the economy generally, banks are highly regulated in most countries. Most banks operate under a system known as fractional reserve banking where they hold only a small reserve of the funds deposited and lend out the rest for profit. They are generally subject to minimum capital requirements which are based on an international set of capital standards, known as the Basel Accords.

The oldest bank still in existence is Monte dei Paschi di Siena, headquartered in Siena, Italy, which has been operating continuously since 1472.

Banking in the modern sense of the word can be traced to medieval and early Renaissance Italy, to the rich cities in the north like Florence, Venice and Genoa. The Bardi and Peruzzi families dominated banking in 14th century, establishing branches in many other parts of Europe. Perhaps the most famous Italian bank was the Medici bank, set up by Giovanni Medici in 1397. The earliest known state deposit bank, Banco di San Giorgio (Bank of St. George), was founded in 1407 at Genoa, Italy.

Origin of the word

The word *bank* was borrowed in Middle English from Middle French *banque*, from Old Italian *banca*, from Old High German *banc, bank* "bench, counter". Benches were used as desks or exchange counters during the Renaissance by Florentine bankers, who used to make their transactions atop desks covered by green tablecloths.

One of the oldest items found showing money-changing activity is a silver Greek drachm coin from ancient Hellenic colony Trapezus on the Black Sea, modern Trabzon, c. 350–325 BC, presented in the British Museum in London. The coin shows a banker's table (*trapeza*) laden with coins, a pun on the name of the city. In fact, even today in Modern Greek the word Trapeza (*Τράπεζα*) means both a table and a bank.

Another possible origin of the word is from the Sanskrit words Baya (Expense) and Onka (Calculation) = BayaOnka. This word still survives in Bangla, which is one of the Sanskrit's child languages ব্যায় + অঙ্ক = ব্যাঙ্ক . Such expense calculations were the biggest part of mathematical treaties written by Indian mathematicians as early as 500 B.C.

Definition

The definition of a bank varies from country to country. Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as:

- conducting current accounts for his customers
- paying cheques drawn on him, and
- Collecting cheques for his customers.

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In most common law jurisdictions there is a Bills of Exchange Act that codifies the law in relation to negotiable instruments, including cheques, and this Act contains a statutory definition of the term *banker*: *banker* includes a body of persons, whether incorporated or not, who carry on the business of banking. Although this definition seems circular, it is actually functional, because it ensures that the legal basis for bank transactions such as cheques does not depend on how the bank is organized or regulated.

The business of banking is in many English common law countries not defined by statute but by common law, the definition above. In other English common law jurisdictions there are statutory definitions of the *business of banking* or *banking business*. When looking at these definitions it is important to keep in mind that they are defining the business of banking for the purposes of the legislation, and not necessarily in general. In particular, most of the definitions are from legislation that has the purposes of entry regulating and supervising banks rather than regulating the actual business of banking. However, in many cases the statutory definition closely mirrors the common law one. Examples of statutory definitions:

- "Banking Business" means the business of receiving money on current or deposit account, paying and collecting cheques drawn by or paid in by customers, the making of advances to customers, and includes such other business as the Authority may prescribe for the purposes of this Act; (Banking Act (Singapore), Section 2, Interpretation).
- "Banking Business" means the business of either or both of the following:
  1. receiving from the general public money on current, deposit, savings or other similar account repayable on demand or within less than [3 months] ... or with a period of call or notice of less than that period;
  2. paying or collecting checks drawn by or paid in by customers

Since the advent of EFTPOS (Electronic Funds Transfer at Point Of Sale), direct credit, direct debit and internet banking, the cheque has lost its primacy in most banking systems as a payment instrument. This has led legal theorists to suggest that the cheque based definition should be broadened to include financial institutions that conduct current accounts for customers and enable customers to pay and be paid by third parties, even if they do not pay and collect checks.

Banking in India

Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1790; both are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three

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presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955.

History

Indian merchants in Calcutta established the Union Bank in 1839, but it failed in 1848 as a consequence of the economic crisis of 1848-49. The Allahabad Bank, established in 1865 and still functioning today, is the oldest Joint Stock bank in India.(**Joint Stock Bank**: A company that issues stock and requires shareholders to be held liable for the company's debt) It was not the first though. That honor belongs to the Bank of Upper India, which was established in 1863, and which survived until 1913, when it failed, with some of its assets and liabilities being transferred to the Alliance Bank of Simla.

When the American Civil War stopped the supply of cotton to Lancashire from the Confederate States, promoters opened banks to finance trading in Indian cotton. With large exposure to speculative ventures, most of the banks opened in India during that period fey and lost interest in keeping deposits with banks. Subsequently, banking in India remained the exclusive domain of Europeans for next several decades until the beginning of the 20th century.

Foreign banks too started to arrive, particularly in Calcutta, in the 1860s. The Comptoire d'Escompte de Paris opened a branch in Calcutta in 1860, and another in Bombay in 1862; branches in Madras and Pondicherry, then a French colony, followed. HSBC established itself in Bengal in 1869. Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, and so became a banking center.

The first entirely Indian joint stock bank was the Oudh Commercial Bank, established in 1881 in Faizabad. It failed in 1958. The next was the Punjab National Bank, established in Lahore in 1895, which has survived to the present and is now one of the largest banks in India.

Around the turn of the 20th Century, the Indian economy was passing through a relative period of stability. Around five decades had elapsed since the Indian Mutiny, and the social, industrial and other infrastructure had improved. Indians had established small banks, most of which served particular ethnic and religious communities.

The presidency banks dominated banking in India but there were also some exchange banks and a number of Indian joint stock banks. All these banks operated in different segments of the economy. The exchange banks, mostly owned by Europeans, concentrated on financing foreign trade. Indian joint stock banks were generally under capitalized and lacked the experience and maturity to compete with the presidency and exchange banks. This segmentation let Lord Curzon to observe, ***"In respect of banking it seems we are behind the times. We are like some old fashioned sailing ship, divided by solid wooden bulkheads into separate and cumbersome compartments."***

The period between 1906 and 1911, saw the establishment of banks inspired by the Swadeshi movement. The Swadeshi movement inspired local businessmen and political figures to found banks of and for the Indian community. A number of banks established then have survived to the present such as Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India.

The fervour of Swadeshi movement lead to establishing of many private banks in Dakshina Kannada and Udupi district which were unified earlier and known by the name **South Canara** (South Kanara) district. Four nationalised banks started in this district and also a leading private sector bank. Hence undivided Dakshina Kannada district is known as "Cradle of Indian Banking".

During the First World War (1914–1918) through the end of the Second World War (1939–1945), and two years thereafter until the independence of India were challenging for Indian banking. The years of the First World War were turbulent, and it took its toll with banks simply collapsing despite the Indian economy gaining indirect boost due to war-related economic activities. At least 94 banks in India failed between 1913 and 1918 as indicated in the following table:

Years	Number of banks that failed	Authorized capital (Rs. Lakhs)	Paid-up Capital (Rs. Lakhs)
1913	12	274	35
1914	42	710	109
1915	11	56	5
1916	13	231	4
1917	9	76	25
1918	7	209	1

Post-Independence

The partition of India in 1947 adversely impacted the economies of Punjab and West Bengal, paralyzing banking activities for months. India's independence marked the end of a regime of the Laissez-faire for the Indian banking. The Government of India initiated measures to play an active role in the economic life of the nation, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted into greater involvement of the state in different segments of the economy including banking and finance. The major steps to regulate banking included:

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- The Reserve Bank of India, India's central banking authority, was established in April 1934, but was nationalized on January 1, 1949 under the terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 (RBI, 2005b).[Reference www.rbi.org.in]
- In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the banks in India."
- The Banking Regulation Act also provided that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

Nationalization

Despite the provisions, control and regulations of Reserve Bank of India, banks in India except the State Bank of India or SBI, continued to be owned and operated by private persons. By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the nationalization of the banking industry. Indira Gandhi, then Prime Minister of India, expressed the intention of the Government of India in the annual conference of the All India Congress Meeting in a paper entitled *"Stray thoughts on Bank Nationalization."* The meeting received the paper with enthusiasm.

Thereafter, her move was swift and sudden. The Government of India issued an ordinance and nationalised the 14 largest commercial banks with effect from the midnight of July 19, 1969.Jayaprakash Narayan, a national leader of India, described the step as a *"masterstroke of political sagacity."* Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August 1969.

A second dose of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second dose of nationalization, the Government of India controlled around 91% of the banking business of India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalised banks from 20 to 19. After this, until the 1990s, the nationalised banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy.

Liberalization

In the early 1990s, the then Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as *New Generation tech-savvy banks*, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank(earlier as UTI Bank), Bank and HDFC Bank. This

move, along with the rapid growth in the economy of India, revitalized the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks.

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The next stage for the Indian banking has been set up with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 74% with some restrictions.

The new policy shook the Banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%;Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more.

Currently (2010), banking in India is generally fairly mature in terms of supply, product range and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate-and this has mostly been true.

With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong. One may also expect M&As, takeovers, and asset sales.

In March 2006, the Reserve Bank of India allowed Warburg Pincus to increase its stake in Kotak Mahindra Bank (a private sector bank) to 10%. This is the first time an investor has been allowed to hold more than 5% in a private sector bank since the RBI announced norms in 2005 that any stake exceeding 5% in the private sector banks would need to be vetted by them.

In recent years critics have charged that the non-government owned banks are too aggressive in their loan recovery efforts in connection with housing, vehicle and personal loans. There are press reports that the banks' loan recovery efforts have driven defaulting borrowers to suicide.

Early phase from 1786 to 1969 of Indian Banks:

Phase I

The General Bank of India was set up in the year 1786. Next Bank that came was Hindustan and Bengal Bank came. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called it Presidency Banks. These three banks were amalgamated in 1920 and Imperial Bank of India was established which started as private shareholders banks, mostly Europeans shareholders.

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In 1865 Allahabad Bank was established exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. Reserve Bank of India came in 1935.

During the first phase the growth was very slow and banks also experienced periodic failures between 1913 and 1948. There were approximately 1100 banks, mostly small. To streamline the functioning and activities of commercial banks, the Government of India came up with The Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No. 23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as the Central Banking Authority.

During those day's public has lesser confidence in the banks. As an aftermath deposit mobilization was slow. Abreast of it the savings bank facility provided by the Postal department was comparatively safer. Moreover, funds were largely given to traders.

Phase II

Government took major steps in this Indian Banking Sector Reform after independence. In 1955, it nationalized Imperial Bank of India with extensive banking facilities on a large scale especially in rural and semi-urban areas. It formed State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State Governments all over the country.

Seven banks forming subsidiary of State Bank of India was nationalized in 1960 on 19th July, 1969, major process of nationalization was carried out. It was the effort of the then Prime Minister of India, Mrs. Indira Gandhi. 14 major commercial banks in the country was nationalized.

Second phase of nationalization Indian Banking Sector Reform was carried out in 1980 with seven more banks. This step brought 80% of the banking segment in India under Government ownership.

The following are the steps taken by the Government of India to Regulate Banking Institutions in the Country:

1949: Enactment of Banking Regulation Act.

1955: Nationalization of State Bank of India.

1959: Nationalization of SBI subsidiaries.

1961: Insurance cover extended to deposits.

1969: Nationalization of 14 major banks.

1971: Creation of credit guarantee corporation.

1975: Creation of regional rural banks.

1980: Nationalization of seven banks with deposits over 200 crore.

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After the nationalization of banks, the branches of the public sector bank India rose to approximately 800% in deposits and advances took a huge jump by 11,000%. Banking in the sunshine of Government ownership gave the public implicit faith and immense confidence about the sustainability of these institutions.

Phase III

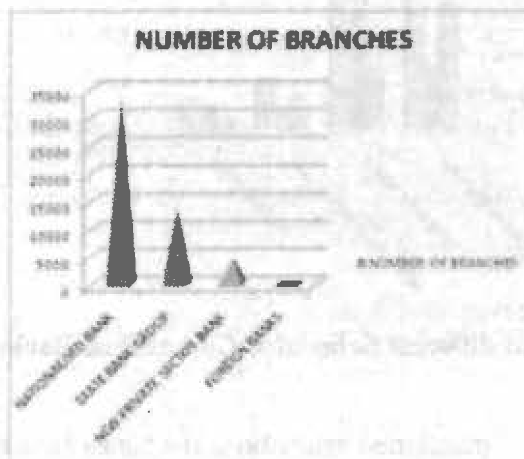
This phase has introduced many more products and facilities in the banking sector in its reforms measure. In 1991, under the chairmanship of M Narasimham, a committee was set up by his name which worked for the liberalization of banking practices.

The country is flooded with foreign banks and their ATM stations. Efforts are being put to give a satisfactory service to customers. Phone banking and net banking is introduced. The entire system became more convenient and swift. Time is given more importance than money.

The financial system of India has shown a great deal of resilience. It is sheltered from any crisis triggered by any external macroeconomics shock as other East Asian Countries suffered. This is all due to a flexible exchange rate regime, the foreign reserves are high, the capital account is not yet fully convertible, and banks and their customers have limited foreign exchange exposure.

Adoption of banking technology

The IT revolution had a great impact in the Indian banking system. The use of computers had led to introduction of online banking in India. The use of the modern innovation and computerization of the banking sector of India has increased many folds after the economic liberalization of 1991 as the country's banking sector has been exposed to the world's market. The Indian banks were finding it difficult to compete with the international banks in terms of the customer service without the use of the information technology and computers.



Number of branches of scheduled banks of India as of March 2009

The RBI in 1984 formed Committee on Mechanization in the Banking Industry (1984) whose chairman was Dr C Rangarajan, Deputy Governor, Reserve Bank of

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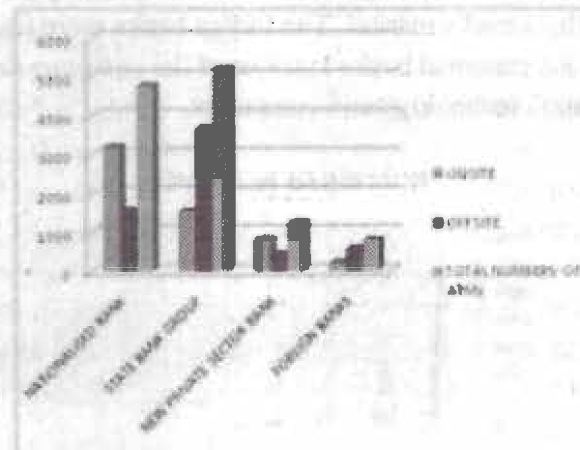
India. The major recommendations of this committee were introducing MICR Technology in all the banks in the metropolis in India. This provided use of standardized cheque forms and encoders.

In 1988, the RBI set up Committee on Computerization in Banks (1988) headed by Dr. C.R. Rangarajan which emphasized that settlement operation must be computerized in the clearing houses of RBI in Bhubaneshwar, Guwahati, Jaipur, Patna and Thiruvananthapuram.It further stated that there should be National Clearing of inter-city cheques at Kolkata, Mumbai, Delhi, Chennai and MICR should be made Operational. It also focused on computerization of branches and increasing connectivity among branches through computers. It also suggested modalities for implementing on-line banking. The committee submitted its reports in 1989 and computerization began form 1993 with the settlement between IBA and bank employees' association.

In 1994, Committee on Technology Issues relating to Payments System, Cheque Clearing and Securities Settlement in the Banking Industry (1994) was set up with chairman Shri WS Saraf, Executive Director, Reserve Bank of India. It emphasized on Electronic Funds Transfer (EFT) system, with the BANKNET communications network as its carrier. It also said that MICR clearing should be set up in all branches of all banks with more than 100 branches.

Committee for proposing Legislation On Electronic Funds Transfer and other Electronic Payments (1995)[9] emphasized on EFT system. Electronic banking refers to DOING BANKING by using technologies like computers, internet and networking, MICR, EFT so as to increase efficiency, quick service, productivity and transparency in the transaction.



Number of ATMs of different Scheduled Commercial Banks of India as on end March 2009

Apart from the above mentioned innovations the banks have been selling the third party products like Mutual Funds, insurances to its clients. Total numbers of ATMs installed in India by various banks as on end March 2009 is 17,642. The New Private Sector Banks in India is having the largest numbers of ATMs which is followed by the SBI and its subsidiaries and then it is followed by New Private Banks, Nationalised banks and foreign banks. While on site is highest for the Nationalised banks of India.

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BANK GROUP	NUMBER OF BRANCHES	ON SITE ATM	OFF SITE ATM	TOTAL ATM
NATIONALISED BANKS	33627	3205	1567	4772
STATE BANK OF INDIA	13661	1548	3672	5220
OLD PRIVATE SECTOR BANKS	4511	800	441	1241
NEW PRIVATE SECTOR BANKS	1685	1883	3729	5612
FOREIGN BANKS	242	218	579	797

EVOLUTION OF COMMERCIAL BANKS IN INDIA

The commercial banking industry in India started in 1786 with the establishment of the Bank of Bengal in Calcutta. The Indian Government at the time established three Presidency banks, viz., the Bank of Bengal (established in 1809), the Bank of Bombay (established in 1840) and the Bank of Madras (established in 1843). In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, which took up the role of a commercial bank, a bankers' bank and a banker to the Government. The Imperial Bank of India was established with mainly European shareholders. It was only with the establishment of Reserve Bank of India (RBI) as the central bank of the country in 1935, that the quasi-central banking role of the Imperial Bank of India came to an end. In 1860, the concept of limited liability was introduced in Indian banking, resulting in the establishment of joint-stock banks. In 1865, the Allahabad Bank was established with purely Indian shareholders. Punjab National Bank came into being in 1895. Between 1906 and 1913, other banks like Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up.

After independence, the Government of India started taking steps to encourage the spread of banking in India. In order to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a state-partnered and state-sponsored bank taking over the Imperial Bank of India and integrating with it, the former state-owned and state-associate banks. Accordingly, State Bank of India (SBI) was constituted in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former state-associate banks as its subsidiaries. To better align the banking system to the needs of planning and economic policy, it was

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considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalized. This was an important milestone in the history of Indian banking. This was followed by the nationalization of another six private banks in 1980. With the nationalization of these banks, the major segment of the banking sector came under the control of the Government. The nationalization of banks imparted major impetus to branch expansion in un-banked rural and semi-urban areas, which in turn resulted in huge deposit mobilization, thereby giving boost to the overall savings rate of the economy. It also resulted in scaling up of lending to agriculture and its allied sectors. However, this arrangement also saw some weaknesses like reduced bank profitability, weak capital bases, and banks getting burdened with large non-performing assets. To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system.

One important feature of the reforms of the 1990s was that the entry of new private sector banks was permitted. Following this decision, new banks such as ICICI Bank, HDFC Bank, IDBI Bank and UTI Bank were set up.

Commercial banks in India have traditionally focused on meeting the short-term financial needs of industry, trade and agriculture. However, given the increasing sophistication and diversification of the Indian economy, the range of services extended by commercial banks has increased significantly, leading to an overlap with the functions performed by other financial institutions. Further, the share of long-term financing (in total bank financing) to meet capital goods and project-financing needs of industry has also increased over the years.

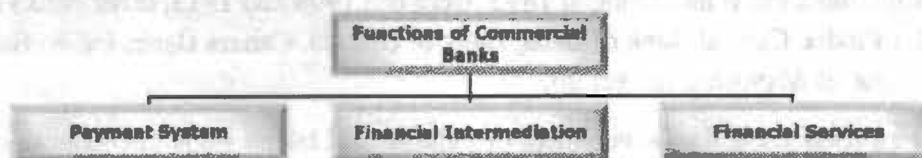
FUNCTIONS OF COMMERCIAL BANK

The main functions of a commercial bank can be segregated into three main areas:

(i) Payment System

(ii) Financial Intermediation

(iii) Financial Services.



(I) PAYMENT SYSTEM

Banks are at the core of the payments system in an economy. A payment refers to the means by which financial transactions are settled. A fundamental method by which banks help in settling the financial transaction process is by issuing and paying cheques issued on behalf of customers. Further, in modern banking, the payments

system also involves electronic banking, wire transfers, settlement of credit card transactions, etc. In all such transactions, banks play a critical role.

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(II) FINANCIAL INTERMEDIATION

The second principal function of a bank is to take different types of deposits from customers and then lend these funds to borrowers, in other words, financial intermediation. In financial terms, bank deposits represent the banks' liabilities, while loans disbursed, and investments made by banks are their assets. Bank deposits serve the useful purpose of addressing the needs of depositors, who want to ensure liquidity, safety as well as returns in the form of interest. On the other hand, bank loans and investments made by banks play an important function in channeling funds into profitable as well as socially productive uses.

(III) FINANCIAL SERVICES

In addition to acting as financial intermediaries, banks today are increasingly involved with offering customers a wide variety of financial services including investment banking, insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc. Income from providing such services improves a bank's profitability.

COMPETITITIVE LANDSCAPE OF BANKS IN INDIA

In India the banks are being segregated in different groups. Each group has their own benefits and limitations in operating in India. Each has their own dedicated target market. Few of them only work in rural sector while others in both rural as well as urban. Many even are only catering in cities.

Banks face competition from a wide range of financial intermediaries in the public and private sectors in the areas of financial intermediation and financial services (although the payments system is exclusively for banks). Such intermediaries form a diverse group in terms of size and nature of their activities, and play an important role in the financial system by not only competing with banks, but also complementing them in providing a wide range of financial services. Some of these intermediaries include:

- Term-lending institutions
- Non-banking financial companies
- Insurance companies
- Mutual funds

(i) Term-Lending Institutions

Term lending institutions exist at both state and all-India levels. They provide term loans (i.e., loans with medium to long-term maturities) to various industry, service and infrastructure sectors for setting up new projects and for the expansion of existing facilities and thereby compete with banks. At the all-India level, these institutions are typically specialized, catering to the needs of specific sectors, which make them competitors to banks in those areas.3 These include

the Export Import Bank of India (EXIM Bank), Small Industries Development Bank of India (SIDBI), Tourism Finance Corporation of India Limited (TFCI), and Power Finance Corporation Limited (PFCL).

- At the state level, various State Financial Corporations (SFCs) have been set up to finance and promote small and medium-sized enterprises. There are also State Industrial Development Corporations (SIDCs), which provide finance primarily to medium-sized and large-sized enterprises. In addition to SFCs and SIDCs, the North Eastern Development Financial Institution Ltd. (NEDFI) has been set up to cater specifically to the needs of the north-eastern states.

(ii) Non-Banking Finance Companies (NBFCs)

India has many thousands of non-banking financial companies, predominantly from the private sector. NBFCs are required to register with RBI in terms of the Reserve Bank of India (Amendment) Act, 1997. The principal activities of NBFCs include equipment-leasing, hire purchase, loan and investment and asset finance. NBFCs have been competing with and complementing the services of commercial banks for a long time. All NBFCs together currently account for around nine percent of assets of the total financial system. Housing-finance companies form a distinct sub-group of the NBFCs. As a result of some recent government incentives for investing in the housing sector, these companies' business has grown substantially. Housing Development Finance Corporation Limited (HDFC), which is in the private sector and the Government-controlled Housing and Urban Development Corporation Limited (HUDCO) are the two premier housing-finance companies. These companies are major players in the mortgage business, and provide stiff competition to commercial banks in the disbursal of housing loans.

(iii) Insurance Companies

Insurance/reinsurance companies such as Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GICI), and others provide substantial long-term financial assistance to the industrial and housing sectors and to that extent, are competitors of banks. LIC is the biggest player in this area.

(iv) Mutual Funds

Mutual funds offer competition to banks in the area of fund mobilization, in that they offer alternate routes of investment to households. Most mutual funds are standalone asset management companies. In addition, a number of banks, both in the private and public sectors have sponsored asset management companies to undertake mutual fund business. Banks have thus entered the asset management business, sometimes on their own and other times in joint venture with others.

BANKING STRUCTURE IN INDIA

Scheduled Banks in India

Scheduled banks comprise scheduled commercial banks and scheduled co-operative banks. Scheduled commercial banks form the basis of the Indian financial system,

currently accounting for more than three-fourths of all financial institutions' assets. SCBs are present throughout India, and their branches, having grown more than four-fold in the last 40 years now number more than 80,500 across the country (see Table 2.1). Our focus in this module will be only on the scheduled commercial banks. A pictorial representation of the structure of SCBs in India is given in figure.

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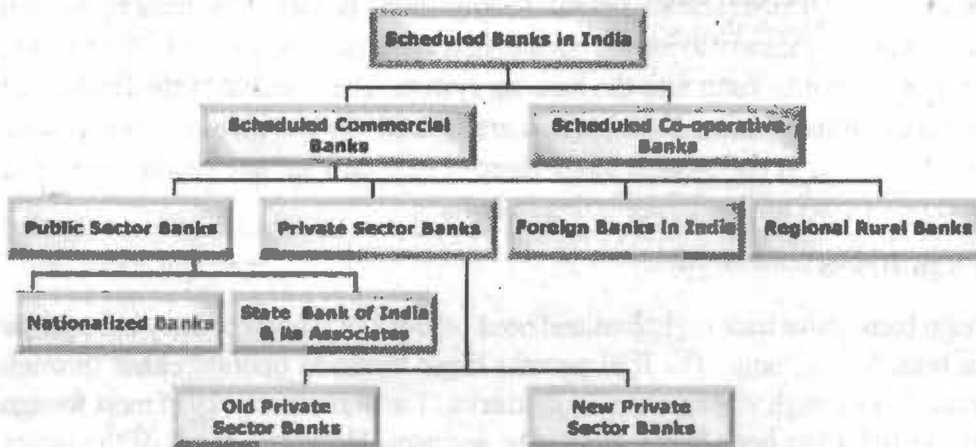
Scheduled Banking Structure in India



Public Sector Banks

Public sector banks are those in which the majority stake is held by the Government of India (GoI). Public sector banks together make up the largest category in the Indian banking system. There are currently 27 public sector banks in India. They include the SBI and its 6 associate banks (such as State Bank of Indore, State Bank of Bikaner and Jaipur etc), 19 nationalized banks (such as Allahabad Bank, Canara Bank etc) and IDBI Bank Ltd. Public sector banks have taken the lead role in branch expansion, particularly in the rural areas. From Table, it can also be seen that:

- Public sector banks account for bulk of the branches in India (88 percent in 2009).
- In the rural areas, the presence of the public sector banks is overwhelming; in 2009, 96 percent of the rural bank branches belonged to the public sector. The private sector banks and foreign banks have limited presence in the rural areas.

Regional Rural Banks

Regional Rural Banks (RRBs) were established during 1976-1987 with a view to develop the rural economy. Each RRB is owned jointly by the Central Government, concerned State Government and a sponsoring public sector commercial bank. RRBs provide credit to small farmers, artisans, small entrepreneurs and agricultural laborers. Over the years, the Government has introduced a number of measures of improve viability and profitability of RRBs, one of them being the amalgamation of the RRBs of the same sponsored bank within a State. This process of consolidation has resulted in a steep decline in the total number of RRBs to 86 as on March 31, 2009, as compared to 196 at the end of March 2005.

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Private Sector Banks

In this type of banks, the majority of share capital is held by private individuals and Corporate. Not all private sector banks were nationalized in in 1969, and 1980. The private banks which were not nationalized are collectively known as the old private sector banks and include banks such as The Jammu and Kashmir Bank Ltd., Lord Krishna Bank Ltd etc.5 Entry of private sector banks was however prohibited during the post-nationalization period. In July 1993, as part of the banking reform process and as a measure to induce competition in the banking sector, RBI permitted the private sector to enter into the banking system. This resulted in the creation of a new set of private sector banks, which are collectively known as the new private sector banks. As at end March, 2009 there were 7 new private sector banks and 15 old private sector banks operating in India.

Foreign Banks

Foreign banks have their registered and head offices in a foreign country but operate their branches in India. The RBI permits these banks to operate either through branches; or through wholly-owned subsidiaries. The primary activity of most foreign banks in India has been in the corporate segment. However, some of the larger foreign banks have also made consumer financing a significant part of their portfolios. These banks offer products such as automobile finance, home loans, credit cards, household consumer finance etc. Foreign banks in India are required to adhere to all banking regulations, including priority-sector lending norms as applicable to domestic banks.8 In addition to the entry of the new private banks in the mid- 90s, the increased presence of foreign banks in India has also contributed to boosting competition in the banking sector.

Co-operative Banks

Co-operative banks cater to the financing needs of agriculture, retail trade, small industry and self-employed businessmen in urban, semi-urban and rural areas of India. A distinctive feature of the co-operative credit structure in India is its heterogeneity. The structure differs across urban and rural areas, across states and loan maturities. Urban areas are served by urban cooperative banks (UCBs), whose operations are either limited to one state or stretch across states. The rural co-operative banks comprise State co-operative banks, district central cooperative banks, SCARDBs and PCARDBs. The co-operative banking sector is the oldest segment of the Indian banking system. The network of UCBs in India consisted of 1721 banks as at end-March 2009, while the number of rural co-operative banks was 1119 as at end-March 2008.10 Owing to their widespread geographical penetration; cooperative banks have the potential to become an important instrument for large-scale financial inclusion, provided they are financially strengthened. The RBI and the National Agriculture and Rural Development Bank (NABARD) have taken a number of measures in recent years to improve financial soundness of co-operative banks.

Role of Reserve Bank of India vis-à-vis Commercial Banks:

The Reserve Bank of India (RBI) is the central bank of the country.12 It was established on April 1, 1935 under the Reserve Bank of India Act, 1934, which

provides the statutory basis for its functioning. When the RBI was established, it took over the functions of currency issue from the Government of India and the power of credit control from the then Imperial Bank of India. As the central bank of the country, the RBI performs a wide range of functions; particularly, it:

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- Acts as the currency authority
- Controls money supply and credit
- Manages foreign exchange
- Serves as a banker to the government
- Builds up and strengthens the country's financial infrastructure
- Acts as the banker of banks
- Supervises banks

As regards the commercial banks, the RBI's role mainly relates to the last two points stated above.

RBI as Bankers' Bank:

As the bankers' bank, RBI holds a part of the cash reserves of banks,; lends the banks funds for short periods, and provides them with centralized clearing and cheap and quick remittance facilities.

Banks are supposed to meet their shortfalls of cash from sources other than RBI and approach RBI only as a matter of last resort, because RBI as the central bank is supposed to function as only the 'lender of last resort'.

To ensure liquidity and solvency of individual commercial banks and of the banking system as a whole, the RBI has stipulated that banks maintain a Cash Reserve Ratio (CRR). The CRR refers to the share of liquid cash that banks have to maintain with RBI of their net demand and time liabilities (NDTL).13 CRR is one of the key instruments of controlling money supply. By increasing CRR, the RBI can reduce the funds available with the banks for lending and thereby tighten liquidity in the system; conversely reducing the CRR increases the funds available with the banks and thereby raises liquidity in the financial system.

RBI as supervisor

To ensure a sound banking system in the country, the RBI exercises powers of supervision, regulation and control over commercial banks. The bank's regulatory functions relating to banks cover their establishment (i.e. licensing), branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. RBI controls the commercial banks through periodic inspection of banks and follow-up action and by calling for returns and other information from them, besides holding periodic meetings with the top management of the banks. While RBI is directly involved with commercial banks in carrying out these two roles, the commercial banks help RBI indirectly to carry out some of its other roles as well. For example, commercial banks are required by law to invest a prescribed minimum percentage of their respective net demand and time liabilities

Check Your Progress:

1. What are banks?
2. The word bank taken from the word _____.

(NDTL) in prescribed securities, which are mostly government securities.14 This helps the RBI to perform its role as the banker to the Government under which the RBI conducts the Government's market borrowing program.

NOTES

Banking Article (Case)

Canara Bank is set to become the first state-run bank to defy a government diktat to sell products of multiple insurers.

The Bangalore-based bank plans to pass a resolution rejecting the government's proposal as "not implementable", said two senior Canara Bank officials, who did not want to be named. The bank has already circulated a note in this regard to its board members, they said. Resolutions can be passed through board notes when directors are unable to meet within a given timeframe.

The finance ministry had last month directed state-run banks to adopt the insurance broking model, which would allow them to sell products of multiple insurers. Most of them currently sell policies under the corporate agency arrangement that prohibits them from dealing in the products of more than one life insurer and one general insurance company.

The finance ministry's proposal was aimed at improving the reach of insurance products as staterun banks have a wide network of branches. However, most large banks have floated insurance companies in partnership with foreign insurers with an understanding that they would sell products of only the company they have promoted.

For Instance, Canara Bank and Oriental Bank of Commerce, both government-run, have floated a joint life insurance company in partnership with HSBC. As per the agreement among the three, the partners are prevented from selling products of any other life insurance company.

Check Your Progress

1. What are banks?
2. The word bank taken from the word____.

Last week, the Indian Banks' Association had written to the finance ministry, saying that the management of each bank should be given the freedom to decide on whether they would be competent enough to sell products of more than one insurer.

According to the association, not all banks would be positioned to provide insurance broking service since banking regulator Reserve Bank of India is not in favour of banks with bad loans above 3% to get into insurance broking. As of now, State Bank of India, Central Bank of India and Punjab National Bank have bad loans of more than 3%.

Chapter Summary

The banking system in India is significantly different from that of other Asian nations because of the country's unique geographic, social, and economic characteristics. India has a large population and land size, a diverse culture, and extreme disparities

in income, which are marked among its regions. There are high levels of illiteracy among a large percentage of its population but, at the same time, the country has a large reservoir of managerial and technologically advanced talents. Between about 30 and 35 percent of the population resides in metro and urban cities and the rest is spread in several semi-urban and rural centers. The country's economic policy framework combines socialistic and capitalistic features with a heavy bias towards public sector investment. India has followed the path of growth-led exports rather than the "export led growth" of other Asian economies, with emphasis on self-reliance through import substitution. These features are reflected in the structure, size, and diversity of the country's banking and financial sector. The banking system has had to serve the goals of economic policies enunciated in successive five year development plans, particularly concerning equitable income distribution, balanced regional economic growth, and the reduction and elimination of private sector monopolies in trade and industry. In order for the banking industry to serve as an instrument of state policy, it was subjected to various nationalization schemes in different phases (1955, 1969, and 1980). As a result, banking remained internationally isolated (few Indian banks had presence abroad in international financial centers) because of preoccupations with domestic priorities, especially massive branch expansion and attracting more people to the system. Moreover, the sector has been assigned the role of providing support to other economic sectors such as agriculture, small-scale industries, exports, and banking activities in the developed commercial centers (i.e., metro, urban, and a limited number of semi-urban centers).

NOTES

The banking system's international isolation was also due to strict branch licensing controls on foreign banks already operating in the country as well as entry restrictions facing new foreign banks. A criterion of reciprocity is required for any Indian bank to open an office abroad. These features have left the Indian banking sector with weaknesses and strengths. A big challenge facing Indian banks is how, under the current ownership structure, to attain operational efficiency suitable for modern financial intermediation. On the other hand, it has been relatively easy for the public sector banks to recapitalize, given the increases in nonperforming assets (NPAs), as their Government dominated ownership structure has reduced the conflicts of interest that private banks would face.

Answers to check your progress

1. A **bank** is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly or through capital markets.
2. Banque

Test Yourself

1. Describe the history of Banking in India.
2. Discuss the evolution of Commercial Banks in India.
3. Discuss the various functions of commercial bank.

NOTES

4. Write a short note on:

i) Term-Lending Institutions

ii) Non-Banking Finance Companies

iii) Insurance Companies

iv) Mutual Funds

5. Explain the structure of banking services in India.

6. Discuss the role of Reserve Bank of India in regulating banking practices in India.

2 Bank Deposit Accounts

NOTES

The Unit Include:

- Indroduction
- Major types
- Types of Deposit Accounts:
- Certificate of Deposit:
- Bank Lending
- Compliance with RBI guidelines:
- Types of Advances
- Secured Advances
- Mortgage loan
- Mortgage loan types
- Hypothecation
- Chapter Summary
- Test yourself
- Banking Article (Case)

Learning Objectives:

After going through this chapter, you should be able to:

- **Define what bank accounts are.**
- **Describe the importance of bank accounts.**
- **Discuss their types.**
- **Understand key features.**

NOTES

INDRODUCTION

A deposit account is a current account, savings account, or other type of bank account, at a banking institution that allows money to be deposited and withdrawn by the account holder. These transactions are recorded on the bank's books, and the resulting balance is recorded as a liability for the bank, and represent the amount owed by the bank to the customer. Some banks charge a fee for this service, while others may pay the customer interest on the funds deposited.

MAJOR TYPES

- Checking accounts: A deposit account held at a bank or other financial institution, for the purpose of securely and quickly providing frequent access to funds on demand, through a variety of different channels. Because money is available on demand these accounts are also referred to as demand accounts or demand deposit accounts.
- Savings accounts: Accounts maintained by retail banks that pay interest but can not be used directly as money (for example, by writing a cheque). Although not as convenient to use as checking accounts, these accounts let customers keep liquid assets while still earning a monetary return.
- Money market account: A deposit account with a relatively high rate of interest, and short notice (or no notice) required for withdrawals. In some countries, it is a style of instant access deposit subject to federal savings account regulations, such as a monthly transaction limit.
- Time deposit: A money deposit at a banking institution that cannot be withdrawn for a preset fixed 'term' or period of time. When the term is over it can be withdrawn or it can be rolled over for another term. Generally speaking, the longer the term the better the yield on the money.

Table.1 provides the share of deposits of different classes of scheduled commercial banks (SCBs). It can be seen that the public sector banks continue to dominate the Indian banking industry. However, the share of the new private sector banks has been raising at the expense of the public sector banks, particularly in the last few years.

Table .3: Share of Deposits of SCBs-GroupWise

Bank Group	At end-March (in percent)	
	2003	2009
Public Sector Banks	79.6	76.7
- Nationalised Banks	50.8	49.1
- State Bank Group	28.8	24.8
- Other Public Sector Banks	--	2.8
Private Sector Banks	15.3	18.1
- Old Private Sector Banks	6.7	4.9
- New Private Sector Banks	8.5	13.2
Foreign Banks	5.1	5.2
Total SCBs	100.0	100.0

The 3 key features of Banking Deposit Practices

Safety of deposits:

At the time of depositing money with the bank, a depositor would want to be certain that his/ her money is safe with the bank and at the same time, wants to earn a reasonable return. The safety of depositors' funds, therefore, forms a key area of the regulatory framework for banking. In India, this aspect is taken care of in the Banking Regulation Act, 1949 (BR Act). The RBI is empowered to issue directives/ advices on several aspects regarding the conduct of deposit accounts from time to time. Further, the establishment of the Deposit Insurance Corporation in 1962 (against the backdrop of failure of banks) offered protection to bank depositors, particularly small-account holders.

NOTES

Deregulation of interest rates:

The process of deregulation of interest rates started in April 1992. Until then, all interest rates were regulated; that is, they were fixed by the RBI. In other words, banks had no freedom to fix interest rates on their deposits. With liberalization in the financial system, nearly all the interest rates have now been deregulated. Now, banks have the freedom to fix their own deposit rates with only a very few exceptions. The RBI prescribes interest rates only in respect of savings deposits and NRI deposits, leaving others for individual banks to determine.

Deposit policy:

The Board of Directors of a bank, along with its top management, formulates policies relating to the types of deposit the bank should have, rates of interest payable on each type, special deposit schemes to be introduced, types of customers to be targeted by the bank, etc. Of course, depending on the changing economic environment, the policy of a bank towards deposit mobilization undergoes changes.

TYPES OF DEPOSIT ACCOUNTS:

The bank deposits can also be classified into

- demand deposits and
- Time deposits.

Demand deposits are defined as deposits payable on demand through cheque or otherwise. Demand deposits serve as a medium of exchange, for their ownership can be transferred from one person to another through cheques and clearing arrangements provided by banks. They have no fixed term to maturity.

Time deposits are defined as those deposits which are not payable on demand and on which cheques cannot be drawn. They have a fixed term to maturity. A certificate of deposit (CD), for example, is a time deposit.

CERTIFICATE OF DEPOSIT:

A Certificate of Deposit (CD) is a negotiable money market instrument and is issued in dematerialized form or as a Promissory Note, for funds deposited at a bank or

other eligible financial institution for a specified time period. Guidelines for issue of CDs are currently governed by various directives issued by the RBI, as amended from time to time. CDs can be issued by

i) scheduled commercial banks (SCBs) excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and

ii) Select all-India Financial Institutions that have been permitted by the RBI to raise short-term resources within the umbrella limit fixed by RBI. Deposit amounts for CDs are a minimum of Rs.1 lakh, and multiples thereof.

Demand and time deposits are two broad categories of deposits. Note that these are only categories of deposits; there are no deposit accounts available in the banks by the names 'demand deposits' or 'time deposits'. Different deposit accounts offered by a bank, depending on their characteristics, fall into one of these two categories. There are several deposit accounts offered by banks in India; but they can be classified into three main categories:

- Current account
- Savings bank account
- Term deposit account

Current account deposits fall entirely under the demand-deposit category and term deposit account falls entirely under time deposit. Savings bank accounts have both demand-deposit and time-deposit components. In other words, some parts of savings deposits are considered demand deposits and the rest as time deposits. We provide below the broad terms and conditions governing the conduct of current, savings and term-deposit accounts.

Current Deposits:

A current account is a form of demand-deposit, as the banker is obliged to repay these liabilities on demand from the customer. Withdrawals from current accounts are allowed any number of times depending upon the balance in the account or up to a particular agreed amount. Current deposits are non-interest bearing. Among the three broad categories of deposits—current account deposit, savings accounts deposit and term deposits—current account deposits account for the smallest fraction.

A current account is basically a running and actively operated account with very little restriction on the number and amount of drawings. The primary objective of a current account is to provide convenient operation facility to the customer, via continuous liquidity. On account of the high cost of maintaining such accounts, banks do not pay any interest on such deposits. In addition, many banks insist on customers maintaining minimum balances to offset the transaction costs involved. If minimum balances are not maintained, these banks charge the customers a certain amount. Current accounts can be opened by rich individuals/ partnership firms/ private and limited companies/ Hindu Undivided Families (HUFs)/ societies/ trusts, etc.

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Savings Bank Deposits:

Savings deposits are a form of demand deposits, which is subject to restrictions on the number of withdrawals as well as on the amounts of withdrawals during any specified period. Further, minimum balances may be prescribed in order to offset the cost of maintaining and servicing such deposits. Savings deposits are deposits that accrue interest at a fixed rate set by RBI (3.5 percent as of January 2010).

Savings bank accounts are used by a large segment of small depositors as they can put their regular incomes into these accounts, withdraw the money on demand and also earn interest on the balance left in the account.

The flexibility provided by such a product means that savings bank accounts cannot be opened by big trading or business firms. Similarly, institutions such as government departments and bodies, local authorities, etc. cannot open savings bank accounts.

Term Deposits

A "Term deposit" is a deposit received by the Bank for a fixed period, after which it can be withdrawn. Term deposits include deposits such as Fixed Deposits / Reinvestment deposits/ Recurring Deposits etc. The term deposits account for the largest share and have remained within the range of 61% to 67 % of total deposits in the recent years. Interest is paid on term-deposits, either on maturity or at stipulated intervals depending upon the deposit scheme under which the money is placed. Also, a customer can earn interest on a term-deposit for a minimum period of 7 days. Interest rates on term-deposits are usually higher than on savings deposits. Term deposits include:

- Fixed deposits on which a fixed rate of interest is paid at fixed, regular intervals;
- Re-investment deposits, under which the interest is compounded quarterly and paid on maturity, along with the principal amount of the deposit. Some banks have introduced "flexi" deposits under which, the amount in savings deposit accounts beyond a fixed limit is automatically converted into term-deposits; and
- Recurring deposits, under which a fixed amount is deposited at regular intervals for a fixed term and the repayment of principal and accumulated interest is made at the end of the term. These deposits are usually targeted at persons who are salaried or receive other regular income. A Recurring Deposit can usually be opened for any period from 6 months to 120 months.

STRATEGIES OF MOBILIZING DEPOSITS:

To maximize their profits, commercial banks always attempt to mobilize savings at the lowest cost possible. While mobilizing deposits, banks have to comply with various directives issued by the RBI, the Indian Bank Association (IBA), Government of India and other statutory authorities/agencies. At the same time, since banks operate in a very competitive environment, they have to reach out to a wide spectrum of customers and also offer deposit products that lead to higher customer satisfaction.

NOTES

Banks devise various strategies to expand the customer base and reducing the cost of raising deposits. This is done by identifying target markets, designing the products as per the requirements for customers, taking measures for marketing and promoting the deposit products.

It is essential not only to expand the customer base but also to retain it. This is done by providing counseling, after-sales information and also through prompt handling of customer complaints.

While the strategies for mobilizing bank deposits vary from bank to bank, one common feature is to maximize the share of CASA deposits.

The other common features generally observed are as follows:

1) Staff members posted at branches are adequately trained to offer efficient and courteous service to the customers and to educate them about their rights and obligations. A bank often offers personalized banking relationship for its high-value customers by appointing Customer Relationship Managers (CRMs).

2) Senior citizens/pensioners have become an important category of customers to be targeted by a bank. Products are developed by banks to meet the specific requirements of this group.

3) While banks endeavor to provide services to the satisfaction of customers, they put in place an expeditious mechanism to redress the complaints of the customers.

BANK LENDING

Basics of Bank Lending

Banks extend credit to different categories of borrowers for a wide variety of purposes. For many borrowers, bank credit is the easiest to access at reasonable interest rates. Bank credit is provided to households, retail traders, small and medium enterprises (SMEs), Corporate, the Government undertakings etc. in the economy. Retail banking loans are accessed by consumers of goods and services for financing the purchase of consumer durables, housing or even for day-to-day consumption. In contrast, the need for capital investment, and day-to-day operations of private corporate and the Government undertakings are met through wholesale lending.

Loans for capital expenditure are usually extended with medium and long-term maturities, while day-to-day finance requirements are provided through short-term credit (working capital loans). Meeting the financing needs of the agriculture sector is also an important role that Indian banks play.

PRINCIPLES OF LENDING:

To lend, banks depend largely on deposits from the public. Banks act as custodian of public deposits. Since the depositors require safety and security of their deposits, want to withdraw deposits whenever they need and also adequate return, bank lending must necessarily be based on principles that reflect these concerns of the depositors. These principles include: safety, liquidity, profitability, and risk diversion.

NOTES

Safety:

Banks need to ensure that advances are safe and money lent out by them will come back. Since the repayment of loans depends on the borrowers' capacity to pay, the banker must be satisfied before lending that the business for which money is sought is a sound one. In addition, bankers many times insist on security against the loan, which they fall back on if things go wrong for the business. The security must be adequate, readily marketable and free of encumbrances.

Liquidity:

To maintain liquidity, banks have to ensure that money lent out by them is not locked up for long time by designing the loan maturity period appropriately. Further, money must come back as per the repayment schedule. If loans become excessively illiquid, it may not be possible for bankers to meet their obligations vis-à-vis depositors.

Profitability:

To remain viable, a bank must earn adequate profit on its investment. This calls for adequate margin between deposit rates and lending rates. In this respect, appropriate fixing of interest rates on both advances and deposits is critical. Unless interest rates are competitively fixed and margins are adequate, banks may lose customers to their competitors and become unprofitable.

Risk diversification:

To mitigate risk, banks should lend to a diversified customer base. Diversification should be in terms of geographic location, nature of business etc. If, for example, all the borrowers of a bank are concentrated in one region and that region gets affected by a natural disaster, the bank's profitability can be seriously affected.

LOAN POLICY:

Based on the general principles of lending stated above, the Credit Policy Committee (CPC) of individual banks prepares the basic credit policy of the Bank, which has to be approved by the Bank's Board of Directors. The loan policy outlines lending guidelines and establishes operating procedures in all aspects of credit management including standards for presentation of credit proposals, financial covenants, rating standards and benchmarks, delegation of credit approving powers, prudential limits on large credit exposures, asset concentrations, portfolio management, loan review mechanism, risk monitoring and evaluation, pricing of loans, provisioning for bad debts, regulatory/ legal compliance etc. The lending guidelines reflect the specific bank's lending strategy (both at the macro level and individual borrower level), and have to be in conformity with RBI guidelines. The loan policy typically lays down lending guidelines in the following areas:

- Level of credit-deposit ratio
- Targeted portfolio mix
- Hurdle ratings
- Loan pricing
- Collateral security

Credit Deposit (CD) Ratio:

A bank can lend out only a certain proportion of its deposits, since some part of deposits have to be statutorily maintained as Cash Reserve Ratio (CRR) deposits, and an additional part has to be used for making investment in prescribed securities (Statutory Liquidity Ratio or SLR requirement). It may be noted that these are minimum requirements. Banks have the option of having more cash reserves than CRR requirement and invest more in SLR securities than they are required to. Further, banks also have the option to invest in non-SLR securities. Therefore, the CPC has to lay down the quantum of credit that can be granted by the bank as a percentage of deposits available. Currently, the average CD ratio of the entire banking industry is around 70 percent, though it differs across banks. It is rarely observed that banks lend out of their borrowings.

Targeted Portfolio Mix:

The CPC aims at a targeted portfolio mix keeping in view both risk and return. Toward this end, it lays down guidelines on choosing the preferred areas of lending (such as sunrise sectors and profitable sectors) as well as the sectors to avoid.25 Banks typically monitor all major sectors of the economy. They target a portfolio mix in the light of forecasts for growth and profitability for each sector. If a bank perceives economic weakness in a sector, it would restrict new exposures to that segment and similarly, growing and profitable sectors of the economy prompt banks to increase new exposures to those sectors. This entails active portfolio management. Further, the bank also has to decide which sectors to avoid. For example, the CPC of a bank may be of the view that the bank is already overextended in a particular industry and no more loans should be provided in that sector. It may also like to avoid certain kinds of loans keeping in mind general credit discipline, say loans for speculative purposes, unsecured loans, etc.

Hurdle ratings:

There are a number of diverse risk factors associated with borrowers. Banks should have a comprehensive risk rating system that serves as a single point indicator of diverse risk factors of a borrower. This helps taking credit decisions in a consistent manner. To facilitate this, a substantial degree of standardization is required in ratings across borrowers. The risk rating system should be so designed as to reveal the overall risk of lending. For new borrowers, a bank usually lays down guidelines regarding minimum rating to be achieved by the borrower to become eligible for the loan. This is also known as the 'hurdle rating' criterion to be achieved by a new borrower.

Pricing of loans:

Risk-return trade-off is a fundamental aspect of risk management. Borrowers with weak financial position and, hence, placed in higher risk category are provided credit facilities at a higher price (that is, at higher interest). The higher the credit risk of a borrower the higher would be his cost of borrowing. To price credit risks, banks devise appropriate systems, which usually allow flexibility for revising the price (risk premium) due to changes in rating. In other words, if the risk rating of a borrower deteriorates, his cost of borrowing should rise and vice versa. At the

macro level, loan pricing for a bank is dependent upon a number of its cost factors such as cost of raising resources, cost of administration and overheads, cost of reserve assets like CRR and SLR, cost of maintaining capital, percentage of bad debt, etc. Loan pricing is also dependent upon competition.

NOTES

Collateral security:

As part of a prudent lending policy, banks usually advance loans against some security. The loan policy provides guidelines for this. In the case of term loans and working capital assets, banks take as 'primary security' the property or goods against which loans are granted. In addition to this, banks often ask for additional security or 'collateral security' in the form of both physical and financial assets to further bind the borrower. This reduces the risk for the bank. Sometimes, loans are extended as 'clean loans' for which only personal guarantee of the borrower is taken.

COMPLIANCE WITH RBI GUIDELINES:

The credit policy of a bank should be conformant with RBI guidelines; some of the important guidelines of the RBI relating to bank credit are discussed below.

Directed credit stipulations:

The RBI lays down guidelines regarding minimum advances to be made for priority sector advances, export credit finance, etc. These guidelines need to be kept in mind while formulating credit policies for the Bank.

Capital adequacy

If a bank creates assets-loans or investment-they are required to be backed up by bank capital; the amount of capital they have to be backed up by depends on the risk of individual assets that the bank acquires. The riskier the asset, the larger would be the capital it has to be backed up by. This is so, because bank capital provides a cushion against unexpected losses of banks and riskier assets would require larger amounts of capital to act as cushion. The Basel Committee for Bank Supervision (BCBS) has prescribed a set of norms for the capital requirement for the banks for all countries to follow. These norms ensure that capital should be adequate to absorb unexpected losses. In addition, all countries, including India, establish their own guidelines for risk based capital framework known as Capital Adequacy Norms. These norms have to be at least as stringent as the norms set by the Basel committee. A key norm of the Basel committee is the Capital Adequacy Ratio (CAR), also known as Capital Risk Weighted Assets Ratio, is a simple measure of the soundness of a bank. The ratio is the capital with the bank as a percentage of its risk-weighted assets. Given the level of capital available with an individual bank, this ratio determines the maximum extent to which the bank can lend.

The Basel committee specifies a CAR of at least 8% for banks. This means that the capital funds of a bank must be at least 8 percent of the bank's risk weighted assets. In India, the RBI has specified a minimum of 9%, which is more stringent than the international norm. In fact, the actual ratio of all scheduled commercial banks (SCBs) in India stood at 13.2% in March 2011.

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The RBI also provides guidelines about how much risk weights banks should assign to different classes of assets (such as loans). The riskier the asset class, the higher would be the risk weight. Thus, the real estate assets, for example, are given very high risk weights. This regulatory requirement that each individual bank has to maintain a minimum level of capital, which is commensurate with the risk profile of the bank's assets, plays a critical role in the safety and soundness of individual banks and the banking system.

Credit Exposure Limits

As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank has fixed limits on bank exposure to the capital market as well as to individual and group borrowers with reference to a bank's capital. Limits on inter-bank exposures have also been placed. Banks are further encouraged to place internal caps on their sectoral exposures, their exposure to commercial real estate and to unsecured exposures. These exposures are closely monitored by the Reserve Bank. Prudential norms on banks' exposures to NBFCs and to related entities are also in place. Table 2.1 gives a summary of the RBI's guidelines on exposure norms for commercial banks in India.

Table: Exposure norms for Commercial banks in India

Exposure to		Limit
1.	Single Borrower	15 per cent of capital fund (Additional 5 percent on infrastructure exposure)
2.	Group Borrower	40 percent of capital fund (Additional 10 percent on infrastructure exposure)
3.	NBFC	10 percent of capital fund
4.	NBFC - AFC	15 percent of capital fund
5.	Indian Joint Venture/Wholly owned subsidiaries abroad/ Overseas step down subsidiaries of Indian corporates	20 percent of capital fund
6.	Capital Market Exposure	
(a)	Banks' holding of shares in any company	The lesser of 30 percent of paid-up share capital of the company or 30 percent of the paid-up capital of banks
(b)	Banks' aggregate exposure to capital market (solo basis)	40 percent of its net worth
(c)	Banks' aggregate exposure to capital market (group basis)	40 percent of its consolidated net worth
(d)	Banks' direct exposure to capital market (solo basis)	20 percent of net worth
(e)	Banks' direct exposure to capital market (group basis)	20 percent of consolidated net worth
7.	Gross Holding of capital among banks / financial institutions	10 per cent of capital fund

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Some of the categories of the above table are discussed below:

- Individual Borrowers: A bank's credit exposure to individual borrowers must not exceed 15 % of the Bank's capital funds. Credit exposure to individual borrowers may exceed the exposure norm of 15 % of capital funds by an additional 5 % (i.e. up to 20 %) provided the additional credit exposure is on account of infrastructure financing.
- Group Borrowers: A bank's exposure to a group of companies under the same management control must not exceed 40% of the Bank's capital funds unless the exposure is in respect of an infrastructure project. In that case, the exposure to a group of companies under the same management control may be up to 50% of the Bank's capital funds.
- Aggregate exposure to capital market: A bank's aggregate exposure to the capital market, including both fund based and non-fund based exposure to capital market, in all forms should not exceed 40 percent of its net worth as on March 31 of the previous year.

In addition to ensuring compliance with the above guidelines laid down by RBI, a Bank may fix its own credit exposure limits for mitigating credit risk. The bank may, for example, set upper caps on exposures to sensitive sectors like commodity sector, real estate sector and capital markets. Banks also may lay down guidelines regarding exposure limits to unsecured loans.

Lending Rates:

Banks are free to determine their own lending rates on all kinds of advances except a few such as export finance; interest rates on these exceptional categories of advances are regulated by the RBI. It may be noted that the Section 21A of the BR Act provides that the rate of interest charged by a bank shall not be reopened by any court on the ground that the rate of interest charged is excessive.

The concept of benchmark prime lending rate (BPLR) was however introduced in November 2003 for pricing of loans by commercial banks with the objective of enhancing transparency in the pricing of their loan products. Each bank must declare its benchmark prime lending rate (BPLR) as approved by its Board of Directors. A bank's BPLR is the interest rate to be charged to its best clients; that is, clients with the lowest credit risk. Each bank is also required to indicate the maximum spread over the BPLR for various credit exposures.

However, BPLR lost its relevance over time as a meaningful reference rate, as the bulk of loans were advanced below BPLR. Further, this also impedes the smooth transmission of monetary signals by the RBI. The RBI therefore set up a Working Group on Benchmark Prime Lending Rate (BPLR) in June 2009 to go into the issues relating to the concept of BPLR and suggest measures to make credit pricing more transparent.

Following the recommendations of the Group, the Reserve Bank has issued guidelines in February 2010. According to these guidelines, the 'Base Rate system' will replace the BPLR system with effect from July 01, 2010.All categories of loans should

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henceforth be priced only with reference to the Base Rate. Each bank will decide its own Base Rate. The actual lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, which will include product specific operating costs, credit risk premium and tenor premium.

Since transparency in the pricing of loans is a key objective, banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels. Apart from transparency, banks should ensure that interest rates charged to customers in the above arrangement are non-discriminatory in nature.

TYPES OF ADVANCES:

Advances can be broadly classified into: fund-based lending and non-fund based lending. Fund based lending: This is a direct form of lending in which a loan with an actual cash outflow is given to the borrower by the Bank. In most cases, such a loan is backed by primary and/or collateral security. The loan can be provided for financing capital goods and/or working capital requirements.

Non-fund based lending: In this type of facility, the Bank makes no funds outlay. However, such arrangements may be converted to fund-based advances if the client fails to fulfill the terms of his contract with the counterparty. Such facilities are known as contingent liabilities of the bank. Facilities such as 'letters of credit' and 'guarantees' fall under the category of non-fund based credit.

Let us explain with an example how guarantees work. A company takes a term loan from Bank A and obtains a guarantee from Bank B for its loan from Bank A, for which he pays a fee. By issuing a bank guarantee, the guarantor bank (Bank B) undertakes to repay Bank A, if the company fails to meet its primary responsibility of repaying Bank A.

Methods of Granting Advances

Following are some of the methods of granting Advances used by banks -

1. **Working Capital Finance**

   Working capital finance is utilized for operating purposes, resulting in creation of current assets (such as inventories and receivables). This is in contrast to term loans which are utilized for establishing or expanding a manufacturing unit by the acquisition of fixed assets.

   Banks carry out a detailed analysis of borrowers' working capital requirements. Credit limits are established in accordance with the process approved by the board of directors. The limits on Working capital facilities are primarily secured by inventories and receivables (chargeable current assets).

   Working capital finance consists mainly of cash credit facilities, short term loan and bill discounting. Under the cash credit facility, a line of credit is provided up to a pre-established amount based on the borrower's projected level of sales

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inventories, receivables and cash deficits. Up to this pre-established amount, disbursements are made based on the actual level of inventories and receivables. Here the borrower is expected to buy inventory on payments and, thereafter, seek reimbursement from the Bank. In reality, this may not happen. The facility is generally given for a period of up to 12 months and is extended after a review of the credit limit. For clients facing difficulties, the review may be made after a shorter period. One problem faced by banks while extending cash credit facilities, is that customers can draw up to a maximum level or the approved credit limit, but may decide not to. Because of this, liquidity management becomes difficult for a bank in the case of cash credit facility. RBI has been trying to mitigate this problem by encouraging the Indian corporate sector to avail of working capital finance in two ways: a short-term loan component and a cash credit component. The loan component would be fully drawn, while the cash credit component would vary depending upon the borrower's requirements.

According to RBI guidelines, in the case of borrowers enjoying working capital credit limits of Rs. 10 crores and above from the banking system, the loan component should normally be 80% and cash credit component 20 %. Banks, however, have the freedom to change the composition of working capital finance by increasing the cash credit component beyond 20% or reducing it below 20 %, as the case may be, if they so desire. Bill discounting facility involves the financing of short-term trade receivables through negotiable instruments. These negotiable instruments can then be discounted with other banks, if required, providing financing banks with liquidity.

2. **Project Finance:**

Project finance business consists mainly of extending medium-term and long-term rupee and foreign currency loans to the manufacturing and infrastructure sectors. Banks also provide financing by way of investment in marketable instruments such as fixed rate and floating rate debentures. Lending banks usually insist on having a first charge on the fixed assets of the borrower.

During the recent years, the larger banks are increasingly becoming involved in financing large projects, including infrastructure projects. Given the large amounts of financing involved, banks need to have a strong framework for project appraisal. The adopted framework will need to emphasize proper identification of projects, optimal allocation and mitigation of risks. The project finance approval process entails a detailed evaluation of technical, commercial, financial and management factors and the project sponsor's financial strength and experience. As part of the appraisal process, a risk matrix is generated, which identifies each of the project risks, mitigating factors and risk allocation. Project finance extended by banks is generally fully secured and has full recourse to the borrower company. In most project finance cases, banks have a first lien on all the fixed assets and a second lien on all the current assets of the borrower company. In addition, guarantees may be taken from sponsors/ promoters of the company. Should the borrower company fail to repay on time, the lending bank can have full recourse to the sponsors/ promoters of the company. (Full recourse means that the lender

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can claim the entire unpaid amount from the sponsors / promoters of the company.) However, while financing very large projects, only partial recourse to the sponsors/ promoters may be available to the lending banks.

3. **Loans to Small and Medium Enterprises:**

A substantial quantum of loans is granted by banks to small and medium enterprises (SMEs). While granting credit facilities to smaller units, banks often use a cluster-based approach, which encourages financing of small enterprises that have a homogeneous profile such as leather manufacturing units, chemical units, or even export oriented units. For assessing the credit risk of individual units, banks use the credit scoring models. As per RBI guidelines, banks should use simplified credit appraisal methods for assessment of bank finance for the smaller units. Further, banks have also been advised that they should not insist on collateral security for loans up to Rs.10 lakh for the micro enterprises. Small Industries Development Bank of India (SIDBI) also facilitates the flow of credit at reasonable interest rates to the SME sector. This is done by incentivizing banks and State Finance Corporations to lend to SMEs by refinancing a specified percentage of incremental lending to SMEs, besides providing direct finance along with banks.

4. **Rural and Agricultural Loans**

The rural and agricultural loan portfolio of banks comprises loans to farmers, small and medium enterprises in rural areas, dealers and vendors linked to these entities and even Corporate. For farmers, banks extend term loans for equipments used in farming, including tractors, pump sets, etc. Banks also extend crop loan facility to farmers. In agricultural financing, banks prefer an 'area based' approach; for example, by financing farmers in an adopted village. The regional rural banks (RRBs) have a special place in ensuring adequate credit flow to agriculture and the rural sector. The concept of 'Lead Bank Scheme (LBS)' was first mooted by the Gadgil Study Group, which submitted its report in October 1969. Pursuant to the recommendations of the Gadgil Study Group and those of the Nariman Committee, this suggested the adoption of 'area approach' in evolving credit plans and programmes for development of banking and the credit structure, the LBS was introduced by the RBI in December, 1969. The scheme envisages allotment of districts to individual banks to enable them to assume leadership in bringing about banking developments in their respective districts. More recently, a High Level Committee was constituted by the RBI in November 2007, to review the LBS and improve its effectiveness, with a focus on financial inclusion and recent developments in the banking sector. The Committee has recommended several steps to further improve the working of LBS. The importance of the role of State Governments for supporting banks in increasing banking business in rural areas has been emphasized by the Committee.

5. **Directed Lending**

The RBI requires banks to deploy a certain minimum amount of their credit in certain identified sectors of the economy. This is called directed lending. Such directed lending comprises priority sector lending and export credit.

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A. Priority sector lending

The objective of priority sector lending program is to ensure that adequate credit flows into some of the vulnerable sectors of the economy, which may not be attractive for the banks from the point of view of profitability. These sectors include agriculture, small scale enterprises, retail trade, etc. Small housing loans, loans to individuals for pursuing education, loans to weaker sections of the society etc also qualify as priority sector loans. To ensure banks channelize a part of their credit to these sectors, the RBI has set guidelines defining targets for lending to priority sector as whole and in certain cases, sub-targets for lending to individual priority sectors (See Table).

Table: Targets under Priority Sector Lending

	Domestic commercial banks	Foreign banks
Total Priority Sector advances	40 per cent of ANBC or CEOBSE, whichever is higher	32 percent of ANBC or CEOBSE, whichever is higher
Total agricultural advances	18 percent of ANBC or CEOBSE, whichever is higher	No Target
Small Enterprise advances	No Target	10 per cent of ANBC or CEOBSE, whichever is higher
Export credit	Export credit is not a part of priority sector for domestic commercial banks	12 per cent of ANBC or CEOBSE, whichever is higher
Advances to weaker sections	10 percent of ANBC or CEOBSE, whichever is higher	No target
Differential Rate of Interest Scheme	1 percent of total advances outstanding as at the end of the previous year	No target

Note: ANBC: Adjusted Net Bank Credit

CEOBSE: Credit Equivalent of Off-Balance Sheet Exposure

The RBI guidelines require banks to lend at least 40% of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure (CEOBSE), whichever is higher. In case of foreign banks, the target for priority sector advances is 32% of ANBC or CEOBSE, whichever is higher.

In addition to these limits for overall priority sector lending, the RBI sets sub-limits for certain sub-sectors within the priority sector such as agriculture. Banks are required to comply with the priority sector lending requirements at the end of each financial year. A bank having shortfall in lending to priority sector lending target or sub-target shall be required to make contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD or funds with other financial institutions as specified by the RBI.

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B. Export Credit

As part of directed lending, RBI requires banks to make loans to exporters at concessional rates of interest. Export credit is provided for pre-shipment and post-shipment requirements of exporter borrowers in rupees and foreign currencies. At the end of any fiscal year, 12.0% of a bank's credit is required to be in the form of export credit. This requirement is in addition to the priority sector lending requirement but credits extended to exporters that are small scale industries or small businesses may also meet part of the priority sector lending requirement.

6. Retail Loan

Banks, today, offer a range of retail asset products, including home loans, automobile loans, personal loans (for marriage, medical expenses etc), credit cards, consumer loans (such as TV sets, personal computers etc) and, loans against time deposits and loans against shares. Banks also may fund dealers who sell automobiles, two wheelers, consumer durables and commercial vehicles. The share of retail credit in total loans and advances was 22.63% at end-March 2010.

Customers for retail loans are typically middle and high-income, salaried or self-employed individuals, and, in some cases, proprietorship and partnership firms. Except for personal loans and credit through credit cards, banks stipulate that (a) a certain percentage of the cost of the asset (such as a home or a TV set) sought to be financed by the loan, to be borne by the borrower and (b) that the loans are secured by the asset financed. Many banks have implemented a credit-scoring program, which is an automated credit approval system that assigns a credit score to each applicant based on certain attributes like income, educational background and age. The credit score then forms the basis of loan evaluation. External agencies such as field investigation agencies and credit processing agencies may be used to facilitate a comprehensive due diligence process including visits to offices and homes in the case of loans to individual borrowers. Before disbursements are made, the credit officer checks a centralized delinquent database and reviews the borrower's profile. In making credit decisions, banks draw upon reports from agencies such as the Credit Information Bureau (India) Limited (CIBIL).

Some private sector banks use direct marketing associates as well as their own branch network and employees for marketing retail credit products. However, credit approval authority lies only with the bank's credit officers.

Two important categories of retail loans—home finance and personal loans—are discussed below.

Home Finance:

Banks extend home finance loans, either directly or through home finance subsidiaries. Such long term housing loans are provided to individuals and corporations and also given as construction finance to builders. The loans are

secured by a mortgage of the property financed. These loans are extended for maturities generally ranging from five to fifteen years and a large proportion of these loans are at floating rates of interest. This reduces the interest rate risk that banks assume, since a bank's sources of finance are generally of shorter maturity. However, fixed rate loans may also be provided; usually with banks keeping a higher margin over benchmark rates in order to compensate for higher interest rate risk. Equated monthly installments are fixed for repayment of loans depending upon the income and age of the borrower(s).

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Personal Loans:

These are often unsecured loans provided to customers who use these funds for various purposes such as higher education, medical expenses, social events and holidays. Sometimes collateral security in the form of physical and financial assets may be available for securing the personal loan. Portfolio of personal loans also includes micro-banking loans, which are relatively small value loans extended to lower income customers in urban and rural areas.

7. International Loans Extended by Banks

Indian Corporate raise foreign currency loans from banks based in India as well as abroad as per guidelines issued by RBI/ Government of India. Banks raise funds abroad for on-lending to Indian Corporate. Further, banks based in India have an access to deposits placed by Non Resident Indians (NRIs) in the form of FCNR (B) deposits, which can be used by banks in India for on-lending to Indian customers.

SECURED ADVANCES

A banker secures the advances by means of:

a) Lien

b) Pledge

c) Mortgage

d) Hypothecation

Lien

In law, a **lien** is a form of security interest granted over an item of property to secure the payment of a debt or performance of some other obligation. The owner of the property, who grants the lien, is referred to as the *lienor* and the person who has the benefit of the lien is referred to as the *lienee*.

The etymological root is Anglo-French *lien*, *loyen* "bond", "restraint", from Latin *ligamen*, from *ligare* "to bind".

Common-law liens are divided into *special liens* and *general liens*. A special lien, the more common kind, requires a close connection between the property and the service rendered. A special lien can only be exercised in respect of fees relating to the instant transaction; the lienee cannot use the property held as security for past

Check Your Progress:

1. What are bank accounts?
2. How many types of mortgage loans are there?

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debts as well. A general lien affects all of the property of the lienor in the possession of the lienee, and stands as security for all of the debts of the lienor to the lienee. A special lien can be extended to a general lien by contract, and this is commonly done in the case of carriers. A common-law lien only gives a passive right to retain; there is no power of sale which arises at common law,[1] although some statutes have also conferred an additional power of sale, and it is possible to confer a separate power of sale by contract.

Pledge

A pledge is a contract whereby an article is deposited with a lender or a promise as security for the repayment of loan or performance of a promise. To complete a contract of pledge, delivery of goods to the banker is necessary. Delivery of documents of title relating to the good, or the key of the godown where the goods are stored may be sufficient to create a valid pledge.

The pledge has a common law power of sale in the event of a default on the secured obligations which arises if the secured obligations are not satisfied by the agreed time (or, in default of agreement, within a reasonable period of time). If the power of sale is exercised, then the holder of the pledge must account to the pledgor for any surplus after payment of the secured obligations.

A pledge does not confer a right to appoint a receiver or foreclose. If the holder of pledge sells or disposes of the pledged assets when not entitled to do so, they may be liable in conversion to the pledgor.

MORTGAGE LOAN

Basic concepts and legal regulation

According to Anglo-American property law, a mortgage occurs when an owner (usually of a fee simple interest in realty) pledges his or her interest (right to the property) as security or collateral for a loan. Therefore, a mortgage is an encumbrance (limitation) on the right to the property just as an easement would be, but because most mortgages occur as a condition for new loan money, the word *mortgage* has become the generic term for a loan secured by such real property. As with other types of loans, mortgages have an interest rate and are scheduled to amortize over a set period of time, typically 30 years. All types of real property can be, and usually are, secured with a mortgage and bear an interest rate that is supposed to reflect the lender's risk.

Mortgage lending is the primary mechanism used in many countries to finance private ownership of residential and commercial property (see commercial mortgages). Although the terminology and precise forms will differ from country to country, the basic components tend to be similar:

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- Property: the physical residence being financed. The exact form of ownership will vary from country to country, and may restrict the types of lending that are possible.
- Mortgage: the security interest of the lender in the property, which may entail restrictions on the use or disposal of the property. Restrictions may include requirements to purchase home insurance and mortgage insurance, or pay off outstanding debt before selling the property.
- Borrower: the person borrowing who either has or is creating an ownership interest in the property.
- Lender: any lender, but usually a bank or other financial institution. Lenders may also be investors who own an interest in the mortgage through a mortgage-backed security. In such a situation, the initial lender is known as the mortgage originator, which then packages and sells the loan to investors. The payments from the borrower are thereafter collected by a loan servicer.
- Principal: the original size of the loan, which may or may not include certain other costs; as any principal is repaid, the principal will go down in size.
- Interest: a financial charge for use of the lender's money.
- Foreclosure or repossession: the possibility that the lender has to foreclose, repossess or seize the property under certain circumstances is essential to a mortgage loan; without this aspect, the loan is arguably no different from any other type of loan.

Many other specific characteristics are common to many markets, but the above are the essential features. Governments usually regulate many aspects of mortgage lending, either directly (through legal requirements, for example) or indirectly (through regulation of the participants or the financial markets, such as the banking industry), and often through state intervention (direct lending by the government, by state-owned banks, or sponsorship of various entities). Other aspects that define a specific mortgage market may be regional, historical, or driven by specific characteristics of the legal or financial system.

Mortgage loans are generally structured as long-term loans, the periodic payments for which are similar to an annuity and calculated according to the time value of money formulae. The most basic arrangement would require a fixed monthly payment over a period of ten to thirty years, depending on local conditions. Over this period the principal component of the loan (the original loan) would be slowly paid down through amortization. In practice, many variants are possible and common worldwide and within each country.

Lenders provide funds against property to earn interest income, and generally borrow these funds themselves (for example, by taking deposits or issuing bonds). The price

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at which the lenders borrow money therefore affects the cost of borrowing. Lenders may also, in many countries, sell the mortgage loan to other parties who are interested in receiving the stream of cash payments from the borrower, often in the form of a security (by means of a securitization).

Mortgage lending will also take into account the (perceived) riskiness of the mortgage loan, that is, the likelihood that the funds will be repaid (usually considered a function of the creditworthiness of the borrower); that if they are not repaid, the lender will be able to foreclose and recoup some or all of its original capital; and the financial, interest rate risk and time delays that may be involved in certain circumstances.

MORTGAGE LOAN TYPES

There are many types of mortgages used worldwide, but several factors broadly define the characteristics of the mortgage. All of these may be subject to local regulation and legal requirements.

- Interest: interest may be fixed for the life of the loan or variable, and change at certain pre-defined periods; the interest rate can also, of course, be higher or lower.
- Term: mortgage loans generally have a maximum term, that is, the number of years after which an amortizing loan will be repaid. Some mortgage loans may have no amortization, or require full repayment of any remaining balance at a certain date, or even negative amortization.
- Payment amount and frequency: the amount paid per period and the frequency of payments; in some cases, the amount paid per period may change or the borrower may have the option to increase or decrease the amount paid.
- Prepayment: some types of mortgages may limit or restrict prepayment of all or a portion of the loan, or require payment of a penalty to the lender for prepayment.

The two basic types of amortized loans are the fixed rate mortgage (FRM) and adjustable-rate mortgage (ARM) (also known as a floating rate or variable rate mortgage). In many countries (such as the United States), floating rate mortgages are the norm and will simply be referred to as mortgages. Combinations of fixed and floating rate are also common, whereby a mortgage loan will have a fixed rate for some period, and vary after the end of that period.

- In a fixed rate mortgage, the interest rate, and hence periodic payment, remains fixed for the life (or term) of the loan. Therefore the payment is fixed, although ancillary costs (such as property taxes and insurance) can

and do change. For a fixed rate mortgage, payments for principal and interest should not change over the life of the loan,

- In an adjustable rate mortgage, the interest rate is generally fixed for a period of time, after which it will periodically (for example, annually or monthly) adjust up or down to some market index. Adjustable rates transfer part of the interest rate risk from the lender to the borrower, and thus are widely used where fixed rate funding is difficult to obtain or prohibitively expensive. Since the risk is transferred to the borrower, the initial interest rate may be from 0.5% to 2% lower than the average 30-year fixed rate; the size of the price differential will be related to debt market conditions, including the yield curve.

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The charge to the borrower depends upon the credit risk in addition to the interest rate risk. The mortgage origination and underwriting process involves checking credit scores, debt-to-income, down payments, and assets. Jumbo mortgages and subprime lending are not supported by government guarantees and face higher interest rates.

HYPOTHECATION

Hypothecation is the practice where a borrower pledges collateral to secure a debt. The borrower retains ownership of the collateral, but it is "hypothetically" controlled by the creditor in that he has the right to seize possession if the borrower defaults. A common example occurs when a consumer enters into a mortgage agreement, in which the consumer's house becomes collateral until the mortgage loan is paid off.

Rehypothecation is a practice that occurs principally in the financial markets, where a bank or other broker-dealer reuses the collateral pledged by its clients as collateral for its own borrowing.

Hypothecation is a common feature of consumer contracts involving mortgages – the borrower legally owns the house, but until the mortgage is paid off the creditor has the right to take possession in the hypothetical case that the borrower fails to keep up with repayments. If a consumer takes out an additional loan secured against the value of his mortgage (approximately the current value of the house minus outstanding repayments) the consumer is then hypothecating the mortgage itself – the creditor can still seize the house but in this case the creditor then becomes responsible for the outstanding mortgage debt. Sometimes consumer goods and business equipment can be bought on credit agreements involving hypothecation – the goods are legally owned by the borrower, but once again the creditor can seize them if required.

CHAPTER SUMMARY

Bank deposits serve different purposes for different people. Some people cannot save regularly; they deposit money in the bank only when they have extra income.

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The purpose of deposit then is to keep money safe for future needs. Some may want to deposit money in a bank for as long as possible to earn interest or to accumulate savings with interest so as to buy a flat, or to meet hospital expenses in old age, etc. Some, mostly businessmen, deposit all their income from sales in a bank account and pay all business expenses out of the deposits. Keeping in view these differences, banks offer the facility of opening different types of deposit accounts by people to suit their purpose and convenience.

On the basis of purpose they serve, bank deposit accounts may be classified as follows:

a. Savings Bank Account

b. Current Deposit Account

c. Fixed Deposit Account

d. Recurring Deposit Account.

ANSWERS TO CHECK YOUR PROGRESS

1. A deposit account is a current account, savings account, or other type of bank account, at a banking institution that allows money to be deposited and withdrawn by the account holder.

TEST YOURSELF

1) Explain what Bank Deposit Accounts are.

2) Discuss various types of Deposit Accounts that can be opened in Banks.

3) What are the strategies of mobilizing deposits?

4) Explain the Principles of lending.

5) Describe various types of Advances at a Bank grants to consumers.

6) Distinguish between pledge and mortgage.

7) What is meant by Hypothecation?

BANKING ARTICLE (CASE)

How to open a Savings Bank Account

To open a savings bank account in a commercial bank, you have to first decide what amount of money you would like to deposit initially. You may enquire and find out from the nearest bank what is the minimum amount to be deposited while opening a savings bank account. You have to deposit at least that amount or more,

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if you want. On entering a bank (any branch of a bank) you will find a counter for enquiry (or a counter with: 'May I help you' board). Having known the minimum amount to be deposited, you should ask for a form of application for opening Savings Bank Account. You are not required to pay anything for it. You should then take the following

Steps:

i. **Filling up the Form**

The application form has to be filled up giving the following necessary information:

a. Name of the person (applicant)

b. His/her occupation

c. Residential Address

d. Specimen signature of the applicant

e. Name, address, account number and signature of the person introducing the applicant

Besides the above information you have to give an undertaking that you will abide by the rules and regulations of the bank, which are in force. At the end of the application form, you have to put your signature. (In some banks it is required to attach two passport size photographs of the applicant along with the application.)

ii. **Proper Introduction**

Every bank requires that a person known to the bank should introduce the applicant. It may be convenient to be introduced by a person having already an account in that bank. Some banks may accept the attested copy of Passport or Driving License, if any, of the applicant. In that case personal introduction is not necessary. Introduction is required to prevent the possibility of opening of account by an undesirable person.

iii. **Specimen Signature**

The applicant has to put his/her specimen signatures at the blank space provided on the application form for that purpose. In addition, specimen signatures have to be put separately on a card on which a photograph of the applicant may be pasted, along with his/her name and account number.

After the above steps have been taken and the officer concerned is satisfied that the application form is in order, money is to be deposited at the cash counter after filling in a printed 'Pay-in slip'.

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An account number will then be allotted and written on the application form as well as the card having your specimen signatures. At the same time you will be issued a Passbook with the initial deposit recorded in it. All future deposits and withdrawals will also be entered in the passbook, and it will remain with you. If you want to use cheques for withdrawal or payment of money out of your deposits, a cheque book will be issued on your request. A cheque form is a printed form in which you may issue an order to the bank to pay the amount specified in it to a person.

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3 Investment Management and Investment Banking

The Unit Include:

- Indroduction
- Process of investment management
- Key problems of Investment Management
- Representing the owners of shares
- Size of the global fund management industry
- Approaches to investment decision making
- Investment styles
- Preparation of Cheque
- Endorsements
- Bill of Landing
- Main Types of Bill
- Government Securities
- Exchange Traded Fund
- Structure of ETF's
- Banking Article (CASE)
- Chapter Summary
- Test yourself.

Learning Objectives:

After going through this chapter, you should be able to:

- **Define investment banking.**
- **Describe the importance of investment banking.**
- **Discuss issues and concerns involved.**
- **Understand various banking provisions.**

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INTRODUCTION

Investment management is the professional management of various securities (shares, bonds and other securities) and assets (e.g., real) in order to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations, charities, educational establishments etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes e.g. mutual funds or exchange-traded funds).

The term asset management is often used to refer to the investment management of collective investments, (not necessarily) while the more generic fund management may refer to all forms of institutional investment as well as investment management for private investors. Investment managers who specialize in *advisory* or *discretionary* management on behalf of (normally wealthy) private investors may often refer to their services as wealth management or portfolio management often within the context of so-called "private banking".

The provision of 'investment management services' includes elements of financial statement analysis, asset selection, stock selection, plan implementation and ongoing monitoring of investments. Investment management is a large and important global industry in its own right responsible for caretaking of trillions of rupees, yuan, dollars, euro, pounds and yen. Coming under the remit of financial services many of the world's largest companies are at least in part investment managers and employ millions of staff and create billions in revenue.

Fund manager refers to both a firm that provides investment management services and an individual who directs fund management decisions.

The business of investment has several facets, the employment of professional fund managers, research (of individual assets and asset classes), dealing, settlement, marketing, internal auditing, and the preparation of reports for clients. The largest financial fund managers are firms that exhibit all the complexity their size demands. Apart from the people who bring in the money (marketers) and the people who direct investment (the fund managers), there are compliance staff (to ensure accord with legislative and regulatory constraints), internal auditors of various kinds (to examine internal systems and controls), financial controllers (to account for the institutions' own money and costs), computer experts, and "back office" employees (to track and record transactions and fund valuations for up to thousands of clients per institution).

PROCESS OF INVESTMENT MANAGEMENT

Investment management also known as portfolio management is not a simple activity as it involves many complex steps which is broken down into following steps for a better understanding. Steps are as follows -

Specification of investment objectives & constraints

Investment needs to be guided by a set of objectives. The main objectives taken into consideration by investors are capital appreciation, current income and safety

of principal. The relative importance of each of these objectives needs to be determined. The main aspect that affects the objectives is risk. Some investors are risk takers while others try to reduce risk to the minimum level possible. Identification of constrains arising out of liquidity, time horizon, tax and special situations need to be addressed.

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Choice of the asset mix

In investment management the most important decision is with respect to the asset mix decision. It is to do with the proportion of equity shares or shares of equity oriented mutual funds i.e. stocks and proportion of bonds in the portfolio. The combination on the number of stocks and bonds depends upon the risk tolerance of the investor. This step also involves which classes of asset investments will be placed and also determines which securities should be purchased in a particular class.

Formulation of portfolio strategy

After the stock – bond combination is chosen, it is important to formulate a suitable portfolio strategy. There are two types of portfolio strategies. The first is an active portfolio strategy which aims to earn greater risk adjusted returns depending on the market timing, sector rotation, security selection or a mix of these. The second strategy is the passive strategy which involves holding a well diversified portfolio and also maintaining a pre-decided level risk.

Selection of securities

Investors usually select stocks after a careful fundamental and technical analysis of the security they are interested in purchasing. In case of bonds credit ratings, liquidity, tax shelter, term of maturity and yield to maturity are factors that are considered.

Portfolio Execution

This step involves implementing the formulated portfolio strategy by buying or selling certain securities in specified amounts. This step is the one which actually affects investment results.

Portfolio Revision

Fluctuation in the prices of stocks and bonds lead to changes in the value of the portfolio and this calls for a rebalancing of the portfolio from time to time. This principally involves shifting from bonds to stocks or vice-versa. Sector rotation and security changes may also be needed.

Performance Evaluation

The assessment of the performance of the portfolio should be done from time to time. It helps the investor to realize if the portfolio return is in proportion with its risk exposure. Along with this it is also necessary to have a benchmark for comparison with other portfolios that have a similar risk exposure.

KEY PROBLEMS OF INVESTMENT MANAGEMENT

Key problems include:

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- Revenue is directly linked to market valuations, so a major fall in asset prices can cause a precipitous decline in revenues relative to costs;
- Above-average fund performance is difficult to sustain, and clients may not be patient during times of poor performance;
- Successful fund managers are expensive and may be headhunted by competitors;
- Above-average fund performance appears to be dependent on the unique skills of the fund manager; however, clients are loath to stake their investments on the ability of a few individuals- they would rather see firm-wide success, attributable to a single philosophy and internal discipline;
- Analysts who generate above-average returns often become sufficiently wealthy that they avoid corporate employment in favor of managing their personal portfolios.

REPRESENTING THE OWNERS OF SHARES

Institutions often control huge shareholdings. In most cases they are acting as fiduciary agents rather than principals (direct owners). The owners of shares theoretically have great power to alter the companies via the voting rights the shares carry and the consequent ability to pressure managements, and if necessary out-vote them at annual and other meetings.

In practice, the ultimate owners of shares often do not exercise the power they collectively hold (because the owners are many, each with small holdings); financial institutions (as agents) sometimes do. There is a general belief that shareholders – in this case, the institutions acting as agents—could and should exercise more active influence over the companies in which they hold shares (e.g., to hold managers to account, to ensure Boards effective functioning). Such action would add a pressure group to those (the regulators and the Board) overseeing management.

However there is the problem of how the institution should exercise this power. One way is for the institution to decide, the other is for the institution to poll its beneficiaries. Assuming that the institution polls, should it then: (i) Vote the entire holding as directed by the majority of votes cast? (ii) Split the vote (where this is allowed) according to the proportions of the vote? (iii) Or respect the abstainers and only vote the respondents' holdings?

The price signals generated by large active managers holding or not holding the stock may contribute to management change. For example, this is the case when a large active manager sells his position in a company, leading to (possibly) a decline in the stock price, but more importantly a loss of confidence by the markets in the management of the company, thus precipitating changes in the management team.

Some institutions have been more vocal and active in pursuing such matters; for instance, some firms believe that there are investment advantages to accumulating substantial minority shareholdings (i.e. 10% or more) and putting pressure on management to implement significant changes in the business. In some cases,

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institutions with minority holdings work together to force management change. Perhaps more frequent is the sustained pressure that large institutions bring to bear on management teams through persuasive discourse and PR. On the other hand, some of the largest investment managers—such as Black Rock and Vanguard—advocate simply owning every company, reducing the incentive to influence management teams. A reason for this last strategy is that the investment manager prefers a closer, more open and honest relationship with a company's management team than would exist if they exercised control; allowing them to make a better investment decision.

The national context in which shareholder representation considerations are set is variable and important. The USA is a litigious society and shareholders use the law as a lever to pressure management teams. In Japan it is traditional for shareholders to be low in the 'pecking order,' which often allows management and labor to ignore the rights of the ultimate owners. Whereas US firms generally cater to shareholders, Japanese businesses generally exhibit a *stakeholder* mentality, in which they seek consensus amongst all interested parties (against a background of strong unions and labor legislation).

SIZE OF THE GLOBAL FUND MANAGEMENT INDUSTRY

Conventional assets under management of the global fund management industry increased by 10% in 2010, to $79.3 trillion. Pension assets accounted for $29.9 trillion of the total, with $24.7 trillion invested in mutual funds and $24.6 trillion in insurance funds. Together with alternative assets (sovereign wealth funds, hedge funds, private equity funds and exchange traded funds) and funds of wealthy individuals, assets of the global fund management industry totaled around $117 trillion. Growth in 2010 followed a 14% increase in the previous year and was due both to the recovery in equity markets during the year and an inflow of new funds.

Philosophy, Process and People

The 3-P's (Philosophy, Process and People) are often used to describe the reasons why the manager is able to produce above average results.

- **Philosophy** refers to the over-arching beliefs of the investment organization. For example: (i) Does the manager buy growth or value shares, or a combination of the two (and why)? (ii) Do they believe in market timing (and on what evidence)? (iii) Do they rely on external research or do they employ a team of researchers? It is helpful if any and all of such fundamental beliefs are supported by proof-statements.

- **Process** refers to the way in which the overall philosophy is implemented. For example: (i) Which universe of assets is explored before particular assets are chosen as suitable investments? (ii) How does the manager decide what to buy and when? (iii) How does the manager decide what to sell and when? (iv) Who takes the decisions and are they taken by committee? (v) What controls are in place to ensure that a rogue fund (one very different from others and from what is intended) cannot arise?

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- **People** refer to the staff, especially the fund managers. The questions are, Who are they? How are they selected? How old are they? Who reports to whom? How deep is the team (and do all the members understand the philosophy and process they are supposed to be using)? And most important of all, How long has the team been working together? This last question is vital because whatever performance record was presented at the outset of the relationship with the client may or may not relate to (have been produced by) a team that is still in place. If the team has changed greatly (high staff turnover or changes to the team), then arguably the performance record is completely unrelated to the existing team (of fund managers).

At the heart of the investment management industry are the managers who invest and divest client investments.

A certified company investment advisor should conduct an assessment of each client's individual needs and risk profile. The advisor then recommends appropriate investments.

APPROACHES TO INVESTMENT DECISION MAKING

The stock market is thronged by investors pursuing diverse investment approaches which may be broadly divided into four categories as follows

1. Fundamental approach
2. Psychological approach
3. Academic approach
4. Eclectic approach

Fundamental approach

The basic belief of the fundamental approach and commonly used by the majority of investment expert are as follows We know that security has an intrinsic value and this intrinsic value depends upon the basic economic (fundamental) factors and it can be determined by an insightful analysis of the fundamental factors concerning to the company, industry and economy. In some cases, at some given period of time the current market value of a security will differ from the intrinsic value of the security. Over the period of time the market price will fall in line with the intrinsic value. By buying under-valued securities (securities whose intrinsic value is more than its market value) and selling over-valued securities (securities whose intrinsic value is less than its market value) good amount of returns can be earned.

Psychological approach

Psychological mood of an investor is believed to influence the stock price. Therefore it is rightly said that psychological approach is based on the belief that the stock market is not guided by reason but by emotions. Prices rises to great heights when greed and euphoria sweep the market and when the market is surrounded with fear and despair, prices falls drastically. J.M.Keynes in his book - The general theory of employment, interest and money described this phenomenon in eloquent terms. He said:

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" *A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield.* "

Since psychic value seems to be more valued than the intrinsic value therefore it is suggested by the psychological approach for a profitable outcome to analyze how investors tend to react as the market is swept by waves of optimism and pessimism. The 'castles-in-the-air' theory by Burton G. Malkiel describes the psychological approach vividly. It is more of a technical analysis which involves study of internal market data and it also concerns in building some trading rules as it beneficial and aimed at profit making. By analyzing the market data one can recognize certain persistent and recurring patterns of price movement. Variety of tools are used in technical analysis such as moving average analysis, point and figure chart, bar chart, breadth of market analysis etc.

Academic Approach

Over the last four- five decades, various aspects of capital structure are studied by the academic community particularly in the advanced countries by taking help of comparatively sophisticated methods of examination. There appears to be substantial support for the following belief despite numerous unsolved issues and controversies arising from the studies which are pointing out in different directions. Stock price reflect the intrinsic value fairly well as they are practically efficient in responding promptly and reasonably to the flow of information. This means that

Current market price = Intrinsic value

We can say that stock price behavior is like a random walk in the park that means past price behavior cannot be used to determine or predict future price behavior as the successive price changes are independent. The expected return from the security is linearly associated to its systematic risk (market risk or non-diversifiable risk) because in a capital market there is a positive relationship between risk and return.

Eclectic approach

It is the combination of all the three approaches discussed above, the basic belief of eclectic approach are as follows.

- Total dependency on fundamental analysis is not appreciated as there are some uncertainties associated with it but fundamental analysis is helpful in forming a basic standard and benchmark. Fundamental analysis should be viewed with caution because of excessive refinement and complexity associated with it.
- Technical analysis is usefully in gauging the current mood of investors and comparative strength of supply and demand forces. Total dependency on technical indicators can result in to a situation which is very dangerous and one might not be able to control it, as the mood of the investors is very unpredictable. Complicated fundamental system habitually represents figments

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of imagination to a certain extent than tool of proven usefulness therefore it should ordinarily be regarded as the suspect.

- The market is neither as speculative as the psychological approach indicates nor as well planned as academic approach recommends. Eclectic approach does have some inefficiency and it is not perfect but it does react rationally and quite efficiently to the flow of information. There are some instances that the securities are mispriced but still there appears to be quite strong association between risk and return.

The operational implications of the eclectic approach are as follows

- Certain value 'Anchors' are established by conducting fundamental analysis.
- The state of market psychology is assessed by technical analysis.
- Which securities are worth buying, worth selling or worth disposing is determined by the combine result of fundamental and technical analysis.

Asset allocation

The different asset class definitions are widely debated, but four common divisions are stocks, bonds, real-estate and commodities. The exercise of allocating funds among these assets (and among individual securities within each asset class) is what investment management firms are paid for. Asset classes exhibit different market dynamics, and different interaction effects; thus, the allocation of money among asset classes will have a significant effect on the performance of the fund. Some research suggests that allocation among asset classes has more predictive power than the choice of individual holdings in determining portfolio return. Arguably, the skill of a successful investment manager resides in constructing the asset allocation, and separately the individual holdings, so as to outperform certain benchmarks (e.g., the peer group of competing funds, bond and stock indices).

Long-term returns

It is important to look at the evidence on the long-term returns to different assets, and to holding period returns (the returns that accrue on average over different lengths of investment). For example, over very long holding periods (e.g. 10+ years) in most countries, equities have generated higher returns than bonds, and bonds have generated higher returns than cash. According to financial theory, this is because equities are riskier (more volatile) than bonds which are themselves more risky than cash.

Diversification

Against the background of the asset allocation, fund managers consider the degree of diversification that makes sense for a given client (given its risk preferences) and construct a list of planned holdings accordingly. The list will indicate what percentage of the fund should be invested in each particular stock or bond. The theory of portfolio diversification was originated by Markowitz (and many others) and effective diversification requires management of the correlation between the asset returns and

the liability returns, issues internal to the portfolio (individual holdings volatility), and cross-correlations between the returns.

INVESTMENT STYLES

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There are a range of different styles of fund management that the institution can implement. For example, growth, value, growth at a reasonable price (GARP), market neutral, small capitalization, indexed, etc. Each of these approaches has its distinctive features, adherents and, in any particular financial environment, distinctive risk characteristics. For example, there is evidence that growth styles (buying rapidly growing earnings) are especially effective when the companies able to generate such growth are scarce; conversely, when such growth is plentiful, then there is evidence that value styles tend to outperform the indices particularly successfully.

Investment Banking

Investment banking includes a wide variety of activities, including underwriting, selling, and trading securities, providing financial advisory services, and managing assets. Investment banks cater to a diverse group of stakeholders – companies, governments, non-profit institutions, and individuals – and help them raise funds on the capital market. They perform the following major functions for their customers:

- Serve as trading intermediaries for clients
- Lend and invest banks' assets
- Provide advice on mergers, acquisitions, and other financial transactions
- Research and develop opinions on securities, markets, and economies
- Issue, buy, sell, and trade stocks and bonds
- Manage investment portfolios

Investment banks once contrasted sharply with commercial banks, where people mainly deposited their money and sought commercial and retail loans. In recent years, though, the two types of structures have become increasingly similar; commercial banks now offer more investment banking services as they attempt to corner the market by presenting themselves as one-stop shops.

INVESTMENT POLICY OF BANKS:

The financial position of a commercial bank is reflected in its balance sheet. The balance sheet is a statement of the assets and liabilities of the bank. The assets of the bank are distributed in accordance with certain guiding principles. These principles underline the investment policy of the bank. They are discussed below:

1) **Liquidity:** In the context of the balance sheet of a bank the term liquidity has two interpretations. First, it refers to the ability of the bank to honor the claims of the depositors. Second, it connotes the ability of the bank to convert its non-cash assets into cash easily and without loss. It is a well known fact that a bank deals in funds belonging to the public. Hence, the bank should always be on its guard in handling these funds. The bank should

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always have enough cash to meet the demands of the depositors. In fact, the success of a bank depends to a considerable extent upon the degree of confidence it can instill in the minds of its depositors. If the depositors lose confidence in the integrity of their bank, the very existence of the bank will be at stake. So, the bank should always be prepared to meet the claims of the depositors by having enough cash. Among the various items on the assets side of the balance sheet, cash on hand represents the most liquid asset. Next comes cash with other banks and the central bank. The order of liquidity goes on descending. Liquidity also means the ability of the bank to convert its non-cash assets into cash easily and without loss. The bank cannot have all its assets in the form of cash because each is an idle asset which does not fetch any return to the bank. So some of the assets of the bank, money at call and short notice, bills discounted, etc. could be made liquid easily and without loss.

2) **Profitability:** A commercial bank by definition is a profit hunting institution. The bank has to earn profit to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and to meet the day-to-day expenditure. Since cash is the least profitable asset to the bank, there is no point in keeping all the assets in the form of cash on hand. The bank has got to earn income. Hence, some of the items on the assets side are profit yielding assets. They include money at call and short notice, bills discounted, investments, loans and advances, etc. Loans and advances, though the least liquid asset, constitute the most profitable asset to the bank. Much of the income of the bank accrues by way of interest charged on loans and advances. But, the bank has to be highly discreet while advancing loans.

3) **Safety or Security:** Apart from liquidity and profitability, the bank should look to the principle of safety of its funds also for its smooth working. While advancing loans, it is necessary that the bank should consider the three 'C's of credit character, capacity and the collateral of the borrower. The bank cannot afford to invest its funds recklessly without considering the principle of safety. The loans and investments made by the bank should be adequately secured. For this purpose, the bank should always insist on security of the borrower. Of late, somehow or other the banks have not been paying adequate importance to safety, particularly in India.

4) **Diversity:** The bank should invest its funds in such a way as to secure for itself an adequate and permanent return. And while investing its funds, the bank should not keep all its eggs in the same basket. Diversification of investment is necessary to avoid the dangerous consequences of investing in one or two channels. If the bank invest its funds in different types of securities or makes loans and advances to different objectives and enterprises, it shall ensure for itself a regular flow of income.

5) **Saleability of Securities:** Further, the bank should invest its funds in such types of securities as can be easily marketed at a time of emergency. The bank cannot afford to invest its funds in very long term securities or those

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securities which are unsaleable. It is necessary for the bank to invest its funds in government or in first class securities or in debentures of reputed firms. It should also advance loans against stocks which can be easily sold.

6) **Stability in the Value of Investments**: The bank should invest its funds in those stocks and securities the prices of which are more or less stable. The bank cannot afford to invest its funds in securities, the prices of which are subject to frequent fluctuations.

7) **Principles of Tax-Exemption of Investments:** Finally, the investment policy of a bank should be based on the principle of tax exemption of investments. The bank should invest in those government securities which are exempted from income and other taxes. This will help the bank to increase its profits.

Of late, there has been a controversy regarding the relative importance of the various principles influencing the investment policy of a bank particularly between liquidity and profitability. It is interesting to examine this controversy.

Let us examine what happens if the bank sticks to the principle of liquidity only. It is true that if the bank pays importance to liquidity, it can easily meet the demands of the depositors. The bank should have adequate cash to meet the claims of the depositors. It is true that a successful banking business calls for installing confidence in the minds of the depositors. But, it should be noted that accepting deposits is not the only function of a bank. Moreover, the bank cannot afford to forget the fact that it has to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and meet the day-to-day expenditure. If the bank keeps all its resources in liquid form, it will not be able to earn even a rupee. But profitability is a must for the bank. Though cash on hand is the most liquid asset, it is the least profitable asset as well. Cash is an idle asset. Hence, the banker cannot concentrate on liquidity only.

If the bank attaches importance to profitability only, it would be equally disastrous to the very survival of a bank. It is true that a bank needs income to meet its expenditure and pay returns to the depositors and shareholders. The bank cannot undermine the interests of the depositors. If the bank lends out all its funds, it will be left with no cash at all to meet the claims of the depositors. It should be noted that the bank should have cash to honor the obligations of the depositors. Otherwise, there will be a 'run' on the bank. A run on the bank would be suicidal to the very existence of the bank. Loans and advances, though the most profitable asset, constitute the least liquid asset.

It follows from the above that the choice is between liquidity and profitability. The constant tug of war between liquidity and profitability is the feature of the assets side. **According to Crowther**, liquidity and profitability are opposing or conflicting considerations. The secret of successful banking lies in striking a balance between the two.

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PREPARATION OF CHEQUE:

A **cheque** (or **check** in American English) is a document/instrument (usually a piece of paper) that orders a payment of money. The person writing the cheque, the *drawer*, usually has a current account (British), or checking account (US) where their money was previously deposited. The drawer writes the various details including the money amount, date, and a payee on the cheque, and signs it, ordering their bank, known as the *drawee*, to pay that person or company the amount of money stated.

Cheques are a type of bill of exchange and were developed as a way to make payments without the need to carry around large amounts of gold and silver. Paper money also evolved from bills of exchange, and is similar to cheques in that they were originally a written order to pay the given amount to whoever had it in their possession (the "bearer").

Technically, a cheque is a negotiable instrument instructing a financial institution to pay a specific amount of a specific currency from a specified transactional account held in the drawer's name with that institution. Both the drawer and payee may be natural persons or legal entities. Specifically, cheques are *order instruments*, and are not in general payable simply to the bearer (as bearer instruments are) but must be paid to the payee. In some countries, such as the US, the payee may endorse the cheque, allowing them to specify a third party to whom it should be paid.

Although cheques have been around since at least the 9th century, it was during the 20th century that cheques became a highly popular non-cash method for making payments and the usage of cheques peaked. By the second half of the 20th century, as cheque processing became automated, billions of cheques were issued each year; these volumes peaked in or around the early 1990s. Since then cheque usage has fallen, being partly replaced by electronic payment systems. In some countries cheques have become a marginal payment system or have been phased out completely.

Cheque Payments and Electronic Payments:

Payments must be made by electronic means or by cheque unless the Treasurer authorizes otherwise, with the exception of:

- a payment in the nature of an allowance or an advance which is payable in accordance with an industrial award and which is for a small monetary amount considered by the Head of Agency to be most appropriately paid in the form of cash; and
- the purchase of minor items from petty cash available for that purpose, subject to any conditions or procedures contained in an Agency's Accounting Manual with respect to petty cash.

  Cheques must be drawn "to order" and must be crossed and marked "not negotiable" except in the following circumstances:

- where the cheque is for the recoup of petty cash advances and special arrangements have been made with a bank for the responsible officer to cash appropriately endorsed cheques; and

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- where the payment is in the nature of a travel advance and the Head of Agency, having regard to the nature of the travel and security of the cheque, considers that the requirements may be waived

In effecting electronic payment of expenditure, agencies are required to implement appropriate internal control procedures. Agencies are encouraged to minimize the use of cheques by making as many payments as possible by electronic means through the Government's banker.

Preparation and Handling of Cheques:

i) Amounts payable on cheques must be expressed in words and figures, unless the Treasurer authorizes otherwise.

ii) Unless otherwise approved by the Treasurer, all cheques must be signed in handwriting by two officers, authorized for that purpose, by the Head of Agency.

iii) A cheque signing officer must not sign a blank, incorrect or incompletely prepared cheque.

iv) At least one of the persons who sign a cheque shall not have certified, authorized, or otherwise been involved in the preparation process for the specific payment to which that cheque relates.

v) Every alteration to a cheque must be initialed by the signing officer or officers.

vi) Every cheque requiring substantial alteration must be cancelled and a replacement cheque drawn.

vii) Every cancelled cheque must be conspicuously marked or stamped "CANCELLED" and retained for audit examination.

The cheque signing officer must ensure that:

- every payment has been certified;
- each cheque is drawn in favor of the payee shown on the payment document; and
- the amount of each cheque agrees with the amount due to the payee

The Head of Agency must be satisfied, that in cases of large computerized cheque production systems and where cheques are signed automatically, appropriate internal controls are in place to meet the above requirements

Returned and Uncollected Cheques:

An Agency must adopt procedures to record the particulars and clearance action taken for every cheque returned without explanation or which is uncollected. Where action to locate the payee of a returned or uncollected cheque is unsuccessful, the cheque must be re-banked and the amount credited to the appropriate Public Account item.

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Replacement Cheques:

A replacement cheque will be paid to a claimant where:

a) a claim received in respect of a cheque re-banked in accordance with paragraph (14) is proved to the satisfaction of the authorized officer to be valid, provided that:

   i) the details of the original cheque and the replacement cheque are appropriately recorded in a register established for the purpose; and

   ii) the amount so claimed is charged to the item to which the original payment was credited upon its return;

b) a claim is received in respect of a cheque which has apparently been lost or destroyed, provided that:

   i) a notice stopping payment of the original cheque is issued to, and acknowledged by, the bank at which the account is kept; and

   ii) the original cheque has not been paid by the bank to the credit of the original payee, up to and including the date of the bank's acknowledgment of the stop payment order.

Where a cheque, which has been reported as lost, mislaid or destroyed, has been negotiated by a person or organization other than the payee, action must be taken to recover the amount involved.

ENDORSEMENTS:

A cheque or a bill is endorsed when the transferor puts his signature on the back or on along with a cheque and a bill as a part of negotiation if the cheque is bearer it needs no endorsement.

Requirements of Valid Endorsement:

It must be on the back of the cheque or bill or on an along of them. It may be in ink, print or with stamp. Partial endorsement is not valid of the cheque or bill. Partial endorsement is not valid legally it must of the entire value of the cheque or bill. If the number of payees are more than one, then all the payees will sign or that person who is authorized.

The endorsement can also add the proper signatures, if the endorse is misprint. If the payees are more than two, the endorsement should be in the same order which is penned down on the back of the bill.

Classifications of Endorsement:

If the endorsement makes the payment of a bill subjects to the fulfillment of a condition the endorsement is called the conditional. If the endorsement sign, but does not give his name to whom he wishes to transfer the cheque is called blank endorsement.

An endorsement which specifies the name of the transferee for the payment of the bill is called special endorsement. An endorsement which restricts the further negotiation of the bill is called restrictive endorsement.

BILL OF LADING

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A **bill of lading** (**BL** - sometimes referred to as **BOL** or **B/L**) is a document issued by a carrier to a shipper, acknowledging that specified goods have been received on board as cargo for conveyance to a named place for delivery to the consignee who is usually identified. A *through* bill of lading involves the use of at least two different modes of transport from road, rail, air, and sea. The term derives from the verb "to lade" which means to load a cargo onto a ship or other form of transportation.

A bill of lading can be used as a traded object. The standard short form bill of lading is evidence of the contract of carriage of goods and it serves a number of purposes:

- It is evidence that a valid contract of carriage, or a chartering contract, exists, and it may incorporate the full terms of the contract between the consignor and the carrier by reference (i.e. the short form simply refers to the main contract as an existing document, whereas the long form of a bill of lading (*connaissement intégral*) issued by the carrier sets out all the terms of the contract of carriage);
- It is a receipt signed by the carrier confirming whether goods matching the contract description have been received in good condition (a bill will be described as *clean* if the goods have been received on board in apparent good condition and stowed ready for transport); and
- It is also a document of transfer, being freely transferable but not a negotiable instrument in the legal sense, i.e. it governs all the legal aspects of physical carriage, and, like a cheque or other negotiable instrument, it may be endorsed affecting ownership of the goods actually being carried. This matches everyday experience in that the contract a person might make with a commercial carrier like FedEx for mostly airway parcels, is separate from any contract for the sale of the goods to be carried; however, it binds the carrier to its terms, irrespectively of who the actual holder of the B/L, and owner of the goods, may be at a specific moment.

The BL must contain the following information:

- Name of the shipping company;
- Flag of nationality;
- Shipper's name;
- Order and notify party;
- Description of goods;
- Gross/net/tare weight; and
- Freight rate/measurements and weighment of goods/total freight

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While an air waybill (AWB) must have the name and address of the consignee, a BL may be consigned to the order of the shipper. Where the word order appears in the consignee box, the shipper may endorse it in blank or to a named transferee. A BL endorsed in blank is transferable by delivery. Once the goods arrive at the destination they will be released to the bearer or the endorsee of the original bill of lading. The carrier's duty is to deliver goods to the first person who presents any one of the original BL. The carrier need not require all originals to be submitted before delivery. It is therefore essential that the exporter retains control over the full set of the originals until payment is effected or a bill of exchange is accepted or some other assurance for payment has been made to him. In general, the importer's name is not shown as consignee. The bill of lading has also provision for incorporating notify party. This is the person whom the shipping company will notify on arrival of the goods at destination. The BL also contains other details such as the name of the carrying vessel and its flag of nationality, the marks and numbers on the packages in which the goods are packed, a brief description of the goods, the number of packages, their weight and measurement, whether freight costs have been paid or whether payment of freight is due on arrival at the destination. The particulars of the container in which goods are stuffed are also mentioned in case of containerized cargo. The document is dated and signed by the carrier or its agent. The date of the BL is deemed to be the date of shipment. If the date on which the goods are loaded on board is different from the date of the bill of lading then the actual date of loading on board will be evidenced by a notation the BL. In certain cases a carrier may issue a separate on board certificate to the shipper.

MAIN TYPES OF BILL

Straight bill of lading:

In this importer/consignee/agent is named in the bill of lading, it is called straight bill of lading. It is a document, in which a seller agrees to use a certain transportation to ship a good to a certain location, where the bill assigned to a certain party. It details to the quality and quantity of goods.

Order bill of lading:

This bill uses express words to make the bill negotiable, e.g. it states that delivery is to be made to the further order of the consignee using words such as "delivery to A Ltd. or to order or assigns". Consequently, it can be indorsed (legal spelling of endorse, maintained in all statute, including Bills of Exchange Act 1909 (CTH)) by A Ltd. or the right to take delivery can be transferred by physical delivery of the bill accompanied by adequate evidence of A Ltd.'s intention to transfer.

Bearer bill of lading:

This bill states that delivery shall be made to whosoever holds the bill. Such bill may be created explicitly or it is an order bill that fails to nominate the consignee whether in its original form or through an endorsement in blank. A bearer bill can be negotiated by physical delivery.

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Surrender bill of lading:

Under a term import **documentary credit** the bank releases the documents on receipt from the negotiating bank but the importer does not pay the bank until the maturity of the draft under the relative credit. This direct liability is called Surrender Bill of Lading (SBL), i.e. when we hand over the bill of lading we surrender title to the goods and our power of sale over the goods.

A clean bill of lading states that the cargo has been loaded on board the ship in apparent good order and condition. Such a BL will not bear a clause or notation which expressively declares a defective condition of goods and/or the packaging. Thus, a BL that reflects the fact, carrier received the goods in good condition. The opposite term is a soiled bill of lading, which reflects that the goods are received by the carrier in anything but good condition.

"Document of Title to Goods" includes bill of lading dock-warrant, warehouse keeper's certificate, wharfingers' certificate, railway receipt, 4[multimodal transport document,] warrant or order for the delivery of goods and any other document used in the ordinary course of business as proof of the possession or control of goods or authorizing or purporting to authorize, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented;

GOVERNMENT SECURITIES:

Government Securities are securities issued by the Government for raising a public loan or as notified in the official Gazette. They consist of Government Promissory Notes, Bearer Bonds, Stocks or Bonds held in Bond Ledger Account. They may be in the form of Treasury Bills or Dated Government Securities.

Government Securities are mostly interest bearing dated securities issued by RBI on behalf of the Government of India. GOI uses these funds to meet its expenditure commitments. These securities are generally fixed maturity and fixed coupon securities carrying semi-annual coupon. Since the date of maturity is specified in the securities, these are known as dated Government Securities, e.g. 8.24% GOI 2018 is a Central Government Security maturing in 2018, which carries a coupon of 8.24% payable half yearly.

Features of Government Securities

1. Issued at face value
2. No default risk as the securities carry sovereign guarantee.
3. Ample liquidity as the investor can sell the security in the secondary market
4. Interest payment on a half yearly basis on face value
5. No tax deducted at source
6. Can be held in D-mat form.
7. Rate of interest and tenor of the security is fixed at the time of issuance and is not subject to change (unless intrinsic to the security like FRBs).

Check Your Progress:

1. What is investment banking?
2. Define process.

8. Redeemed at face value on maturity
9. Maturity ranges from of 2-30 years.
10. Securities qualify as SLR investments (unless otherwise stated).

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The dated Government securities market in India has two segments:

1. **Primary Market**: The Primary Market consists of the issuers of the securities, viz., Central and Sate Government and buyers include Commercial Banks, Primary Dealers, Financial Institutions, Insurance Companies & Co-operative Banks. RBI also has a scheme of non-competitive bidding for small investors (see SBI DFHI Invest on our website for further details).
2. **Secondary Market**: The Secondary Market includes Commercial banks, Financial Institutions, Insurance Companies, Provident Funds, Trusts, Mutual Funds, Primary Dealers and Reserve Bank of India. Even Corporate and Individuals can invest in Government Securities. The eligibility criteria are specified in the relative Government notification.

EXCHANGE TRADED FUND

An **exchange-traded fund** (ETF) is an investment fund traded on stock exchanges, much like stocks. An ETF holds assets such as stocks, commodities, or bonds, and trades close to its net asset value over the course of the trading day. Most ETFs track an index, such as the S&P 500 or MSCI EAFE. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features. ETFs are the most popular type of exchange-traded product.

Only so-called *authorized participants* (typically, large institutional investors) actually buy or sell shares of an ETF directly from or to the fund manager, and then only in *creation units*, large blocks of tens of thousands of ETF shares, which are usually exchanged in-kind with *baskets* of the underlying securities. Authorized participants may wish to invest in the ETF shares for the long-term, but usually act as market makers on the open market, using their ability to exchange creation units with their underlying securities to provide liquidity of the ETF shares and help ensure that their intraday market price approximates to the net asset value of the underlying assets. Other investors, such as individuals using a retail broker, trade ETF shares on this secondary market.

An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. Closed-end funds are not considered to be "ETFs", even though they are funds and are traded on an exchange. ETFs have been available in the US since 1993 and in Europe since 1999. ETFs traditionally have been index funds, but in 2008 the Securities and Exchange Commission began to authorize the creation of actively managed ETFs.

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STRUCTURE OF ETF'S

ETFs offer public investors an undivided interest in a pool of securities and other assets and thus are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on a securities exchange through a broker-dealer. Unlike traditional mutual funds, ETFs do not sell or redeem their individual shares at net asset value, or NAV. Instead, financial institutions purchase and redeem ETF shares directly from the ETF, but only in large blocks, varying in size by ETF from 25,000 to 200,000 shares, called "creation units". Purchases and redemptions of the creation units generally are in kind, with the institutional investor contributing or receiving a basket of securities of the same type and proportion held by the ETF, although some ETFs may require or permit a purchasing or redeeming shareholder to substitute cash for some or all of the securities in the basket of assets.

The ability to purchase and redeem creation units gives ETFs an arbitrage mechanism intended to minimize the potential deviation between the market price and the net asset value of ETF shares. Existing ETFs have transparent portfolios, so institutional investors will know exactly what portfolio assets they must assemble if they wish to purchase a creation unit, and the exchange disseminates the updated net asset value of the shares throughout the trading day, typically at 15-second intervals.

If there is strong investor demand for an ETF, its share price will (temporarily) rise above its net asset value per share, giving arbitrageurs an incentive to purchase additional creation units from the ETF and sell the component ETF shares in the open market. The additional supply of ETF shares reduces the market price per share, generally eliminating the premium over net asset value. A similar process applies when there is weak demand for an ETF and its shares trade at a discount from net asset value.

In developed countries, most ETFs are structured as open-end management investment companies (the same structure used by mutual funds and money market funds), although a few ETFs, including some of the largest ones, are structured as unit investment trusts. ETFs structured as open-end funds have greater flexibility in constructing a portfolio and are not prohibited from participating insecurities lending programs or from using futures and options in achieving their investment objectives.

Under existing regulations, a new ETF must receive an order from the Securities and Exchange Commission, or SEC, giving it relief from provisions of the Investment Company Act of 1940 that would not otherwise allow the ETF structure. In 2008, however, the SEC proposed rules that would allow the creation of ETFs without the need for exemptive orders. Under the SEC proposal, an ETF would be defined as a registered open-end management investment company that:

- Issues (or redeems) creation units in exchange for the deposit (or delivery) of basket assets the current value of which is disseminated per share by a national securities exchange at regular intervals during the trading day;
- Identifies itself as an ETF in any sales literature;

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- Issues shares that are approved for listing and trading on a securities exchange;
- Discloses each business day on its publicly available web site the prior business day's net asset value and closing market price of the fund's shares, and the premium or discount of the closing market price against the net asset value of the fund's shares as a percentage of net asset value; and
- Either is an index fund, or discloses each business day on its publicly available web site the identities and weighting of the component securities and other assets held by the fund.

The SEC rule proposal would allow ETFs either to be index funds or to be fully transparent actively managed funds. Historically, all ETFs have been index funds. In 2008, however, the SEC began issuing exemptive orders to fully transparent actively managed ETFs. The first such order was to Power Shares Actively Managed Exchange-Traded Fund Trust, and the first actively managed ETF was the Bear Stearns Current Yield Fund, a short-term income fund that began trading on the American Stock Exchange under the symbol YYY on 25 March 2008. The SEC rule proposal indicates that the SEC may still consider future applications for exemptive orders for actively managed ETFs that do not satisfy the proposed rule's transparency requirements.

Some ETFs invest primarily in commodities or commodity-based instruments, such as crude oil and precious metals. Although these commodity ETFs are similar in practice to ETFs that invest in securities, they are not "investment companies" under the Investment Company Act of 1940.

Publicly traded grantor trusts, such as Merrill Lynch's HOLDRs securities, are sometimes considered to be ETFs, although they lack many of the characteristics of other ETFs. Investors in a grantor trust have a direct interest in the underlying basket of securities, which does not change except to reflect corporate actions such as stock splits and mergers. Funds of this type are not "investment companies" under the Investment Company Act of 1940.

As of 2009, there were approximately 1,500 exchange-traded funds traded on US exchanges. This count uses the wider definition of ETF, including HOLDRs and closed-end funds.

Investment Uses

ETFs generally provide the easy diversification, low expense ratios, and tax efficiency of index funds, while still maintaining all the features of ordinary stock, such as limit orders, short selling, and options. Because ETFs can be economically acquired, held, and disposed of, some investors invest in ETF shares as a long-term investment for asset allocation purposes, while other investors trade ETF shares frequently to implement market timing investment strategies. Among the advantages of ETFs are the following:

- Lower costs – ETFs generally have lower costs than other investment products because most ETFs are not actively managed and because ETFs are insulated from the costs of having to buy and sell securities to accommodate shareholder

purchases and redemptions. ETFs typically have lower marketing, distribution and accounting expenses, and most ETFs do not have 12b-1 fees.

- Buying and selling flexibility – ETFs can be bought and sold at current market prices at any time during the trading day, unlike mutual funds and unit investment trusts, which can only be traded at the end of the trading day. As publicly traded securities, their shares can be purchased on margin and sold short, enabling the use of hedging strategies, and traded using stop orders and limit orders, which allow investors to specify the price points at which they are willing to trade.

- Tax efficiency – ETFs generally generate relatively low capital gains, because they typically have low turnover of their portfolio securities. While this is an advantage they share with other index funds, their tax efficiency is further enhanced because they do not have to sell securities to meet investor redemptions.

- Market exposure and diversification – ETFs provide an economical way to rebalance portfolio allocations and to "equitize" cash by investing it quickly. An index ETF inherently provides diversification across an entire index. ETFs offer exposure to a diverse variety of markets, including broad-based indices, broad-based international and country-specific indices, industry sector-specific indices, bond indices, and commodities.

Transparency – ETFs, whether index funds or actively managed, have transparent portfolios and are priced at frequent intervals throughout the trading day.

BANKING ARTICLE (CASE)

1. How to transfer

The online options include e-transfers and power transfers (a Web-based wire transfer that eliminates errors associated with a normal wire transfer), while the most common offline modes are cheques and bank drafts. While there is no single option that can be considered best, you should opt for a reputed player with established systems in place so that you can be assured of a safe transfer.

While opting for offline options, be sure to ask your bank to list its correspondent banks. This becomes especially important if you are remitting money from abroad. Take a look at the foreign banks your financial institution has partnered with to make the money transfer smooth. For instance, Federal Bank has tied up with the Arab National Bank of Saudi Arabia and Doha Bank of Qatar. In addition, several Private Exchange Houses (PEHs) have come up in the Gulf region to facilitate remittances to India, and several Indian banks have signed up rupee drawing arrangements with them.

On the other hand, when it comes to sending money abroad, not all online options fit the bill due to RBI guidelines. For instance, the Money Transfer Service Scheme (MTSS) is limited to inward personal remittances (to India).

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2. **Speed of disbursement**

If you are in a hurry to transfer money, your only viable option is an online one, such as wire transfer and the National Electronic Funds Transfer (NEFT) system. This typically takes 24-96 hours, but can also take place in real time. For instance, you can instantly move money through 'direct transfer to bank accounts'. This is operated through an arrangement with overseas correspondent banks or via the automated clearing house facility in countries such as the US.

Of course, the offline options take time. If a cheque is issued in a foreign currency, there can be a delay of 7-15 days before the holder can encash it as the bank needs to verify the deposit. Remittances made through money orders can take from three to 30 days, while transfers made through debit/ credit cards are quicker, taking 1-4 days. Keep in mind that most banks and financial institutions do not remit money on public holidays.

3. **Coverage offered**

Not all money transfer options are available at every location. While you can avail of the offline route at all bank branches, the online ones are mostly limited to urban areas. If you are remitting money from abroad, you will also have to check if the currency you want to transfer is covered by the bank; the US dollar, euro and pound sterling are generally remitted by all banks. However, remember that not all banks allow you to route money through foreign currency cheques. A handy option for non-resident Indians is the Foreign Currency (Non-Resident) Account (Banks) Scheme. The currency in which the account is denominated covers all freely convertible foreign currencies like the Australian dollar, Bahrain dinar, deutsche mark, euros, HK dollar, Japanese yen, Kuwaiti dinar, pounds sterling and the US dollar. This can be held jointly with relatives in India.

4. **Cost of service**

Before you choose a mode of transfer, consider the damage to your wallet. It's an accepted fact that there is an inverse relationship between the speed of transfer and the associated cost. According to an RBI survey, SWIFT (an international wire transfer system) is costlier vis-a-vis drafts and cheques. While the cost of sending up to $500 from the US to India through SWIFT is less than 1-5% of the funds transferred, the comparative rates for demand drafts/cheques is just 2% of the remitted amount. Money transfer services like Western Union charge a higher commission, nearly 25-30% more than banks.

This is because they offer more specialised services—neither the sender nor receiver needs to own a bank account, for one—and have a better reach. However, they don't generally offer a competitive exchange rate, so rate shopping is a must before picking any option. Also check for hidden charges such as service tax.

5. **Convenience**

It's not just the speed and cost, but also convenience of transfer for both you and the recipient, that matter. If either party is not comfortable using the Internet option, an offline route would be better. Another factor is the amount to be transferred. While there is no ceiling on demand drafts (cash purchases are not permitted for over Rs 50,000), a cap of Rs 5 lakh has been imposed by some banks on NEFT transactions, and $2,500 (Rs 1.35 lakh) is the maximum limit under the MTSS scheme. Also make sure you ask the service provider about its refund policy and your rights in case the money is not received within the specified period.

CHAPTER SUMMARY

The professional management of assets, such as real estate, and securities, such as equities, bond and other debt instruments, is called **investment management**. Investment management services are sought by investors, which could be companies, banks, insurance firms or individuals, with the purpose of meeting stated financial goals.

Every individual practices investment management to some degree, including budgeting, saving, investing and spending. However, an investment manager is one who specializes in placing money in diverse instruments in order to accomplish predetermined goals. Investment managers are also widely known as fund managers. Investment managers may specialize in advisory or discretionary management. When an investment manager merely offers suggestions regarding where to invest money and when to sell securities, the practice is known as advisory investment management. When an investment manager can take action in managing portfolios without requiring client approval, it is called "discretionary" investment management.

Investment management is often used synonymously with fund management. Moreover, terms like asset management, wealth management and portfolio management are used, with a thin line differentiating them. Asset management is often used for the management of collective investments, which refers to investing money on behalf of a large group of clients in a wide range of investment options. An example of this is mutual funds. Investment management that involves managing the investments of high net worth individuals is often referred to as wealth management. Asset management and wealth management are also called portfolio management.

An investment bank is a financial institution that assists individuals, corporations and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank may also assist companies involved in mergers and acquisitions, and provide ancillary services such as market making, trading of derivatives, income instruments, foreign exchange, commodities, and equity securities.

Investment banking is split into front office, middle office, and back office activities. While large service investment banks offer all lines of business, both sell side and buy side, smaller sell side investment firms such as boutique investment banks and

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small broker-dealers focus on investment banking and sales/trading/research, respectively.

Investment banks offer services to both corporations issuing securities and investors buying securities. For corporations, investment bankers offer information on when and how to place their securities on the open market, an activity very important to an investment bank's reputation. Therefore, investment bankers play a very important role in issuing new security offerings.

Investment banking is a financial intermediary that performs a variety of services. This includes underwriting, acting as an intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and also acting as a broker for institutional clients.

ANSWERS TO CHECK YOUR PROGRESS

1. **Investment management** is the professional management of various securities (shares, bonds and other securities) and assets (e.g., real) in order to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations, charities, educational establishments etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes e.g. mutual funds or exchange-traded funds).

2. Process refers to the way in which the overall philosophy is implemented

TEST YOURSELF:

1) What do you mean by Investment Management?
2) Explain the Investment Policy of Banks.
3) What is the mechanism of preparing cheques?
4) Explain Cheque Payments and Electronic Payments.
5) What is Endorsements?
6) What do you mean by Bill of Lading?
7) Write a short note on Government Securities.

4 Banking Regulation ACT, 1949

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The Unit Include:

- Part I - Preliminary
- Minimum capital
- Nomination
- Cooperative banks:
- Explanation:
- Summary
- Test yourself

Learning Objectives:

After going through this chapter, you should be able to:

- **Define Banking Regulation Act.**
- **Describe various regulations**
- **Discuss issues and concerns involved.**
- **Understand remittances on debts.**

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PART I
PRELIMINARY

1. Short title, extent and commencement.—

- This Act may be called the Banking Regulation Act, 1949.
- It extends to the whole of India.
- It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint in this behalf.

2. Application of other laws riot barred

The provisions of this Act shall be in addition to, and not, save as hereinafter expressly provided, in derogation of the [Companies Act, 1956 (1 of 1956)] and any other law for the time being in force.

Banking Regulation Act Applicable to Banking Companies to Public Sector Banks:

Forms of business in which banking companies may engage —

1) In addition to the business of banking, banking company may engage in any one or more of the following forms of business, namely

a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, *hundis* promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scripts and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveler's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling, of foreign exchange including foreign bank notes; the acquiring holding, issuing on commission, underwriting and dealing in stock, funds, shares debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities;

b) acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a [managing agent or secretary and treasurer] of a company;

c) contracting for public and private loans and negotiating and issuing the same;

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d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

e) carrying on and transacting every kind of guarantee and indemnity business;

f) managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

g) acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

h) undertaking and executing trusts;

i) undertaking the administration of estates as executor, trustee or otherwise;

j) establishing and supporting or aiding in the establishment and support of association., institutions, funds, trusts and conveniences calculated to benefit employees or ex employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

k) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

l) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

m) acquiring and undertaking the whole or any part of the business of any person or company, when such business is of nature enumerated or described in this sub section;

n) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

o) any other forms of business which the Central Government may by notification in the Official Gazette specify as a form of business in which it is lawful for a banking company to engage.

2) No banking company shall engage in any form of business other than those referred to in sub section (1).

Objectives of the Banking Regulation Act broadly are:

1. To safeguard the interest of depositors;

2. To develop banking institutions on sound lines; and

3. To attune the monetary and credit system to the larger interests and priorities of the nation.

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The Act was originally in force from 16 March 1949 as the Banking Companies Act, 1949. It was amended and renamed as Banking Regulation Act, 1949 and extended to the cooperative banks from 1 March 1966 as the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies) [B R Act, 1949 (AACS)].

Some Definitions according to BR Act 1949

A cooperative bank is

1. a State Cooperative Bank,
2. a Central Cooperative Bank or
3. a Primary Cooperative Bank

Section 5 (cci)

A Primary Cooperative Bank is:

1. a Cooperative Society (other than a Primary Agricultural Cooperative Society);
2. primarily in banking business;
3. with capital and reserves of not less than Rs.1 lakh; &
4. whose byelaws do not permit admission of any other society as a member. Section 5 (ccv)

Banking is:

1. the accepting,
2. for the purpose of lending or investment,
3. of deposits of money
4. from the public
5. repayable on demand or otherwise and
6. Withdrawable by cheque, draft, order or otherwise.

Section 5 (b)

A cooperative society which accepts deposits from the public i.e., members and non-members and utilizes these for lending will be deemed to be transacting banking business.

Secured Loan is:

- a loan made on the security of assets, the market value of which is not at any time less than the amount of such loan.

BUSINESS

The businesses a bank may carry on are summarized into three categories:

1. Main business i.e., Banking i.e., borrowing, taking or lending money, dealing in Bills of Exchange, Bills of lending and Debentures, issuing letters of credit, buying/selling foreign exchange, acquiring or underwriting stocks.
2. Allied business: Acting as agent/trustee/administrator, carrying on guarantee business, providing safe custody.
3. Dealing in property is restricted to (i) property coming in satisfaction of claims or as security and (ii) property necessary for its own sake. Section 6

A bank is prohibited from doing any business other than those mentioned in Section 6. Section 8 specifically prohibits a bank from engaging in trading. However, banks, as agents, have supplied registers, articles or have financed hire purchase. What is important is that the purchases should be carried out purely on indent basis; bank must have no ownership of the article and it should not involve bank's own funds.

Immovable property, howsoever acquired, shall, except such as is required for its own use, be disposed of within 7 years. Reserve Bank of India (RBI) may extend the period if it is in the interest of the depositors. Section 9

MINIMUM CAPITAL

The value of paid up capital and reserves should not be less than Rs.1 lakh. Value is the real value or exchangeable value and decision of RBI on valuation is final. Section 11

Section 14 and 14A prohibit creation of floating charge on unpaid capital or any property of the bank unless RBI certifies that it is not detrimental to the depositors' interest. A floating charge attaches assets in conditions varying from time to time until the charge crystallizes, when it will be a specific charge. The above Sections ensure that future assets are not earmarked to preferred creditors, but are available to all.

Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

i) Section 18, every non-scheduled urban cooperative bank (UCB) has to maintain, on daily basis, by way of cash reserve, an amount not less than 3% of the total of its Demand and Time Liabilities (DTL) as obtaining on the last Friday of the second preceding fortnight. It can maintain the balance in the form of cash resources with itself or in current account with RBI or State Bank of India (SBI) or concerned State Cooperative Bank (SCB) / District Central Cooperative Bank (DCCB) or by way of net balance with any other bank notified by the Govt. of India [presently all Public Sector Banks (PSBs)]. It has to submit a return (in Form I) every month to the concerned Regional Office (RO) of the Urban Banks Department (UBD) of RBI showing the position of cash reserve so maintained and its DTL at the close of alternate Fridays during the preceding month. Banks have to submit the return within 20 days from the month to which it relates. Balance in

current account with SBI and PSBs is net balance i.e. after setting off the balance held by that bank in current account with the cooperative bank. Netting of assets and liabilities is applicable also to the dealings with the Discount and Finance House of India (DFHI).

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ii) Section 24, Every UCB (scheduled and non-scheduled) has to also maintain, on daily basis, liquid assets, amounting to not less than 25% (or such other percentage not exceeding 40% as the RBI may specify) of the total of its DTL as on the last Friday of the second preceding fortnight. The liquid assets have to be maintained in the form of cash or gold or unencumbered *approved securities*. UCBs have to submit to the concerned RO of UBD, RBI every month a return (in Form I) showing the position of liquid assets so maintained. Banks have to submit the return within 20 days from the month to which it relates.

A fortnight means the period from Saturday to the second following Friday, both days inclusive. The CRR and SLR to be maintained by a UCB for the fortnight from January 20, 2007 to February 2, 2007 is required to be based on the amount of its DTL as on January 5, 2007.

For the purpose of Section 18 and Section 24, DTL will not include:

- Paid up capital and reserves;
- Provisions not involving payment to outside parties, for example, those for bad debts, depreciation;
- Advances from State Govt., RBI, SCB, DCCB, etc;
- Balance maintained with the bank to the extent of the outstanding advance granted against it;
- Bank's borrowings against approved securities.

Approved securities are securities in which a registered Trust may invest money under Section 20 of the Indian Trust Act 1982 and such other securities authorized by the Central Government under Section 20 of the act ibid. However, not all securities under Section 20 of the Indian Trust Act, 1982 will qualify as approved securities for the purpose of Section 24 of the B R Act, 1949 (AACS). RBI has to specify such securities as approved securities for the purpose of Section 24 ibid.

RBI has prescribed, for the purpose of valuation for SLR purpose, the same guidelines as applicable for classification and valuation of UCBs' investment portfolio.

Shares in other cooperative societies

No cooperative bank shall hold shares in any other cooperative society except as RBI may approve. The provision does not apply to the shares acquired through Govt. funds or shares of the concerned DCCB and SCB. Section 19

RBI has given general approval vide its circular No.ACD.BR.388/A(II)19/ 65-66 dated March 1, 1966 that a UCB may invest in shares of cooperatives if:

i) the total of such investment does not exceed 2% of its owned funds and

ii) it does not cause holding of all the cooperatives to exceed 5% of the subscribed capital of the receiving institution.

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Restriction on loans and advances

No cooperative bank shall:

a) make loans on the security of its own shares;

b) Grant unsecured loans to any Director or to firms / individuals / companies in which a Director is interested or is a guarantor. Section 20

The term "Director" includes, near relatives of the Director.

The restrictions do not apply to loans against Govt. supply bills, bona fide commercial bills and trust receipts or to advances granted with RBI approval.

Rule 5 provides that a monthly return be submitted to RBI in form II.

Restriction on remitting debts

A cooperative bank shall not, except with RBI's approval, remit debts due by Directors, past or present, or by others in whom/in which a Director is interested or is a guarantor.

Section 20A

RBI's power to control advances

RBI, in the public interest or in the interest of depositors, may determine policy in relation to advances of banks, or a bank in particular, and all banks or the concerned bank shall be bound to follow the policy.

RBI may also give directions to:

a) purpose;

b) margin;

c) maximum amount;

d) rate of interest; and

e) Other terms and conditions on which advances or other financial accommodation may be given.

Section 21

The RBI has been issuing directives for controlling the advances against sensitive commodities, such as food grains, sugar and gur, to avoid hoarding of essential commodities. In addition to these powers regarding advances, RBI can issue directions under Section 35A regarding all aspects of functions of UCBs.

Licensing

No UCB shall carry on banking business unless it holds a license issued by RBI. Before granting a license, RBI needs to be satisfied, by an inspection or otherwise, that the following conditions are fulfilled:

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a) that the bank will be in a position to pay its present or future depositors;

b) that the affairs of the bank are not being conducted in a manner detrimental to the interest of depositors;

c) that the general character of the proposed management will not be prejudicial to the public interest or the interest of its depositors

d) that the Bank has adequate capital structure and earning prospects,

e) that the public interest will be served.

The RBI may cancel a license if the bank fails to comply / fulfill any of the conditions referred to above. A bank aggrieved by the decision of RBI may, within 30 days, appeal to the Central Govt. whose decision will be final. Section 22

Opening of new offices

No bank shall open new place of business or change the location of existing place of business without obtaining prior permission of RBI. Before granting permission, RBI may need to be satisfied by an inspection under Section 35 or otherwise as to:

i) financial condition and history of the bank;

ii) general character of its management;

iii) adequacy of its capital structure;

iv) earning prospects; and

v) that public interest would be served. Section 23

The restriction does not apply to the opening of a temporary place of business in the same city or village for a period not exceeding one month on special occasions like exhibition or mela.

Every UCB is required to submit to RBI a quarterly return showing Offices opened and closed in Form – VI.

Returns

Every UCB shall, before the close of succeeding month, submit to RBI a return showing assets and liabilities in India as at the close of business on the last Friday of every month in Form IX.

RBI may direct a bank to furnish it with such statement and information relating to the business and affairs of the bank as may be considered necessary.

Section 27

Accounts and Balance sheet

Every UCB shall prepare Balance Sheet (BS) and Profit & Loss (P & L) Account as on the last working day of the year in the prescribed form. The Principal Officer and three Directors should sign the BS and P & L Account. The accounts and BS, together with auditor's report, should be published in a local newspaper and three copies thereof submitted to RBI within six months from the end of the year.

Section 29 & 31

Banks with deposits of less than Rs.20 lakhs may only display the accounts in every office of the bank instead of publishing in newspaper.

Inspection

RBI may on its own, and on a direction from the Govt. of India, inspect, through its officers, any UCB and its books and accounts. RBI shall supply to the bank a copy of its report.

It shall be the duty of every Director, officer or employee of the UCB to produce to any officer making inspection all such books, accounts and other documents in his custody or power and to furnish to him any statement and information relating to the Bank within such time as the said Officer may specify. Section 35

RBI directions

RBI may

1. in the public interest;
2. in the interest of banking policy; or
3. to prevent affairs detrimental to the interest of depositors; or
4. to secure proper management of the business of the bank issue directions and an UCB shall be bound to comply.

Section 35A

Further powers of RBI

RBI may

1. caution or prohibit a bank against any transaction;
2. give assistance of loan;
3. In order to ensure reorganization or expansion of cooperative credit on sound lines
   a) Depute its officers to watch the proceedings of the Board meeting and the officers shall be heard.
   b) Appoint one or more of its officers to observe the manner in which affairs of the UCB or its branches are being conducted.

Section 36

Suspension of Business:

RBI may apply to the Central Government for issuing an Order of moratorium in respect of any UCB, where it feels that there is a good reason to do so. Section 45

NOMINATION

1. Section 45ZA, Where a deposit is held by an UCB, all the depositor/s together may nominate, in the prescribed manner, one person to whom (in case of minor, to whose guardian), the amount may be returned by the bank, in the event of death of the sole depositor or the death of all the depositors. Payment by the bank in accordance with this provision shall constitute a full discharge to the UCB of its liability.

   In the case of a joint deposit account, the nominee's right arises only after the death of all the depositors.

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2. Section 45ZC, any person leaving any article in Safe Custody may nominate, in the prescribed manner, one person to whom, in the event of death, the article may be returned. The UCB shall, before returning any article under this Section to the Nominee (to the guardian, if the nominee is a minor) prepares (as laid down by RBI) an inventory of the said articles which shall be signed by such nominee (or guardian).

   Nomination facilities in respect of Safe Custody articles are available only in case of the sole depositors.

3. Section 45ZE,

   i) An individual who is a sole hirer of a locker may nominate one person.

   ii) Where such locker is hired by two or more individuals jointly and the locker is to be operated jointly by two or more hirers, such hirers may nominate one or more persons to whom, in the event of the death of such joint hirer or joint heirs, the UCB may give, jointly with the surviving joint hirer or joint hirers, access to the locker. The bank, before permitting the removal of contents of any locker shall prepare (as laid down by RBI) an inventory of the contents of the locker, which shall be signed jointly by the nominee and the survivor/s. On the removal of the contents of any locker jointly by the nominee and the survivor/s, the liability of the Bank in relation to the contents of the locker shall stand discharged.

Nomination facility is intended only for individuals, and hence, is not available for sole proprietorship concerns, officials etc. Nominee should also be an individual. The Cooperative Bank (Nomination) Rules 1985 have been framed and the form prescribed.

Penalties:

Section 46 provides for penalties in case of:

1. False statement/data furnished in any return, balance sheet etc., or for the purpose of any provisions of this Act (3 years imprisonment and fine).
2. Failure to produce books of accounts, documents etc. for inspection. (A fine up to Rs.2, 000 for each failure + Rs.100 for every day the failure continues).
3. Deposits received in contravention of Sec. 35(4) (A fine up to twice the amount of deposit received).
4. Contravention or non-compliance with the provisions of the Act, Rule, order or direction made under the Act. (A fine up to Rs.50, 000@ for each failure or twice the amount involved in such contravention or default + Rs.2500/-@ for every day the failure continues).

COOPERATIVE BANKS:

1) The provisions of the Banking Regulation Act (as applicable to cooperative societies) shall apply to a cooperative bank registered under this Act.
2) No cooperative society other than a cooperative bank shall use as part of its name the words 'bank', 'banker' or 'banking'.

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3) No cooperative society other than a cooperative bank shall accept deposits from any person other than its members or accept deposits withdrawable by cheque.

4) No cooperative bank shall change its name ,open a new place of business or change its existing place of business outside the city ,town or village where it is located without the prior approval of the Reserve Bank

5) Every cooperative bank shall have at least 3 of its directors who have special knowledge or experience in the field of accountancy, law, banking, management, agriculture or rural economy.

6) The Chief Executive Officer, by whatever name called, of a cooperative bank shall have such qualifications as may be specified by Reserve Bank .

7) Every cooperative bank shall have its account audited by a qualified chartered accountant in each financial year, subject to such directions as the Reserve Bank may issue from time to time.

8) Every cooperative bank shall abide by the directions, guidelines and prudential norms issued by the Reserve Bank from time to time in respect of acceptance of deposits, borrowing, lending, investment or any other financial matters.

9) No cooperative bank shall be given exemption from the provisions of this chapter by the State Government in exercise of its powers to exempt societies from the provision of the Act without the prior approval of the Reserve Bank.

10) a) The Reserve Bank may in the public interest or for preventing the affairs of the cooperative bank being conducted in a manner detrimental to the interests of the depositors or for securing the proper management of the bank ,order the supersession of the board and appointment of an Administrator therefore for such period or periods not exceeding five years in the aggregate as may from time to time be specified by the Reserve Bank, and the Administrator so appointed shall continue in office after the expiry of his term of office until the day immediately preceding the date of the first meeting of the new committee;

b) No order for supersession of the board of a cooperative bank shall be made by the Registrar without the prior approval in writing of the Reserve Bank ;

c) An order of supersession of the board and appointment of Administrator therefore made by the Reserve Bank shall not be liable to be called in question in any manner.

EXPLANATION:

"Cooperative bank" means a cooperative bank as defined in section 5 (cci) of the Banking Regulation Act, 1949 (as applicable to the cooperative societies).

Banking Article (Case)

Targetting young individuals, public sector Indian Overseas Bank today launched 'Connect Card', a new ATMcum Debit card in association with VISA that can be used for e-commerce across five lakh merchant outlets.

Check Your Progress:

1. When Banking Regulation Act came into?
2. Define Cooperative bank.

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Though all IOB customers have been provided ATM cum Debit card, Connect Card is targeted at the younger generation aged between 10 and 28 years, the city-based bank said in a statement.

IOB Connect cards can be used at over five lakh outlets as well as for online shopping. Encouraging e-payments, the bank offers five per cent cash back offer till the end of this financial year, it said.

Besides, the bank also launched Channel Financing for its corporate, institutional and SME credit customers.

"IOB Channel Financing is a facility for financing supply chain partners. All activities under Channel Financing are digitally signed and electronically exchanged for speedy disposal and effective management," it added.

SUMMARY

Banking means accepting for the purpose of lending or investment of deposits of money from public repayable on demand or otherwise and withdrawable by cheque, drafts order or otherwise (5 (i) (b)).

- Banking company means any company which transacts the business of banking (5(i)(c)
- Transact banking business in India (5 (i) (e).
- Demand liabilities are the liabilities which must be met on demand and time liabilities means liabilities which are not demand liabilities (5(i)(f)
- Secured loan or advances means a loan or advance made on the security of asset the market value of which is not at any time less than the amount of such loan or advances and unsecured loan or advances means a loan or advance not secured (5(i)(h).
- Defines business a banking company may be engaged in like borrowing, lockers, letter of credit, traveller cheques, mortgages etc (6(1).
- States that no company shall engage in any form of business other than those referred in Section 6(1) (6(2).

ANSWERS TO CHECK YOUR PROGRESS

1. 1949
2. "Cooperative bank" means a cooperative bank as defined in section 5 (cci) of the Banking Regulation Act, 1949 (as applicable to the cooperative societies).

TEST YOURSELF

1) Write a short note on Banking Regulation Act, 1949.
2) What different forms of business are there in which banking companies may engage?
3) What are the objectives of the Banking Regulation Act?
4) Explain various powers of RBI.
5) What do you mean by the term 'Cooperative bank'?

5 Functions of RBI - I

The Unit Include:

- Monetary Management
- Monetary Policy in India
- Monetary Policy Framework
- Monetary Policy Transmission
- Institutional Mechanism for Monetary Policy making
- Monetary policy of India 2011-12 Report
- Introduction
- General Analysis of Monetary Policy 2011-12
- Functions of RBI – II
- Currency Unit and denomination
- Combating Counterfeiting
- Banker to the Central Government
- Management of Public Debt
- Reserve Bank as Banker to Banks
- Lender of last resort
- Regulatory and Supervisory Functions
- Commercial Banks
- Prudential Norms
- Foreign Banks
- Financial Institutions
- Rural Financing Institutions
- Urban Cooperative Banks
- Non Banking Financial Companies
- Primary Dealers
- Financial Markets
- Foreign Exchange Reserves Management – The RBI's approach
- Evolution
- Exchange rate policy
- Development, Consolidation and Integration
- Legal Framework
- Rural Credit
- Data and Research Dissemination
- Summary
- Test yourself
- Banking Article (Case)

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Learning Objectives:

After going through this chapter, you should be able to:

- **Define RBI.**
- **Describe various functions of RBI.**
- **Discuss monetary policy.**
- **Understand cash transactions**

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MONETARY MANAGEMENT

One of the most important functions of central banks is formulation and execution of monetary policy. In the Indian context, the basic functions of the Reserve Bank of India as enunciated in the Preamble to the RBI Act, 1934 are: "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." Thus, the Reserve Bank's mandate for monetary policy flows from its monetary stability objective. Essentially, monetary policy deals with the use of various policy instruments for influencing the cost and availability of money in the economy.

As macroeconomic conditions change, a central bank may change the choice of instruments in its monetary policy. The overall goal is to promote economic growth and ensure price stability.

MONETARY POLICY IN INDIA

Over time, the objectives of monetary policy in India have evolved to include maintaining price stability, ensuring adequate flow of credit to productive sectors of the economy for supporting economic growth, and achieving financial stability.

Based on its assessment of macroeconomic and financial conditions, the Reserve Bank takes the call on the stance of monetary policy and monetary measures. Its monetary policy statements reflect the changing circumstances and priorities of the Reserve Bank and the thrust of policy measures for the future.

Faced with multiple tasks and a complex mandate, the Reserve Bank emphasizes clear and structured communication for effective functioning of the monetary policy. Improving transparency in its decisions and actions is a constant endeavor at the Reserve Bank.

The Governor of the Reserve Bank announces the Monetary Policy in April every year for the financial year that ends in the following March. This is followed by three quarterly reviews in July, October and January. However, depending on the evolving situation, the Reserve Bank may announce monetary measures at any point of time. The Monetary Policy in April and its

Second Quarter Review in October consists of two parts:

Part A provides a review of the macroeconomic and monetary developments and sets the stance of the monetary policy and the monetary measures. Part B provides a synopsis of the action taken and the status of past policy announcements together with fresh policy measures. It also deals with important topics, such as, financial stability, financial markets, interest rates, credit delivery, regulatory norms, financial inclusion and institutional developments.

However, the First Quarter Review in July and the Third Quarter Review in January consist of only Part 'A'.

MONETARY POLICY FRAMEWORK

The monetary policy framework in India, as it is today, has evolved over the years. The success of monetary policy depends on many factors. These are –

Operating Target

There was a time when the Reserve Bank used broad money (M3) as the policy target. However, with the weakened relationship between money, output and prices, it replaced M3 as a policy target with a multiple indicators approach. As the name suggests, the multiple indicators approach looks at a large number of indicators from which policy perspectives are derived. Interest rates or rates of return in different segments of the financial markets along with data on currency, credit, trade, capital flows, fiscal position, inflation, exchange rate, and such other indicators, are juxtaposed with the output data to assess the underlying trends in different sectors. Such an approach provides considerable flexibility to the Reserve Bank to respond more effectively to changes in domestic and international economic environment and financial market conditions.

Monetary Policy Instruments

The Reserve Bank traditionally relied on direct instruments of monetary control such as Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). Cash Reserve Ratio indicates the quantum of cash that banks are required to keep with the Reserve Bank as a proportion of their net demand and time liabilities. SLR prescribes the amount of money that banks must invest in securities issued by the government.

In the late 1990s, the Reserve Bank restructured its operating framework for monetary policy to rely more on indirect instruments such as Open Market Operations (OMOs). In addition, in the early 2000s, the Reserve Bank instituted Liquidity Adjustment Facility (LAF) to manage day-to-day liquidity in the banking system. These facilities enable injection or absorption of liquidity that is consistent with the prevailing monetary policy stance. The repo rate (at which liquidity is injected) and reverse repo rate (at which liquidity is absorbed) under the LAF have emerged as the main instruments for the Reserve Bank's interest rate signaling in the Indian economy. The armour of instruments with the Reserve Bank to manage liquidity was strengthened

in April 2004 with the Market Stabilization Scheme (MSS). The MSS was specifically introduced to manage excess liquidity arising out of huge capital flows coming to India from abroad.

In addition, the Reserve Bank also uses prudential tools to modulate the flow of credit to certain sectors so as to ensure financial stability. The availability of multiple instruments and their flexible use in the implementation of monetary policy has enabled the Reserve Bank to successfully influence the liquidity and interest rate conditions in the economy. While the Reserve Bank prefers indirect instruments of monetary policy, it has not hesitated in taking recourse to direct instruments if circumstances warrant such actions. Often, complex situations require varied combination of direct and indirect instruments to make the policy transmission effective.

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The recent legislative amendments to the Reserve Bank of India Act, 1934 enable a flexible use of CRR for monetary management, without being constrained by a statutory floor or ceiling on the level of the CRR. The amendments to the Banking Regulation Act, 1949 also provide further flexibility in liquidity management by enabling the Reserve Bank to lower the SLR to levels below the pre-amendment statutory minimum of 25 per cent of net demand and time liabilities (NDTL) of banks.

MONETARY POLICY TRANSMISSION

An important factor that determines the effectiveness of monetary policy is its transmission – a process through which changes in the policy achieve the objectives of controlling inflation and achieving growth.

In the implementation of monetary policy, a number of transmission channels have been identified for influencing real sector activity. These are (a) the quantum channel relating to money supply and credit; (b) the interest rate channel; (c).the exchange rate channel; and (d) the asset price channel.

How these channels function in an economy depends on its stage of development and its underlying financial structure. For example, in an open economy one would expect the exchange rate channel to be important; similarly, in an economy where banks are the major source of finance as against the capital market, credit channel could be a major conduit for monetary transmission. Of course, these channels are not mutually exclusive, and there could be considerable feedback and interaction among them.

INSTITUTIONAL MECHANISM FOR MONETARY POLICY MAKING

The Reserve Bank has made internal institutional arrangements for guiding the process of monetary policy formulation.

Financial Markets Committee (FMC)

Constituted in 1997, the inter-departmental Financial Markets Committee is chaired by the Deputy Governor in-charge of monetary policy formulation. Heads of various departments dealing with markets, and the head of the Monetary Policy Department (MPD) are its members. They meet every morning and review developments in money, foreign exchange and government securities markets. The FMC also makes an assessment of liquidity conditions and suggests appropriate market interventions on a day-to-day basis.

Monetary Policy Strategy Group

The Monetary Policy Strategy Group is headed by the Deputy Governor in charge of MPD. The group comprises Executive Directors (EDs) in-charge of different markets departments and heads of other departments. It generally meets twice in a quarter to review monetary and credit conditions and takes a view on the stance of the monetary policy.

Technical Advisory Committee (TAC) on Monetary Policy

The Reserve Bank had constituted a Technical Advisory Committee (TAC) on Monetary Policy in July 2005 with a view to strengthening the consultative process in the conduct of monetary policy. This TAC reviews macroeconomic and monetary developments and advises the Reserve Bank on the stance of the monetary policy and monetary measures that may be undertaken in the ensuing policy reviews. The Committee has, as its members, five external experts and two Directors from the Reserve Bank's Central Board. The external experts are chosen from the areas of monetary economics, central banking, financial markets and public finance.

The Committee is chaired by the Governor, with the Deputy Governor in charge of monetary policy as the vice-chairman. The other Deputy Governors of the Reserve Bank are also members of this Committee. The TAC normally meets once in a quarter, although a meeting could be convened at any other time, if necessary. The role of the TAC is advisory in nature. The responsibility, accountability and time path of the decision making remains entirely with the Reserve Bank.

Pre-Policy Consultation Meetings

The Reserve Bank aims to make the policy making process consultative, reaching out to a variety of stakeholders and experts ahead of each Monetary Policy and quarterly Review.

From October 2005, the Reserve Bank has introduced pre-policy consultation meetings with the Indian Banks' Association (IBA), market participants, representatives of trade and industry, credit rating agencies and other institutions, such as, urban co-operative banks, micro-finance institutions, small and medium enterprises, non-banking finance companies, rural cooperatives and regional rural banks. In order to further improve monetary policy communication, the Governor also meets economists, journalists and media analysts. These meetings focus on macroeconomic developments, liquidity position, interest rate environment and monetary and credit developments. This consultative process contributes to enriching the policy formulation process and enhances the effectiveness of monetary policy measures.

Resource Management Discussions

The Reserve Bank holds Resource Management Discussions (RMD) meetings with select banks about one and a half months prior to the announcement of the Monetary Policy and the Second Quarter Review. These discussions are chaired by the Deputy Governor in-charge of monetary policy formulation.

These meetings mainly focus on perception and outlook of bankers on the economy, liquidity conditions, credit outflows, developments in different market segments and the direction of interest rates. Bankers offer their suggestions for the policy. The feedback received from these meetings is analyzed and taken as inputs while formulating monetary policy.

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MONETARY POLICY OF INDIA 2011-12 REPORT

Third Quarter Review of Monetary Policy 2011-12

**ByDr. D.
Subbarao
Governor**

INTRODUCTION

1. Since the Second Quarter Review (SQR) of Monetary Policy in October 2011, there have been significant changes in the global scenario. On the one hand, concerns over the sustainability of sovereign debt problem in the euro area have intensified. On the other, there are modest signs of improvement in the US. In the emerging and developing economies (EDEs), growth has been moderating, reflecting the sluggishness in the advanced economies and the impact of earlier monetary tightening. Overall, notwithstanding the signs of recovery in the US, global growth prospects have weakened since the SQR.

2. Growth in India has also moderated. In particular, investment activity has decelerated sharply, reflecting heightened global uncertainty and domestic fiscal, monetary, political and administrative conditions.

3. Inflation is beginning to moderate as projected, despite the significant depreciation of the rupee. In particular, the higher than expected deceleration in food inflation has provided some relief, even though this was caused largely by a seasonal decline in vegetable prices. Consistent with the Reserve Bank's earlier projections, inflation is likely to decelerate further to 7 per cent by March 2012.

4. Non-food manufactured products inflation, however, continues to remain high and well above the comfort zone. While indicators of pricing power suggest that the moderating trend will continue, upside risks remain significant. The momentum indicator of non-food manufactured products inflation is yet to show a discernible downward trend. Accordingly, while the Reserve Bank's policy stance has to become more sensitive to growth risks, it also needs to guard against persistent inflation risks.

5. This policy review is set in the context of a highly uncertain global environment and a delicately poised domestic balance between growth and inflation. It should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

6. This Statement is organized in four sections: Section I provides an overview of global and domestic macroeconomic developments; Section II sets out the outlook and projections for growth, inflation and monetary aggregates; Section III explains the stance of monetary policy; and Section IV specifies the monetary measures.

I. The State of the Economy

Global Economy

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7. US GDP growth in Q3 of 2011 [quarter-on-quarter (q-o-q), seasonally adjusted annualized rate (saar) was revised downwards from 2 per cent to 1.8 per cent. Although this is better than the sub-one per cent growth in the first half of 2011, it is still substantially below trend. In the euro area, GDP growth (q-o-q, saar) decelerated from 0.8 per cent in Q2 to 0.4 per cent in Q3. In Japan, growth (q-o-q, saar) recovered to 5.6 per cent in Q3 from the setbacks suffered in Q2 (-2.0 per cent) and Q1 (-6.6 per cent) due to earthquake/tsunami.

8. Amongst the major EDEs, growth [year-on-year (y-o-y)] in China slowed to 8.9 per cent in Q4 of 2011 from 9.1 per cent in Q3 and 9.5 per cent in Q2; it also slowed in Brazil to 2.1 per cent in Q3 from 3.3 per cent in Q2 and in South Africa to 3.1 per cent from 3.2 per cent. Growth in Russia, however, accelerated to 4.8 per cent in Q3 from 3.4 per cent in Q2 of 2011. Various international agencies have scaled down their growth estimate for 2011 and projection for 2012 both for the advanced economies and EDEs.

9. The global purchasing managers' index (PMI) for manufacturing recovered to an expansionary mode in December after remaining below the benchmark 50-mark (suggesting contraction) in both October and November 2011. The services index remains above the 50-mark (suggesting expansion) and improved from 52.7 in November to 53.2 in December. The composite PMI of the euro area has remained well below the benchmark of 50 since September 2011, although the index improved marginally to 48.3 in December from 47.0 in November.

10. Beginning the fourth week of December 2011, increase in international crude oil prices has been driven largely by geo-political uncertainties. In contrast, weak global economic activity has led to some softening of non-oil commodity prices. The World Bank's index of non-energy prices declined by 11 per cent (y-o-y) in December 2011

11. Reflecting international commodity price dynamics, headline measures of inflation moderated in November-December 2011 in a number of countries, but still remain at elevated levels. Among the major advanced economies, headline inflation was 3.0 per cent in the US and 2.7 per cent in the euro area. Amongst the EDEs, headline inflation was 4.1 per cent in China, 6.5 per cent in Brazil and 6.1 per cent in Russia and South Africa. Notably, in many EDEs, the softening, in varying degrees, of the impact of global commodity prices on inflation was offset by the sizeable depreciation of their currencies in the second half of 2011.

12. Given the renewed strains in global financial markets, six major central banks announced coordinated actions in November 2011 to enhance their capacity to provide liquidity support to the global financial system. The

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European Central Bank (ECB) also announced longer-term refinancing operations (LTROs) with a maturity of 36 months. These measures are intended to encourage bank lending in money markets and sovereign bond markets.

Domestic Economy

13. At home, GDP growth moderated from 7.7 per cent in Q1 (April-June) to 6.9 per cent in Q2 (July-September) of 2011-12. This was mainly due to deceleration in industrial growth from 6.7 per cent to 2.8 per cent. However, the services sector held up relatively well. Consequently, GDP growth during H1 (April-September) of 2011-12 slowed to 7.3 per cent from 8.6 per cent in H1 of last year.

14. On the demand side, the contraction in fixed capital formation in Q2 was the main factor behind the slowdown in growth. The real gross fixed capital formation to GDP ratio declined from 31.2 per cent in Q1 to 30.5 per cent in Q2. This pattern, should it persist, will hurt medium-term growth. Private consumption grew by 5.9 per cent in Q2, slightly slower than 6.3 per cent in Q1, but substantially slower than 9.0 per cent a year ago. The global environment is only partly responsible for the weak industrial performance and sluggish investment activity; several domestic factors – the unhealthy fiscal situation, high interest rates and policy and administrative uncertainty – are also playing a role.

15. The index of industrial production (IIP) remained volatile. The y-o-y industrial growth recovered from (-) 4.7 per cent in October to 5.9 per cent in November. Over the year, however, growth in industrial production slowed down to 3.8 per cent during April-November 2011 from 8.4 per cent a year ago. The slowdown was mainly on account of the manufacturing and mining sectors. In terms of the use-based classification, weakness in the capital goods, intermediate goods and consumer durables sectors dragged down industrial production. However, the PMI-Manufacturing rebounded to 54.2 in December 2011 from 51.0 in November. The PMI-Services also recovered markedly to 53.2 in November and further to 54.2 in December from the below 50 levels in the preceding two months. On the agriculture front, *rabi*sowing as of January 20, 2012 was marginally lower (-1.1 per cent) than that in last year.

16. According to the Reserve Bank's order books, inventories and capacity utilization survey, capacity utilization of the manufacturing sector in Q2 of 2011-12 remained broadly the same as in the preceding quarter. Business confidence, as measured by the business expectations indices of the Reserve Bank's industrial outlook survey, showed a slight pick-up in Q3 of 2011-12, while it pointed towards moderation in the next quarter.

17. Headline wholesale price index (WPI) inflation, which averaged 9.7 per cent (y-o-y) during April-October 2011, moderated to 9.1 per cent in November and further to 7.5 per cent in December. The decline in inflation was driven largely by a decline in primary food and non-food articles inflation.

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The momentum indicator of WPI, as measured by the seasonally adjusted 3-month moving average inflation rate, also showed a decline.

18. Primary articles inflation, which was in double digits for over two years from September 2009 to October 2011, moderated to 8.5 per cent in November and further to 3.1 per cent in December. This was essentially on account of vegetables and non-food articles, particularly, fibers'. However, inflation in protein items – 'eggs, fish and meat', milk and pulses – remained in double digits. Excluding vegetables, food articles inflation moderated only marginally from 8.0 per cent in November to 7.1 per cent in December in contrast to the sharp decline in food articles inflation (including vegetables) from 8.5 per cent to 0.7 per cent during the same period.

19. Fuel group inflation remained high at 14.9 per cent in December 2011, reflecting high global crude oil prices and rupee depreciation. In fact, there is sizeable suppressed inflation in the fuel-group as administered prices do not fully reflect the market prices.

20. Notably, non-food manufactured products inflation remains elevated. It declined from 8.1 per cent in October to 7.9 per cent in November and further to 7.7 per cent in December. However, going by the revision in the number for October 2011, the inflation numbers for November and December too are likely to be revised upwards. This indicator is sensitive to international commodity prices and currency movements and the recent rupee depreciation has accentuated price pressures as reflected by this indicator.

21. As measured by the consumer price index (CPI) for industrial workers, inflation moderated from double digits in September to 9.3 per cent in November. Inflation in terms of consumer price indices for agricultural and rural laborers moderated significantly in December. The new combined (rural and urban) consumer price index (base: 2010=100) declined marginally from 114.4 in November to 113.9 in December, reflecting softening of food prices.

22. Money supply (M_3) growth, which was 17.2 per cent at the beginning of the financial year, reflecting the strong growth in time deposits following increase in interest rates by banks, moderated to 15.6 per cent by end-December 2011 consistent with the projected trajectory of 15.5 per cent for the year.

23. However, non-food credit growth moderated from 21.3 per cent at end-March to 15.7 per cent by end-December 2011, a rate below the indicative projection of 18 per cent set out in the SQR. Credit deceleration was particularly sharp for public sector banks, with growth moderating from 21 per cent to about 15 per cent during the same period. Disaggregated data for November showed that there was a general deceleration in the credit flow across sectors, except for personal loans. The deceleration was particularly sharp in agriculture, real estate, infrastructure, engineering, cement and cement products.

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24. Resource flows to the commercial sector from other sources partly offset the deceleration in bank credit. The estimated total flow of financial resources from banks, non-banks and external sources to the commercial sector during April-December of 2011 at around '9.2 trillion was, however, lower than that of '9.5 trillion during the same period of last year.

25. During Q3 of 2011-12, the modal deposit rate of banks increased by 44 basis points for maturity up to 1 year, and 9 basis points for maturity between 1 to 3 years. During Q3, 23 banks raised their base rates by 10-100 basis points even as the modal base rate of banks remained unchanged at 10.75 per cent. The slowdown in total resource flow to the commercial sector and the peaking of base rates of banks reflect slowing down of investment activity.

26. Liquidity conditions, which have generally remained in deficit during 2011-12, tightened further beginning the second week of November 2011, partly reflecting the Reserve Bank's forex market operations and advance tax outflows around mid-December. Average borrowings under the Reserve Bank's daily liquidity adjustment facility (LAF) increased from around '480 billion during April-September 2011 to around '920 billion during November and further to '1,170 billion in December 2011. Average daily borrowings under the LAF were about '1,200 billion during January (up to January 20, 2012). To ease the tightness in liquidity, and consistent with its monetary policy stance of managing liquidity to ensure that it remained in moderate deficit, the Reserve Bank conducted open market operations (OMOs) aggregating over '700 billion during November 2011-mid January 2012.

27. Under the marginal standing facility (MSF), banks can drawdown up to one per cent of their net demand and time liabilities (NDTL) from their prescribed statutory liquidity ratio (SLR) portfolio. On December 21, 2011, the Reserve Bank clarified that banks could access the MSF even if they had excess SLR holdings. In view of the tight liquidity conditions, some banks accessed funds from the MSF window during December 2011-January 2012.

28. With the introduction of the new operating procedure of monetary policy in May 2011, overnight money market rates have become more stable. The overnight interest rates generally remained close to the repo rate during 2011-12 (up to January 20, 2012), barring a few days when the call rate breached the interest rate ceiling determined by the MSF rate owing to tightness of liquidity on account of advance tax outflows.

29. The Central Government's key deficit indicators widened during 2011-12 (April-November) relative to the levels in the corresponding period of last year, and were higher even when compared with the deficit levels adjusted for the one-off spectrum receipts last year. This was reflected in the increase in borrowings by the Government. Beyond the budgeted estimate of '4,170 billion, the Central Government announced an increase in borrowings through dated securities of about '530 billion in September and further '400 billion in December. Consequently, the revised gross (net) borrowings for the year

now work out to about '5,100 billion ('4,360 billion). About 83 per cent of revised gross ('4,220 billion) and 80 per cent of net market borrowings ('3,480 billion) were raised up to January 16, 2012. The Central Government has also announced an increase in the borrowing through net issuances of Treasury Bills by '1,025 billion over the budgeted amount of '150 billion for 2011-12.

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30. The 10-year benchmark government security yield, which remained range-bound during the first half of 2011-12, rose during October, after the commencement of second half borrowing programme of the government. The yield, however, eased subsequently from 8.89 per cent at end-October to 8.74 per cent at end-November and further to 8.22 per cent as on January 20, 2012. The moderation in yield reflected improved demand for government securities as credit demand slackened, OMO purchases by the Reserve Bank, increase in debt cap for foreign institutional investors (FIIs) for investment in government securities, and expectation of moderation in inflation.

31. The foreign exchange market remained under pressure in Q3 of 2011-12, reflecting adverse global sentiments and moderation in capital inflows. Between end-March 2011 and January 13, 2012, the 6, 30 and 36-currency trade weighted real effective exchange rates (REER) depreciated by about 9 per cent each, primarily reflecting the nominal depreciation of rupee against the US dollar by about 13.2 per cent. Much of the depreciation happened during August-December. The Reserve Bank took a number of steps to stimulate capital inflows and curb speculation, besides also intervening in the market consistent with its policy of containing volatility and preventing disruptive movements. The Reserve Bank continues to closely monitor developments in the external sector and their impact on the exchange rate and, as indicated in the Mid-Quarter Review (MQR) of December 2011, will take action, as appropriate.

32. During H1 (April-September) of 2011-12, the current account deficit (CAD), in absolute terms, widened relative to H1 of last year, reflecting widening of the trade deficit due to significant increase in international prices of imported commodities, especially crude oil and gold as well as moderation of growth in exports of services. However, as a proportion of GDP, the CAD at 3.6 per cent was a shade lower than 3.7 per cent in H1 of last year. During Q3 of 2011-12, merchandise exports growth decelerated, on an average, to 7.7 per cent y-o-y from an average of 36.9 per cent during the first half of 2011-12. With imports growth moderating more slowly than exports growth, the trade deficit for Q3 widened further.

II. Outlook and Projections

Global Outlook

Growth

33. Global growth prospects for 2012 have deteriorated in an environment of increasing concerns over the sovereign debt crisis in the euro area amidst

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limited monetary and fiscal policy space. Given the weak growth prospects in advanced economies and past monetary tightening undertaken by EDEs to contain inflation, growth in the EDEs has also been moderating. Accordingly, global growth during 2012 is expected to be lower than the International Monetary Fund's September 2011 projection of 4.0 per cent.

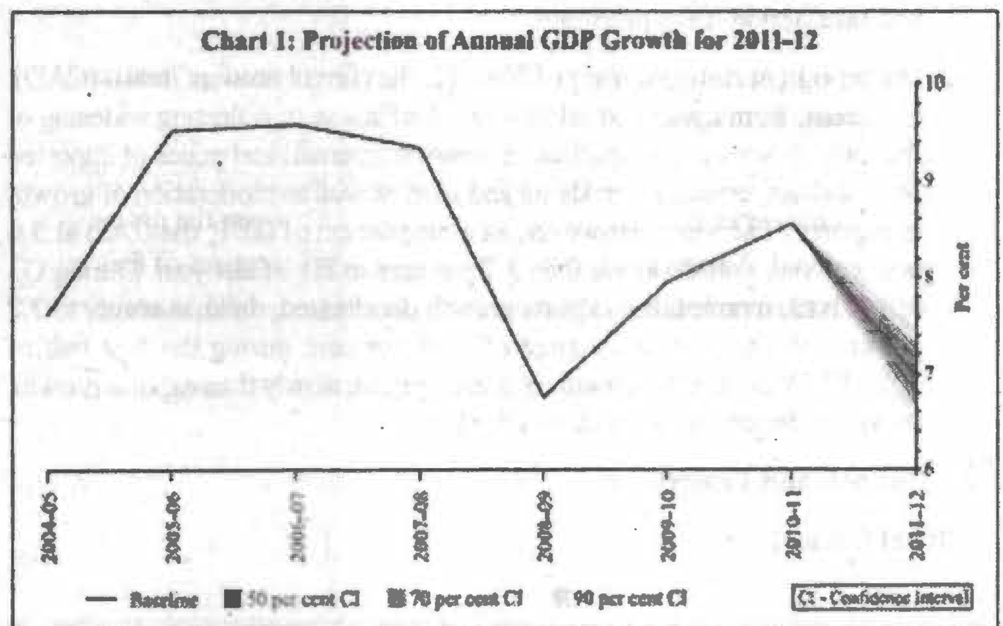
Inflation

34. Although non-oil commodity prices showed some correction in 2011, crude oil prices have remained firm. Supply limitations and continued ultra accommodative monetary policies in major advanced economies pose upside risks to commodity prices in 2012. Currency depreciation in EDEs witnessed in the second half of 2011 and the lagged pass-through to domestic prices could also add to inflationary pressures in EDEs.

Domestic Outlook

Growth

35. In the SQR of October 2011, the Reserve Bank projected GDP growth of 7.6 per cent for 2011-12, though with significant downside risks. In the MQR of December 2011, the Reserve Bank indicated that some of these risks were indeed materializing such as increase in global uncertainty, weak industrial growth, slowdown in investment activity and deceleration in the resource flow to the commercial sector. Consequently, while agricultural prospects look buoyant, industrial production has decelerated. The slowdown in industrial production will also impact service sector growth. Further, weaker global growth will also have an adverse impact. Accordingly, the baseline projection of GDP growth for 2011-12 is revised downwards from 7.6 per cent to 7.0 per cent (Chart 1).



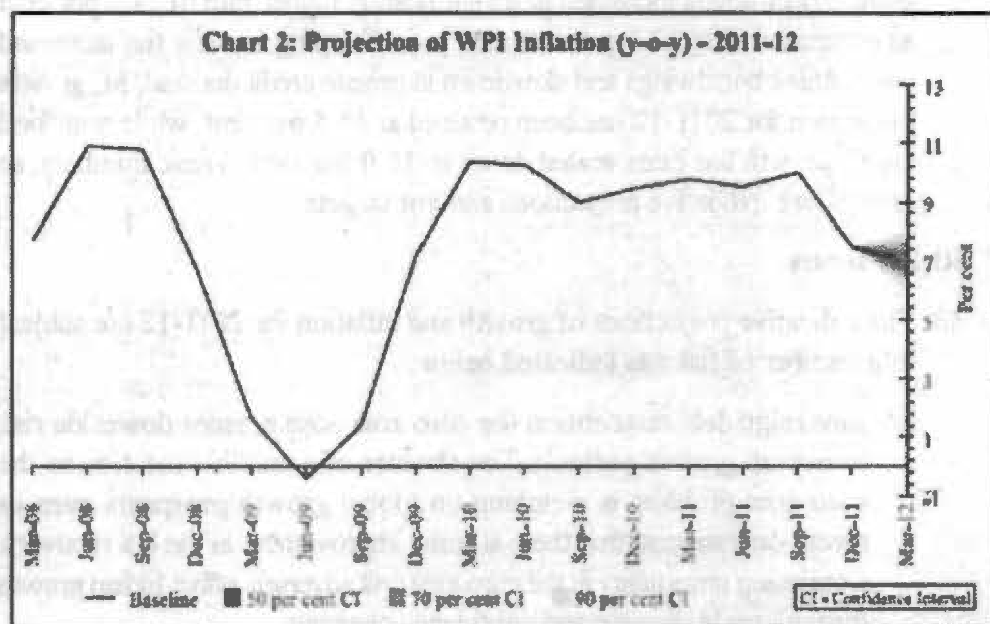
36. Looking ahead to 2012-13, while a formal projection will be made in the Annual Policy Statement in April, the Reserve Bank's baseline scenario is

that the economy will exhibit a modest recovery, with growth being slightly faster than that during the current year.

37. It must be emphasized that investment activity has slowed down significantly. As indicated above, while global factors are contributing, domestic conditions are also responsible and a change in the investment climate is contingent on these adverse conditions being addressed by policy actions. Without this, a continuing decline in investment will push the economy's trend rate of growth down, further aggravating inflationary pressures and threatening external and internal stability.

Inflation

38. Food inflation has moderated more than anticipated because of a sharp drop in vegetable prices. This benefit has, however, been offset to a large extent by the lower than expected moderation in non-food manufactured products inflation. Fuel inflation remains well above double digits. Keeping in view the expected moderation in non-food manufactured products inflation, domestic supply factors and global trends in commodity prices, the baseline projection for WPI inflation is retained at 7 per cent as set out in the SQR (Chart 2).



39. A significant downgrade in the growth projection would normally have been accompanied by a downward revision in the inflation projection. However, in the current circumstances, two factors have prevented this from happening. First, rupee depreciation has been feeding into core inflation, delaying the adjustment of inflation to slower growth. Second, very importantly, suppressed inflation in petroleum product and coal prices remains quite significant. While a rationalization of prices is welcome for a variety of well known reasons, it will impact observed inflation in the short-term. This projection is based on the likelihood of some adjustments being made in these prices.

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40. Looking ahead to 2012-13, while a formal projection will be made in the Annual Policy Statement in April, the Reserve Bank's baseline scenario is that headline inflation may show some moderation, though remaining vulnerable to a variety of upside risks, indicated later in this Review.

41. Although inflation has remained persistently high over the past two years, it is important to note that during the 2000s, it averaged around 5.5 per cent, both in terms of WPI and CPI, down from its earlier trend rate of about 7.5 per cent. Given this record, the conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This is in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

Monetary Aggregates

42. Money supply (M_3) growth at 15.6 per cent (y-o-y) in December 2011 was in line with the indicative trajectory of 15.5 per cent for 2011-12. However, non-food credit growth at 15.7 per cent was below the indicative projection of 18 per cent, reflecting the combined effect of a slowing economy and increasing risk aversion by banks. The deceleration in non-food bank credit is explained, to a large extent, by the expansion in net bank credit to the government which increased at a significantly higher rate of 24.4 per cent as compared with 17.3 per cent last year. Keeping in view the increased government borrowings and slowdown in private credit demand, M_3 growth projection for 2011-12 has been retained at 15.5 per cent, while non-food credit growth has been scaled down to 16.0 per cent. These numbers, as always, are indicative projections and not targets.

Risk Factors

43. The indicative projections of growth and inflation for 2011-12 are subject to a number of risks as indicated below:

    i) Sovereign debt concerns in the euro area pose a major downside risk to overall growth outlook. The absence of a credible solution to the euro area problem is weighing on global growth prospects even as recent data suggest that there is some improvement in the US recovery. Continuing uncertainty in the euro area will adversely affect Indian growth through trade, finance and confidence channels.

    ii) Capital inflows to India have slowed down on account of portfolio re-balancing by FIIs due to global uncertainty. This raises concerns, especially because the current account deficit of India has widened. The exchange rate has already come under significant pressure, which has also added to inflationary pressures. If the global situation does not improve, capital inflows could continue to be adversely affected. In this scenario, the size of the current account deficit poses a significant threat to macroeconomic stability.

    iii) Even as global food and metal prices have moderated further, global energy prices have increased. Should crude prices spike due to supply

constraints on account of geo-political factors or decline significantly due to deterioration in the global macroeconomic situation, they will have implications for domestic growth and inflation. Exchange rate movements will also be an important factor in shaping the impact of global crude prices on domestic prices.

iv) Non-food credit growth has slowed down. Although some slowdown in credit growth was expected on account of monetary tightening, credit growth has decelerated more than expected and is currently below the indicative trajectory of 18 per cent. Apart from slowdown of economic activity, it also reflects increasing risk aversion by banks due to increase in non-performing assets. Although banks need to be prudent while sanctioning credit proposals, risk aversion by the banking sector could adversely affect credit flow to productive sectors of the economy.

v) Although food inflation has declined in the recent period, this was mainly due to a seasonal decline in vegetable prices. Going by past trends, the extent of decline in vegetable prices seen in December this year is usually observed in the winter season (December-February). As such, the decline in food inflation is likely to be limited in coming months. Beyond this, inflation in respect of protein-based items remains high. In the absence of appropriate supply responses of those commodities where there are structural imbalances, particularly protein-based items, risks to food inflation will continue to be on the upside. Significantly, there has been reduction in *rabi* acreage for pulses, which may have an adverse impact on prices.

vi) There is still a large element of suppressed inflation as domestic prices of some administered products do not reflect the underlying market conditions. This is particularly true of coal which had seen an increase towards the end of last year but no increase this year so far. Since coal is an input for electricity, coal prices, as and when raised, will also have implications for electricity tariffs. Further, the current levels of domestic prices of petroleum products do not reflect international prices. Petroleum product prices have also not been revised in response to crude oil prices, contributing to both fiscal slippages and suppressed inflation. Revision in domestic administered prices will add to inflationary pressures, although such revisions are necessary to maintain the balance between supply and demand. Particularly, as the food subsidy bill is expected to rise, it will be prudent to fully deregulate diesel prices to contain both aggregate demand and trade deficit.

vii) The fiscal deficit of the government has remained elevated since 2008-09. If the increase in government borrowing already announced is an indication, the gross fiscal deficit for 2011-12 will overshoot the budget estimate substantially. At the current juncture when there is a need to boost private investment, the increase in fiscal deficit could potentially crowd out credit to the private sector. Moreover, slippage in the fiscal

deficit has been adding to inflationary pressures and it continues to be a risk for inflation.

III. The Policy Stance

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44. The Reserve Bank began exiting from the crisis driven expansionary policy in October 2009. Between January 2010 and October 2011, the Reserve Bank cumulatively raised the cash reserve ratio (CRR) by 100 basis points and the policy rate (the repo rate) 13 times by 375 basis points. This monetary policy response was calibrated on the basis of India specific growth-inflation dynamics. The focus of the monetary policy stance during May-October 2011 was on containing inflation and anchoring inflation expectations even as it meant sacrificing some growth. However, in view of slowdown in growth, especially investment activity and expected moderation in inflation beginning December, it was decided to pause in the MQR of December 2011.

45. Since November 2011, inflation has broadly followed the projected trajectory and has shown moderation as expected. Even as inflation remains elevated, despite moderation, downside risks to growth have increased. The growth-inflation balance of the monetary policy stance has now shifted to growth, while at the same time ensuring that inflationary pressures remain contained. Accordingly, the policy stance in this review is shaped by the following three major considerations.

46. First, growth is decelerating. This reflects the combined impact of several factors: the uncertain global environment, the cumulative impact of past monetary policy tightening and domestic policy uncertainties. Credit off take has also been below the projected trajectory. While slowdown in the growth of demand was the expected outcome of monetary policy actions that were taken to contain inflation, at this juncture, risks to growth have increased. This is also reflected in the scaling down of the growth projection for 2011-12 by the Reserve Bank.

47. Second, though headline WPI inflation is moderating, it largely reflects a sharp deceleration in prices of seasonal food items. Inflation in respect of other key components, particularly protein-based food items and non-food manufactured products remains high. Moreover, upside risks to inflation arise from global crude oil prices, the lingering impact of rupee depreciation and slippage in the fiscal deficit.

48. Third, liquidity conditions have remained tight beyond the comfort zone of the Reserve Bank. Although the Reserve Bank has conducted open market purchase of government securities to inject liquidity of over '700 billion, the structural deficit in the system has increased significantly, which could hurt the credit flow to productive sectors of the economy. The large structural deficit in the system presents a strong case for injecting permanent primary liquidity into the system.

49. Against this backdrop, the stance of monetary policy is intended to:

- Maintain an interest rate environment to contain inflation and anchor inflation expectations.
- Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.
- Respond to increasing downside risks to growth.

IV. Monetary Measures

50. On the basis of current assessment and in line with the policy stance outlined in Section III, the Reserve Bank announces the following policy measures:

Cash Reserve Ratio

51. It has been decided to:

- reduce the cash reserve ratio (CRR) of scheduled banks by 50 basis points from 6.0 per cent to 5.5 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning January 28, 2012.

52. As a result of the reduction in the CRR, around '320 billion of primary liquidity will be injected into the banking system.

Repo Rate

53. The policy repo rate under the liquidity adjustment facility (LAF) has been retained at 8.5 per cent.

Reverse Repo Rate

54. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands at 7.5 per cent.

Marginal Standing Facility (MSF) Rate

55. The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, stands at 9.5 per cent.

Bank Rate

56. The Bank Rate has been retained at 6.0 per cent.

Guidance

57. In reducing the CRR, the Reserve Bank has attempted to address the structural pressures on liquidity in a way that is not inconsistent with the prevailing monetary stance. In the two previous guidances, it was indicated that the cycle of rate increases had peaked and further actions were likely to reverse the cycle. Based on the current inflation trajectory, including consideration of suppressed inflation, it is premature to begin reducing the policy rate. The reduction in the policy rate will be conditioned by signs of sustainable moderation in inflation. However, the persistence of tight liquidity conditions could disrupt credit flow and further exacerbate growth risks. In

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this context, the CRR is the most effective instrument for permanent liquidity injections over a sustained period of time. The reduction can also be viewed as a reinforcement of the guidance that future rate actions will be towards lowering them.

58. However, it must be emphasised that the timing and magnitude of future rate actions is contingent on a number of factors. Policy and administrative actions, which induce investment that will help alleviate supply constraints in food and infrastructure, are critical. Initiatives to narrow skill mismatches in labor markets will help ease the pressure on wages. The anticipated fiscal slippage, which is caused largely by high levels of consumption spending by the government, poses a significant threat to both inflation management and, more broadly, to macroeconomic stability.

59. Strong signs of fiscal consolidation, which will shift the balance of aggregate demand from public to private and from consumption to capital formation, are critical to create the space for lowering the policy rate without the imminent risk of resurgent inflation. In the absence of credible fiscal consolidation, the Reserve Bank will be constrained from lowering the policy rate in response to decelerating private consumption and investment spending. The forthcoming Union Budget must exploit the opportunity to begin this process in a credible and sustainable way.

Expected Outcomes

60. The policy actions and the guidance in this Statement given are expected to:

i. Ease liquidity conditions.

ii. Mitigate downside risks to growth.

iii. Continue to anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.

Mid-Quarter Review of Monetary Policy 2011-12

61. The next mid-quarter review of Monetary Policy for 2011-12 will be announced through a press release on Thursday, March 15, 2012.

Monetary Policy 2012-13

62. The Monetary Policy for 2012-13 will be announced on Tuesday, April 17, 2012.

GENERAL ANALYSIS OF MONETARY POLICY 2011-12

Monetary and Liquidity Measures (Analysis)

1. On the basis of the current macroeconomic assessment, it has been decided to:

- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.75 per cent of their net demand and time liabilities; and

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- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 8.5 per cent.

Consequently, the reverse repo rate under the LAF will remain unchanged at 7.5 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 9.5 per cent.

2. The Reserve Bank reduced the CRR by 75 basis points from 5.5 per cent to 4.75 per cent effective March 10, 2012. This measure was necessitated ahead of this scheduled Mid-Quarter Review to address the persistent structural liquidity deficit beyond the Reserve Bank's comfort level, which would have further worsened during the week of March 12-16 due to advance tax outflows.

3. Since the Reserve Bank's Third Quarter Review (TQR) of January 24, 2012, there has been modest improvement in the global macroeconomic situation. The recent macroeconomic data for the US economy show some positive signs. In particular, labor market conditions have improved. However, the US Fed expects that economic conditions warrant exceptionally low levels for the federal funds rate at least through late 2014.

4. The immediate financial market pressures in the euro area have been alleviated to some extent by the European Central Bank (ECB) injecting liquidity of more than one trillion euro through the two long-term refinancing operations. Growth in the euro area, however, turned negative in Q4. The emerging and developing economies (EDEs) are showing signs of growth slowdown. As a result, the global growth for 2012 and 2013 is expected to be lower than earlier anticipated.

5. Inflation pressures in both advanced economies and EDEs moderated towards the end of 2011 on account of subdued domestic demand and correction in non-fuel commodity prices. Global crude prices, however, have spiked suddenly reflecting both geo-political concerns and abundant global liquidity, accentuating the risks to growth and inflation.

6. GDP growth [year-on-year (y-o-y)] decelerated to 6.1 per cent in Q3 of 2011-12 from 6.9 per cent in Q2 mainly reflecting a slowdown in industrial activity. On the expenditure side, the growth moderation was mainly due to a deceleration in investment activity and weak external demand. The Central Statistics Office (CSO) has estimated the full year growth for 2011-12 at 6.9 per cent, which is in line with the Reserve Bank's projection.

7. Growth in industrial production, as reflected in the index of industrial production (IIP), moderated to 4.0 per cent during 2011-12 (April-January) from 8.3 per cent in the corresponding period a year ago. While growth in the capital goods and intermediate goods sectors was negative, growth in the basic goods and consumer goods sectors decelerated marginally. Given the significant volatility in IIP numbers, the Reserve Bank also uses several other indicators to assess the overall industrial activity. The Manufacturing PMI for February suggested that industrial activity remained in an

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expansionary mode. While corporate sales growth in Q3 of 2011-12 was robust, margins moderated, reflecting increasing difficulty in passing on rising input prices.

8. After remaining above 9 per cent during April-November 2011, y-o-y headline wholesale price index (WPI) inflation rate moderated to 7.7 per cent in December and further to 6.6 per cent in January 2012, before rising to 7.0 per cent in February. While moderation in WPI inflation stemmed mainly from primary food articles, fuel and manufactured products groups also contributed.

9. Primary food articles inflation, which was modest at 0.8 per cent in December, turned negative (-0.5 per cent) in January 2012, before rising to 6.1 per cent in February. Despite the sharp increase in global crude oil prices, fuel group inflation moderated from 15.0 per cent in December to 12.8 per cent in February, reflecting the absence of commensurate pass-through to domestic consumers.

10. Non-food manufactured products inflation moderated from 7.9 per cent in December to 5.8 per cent in February 2012, reflecting both a slowdown in domestic demand following the monetary tightening and moderation in global non-oil commodity prices. The momentum indicator of non-food manufactured products inflation (seasonally adjusted 3-month moving average inflation rate) also showed a moderating trend.

11. Notably, Consumer Price Index (CPI) inflation (as measured by the new series, base year 2010) for the month of January 2012 was 7.7 per cent suggesting that price pressures persist at the retail level.

12. The Centre's fiscal conditions deteriorated during 2011-12 (April-January) with key deficit indicators already crossing the budget estimates for the full year. Apart from sluggishness in tax revenues, Government's non-plan expenditure, particularly subsidies, increased sharply. As indicated in the TQR, the slippage in the fiscal deficit has been adding to inflationary pressures. Credible fiscal consolidation, therefore, will be an important factor in shaping the inflation outlook.

13. The y-o-y money supply (M_3) growth and non-food credit growth moderated, reflecting the slowdown in the economy. Liquidity conditions have remained significantly in deficit mode. In order to mitigate the liquidity tightness, the Reserve Bank undertook steps to inject primary liquidity of a more durable nature through open market operations (OMOs) aggregating '1,247 billion during November 2011- March 9, 2012 and reduced the CRR by 125 basis points (50 basis points effective January 28 and 75 basis points effective March 10), injecting primary liquidity of about '800 billion. The liquidity situation has since improved and it is expected to ease further in the weeks ahead.

14. While merchandise exports growth decelerated, moderation in imports growth was less pronounced leading to a widening of the trade deficit. After the

TQR, the rupee has moved in a range of '48.69 to '50.58 per USD. With sluggish demand conditions in the advanced economies impeding exports growth and crude oil prices rising sharply, the current account deficit (CAD) is likely to remain high. The financing of the CAD will continue to pose a challenge so long as the global situation remains uncertain.

15. While the recovery in the US has been progressing, economic activity in the euro area has contracted. Although abundant liquidity injection by the ECB has mitigated the immediate pressures in financial markets, a credible solution to the sovereign debt problem is yet to emerge. Sluggish global economic activity, uncertainty in the euro area and rising crude oil prices will hamper growth prospects of EDEs.

16. On the domestic front, while most indicators suggest that the economy is slowing down, the performance in Q4 of 2011-12 is expected to be better than that in Q3. Inflation has broadly evolved along the projected trajectory so far. However, upside risks to inflation have increased from the recent surge in crude oil prices, fiscal slippage and rupee depreciation. Besides, there continues to be significant suppressed inflation in fuel, fertilizer and power as administered prices do not fully reflect the costs of production.

17. Recent growth-inflation dynamics have prompted the Reserve Bank to indicate that no further tightening is required and that future actions will be towards lowering the rates. However, notwithstanding the deceleration in growth, inflation risks remain, which will influence both the timing and magnitude of future rate actions.

FUNCTIONS OF RBI – II

II - Issuer of Currency

Management of currency is one of the core central banking functions of the Reserve Bank for which it derives the necessary statutory powers from Section 22 of the RBI Act, 1934. Along with the Government of India, the Reserve Bank is responsible for the design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. In consultation with the Government, the Reserve Bank routinely addresses security issues and targets ways to enhance security features to reduce the risk of counterfeiting or forgery of currency notes.

The Paper Currency Act of 1861 conferred upon the Government of India the monopoly of note issues, thus ending the practice of private and presidency banks issuing currency. Between 1861 and 1935, the Government of India managed the issue of paper currency. In 1935, when the Reserve Bank began operations, it took over the function of note issue from the Office of the

Controller of Currency, Government of India.

CURRENCY UNIT AND DENOMINATION

The Indian Currency is called the *Indian Rupee (abbreviated as Re. in singular and Rs. in plural)*, and its sub-denomination the *Paisa (plural Paise)*. At present,

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notes in India are issued in the denomination of Rs.5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.500 and Rs.1,000. The printing of Re.1 and Rs.2 denominations has been discontinued. However, notes in these denominations issued earlier are still valid and in circulation. The Reserve Bank is also authorized to issue notes in the denominations of five thousand rupees and ten thousand rupees or any other denomination, but not exceeding ten thousand rupees that the Central Government may specify. Thus, in terms of current provisions of RBI Act 1934, notes in denominations higher than ten thousand rupees cannot be issued.

Coin Denomination

Coins in India are available in denominations of 10 paisa, 20 paisa, 25 paisa, 50 paisa, one rupee, two rupees, five rupees and ten rupees. Coins up to 50 paisa are called "*small coins*" and coins of Rupee one and above are called "*Rupee coins*". As per the provisions of Coinage Act, 1906, coins can be issued up to the denomination of Rs.1,000.

Currency Management

The Reserve Bank carries out the currency management function through its Department of Currency Management located at its Central Office in Mumbai, 19 Issue Offices located across the country and a currency chest at its Kochi branch. To facilitate the distribution of notes and rupee coins across the country, the Reserve Bank has authorized selected branches of banks to establish currency chests. There is a network of 4,281 Currency Chests and 4,044 Small Coin Depots with other banks. Currency chests are storehouses where bank notes and rupee coins are stocked on behalf of the Reserve Bank. The currency chests have been established with State Bank of India, six associate banks, nationalized banks, private sector banks, a foreign bank, a state cooperative bank and a regional rural bank. Deposits into the currency chest are treated as reserves with the Reserve Bank and are included in the CRR. The reverse is applicable for withdrawals from chests. Like currency chests, there are also small coin depots which have been established by the authorized bank branches to stock small coins. The small coin depots distribute small coins to other bank branches in their area of operation.

The Department of Currency Management makes recommendations on design of bank notes to the Central Government, forecasts the demand for notes, and ensures smooth distribution of notes and coins throughout the country. It arranges to withdraw unfit notes, administers the provisions of the RBI (Note Refund) Rules, 2009 (these rules deal with the payment of value of the soiled or mutilated notes) and reviews/ rationalizes the work systems and procedures at the issue offices on an ongoing basis.

The RBI Act requires that the Reserve Bank's affairs relating to note issue and its general banking business be conducted through two separate departments – the Issue Department and the Banking Department. All transactions relating to the issue of currency notes are separately conducted, for accounting purposes, in the Issue Department. The Issue Department is liable for the aggregate value of the currency notes of the Government of India (currency notes issued by the Government of India

prior to the issue of bank notes by the Reserve Bank) and bank notes of the Reserve Bank in circulation from time to time and it maintains eligible assets for equivalent value. The assets which form the backing for note issue are kept wholly distinct from those of the

Banking Department. The Issue Department is permitted to issue notes only in exchange for notes of other denominations or against prescribed assets. This Department is also responsible for getting its periodical requirements of notes/coins from the currency printing presses/mints, distribution of notes and coins among the public as well as withdrawal of unserviceable notes and coins from circulation. The mechanism for putting currency into circulation and its withdrawal from circulation (that is, expansion and contraction of currency, respectively) is effected through the Banking Department.

Currency Distribution

The Government of India on the advice of the Reserve Bank decides on the various denominations of the notes to be printed. The Reserve Bank coordinates with the Government in designing the banknotes, including their security features.

For printing of notes, the Security Printing and Minting Corporation of India Limited (SPMCIL), a wholly owned company of the Government of India, has set up printing presses at Nasik, Maharashtra and Dewas, Madhya Pradesh. The Bharatiya Reserve Bank Note Mudran Pvt. Ltd. (BRBNMPL), a wholly owned subsidiary of the Reserve Bank, also has set up printing presses at

Mysore in Karnataka and Salboni in West Bengal. The Reserve Bank estimates the quantity of notes (denomination-wise) that is likely to be required and places indents with the various presses. The notes received from the presses are then issued for circulation both through remittances to banks as also across the Reserve Bank counters. Currency chests, which are maintained by banks, store soiled and re-issuable notes, as also fresh banknotes. The banks send notes, which in their opinion are unfit for circulation, back to the Reserve Bank. The Reserve Bank examines these notes and re-issues those that are found fit for circulation. The soiled notes are destroyed, through shredding, so as to maintain the quality of notes in circulation.

Coin Distribution

The Indian Coinage Act, 1906 governs the minting of rupee coins, including small coins of the value of less than one rupee. One rupee notes (no longer issued now) and coins are legal tender in India for unlimited amounts. Fifty paisa coins are legal tender for any sum not exceeding ten rupees and smaller coins for any sum not exceeding one rupee. The Reserve Bank acts as an agent of the Central Government for distribution, issue and handling of the coins (including one rupee note) and for withdrawing and remitting them back to Government as may be necessary. SPMCIL has four mints at Mumbai, Noida (UP), Kolkata and Hyderabad for coin production.

Similar to distribution of banknotes, coins are distributed through various channels such as Reserve Bank counters, banks, post offices, regional rural banks and urban cooperative banks. The Reserve Bank offices also sometimes organize special coin

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melas for exchanging notes into coins through retail distribution. Just as unfit banknotes are destroyed, unfit coins are also withdrawn from circulation and sent to the mint for melting.

Special types of notes

A special Star series of notes in three denominations of rupees ten, twenty and fifty have been issued since August 2006 to replace defectively printed notes at the printing presses. The Star series banknotes are exactly like the existing Mahatma Gandhi Series banknotes, but have an additional character — a (star) in the number panel in the space between the prefix and the number. The packets containing these banknotes will not, therefore, have sequential serial numbers, but contain 100 banknotes, as usual. This facility has been further extended to Rs. 100 notes with effect from June 2009. The bands on such packets indicate the presence of such notes.

Exchange of notes

Basically there are two categories of notes which are exchanged between banks and the Reserve Bank – soiled notes and mutilated notes. While soiled notes are notes which have become dirty and limp due to excessive use or a two-piece note, mutilated note means a note of which a portion is missing or which is composed of more than two pieces. While soiled notes can be tendered and exchanged at all bank branches, mutilated notes are exchanged at designated bank branches and such notes can be exchanged for value through an adjudication process which is governed by Reserve Bank of India (Note Refund) Rules, 2009. Under current provisions, either full or no value for notes of denomination up to Rs.20 is paid, while notes of Rs.50 and above would get full, half, or no value, depending on the area of the single largest undivided portion of the note. Special adjudication procedures exist at the Reserve Bank Issue offices for notes which have turned extremely brittle or badly burnt, charred or inseparably stuck together and, therefore, cannot withstand normal handling.

COMBATING COUNTERFEITING

To combat the incidence of forged notes, the Reserve Bank has taken certain measures like publicity campaigns on security features of bank notes and display of "Know Your Bank note" poster at bank branches including at offsite ATMs. The Reserve Bank, in consultation with the Government of India, periodically reviews and upgrades the security features of the bank notes to deter counterfeiting. It also shares information with various law enforcement agencies to address the issue of counterfeiting. It has also issued detailed guidelines to banks and government treasury offices on how to detect and impound counterfeit notes.

III – Banker and Debt Manager to Government

Since its inception, the Reserve Bank has undertaken the traditional central banking function of managing the government's banking transactions. The Reserve Bank of India Act, 1934 requires the Central Government to entrust the Reserve Bank with all its money, remittance, exchange and banking transactions in India and the

management of its public debt. The Government also deposits its cash balances with the Reserve Bank. The Reserve Bank may also, by agreement, act as the banker to a State Government. Currently, the Reserve Bank acts as banker to all the State Governments in India, except Jammu & Kashmir and Sikkim. It has limited agreements for the management of the public debt of these two State Governments.

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As a banker to the Government, the Reserve Bank receives and pays money on behalf of the various Government departments. As it has offices in only 27 locations, the Reserve Bank appoints other banks to act as its agents for undertaking the banking business on behalf of the governments. The Reserve Bank pays agency bank charges to the banks for undertaking the government business on its behalf. The Reserve Bank has well defined obligations and provides several services to the governments. The Central Government and State Governments may make rules for the receipt, custody and disbursement of money from the consolidated fund, contingency fund, and public account. These rules are legally binding on the Reserve Bank.

The Reserve Bank also undertakes to float loans and manage them on behalf of the Governments. It also provides Ways and Means Advances – a short-term interest bearing advance – to the Governments, to meet the temporary mismatches in their receipts and payments. Besides, it arranges for investments of surplus cash balances of the Governments as a portfolio manager. The Reserve Bank also acts as adviser to Government, whenever called upon to do so, on monetary and banking related matters.

The banking functions for the governments are carried out by the Public Accounts Departments at the offices / branches of the Reserve Bank, while management of public debt including floatation of new loans is done at Public Debt Office at offices / branches of the Reserve Bank and by the Internal Debt Management Department at the Central Office. For the final compilation of the Government accounts, both of the centre and states, the Nagpur office of the Reserve Bank has a Central Accounts Section.

BANKER TO THE CENTRAL GOVERNMENT

Under the administrative arrangements, the Central Government is required to maintain a minimum cash balance with the Reserve Bank. Currently, this amount is Rs.10 crore on a daily basis and Rs.100 crore on Fridays, as also at the end of March and July.

Under a scheme introduced in 1976, every ministry and department of the Central Government has been allotted a specific public sector bank for handling its transactions. Hence, the Reserve Bank does not handle government's day-to-day transactions as before, except where it has been nominated as banker to a particular ministry or department. In 2004, a Market Stabilisation Scheme (MSS) was introduced for issuing of treasury bills and dated securities over and above the normal market borrowing programme of the Central Government for absorbing excess liquidity. The Reserve Bank maintains a separate MSS cash balance of the Government, which is not part of the Consolidated Fund of India.

As banker to the Government, the Reserve Bank works out the overall funds position and sends daily advice showing the balances in its books, Ways and Means Advances granted to the government and investments made from the surplus fund. The daily advices are followed up with monthly statements.

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Banker to the State Government

All the State Governments are required to maintain a minimum balance with the Reserve Bank, which varies from state to state depending on the relative size of the state budget and economic activity. To tide over temporary mismatches in the cash flow of receipts and payments, the Reserve Bank provides Ways and Means Advances to the State Governments. The WMA scheme for the State Governments has provision for Special and Normal WMA. The Special WMA is extended against the collateral of the government securities held by the State Government. After the exhaustion of the special WMA limit, the State Government is provided a normal WMA. The normal WMA limits are based on three-year average of actual revenue and capital expenditure of the state. The withdrawal above the WMA limit is considered an overdraft. A State Government account can be in overdraft for a maximum 14 consecutive working days with a limit of 36 days in a quarter. The rate of interest on WMA is linked to the Repo Rate. Surplus balances of State Governments are invested in Government of India 14-day Intermediate

Treasury bills in accordance with the instructions of the State Governments.

MANAGEMENT OF PUBLIC DEBT

The Reserve Bank manages the public debt and issues new loans on behalf of the Central and State Governments. It involves issue and retirement of rupee loans, interest payment on the loan and operational matters about debt certificates and their registration. The union budget decides the annual borrowing needs of the Central Government. Parameters, such as, interest rate, timing and manner of raising of loans are influenced by the state of liquidity and the expectations of the market. The Reserve Bank's debt management policy aims at minimizing the cost of borrowing, reducing the roll-over risk, smoothening the maturity structure of debt, and improving depth and liquidity of Government securities markets by developing an active secondary market. While formulating the borrowing programme for the year, the Government and the Reserve Bank take into account a number of factors, such as, the amount of Central and State loans maturing during the year, the estimated available resources, and the absorptive capacity of the market.

IV – Banker to Banks

Banks are required to maintain a portion of their demand and time liabilities as cash reserves with the Reserve Bank, thus necessitating a need for maintaining accounts with the Bank. Further, banks are in the business of accepting deposits and giving loans. Since different persons deal with different banks, in order to settle transactions between various customers maintaining accounts with different banks, these banks have to settle transactions among each other. Settlement of inter-bank obligations thus assumes importance.

To facilitate smooth operation of this function of banks, an arrangement has to be made to transfer money from one bank to another. This is usually done through the mechanism of a clearing house where banks present cheques and other such instruments for clearing. Many banks also engage in other financial activities, such as, buying and selling securities and foreign currencies. Here too, they need to exchange funds between themselves. In order to facilitate a smooth inter-bank transfer of funds, or to make payments and to receive funds on their behalf, banks need a common banker.

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In order to meet the above objectives, in India, the Reserve Bank provides banks with the facility of opening accounts with itself. This is the 'Banker to Banks' function of the Reserve Bank, which is delivered through the Deposit Accounts Department (DAD) at the Regional offices. The Department of Government and Bank Accounts oversees this function and formulates policy and issues operational instructions to DAD.

RESERVE BANK AS BANKER TO BANKS

To fulfill this function, the Reserve Bank opens current accounts of banks with itself, enabling these banks to maintain cash reserves as well as to carry out inter-bank transactions through these accounts. Inter-bank accounts can also be settled by transfer of money through electronic fund transfer system, such as, the Real Time Gross Settlement System (RTGS).

The Reserve Bank continuously monitors operations of these accounts to ensure that defaults do not take place. Among other provisions, the Reserve Bank stipulates minimum balances to be maintained by banks in these accounts. Since banks need to settle funds with each other at various places in India, they are allowed to open accounts with different regional offices of the Reserve Bank. The Reserve Bank also facilitates remittance of funds from a bank's surplus account at one location to its deficit account at another. Such transfers are electronically routed through a computerized system. The computerization of accounts at the Reserve Bank has greatly facilitated banks' monitoring of their funds position in various accounts across different locations on a real-time basis.

As Banker to Banks, RBI focuses on

- Enabling smooth, swift and seamless clearing and settlement of inter-bank obligations.
- Providing an efficient means of funds transfer for banks.
- Enabling banks to maintain their accounts with the Reserve Bank for statutory reserve requirements and maintenance of transaction balances.
- Acting as a lender of last resort.

In addition, the Reserve Bank has also introduced the Centralized Funds Management System (CFMS) to facilitate centralized funds enquiry and transfer of funds across DADs. This helps banks in their fund management as they can access information on their balances maintained across different DADs from a single location. Currently, 75 banks are using the system and all

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DADs are connected to the system.

As Banker to Banks, the Reserve Bank provides short-term loans and advances to select banks, when necessary, to facilitate lending to specific sectors and for specific purposes. These loans are provided against promissory notes and other collateral given by the banks.

LENDER OF LAST RESORT

As a Banker to Banks, the Reserve Bank also acts as the 'lender of last resort'. It can come to the rescue of a bank that is solvent but faces temporary liquidity problems by supplying it with much needed liquidity when no one else is willing to extend credit to that bank. The Reserve Bank extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of a bank, which in turn may also affect other banks and institutions and can have an adverse impact on financial stability and thus on the economy.

V – Financial Regulation and Supervision

The Reserve Bank's regulatory and supervisory domain extends not only to the Indian banking system but also to the development financial institutions (DFIs), non-banking financial companies (NBFCs), primary dealers, credit information companies and select segments of the financial markets. In respect of banks, the Reserve Bank derives its powers from the provisions of the Banking Regulation Act, 1949, while the other entities and markets are regulated and supervised under the provisions of the Reserve Bank of India Act, 1934. The credit information companies are regulated under the provisions of Credit Information Companies (Regulation) Act, 2005.

As the regulator and the supervisor of the banking system, the Reserve Bank has a critical role to play in ensuring the system's safety and soundness on an ongoing basis. The objective of this function is to protect the interest of depositors through an effective prudential regulatory framework for orderly development and conduct of banking operations, and to maintain overall financial stability through various policy measures.

India's financial system includes commercial banks, regional rural banks, local area banks, cooperative banks, financial institutions and non-banking financial companies. The banking sector reforms since the 1990s made stability in the financial sector an important plank of the Reserve Bank's functions. Besides, the global financial markets have, in the last 75 years, grown phenomenally in terms of volumes, number of players and instruments. The Reserve Bank's regulatory and supervisory role has, therefore, acquired added importance. The Board for Financial Supervision (BFS), constituted in November 1994, is the principal guiding force behind the Reserve Bank's regulatory and supervisory initiatives. There are various departments in the Reserve Bank that perform these regulatory and supervisory functions. The Department of Banking Operations and Development (DBOD) frames regulations for commercial banks. The

Department of Banking Supervision (DBS) undertakes supervision of commercial banks, including the local area banks and all-India financial institutions. The

Department of Non-Banking Supervision (DNBS) regulates and supervises the Non-Banking Financial Companies (NBFCs) while the Urban Banks Department (UBD) regulates and supervises the Urban Cooperative Banks (UCBs). Rural Planning and Credit Department (RPCD) regulates the Regional Rural Banks (RRBs) and the Rural Cooperative Banks, whereas their supervision has been entrusted to NABARD.

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REGULATORY AND SUPERVISORY FUNCTIONS

Traditionally, the Reserve Bank's regulatory and supervisory policy initiatives are aimed at protection of the depositors' interests, orderly development and conduct of banking operations, and liquidity and solvency of banks. With the onset of banking sector reforms during the 1990s, various prudential measures were intitated that have, in effect, strengthened the Indian banking system over a period of time. Improved financial soundness of banks has helped them to show stability and resilience in the face of the recent severe global financial crisis, which had seriously impacted several banks and financial institutions in advanced countries. However, there is still a need to strengthen the regulatory and supervisory architecture. The Reserve Bank represents India in various international fora, such as, the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). Its presence on such bodies has enabled the Reserve Bank's active participation in the process of evolving global standards for enhanced regulation and supervision of banks.

The major regulatory functions of the Reserve Bank with respect to the various components of the financial system are as follows:

COMMERCIAL BANKS

Licensing

For commencing banking operations in India, whether by an Indian or a foreign bank, a license from the Reserve Bank is required. The opening of new branches by banks and change in the location of existing branches are also regulated as per the Branch Authorization Policy. This policy has recently been liberalized significantly and Indian banks no longer require a licence from the Reserve Bank for opening a branch at a place with population of below 50,000. The Reserve Bank continues to emphasise opening of branches by banks in unbanked and under-banked areas of the country. The Reserve Bank also regulates merger, amalgamation and winding up of banks.

Corporate Governance

The Reserve Bank's policy objective is to ensure high-quality corporate governance in banks. It has issued guidelines stipulating 'fit and proper' criteria for directors of banks. In terms of the guidelines, a majority of the directors of banks are required to have special knowledge or practical experience in various relevant areas. The Reserve Bank also has powers to appoint additional directors on the board of a banking company.

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Statutory Pre-emptions

Commercial banks are required to maintain a certain portion of their Net Demand and Time Liabilities (NDTL) in the form of cash with the Reserve Bank, called Cash Reserve Ratio (CRR) and in the form of investment in unencumbered approved securities, called Statutory Liquidity Ratio (SLR). The Reserve Bank also monitors compliance with these requirements by banks in their day-to-day operations.

Interest Rate

The interest rates on most of the categories of deposits and lending transactions have been deregulated and are largely determined by banks. However, the Reserve Bank regulates the interest rates on savings bank accounts and deposits of non-resident Indians (NRI), small loans up to rupees two lakh, export credits and a few other categories of advances.

Prudential Norms

The Reserve Bank has prescribed prudential norms to be followed by banks in several areas of their operations. It keeps a close watch on developing trends in the financial markets, and fine-tunes the prudential policies.

PRUDENTIAL NORMS

In order to strengthen the balance sheets of banks, the Reserve Bank has been prescribing appropriate prudential norms for them in regard to income recognition, asset classification and provisioning, capital adequacy, investments portfolio and capital market exposures, to name a few. A brief description of these norms is furnished below:

Capital Adequacy

The Reserve Bank has instructed banks to maintain adequate capital on a continuous basis. The adequacy of capital is measured in terms of Capital to Risk-Weighted Assets Ratio (CRAR). Under the recently revised framework, banks are required to maintain adequate capital for credit risk, market risk, operational risk and other risks. Basel II standardized approach is applicable with road map drawn up for advanced approaches.

Loans and Advances

In order to maintain the quality of their loans and advances, the Reserve Bank requires banks to classify their loan assets as performing and non-performing assets (NPA), primarily based on the record of recovery from the borrowers. NPAs are further categorized into Sub-standard, Doubtful and Loss Assets depending upon age of the NPAs and value of available securities. Banks are also required to make appropriate provisions against each category of NPAs. Banks are also required to have exposure limits in place to prevent credit concentration risk and limit exposures to sensitive sectors, such as, capital markets and real estate.

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For Investments

The Reserve Bank requires banks to classify their investment portfolios into three categories for the purpose of valuation: Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT). The securities held under HFT and AFS categories have to be marked-to-market periodically and depreciation, if any, needs appropriate provisions by banks. Securities under HTM category must be carried at acquisition / amortized cost, subject to certain conditions.

Risk Management

Banks, in their daily business, face various kinds of risks. The Reserve Bank requires banks to have effective risk management systems to cover credit risk, market risk, operational risk and other risks. It has issued guidelines, based on the Basel II capital adequacy framework, on how to measure these risks as well as how to manage them.

Disclosure Norms

Public disclosure of relevant information is an important tool for enforcing market discipline. Hence, over the years, the Reserve Bank has strengthened the disclosure norms for banks. Banks are now required to make disclosures in their annual report, among others, about capital adequacy, asset quality, liquidity, earnings aspects and penalties, if any, imposed on them by the regulator.

Know Your Customer Norms

To prevent money laundering through the banking system, the Reserve Bank has issued 'Know Your Customer' (KYC), Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) guidelines. Banks are required to carry out KYC exercise for all their customers to establish their identity and report suspicious transactions to authorities.

Protection of Small Depositors

The Reserve Bank has set up Deposit Insurance and Credit Guarantee Corporation (DICGC) to protect the interest of small depositors, in case of bank failure. The DICGC provides insurance cover to all eligible bank depositors up to Rs.1 lakh per depositor per bank.

Para - banking Activities

The banking sector reforms and the gradual deregulation of the sector inspired many banks to undertake non-traditional banking activities, also known as para-banking. The Reserve Bank has permitted banks to undertake diversified activities, such as, asset management, mutual funds business, insurance business, merchant banking activities, factoring services, venture capital, card business, equity participation in venture funds and leasing.

Supervisory Functions

The Reserve Bank undertakes supervision of banks to monitor and ensure compliance by them with its regulatory policy framework. This is achieved through on-site inspection, off-site surveillance and periodic meetings with top management of banks.

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On-site Inspection

The Reserve Bank undertakes annual on-site inspection of banks to assess their financial health and to evaluate their performance in terms of quality of management, capital adequacy, asset quality, earnings, liquidity position as well as internal control systems. Based on the findings of the inspection, banks are assigned supervisory ratings based on the CAMELS (CALCS for foreign banks in India) supervisory model and are required to address the weaknesses identified.

Off-site Surveillance

The Reserve Bank requires banks to submit detailed and structured information periodically under its Off Site Surveillance and Monitoring System (OSMOS). This information is thoroughly analyzed by the RBI to assess the health of individual banks and that of the banking system, and also glean early warning signals which could serve as a trigger for necessary supervisory intervention.

Periodic Meetings

The Reserve Bank periodically meets the top management of banks to discuss the findings of its inspections. In addition, it also has quarterly / monthly discussions with them on important aspects based on OSMOS returns and other inputs.

Monitoring of Frauds

The Reserve Bank regularly sensitizes banks about common fraud-prone areas, the modus operandi and the measures necessary to prevent frauds. It also cautions banks about unscrupulous borrowers who have perpetrated frauds with other banks.

FOREIGN BANKS

In February 2005, the Government of India and the Reserve Bank released the 'Roadmap for presence of Foreign Banks in India' laying out a two-track and gradualist approach aimed at increasing the efficiency and stability of the banking sector in India. One track was the consolidation of the domestic banking system, both in private and public sectors, and the second track was the gradual enhancement of the presence of foreign banks in a synchronized manner.

The roadmap was divided into two phases, the first phase spanning the period March 2005 - March 2009, and the second phase beginning April 2009 after a review of the experience gained in the first phase. In view of the recent global financial market turmoil, there are uncertainties surrounding the financial strength of banks around the world. Further, the regulatory and supervisory policies at national and international levels are under review. In view of this, the current policy and procedures governing the presence of foreign banks in India will continue. The proposed review will be taken up after consultation with the stakeholders once there is greater clarity regarding stability, recovery of the global financial system and a shared understanding on the regulatory and supervisory architecture around the world.

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FINANCIAL INSTITUTIONS

Financial institutions are an important part of the Indian financial system as they provide medium to long term finance to different sectors of the economy. These institutions have been set up to meet the growing demands of particular segments, such as, export, rural, housing and small industries. These institutions have been playing a crucial role in channelizing credit to the above sectors and addressing the challenges / issues faced by them.

There are four financial institutions - Exim Bank, National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI) which are under full-fledged regulation and supervision of the Reserve Bank.

As in the case of commercial banks, prudential norms relating to income recognition, asset classification and provisioning, and capital adequacy ratio are applicable to these financial institutions as well. These institutions also are subject to on-site inspection as well as off-site surveillance.

RURAL FINANCING INSTITUTIONS

(A) Rural Cooperative Banks

Rural cooperatives occupy an important position in the Indian financial system. These were the first formal institutions established to purvey credit to rural India. Thus far, cooperatives have been a key instrument of financial inclusion in reaching out to the last mile in rural areas. Cooperative banks are registered under the respective State Co-operative Societies Act or Multi

State Cooperative Societies Act, 2002 and governed by the provisions of the respective acts. The legal character, ownership, management, clientele and the role of state governments in the functioning of the cooperative banks make these institutions distinctively different from commercial banks. The distinctive feature of the cooperative credit structure in India is its heterogeneity.

Structure of Rural Cooperative Credit Institutions

Rural cooperatives structure is bifurcated into short-term and long-term structure. The short-term cooperative structure is a three-tier structure with State Cooperative Banks (StCBs) at the apex (State) level, District Central Cooperative Banks (DCCBs) at the intermediate (district) level and Primary Agricultural Credit Societies (PACS) at the ground (village) level. The short term structure caters primarily to the various short / medium-term production and marketing credit needs for agriculture.

The long-term cooperative structure has the State Cooperative Agriculture and Rural Development Banks (SCARDBs) at the apex level and the Primary Cooperative Agriculture and Rural Development Banks (PCARDBs) at the district or block level. These institutions were conceived with the objective of meeting long-term credit needs in agriculture.

As on end-March, there were 95,352 Short-term Rural Cooperative Credit Institutions (STCCIs). This included 31 StCBs, 371 DCCBs and 94,950 PACS.

There were 717 Long Term Rural Cooperative Credit Institutions (LTCCIs) comprising 20 SCARDBs and 697 PCARDBs.

Regulatory and Supervisory Framework

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While regulation of State Cooperative Banks and District Central Cooperative Banks vests with Reserve Bank, their supervision is carried out by National Bank for Agriculture and Rural Development (NABARD). The Board of Supervision, a Committee of the Board of Directors of NABARD, gives directions and guidance in respect of policies and matters relating to supervision and inspection of StCBs and DCCBs. A large number of StCBs as well as DCCBs are unlicensed and are allowed to function as banks till they are either granted licence or their applications for licence are rejected. The Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) had observed that there is a need for a roadmap to ensure that only licenced banks operate in the cooperative space and that banks which fail to obtain a licence by 2012 should not be allowed to operate to expedite the process of consolidation and weeding out of non viable entities from the cooperative space. A roadmap has been put in place to achieve this position.

Capital Adequacy Norms

At present, the CRAR norms are not applicable to StCBs and DCCBs. However, since March 31, 2008, they are required to disclose the level of CRAR in the 'notes on accounts' to their balance sheets every year. The income recognition, asset classification and provisioning norms are applicable as in the case of commercial banks.

(B) Regional Rural Banks

Regional Rural Banks were set up under the Regional Rural Banks Act, 1976 with a view to developing the rural economy by providing credit and other facilities, particularly to the small and marginal farmers, agricultural laborers, artisans and small entrepreneurs. Being local level institutions, RRBs together with commercial and co-operative banks, were assigned a critical role to play in the delivery of agriculture and rural credit.

The equity of the RRBs was contributed by the Central Government, concerned State Government and the sponsor bank in the proportion of 50:15:35. As of March 31, 2009, there were 86 RRBs having a total of 15,107 branches. The function of financial regulation over RRBs is exercised by Reserve Bank and the supervisory powers have been vested with NABARD. CRAR norms are not applicable to RRBs. However, the income recognition, asset classification and provisioning norms as applicable to commercial banks are applicable to RRBs.

URBAN COOPERATIVE BANKS

Urban co-operative banks play a significant role in providing banking services to the middle and lower income groups of society in urban and semi urban areas. The primary (urban) co-operative banks (UCBs), like other co-operative societies, are registered under the respective State Co-operative Societies Act or Multi State

Cooperative Societies Act, 2002 and governed by the provisions of the respective acts.

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With a view to bringing primary (urban) co-operative banks under the purview of the Banking Regulation Act, 1949, certain provisions of the Banking Regulation Act, 1949 were made applicable to co-operative banks effective March 1, 1966. With this, these banks came under the dual control of respective State Governments/ Central Government and the Reserve Bank. While the non-banking aspects like registration, management, administration and recruitment, amalgamation and liquidation are regulated by the State/ Central Governments, matters related to banking are regulated and supervised by the Reserve Bank under the Banking Regulation Act, 1949 (as applicable to co-operative societies).

As of now, there are 1721 primary (urban) co-operative banks including 53 scheduled banks. The UCBs are largely concentrated in a few States, such as, Andhra Pradesh, Gujarat, Karnataka, Maharashtra and Tamil Nadu. Apart from a few large banks, most of the UCBs are often functioning as a unit bank.

(A) Regulatory Framework

Licensing

UCBs have to obtain a licence from the Reserve Bank for doing banking business. The unlicensed primary (urban) co-operative banks can continue to carry on banking business till they are refused a licence. Further UCBs also have to obtain prior authorization of the Reserve Bank to open a new place of business.

Prudential Norms

Prudential norms relating to income recognition, asset classification, and provisioning and capital adequacy ratio are applicable to urban co-operative banks as well.

(B) Supervisory Framework

To ensure that primary (urban) co-operative banks function on sound lines and their methods of operation are consistent with statutory provisions and are not detrimental to the interests of depositors, they are subject to (i) on-site inspection, and (ii) off-site surveillance.

On-site Inspection

The principal objective of inspection of primary (urban) co-operative banks is to safeguard the interests of depositors and to build and maintain a sound banking system in conformity with the banking laws and regulations. While all scheduled urban co-operative banks, and select non-scheduled urban co-operative banks are inspected on an annual basis, other non-scheduled UCBs are inspected once in two years. The banks are graded into four categories based on four parameters *viz.*, CRAR, net NPA, profitability and compliance with CRR/SLR stipulations.

Off-site Surveillance

In order to have continuous supervision over the UCBs, the Reserve Bank has supplemented the system of periodic on-site inspection with off-site surveillance (OSS) through a set of periodical prudential returns to be submitted by UCBs.

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NON BANKING FINANCIAL COMPANIES

Non-banking Financial Companies play an important role in the financial system. An NBFC is defined as a company engaged in the business of lending, investment in shares and securities, hire purchase, chit fund, insurance or collection of monies. Depending upon the line of activity, NBFCs are categorized into different types. Recognizing the growth in the sector, initially the regulatory set-up primarily focused on the deposit taking activity in terms of limits and interest rate.

The recommendations of the Joint Parliamentary Committee which looked into the stock market scam of early 90s and the Shah Committee (1992) suggested that there was a need to expand the regulatory and supervisory focus also to the asset side of NBFCs' balance sheet. Legislative amendments were adopted to empower the Reserve Bank to regulate Non-Banking

Financial Companies to ensure that they integrate their functioning within the Indian financial system.

The amended Act provides that for commencing /carrying on the business of Non –Banking Financial Institution (NBFI), a company has to have a minimum level of Net Owned Funds (NoF). At end- June 2009 there were 12,740 NBFCs. Out of these, 336 have been permitted to accept deposits and are classified as NBFC-D. The non-deposit taking companies are classified as NBFC-ND.

(A) Regulatory Framework

NBFCs accepting Public Deposits

The Reserve Bank issues directions about the quantum of public deposits that can be accepted, the period of deposits, which should not be less than 12 months and should not exceed 60 months, the maximum rate of interest payable on such deposits (presently 12.5 per cent), brokerage fees and other expenses amounting to a maximum of 2 per cent and 0.5 per cent of the deposits, respectively, and the contents of the application forms, as well as the advertisement for soliciting deposits.

Companies which accept public deposits are required to comply with all the prudential norms on income recognition, asset classification, accounting standards, provisioning for bad and doubtful debts, capital adequacy, and credit and investment concentration. Additional disclosures in balance sheets have also been prescribed.

In order to restrict indiscriminate investment by Non-Banking Financial Companies in real estate and in unquoted shares, they have been directed to limit their investment in real estate, except for their own use, up to 10 per cent of their owned funds. Further, a ceiling of 20 per cent has also been prescribed for investment in unquoted shares of other than group / subsidiary companies.

In case an NBFC defaults in the payment of matured deposits, the depositors can lodge their claims against the Company with the Company Law Board (CLB). NBFCs also have to maintain SLR (15 per cent) as a percentage of deposits. However, there is no CRR prescription for NBFCs as they do not accept demand deposits.

NBFCs not accepting Public Deposits

Non-Banking Financial Companies not accepting public deposits are regulated in a limited manner. However, with the opening up of foreign direct investment in NBFCs and the opportunities for credit growth in the economy, the sector has witnessed the entry of some large companies in the category of NBFC-ND. Since these companies, unlike the NBFC-D, were earlier not subject to prudential norms for capital adequacy and exposures, their borrowings increased considerably. Further, since, unlike banks, the NBFC sector does not have any cap on exposure to the capital market, these entities have, as a part of their business, been taking significant exposure on the capital market. In view of the above, non-deposit taking NBFCs with asset size of Rs 100 crore and above were classified as Systemically Important and were required to comply with exposure and capital adequacy norms . To facilitate off-site supervision, they are also required to provide additional information to the Reserve Bank through monthly and annual returns. Further, to contain the risks of the NBFC sector spilling over to the banking sector, exposure of banks to the NBFC sector, either in the form of credit facilities or in the form of equity contribution has been prudentially capped.

(B) Supervisory Framework

On-Site Inspection

All NBFC-D and all large NBFC – NDs are subjected to regular annual inspection to assess their financial performance and the general compliance with the directions issued by the Reserve Bank. The inspection focuses on Capital, Asset Quality, Management, Earnings, Liquidity and Systems (CAMELS pattern) and identifies the supervisory concerns. These are taken up with the

respective institutions for remedial action.

Off-Site Surveillance System

In order to supplement information between on-site inspections, several returns have been prescribed for NBFCs as part of the off-site surveillance system. The information provided is analyzed to identify potential supervisory concerns and in certain cases serves as a trigger for on-site inspection.

External Auditing

The responsibility of ensuring compliance with the directions issued by the Reserve Bank, as well as adherence to the provisions of the RBI Act has also been entrusted to the statutory auditors of the Non-Banking Financial Companies. The statutory auditors are required to report to the Reserve Bank about any irregularity or violation of regulations concerning acceptance of public deposits, credit rating, prudential norms and exposure limits, capital adequacy, maintenance of liquid assets and regularization of excess deposits held by the companies.

PRIMARY DEALERS

In 1995, the Reserve Bank introduced the system of Primary Dealers (PDs) in the Government Securities Market, which comprised independent entities undertaking

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Primary Dealer activity. PDs play an active role in the Government securities market by underwriting and bidding for fresh issuances and acting as market makers for these securities. In order to broaden the Primary

Dealership system, banks were permitted to undertake Primary Dealership business departmentally in 2006-07. Further, the standalone PDs were permitted to diversify into business activities, other than the core PD business, in 2006-07, subject to certain conditions. As on June 30, 2010, there were six standalone PDs and eleven banks authorized to undertake PD business departmentally.

Regulation

PDs are required to meet registration and such other requirements as stipulated by the Securities and Exchange Board of India (SEBI) including operations on the Stock Exchanges, if they undertake any activity regulated by SEBI. PDs are expected to join the Primary Dealers Association of India (PDAI) and the Fixed Income Money Market and Derivatives Association (FIMMDA) and abide by the code of conduct and such other actions as initiated by these Associations in the interest of the securities markets. Any change in the shareholding pattern / capital structure of a PD needs prior approval of the Reserve Bank. The Reserve Bank reserves the right to cancel the Primary Dealership if, in its view, the concerned institution has failed to adhere to the terms of authorization or any other applicable guideline. A Primary Dealer should bring to the Reserve Bank's attention any major complaint against it or action initiated/taken against it by the Stock Exchanges, SEBI, CBI, Enforcement Directorate, Income Tax, or any other authority.

Supervision

Off-site supervision: PDs are required to submit to the Reserve Bank, periodic returns which are analyzed to identify any concerns. On-site inspection: The Reserve Bank has the right to inspect the books, records, documents and accounts of the PD. PDs are required to make available all such documents and records to the Reserve Bank officers and render all necessary assistance as and when required.

CREDIT INFORMATION COMPANIES

Credit Information Companies (CIC) play an important role in facilitating credit to various borrowers on the basis of their track record. Credit Information Companies (Regulation) Act 2005 empowers the Reserve Bank to regulate CICs. The Reserve Bank announced in November 2008 that Foreign Direct Investment up to 49 per cent in CICs would be considered in cases: where the investor was a company with an established track record of running a credit information bureau in a well regulated environment; (b) no shareholder in the investor company held more than 10 per cent voting rights in that company; and (c) preferably, the company was a listed company on a recognized stock exchange. The Reserve Bank, in April 2009, issued 'in principle approval' to four companies to set up CICs.

FINANCIAL MARKETS

Deep and efficient financial markets are essential for realizing the growth potential of an economy; however, disorderly financial markets could be a source of risk to

both financial institutions and the economy. The Reserve Bank regulates only certain segments of financial markets, namely, the money market, the government securities market and the foreign exchange market. Various measures have been taken to deepen these markets over a period of time.

VI – Foreign Exchange Reserve Management

The Reserve Bank, as the custodian of the country's foreign exchange reserves, is vested with the responsibility of managing their investment. The legal provisions governing management of foreign exchange reserves are laid down in the Reserve Bank of India Act, 1934.

The Reserve Bank's reserves management function has in recent years grown both in terms of importance and sophistication for two main reasons. First, the share of foreign currency assets in the balance sheet of the Reserve Bank has substantially increased. Second, with the increased volatility in exchange and interest rates in the global market, the task of preserving the value of reserves and obtaining a reasonable return on them has become challenging. The basic parameters of the Reserve Bank's policies for foreign exchange reserves management are safety, liquidity and returns. Within this framework, the Reserve Bank focuses on:

a) Maintaining market's confidence in monetary and exchange rate policies.

b) Enhancing the Reserve Bank's intervention capacity to stabilise foreign exchange markets.

c) Limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis, including national disasters or emergencies.

d) Providing confidence to the markets that external obligations can always be met, thus reducing the costs at which foreign exchange resources are available to market participants.

e) Adding to the comfort of market participants by demonstrating the backing of domestic currency by external assets.

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INVESTMENT OF RESERVES

The Reserve Bank of India Act permits the Reserve Bank to invest the reserves in the following types of instruments:

1) Deposits with Bank for International Settlements and other central banks
2) Deposits with foreign commercial banks
3) Debt instruments representing sovereign or sovereign-guaranteed liability of not more than 10 years of residual maturity
4) Other instruments and institutions as approved by the Central Board of the Reserve Bank in accordance with the provisions of the Act
5) Certain types of derivatives

While safety and liquidity continue to be the twin-pillars of reserves management, return optimization has become an embedded strategy within this framework. The Reserve Bank has framed policy guidelines stipulating stringent eligibility criteria for issuers, counterparties, and investments to be made with them to enhance the safety and liquidity of reserves. The Reserve

Bank, in consultation with the Government, continuously reviews the reserves management strategies.

Deployment of Reserves

The foreign exchange reserves include foreign currency assets (FCA), Special Drawing Rights (SDRs) and gold. SDRs are held by the Government of India. The foreign currency assets are managed following the principles of portfolio management.

In deploying reserves, the Reserve Bank pays close attention to currency composition, interest rate risk and liquidity needs. All foreign currency assets are invested in assets of top quality and a good proportion is convertible into cash at short notice. The counterparties with whom deals are conducted are also subject to a rigorous selection process. In assessing the returns from deployment, the total return (both interest and capital gains) is taken into consideration. One crucial area in the process of investment of the foreign currency assets in the overseas markets relates to the risks involved in the process. While there is no set formula to meet all situations, the Reserve Bank follows the accepted portfolio management principles for risk management.

FOREIGN EXCHANGE RESERVES MANAGEMENT – THE RBI'S APPROACH

The Reserve Bank's approach to foreign exchange reserves management has also undergone a change. Until the balance of payments crisis of 1991, India's approach to foreign exchange reserves was essentially aimed at maintaining an appropriate import cover. The approach underwent a paradigm shift following the recommendations of the High Level Committee on Balance of Payments chaired by Dr. C. Rangarajan (1993). The committee stressed the need to maintain sufficient reserves to meet all external payment obligations, ensure a reasonable level of confidence in the international community about India's capacity to honor its obligations, and counter speculative tendencies in the market. After the introduction

of system of market-determined exchange rates in 1993, the objective of smoothening out the volatility in the exchange rates assumed importance.

The overall approach to the management of foreign exchange reserves also reflects the changing composition of Balance of Payments (BoP) and liquidity risks associated with different types of flows. In 1997, the Report of the Committee on Capital Account Convertibility under the chairmanship of Shri S.S. Tarapore, suggested alternative measures for adequacy of reserves. The committee in addition to trade-based indicators also suggested money-based and debt-based indicators. Similar views have been held by the Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore, July 2006).

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The traditional approach of assessing reserve adequacy in terms of import cover has been widened to include a number of parameters about the size, composition, and risk profiles of various types of capital flows. The Reserve Bank also looks at the types of external shocks to which the economy is potentially vulnerable. The objective is to ensure that the quantum of reserves is in line with the growth potential of the economy, the size of risk-adjusted capital flows and national security requirements.

VII – Foreign Exchange Management

The Reserve Bank oversees the foreign exchange market in India. It supervises and regulates it through the provisions of the Foreign Exchange Management Act, 1999. Like other markets, the foreign exchange market has also evolved over time, and the Reserve Bank has been modulating its approach towards its function of supervising the market.

EVOLUTION

For a long time, foreign exchange in India was treated as a controlled commodity because of its limited availability. The early stages of foreign exchange management in the country focused on control of foreign exchange by regulating the demand due to limited supply. Exchange control was introduced in India under the Defence of India Rules on September 3, 1939 on a temporary basis. The statutory power for exchange control was provided by the Foreign Exchange Regulation Act (FERA) of 1947, which was subsequently replaced by a more comprehensive Foreign Exchange Regulation Act, 1973. This Act empowered the Reserve Bank, and in certain cases the Central Government, to control and regulate dealings in foreign exchange payments outside India, exports and import of currency notes and bullion, transfer of securities between residents and non-residents, acquisition of foreign securities, and acquisition of immovable property in and outside India, among other transactions. Extensive relaxations in the rules governing foreign exchange were initiated, prompted by the liberalization measures introduced since 1991 and the Act was amended as a new Foreign Exchange Regulation (Amendment) Act 1993. Significant developments in the external sector, such as, substantial increase in foreign exchange reserves, growth in foreign trade, rationalisation of tariffs, current account convertibility, liberalization of Indian investments abroad, increased access to external commercial borrowings by Indian corporates and participation of foreign institutional investors in Indian stock market, resulted in a changed environment. Keeping in view the changed environment, the Foreign Exchange Management Act (FEMA) was enacted in 1999 to replace

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FERA with effect from June 1, 2000. FEMA aimed at consolidating and amending the laws relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange markets in India. Emphasising the shift in focus, the Reserve Bank in due course also amended (since January 31, 2004) the name of its department dealing with the foreign exchange transactions to Foreign Exchange Department from Exchange Control Department.

Liberalized Approach

The Reserve Bank issues licenses to banks and other institutions to act as Authorized Dealers in the foreign exchange market. In keeping with the move towards liberalization, the Reserve Bank has undertaken substantial elimination of licensing, quantitative restrictions and other regulatory and discretionary controls.

Apart from easing restrictions on foreign exchange transactions in terms of processes and procedure, the Reserve Bank has also provided the exchange facility for liberalized travel abroad for purposes, such as, conducting business, attending international conferences, undertaking technical study tours, setting up joint ventures abroad, negotiating foreign collaboration, pursuing higher studies and training, and also for medical treatment.

Moreover, the Reserve Bank has permitted residents to hold foreign currency up to a maximum of USD 2,000 or its equivalent. Residents can now also open foreign currency accounts in India and credit specified foreign exchange receipts into it.

Foreign Investment

Foreign investment comes into India in various forms. Following the reforms path, the Reserve Bank has liberalized the provisions relating to such investments.

- The Reserve Bank has permitted foreign investment in almost all sectors, with a few exceptions. Foreign companies are permitted to set up 100 per cent subsidiaries in India.
- In many sectors, no prior approval from the Government or the Reserve Bank is required for non-residents investing in India.
- Foreign institutional investors are allowed to invest in all equity securities traded in the primary and secondary markets. The total investment by all the foreign institutional investors put together should not exceed 24 per cent of the issued and paid up capital of a company which can be raised up to the level of the prescribed sectoral cap by the respective companies by passing a special resolution to the effect.
- Foreign institutional investors have also been permitted to invest in Government of India treasury bills and dated securities, corporate debt instruments and mutual funds. The NRIs have the flexibility of investing under the options of repatriation and non-repatriation.
- The Government allows Indian companies to issue Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) to foreign investors The GDRs/ADRs issued by Indian companies to non-residents have free convertibility outside India.

Indian Investment Abroad

Any Indian entity can make investment in an overseas joint venture or in a wholly-owned subsidiary, up to 400 per cent of its net-worth.

External Commercial Borrowings

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Indian companies are allowed to raise external commercial borrowings including commercial-bank loans, buyers' credit, suppliers' credit, and securitized instruments. Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs) are also governed by the ECB guidelines.

Liberalized Remittance Scheme

As a step towards further simplification and liberalization of the foreign exchange facilities available to the residents, the Reserve Bank has permitted resident individuals to freely remit abroad up to USD 200,000 per financial year for any permissible purposes.

Currency Futures

In a recent development, regulators have permitted exchange-traded currency futures in India. Such trading facilities are currently being offered by the National Stock Exchange, the Bombay Stock Exchange and the MCX-Stock Exchange. As the product is exchange traded, the conduct of currency futures trading facility is being regulated jointly by the Reserve Bank and the Securities and Exchange Board of India.

Indian Depository Receipts (IDRs)

Under another reform measure, authorities in India have allowed eligible companies resident outside India to issue Indian Depository Receipts (IDRs) through a domestic depository. Such issuances are subject to approval of the sectoral regulators.

EXCHANGE RATE POLICY

The foreign exchange market in India comprises Authorized Persons (banks, money changers and other entities) in foreign exchange business, foreign exchange brokers who act as intermediaries and customers – individuals as well as corporate – who need foreign exchange for their transactions.

The customer segment is dominated by major public sector entities and Government of India (for civil debt service and defence) on the one hand and large private sector corporate on the other. Foreign Institutional Investors (FIIs) have emerged as an important constituent in the equity market and thus contribute significantly to the foreign exchange market activity. The Indian foreign exchange market primarily comprises two segments – the spot market and the derivatives market. As in other emerging market economies, the spot market is the dominant segment of the Indian foreign exchange market.

India's exchange rate policy has evolved in tandem with the domestic as well as international developments. The period after independence was marked by a fixed exchange rate regime, which was in line with the Bretton Woods system prevalent then. The Indian Rupee was pegged to the Pound Sterling on account of historic links with Britain. After the breakdown of Bretton

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Woods System in the early seventies, most of the countries moved towards a system of flexible/managed exchange rates. With the decline in the share of Britain in India's trade, increased diversification of India's international transactions together with the weaknesses of pegging to a single currency, the Indian Rupee was de-linked from the Pound Sterling in September 1975. The exchange rate subsequently came to be determined with reference to the daily exchange rate movements of an undisclosed basket of currencies of India's major trading partners. As the basket-linked management of the exchange rate of the Rupee did not capture the market dynamics and the developments in the exchange rates of competing countries fully, the Rupee's external value was allowed to be determined by market forces in a phased manner following the balance of payment difficulties in the nineties. A significant two-step downward adjustment in the exchange rate of the Rupee was made in 1991. In March 1992, Liberalized Exchange Rate Management System (LERMS) involving the dual exchange rate was instituted.

A unified single market-determined exchange rate system based on the demand for and supply of foreign exchange replaced the LERMS effective March 1, 1993.

The Reserve Bank's exchange rate policy focuses on ensuring orderly conditions in the foreign exchange market. For the purpose, it closely monitors the developments in the financial markets at home and abroad. When necessary, it intervenes in the market by buying or selling foreign currencies. The market operations are undertaken either directly or through public sector banks.

In addition to the traditional instruments like forward and swap contracts, the Reserve Bank has facilitated increased availability of derivative instruments in the foreign exchange market. It has allowed trading in Rupee-foreign currency swaps, foreign currency-Rupee options, cross-currency options, interest rate swaps and currency swaps, forward rate agreements and currency futures.

VIII – Market Operations

The Reserve Bank oprationalises its monetary policy through its operations in government securities, foreign exchange and money markets.

Open Market Operations

Open Market Operations in the form of outright purchase/sale of Government securities are an important tool of the Reserve Bank's monetary management. The Bank carries out such operations in the secondary market on the electronic Negotiated Dealing System – Order Matching (NDS-OM) platform by placing bids and/or taking the offers for securities. All the secondary market transactions in Government Securities are settled through Clearing Corporation of India Limited (CCIL). The entire settlement is under Delivery versus Payment mode. The netted funds settlement is carried out through members' Current Account maintained at the Reserve Bank and through Designated Settlement Bank for those members who do not maintain current account with the Reserve Bank. The securities settlement is done in SGL/ CSGL Accounts of members maintained at the central bank. CCIL acts as central counter party to all Government securities trade facilitating smooth settlement and also guaranteeing settlement, thus reducing gridlocks and mitigating cascading impact that default by one member could have on the system.

Liquidity Adjustment Facility Auctions

The liquidity management operations are aimed at modulating liquidity conditions such that the overnight rates in the money market remains within the informal corridor set by the repo and reverse repo rates for the liquidity adjustment facility (LAF) operations. In a repo transaction, the Reserve Bank infuses liquidity into the system by taking securities as collateral, while in a reverse repo transaction it absorbs liquidity from the system with the Reserve Bank providing securities to the counter parties. The LAF auctions are also conducted electronically with the market participants, such as, banks and Primary Dealers. The LAF auctions are conducted either only once or two times in a day with the operations effectively modulating overnight liquidity conditions in the market.

Market Stabilization Scheme

The Market Stabilisation Scheme (MSS) was introduced in April 2004 under which Government of India dated securities / treasury bills could be issued to absorb surplus structural / durable liquidity created by the Reserve Bank's foreign exchange operations. MSS operations are a sterilization tool used for offsetting the liquidity impact created by intervention in the foreign exchange markets. The dated securities / treasury bills are the same as those issued for normal market borrowings for avoiding segmentation of the market. The MoU between the Reserve Bank and the Government of India envisaged an annual ceiling, to be fixed through mutual consultations, for MSS operations along with a threshold which would trigger a review of the ceiling. The issuances under MSS are matched by an equivalent cash balance held by the Government in a separate identifiable cash account maintained and operated by the Reserve Bank. While these issuances do not provide budgetary support to the Government, interest costs are borne by the Government. These securities are also traded in the secondary market. By design, the MSS has the flexibility of not only absorbing liquidity but also of injecting liquidity, if required, through unwinding as well as buy-back of securities issued under the MSS.

Domestic Foreign Exchange Market Operations

Operations in the domestic foreign exchange markets are conducted within the Reserve Banks framework of exchange rate management policy. The exchange rate management policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band coupled with the ability to intervene if and when necessary. It also allows underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way. Subject to this predominant objective, the exchange rate management policy is guided by the need to reduce excess volatility, prevent the emergence of destabilizing speculative activities, help maintain adequate level of reserves and develop an orderly foreign exchange market. The Reserve Bank also collates computes and disseminates RBI Reference rate on daily basis.

Money Market

The Reserve Bank also carries out regulation and development of money market instruments such as call / notice / term money market, repo market, certificate of deposit, commercial paper and Collateralized Borrowing and Lending Obligations

(CBLO). The call / notice / term money market operations are transacted / reported on the Negotiated Dealing System – Call (NDS Call) platform.

IX – Payment and Settlement System

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The regulation and supervision of payment systems is being increasingly recognized as a core responsibility of central banks. Safe and efficient functioning of these systems is an important pre-requisite for the proper functioning of the financial system and the efficient transmission of monetary policy.

The Reserve Bank, as the regulator of financial systems, has been initiating reforms in the payment and settlement systems to ensure efficient and faster flow of funds among various constituents of the financial sector. The increasing monetization in the economy, the country's large geographic expanse, people's preference for paper-based instruments and rapid changes in technology are among factors that make this task a formidable one.

DEVELOPMENT, CONSOLIDATION AND INTEGRATION

The Reserve Bank has adopted a three-pronged strategy of consolidation, development and integration to establish a modern and robust payment and settlement system which is also efficient and secure.

The consolidation revolves around expanding the reach of the existing products by introducing clearing process in new locations. The reach is also facilitated by the use of latest technology, such as, mechanized cheque processing, image-based cheque processing systems, and interconnection of the clearing houses.

The Reserve Bank has also taken steps towards integrating the payment system with the settlement systems for government securities and foreign exchange. To facilitate settlement of Government securities transactions, it created the Negotiated Dealing System, a screen-based trading platform.

The NDS facilitates the dealing process and provides for electronic reporting of trades, on-line information dissemination and settlement in a centralized system.

For settlement of trade in foreign exchange, Government securities and other debt instrument, it has set up the Clearing Corporation of India Limited (CCIL). This plays the role of a central counter party to transactions and guarantees settlement of trade, thus managing the counter party risk.

Payment and Settlement System : Evolution and Initiatives

Computerization of clearing operations was the first major step towards modernization of the payments system, its aim being to reduce the time taken in clearing, balancing and settlement, apart from providing accuracy in the final settlement.

- **Mechanisation** of the clearing operations was another milestone with the introduction of Magnetic Ink Character Recognition (MICR)-based cheque processing technology using High Speed Reader Sorter systems driven by mainframe computers. The Reserve Bank introduced mechanized clearing in the four metro cities of Mumbai, New Delhi, Kolkata and Chennai during 1986.

- To facilitate faster clearing of large-value cheques (of value of rupees one lakh and above), the Reserve Bank introduced **'High-Value' Clearing** (HVC), covering select branches of banks for same day settlement. However, with the development of other electronic modes of transfer and to encourage customers to move from paper-based modes to electronic products, the Reserve Bank has advised the clearing houses to gradually discontinue its use.
- The Reserve Bank has also introduced a **'Cheque Truncation System'** (CTS) in the National Capital Territory of New Delhi. This system eliminates the physical movement of cheques and provides a more secure and efficient method for clearing cheques.
- The Reserve Bank has introduced **Electronic Clearing Service** (ECS). This uses a series of electronic payment instructions for transfer of funds instead of paper instruments. The 'ECS–Credit' enables companies to pay interest or dividend to a large number of beneficiaries by direct credit of the amount to their bank accounts. 'ECS-Debit' facilitates payment of charges to utility services, such as, electricity, telephone companies, payment of insurance premia and loan installments, directly by debit to the customer's account with a bank.
- The **National Electronic Clearing Service** (NECS), facilitates credits to bank accounts of multiple customers against a single debit of remitter's account. NECS (Debit) when launched would facilitate multiple debits to destination account holders against a single credit to the sponsor bank. The system has a pan-India characteristic leveraging on Core Banking Solutions (CBS) of member banks, facilitating all CBS bank branches to participate in the system, irrespective of their location. As at the end of September 2009 as many as 114 banks with 30,780 branches were participating in NECS.
- The Reserve Bank has introduced an **Electronic Funds Transfer** scheme to enable an account holder of a bank to electronically transfer funds to another account holder with any other participating bank.
- **The Real Time Gross Settlement** system settles all inter-bank payments and customer transactions above rupees one lakh. Participants in this system include banks, financial institutions, primary dealers and clearing entities. All systemically important payments including securities settlement, forex settlement and money market settlements are processed through the RTGS system.
- **Pre-paid payment instruments** facilitate purchase of goods and services against the value stored on these instruments. To encourage the use of this safe payment mechanism, the Reserve Bank has issued guidelines that lay down the basic eligibility criteria and the conditions for operating such payment systems in the country.
- The Reserve Bank has also issued guidelines for the use of **mobile phones** as a medium for providing banking services. Only banks which are licensed and supervised in India and have a physical presence in India are permitted

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to offer mobile banking services in the country. The guidelines focus on systems for security and inter-bank transfer arrangements through authorized systems.

- The Reserve Bank encouraged the setting up of the **National Payments Corporation of India** (NPCI) to act as an umbrella organization for operating the various retail payment systems in India. NPCI is expected to bring greater efficiency in retail payment by way of uniformity and standardization as also expansion of reach and innovative payment products to augment customer convenience.

LEGAL FRAMEWORK

The Payment and Settlement Systems Act, 2007 provides for regulation and supervision of payment systems in India and designates the Reserve Bank as the authority for the purpose. As per the Act, only payment systems authorized by the Reserve Bank can be operated in the country. The Act also provides for the settlement effected under the rules and procedures of the system provider to be treated as final and irrevocable.

Institutional Framework

The Reserve Bank has put in place an institutional framework and structure for oversight of the payment systems. In 2005, it created a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) as a Committee of the Central Board. A new department called the Department of Payment and Settlement Systems (DPSS) was constituted to assist the BPSS in performing its functions.

X – Developmental Role

The Reserve Bank is one of the few central banks that has taken an active and direct role in supporting developmental activities in their country. The Reserve Bank's developmental role includes ensuring credit to productive sectors of the economy, creating institutions to build financial infrastructure, and expanding access to affordable financial services. Over the years, its developmental role has extended to institution building for facilitating the availability of diversified financial services within the country. The Reserve Bank today also plays an active role in encouraging efficient customer service throughout the banking industry, as well as extension of banking service to all, through the thrust on financial inclusion. Towards this goal, which has evolved over many years, the Reserve Bank has taken various initiatives.

RURAL CREDIT

Given the predominantly agrarian character of the Indian economy, the Reserve Bank's role has been to ensure timely and adequate credit to the agricultural sector at affordable cost. Section 54 of the RBI Act, 1934 states that the Bank may maintain expert staff to study various aspects of rural credit and development and in particular, it may tender expert guidance and assistance to the National Bank (NABARD) and conduct special studies in such areas as it may consider necessary to do so for promoting integrated rural development.

Priority Sector Lending

The focus on priority sectors can be traced to the Reserve Bank's credit policy for the year 1967-68, and institution of a scheme of 'social control' over commercial banks in 1967 by the Government of India to remove certain deficiencies observed in the functioning of the banking system, such as, bulk of bank advances directed to large and medium-scale industries and established business houses. In order to provide access to credit to the neglected sectors, a target based priority sector lending was introduced from the year 1974, initially with public sector banks. The scheme was gradually extended to all commercial banks by 1992.

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The scope and extent of priority sectors have undergone several changes since the formalization of description of the priority sectors in 1972. The guidelines on lending to priority sector were revised with effect from April 30, 2007. The guiding principle of the revised guidelines on lending to priority sector has been to ensure adequate flow of bank credit to those sectors of the society/ economy that impact large segments of the population and weaker sections, and to the sectors which are employment-intensive, such as, agriculture and small enterprises. The broad categories of advances under priority sector now include agriculture, micro and small enterprises sector, microcredit, education and housing.

The domestic scheduled commercial banks, both in the public and private sector, having shortfall in lending to priority sector and/or agricultural lending and/or weaker section lending targets, are required to deposit in Rural Infrastructure Development Fund (RIDF) established with NABARD or other Funds set up with other financial institutions. RIDF was established with NABARD in April 1995 to assist State Governments / State-owned corporations in quick completion of projects relating to irrigation, soil conservation, watershed management and other forms of rural infrastructure (such as, rural roads and bridges, market yards, etc.). Since then, the RIDF has been extended on a year-to-year basis to presently RIDF XV through announcements in the Union Budgets.

The interest rates charged from State Governments and payable to banks under the Rural Infrastructure Development Fund (RIDF) have been brought down over the years in accordance with the reduction of market interest rates. As a measure of disincentive for non-achievement of agricultural lending target, effective RIDF-VII, the rate of interest on RIDF deposits has been linked to the banks' performance in lending to agriculture. Accordingly, while the State Governments are required to pay interest at Bank Rate plus 0.5 percentage points, the rates of interest on deposits vary between Bank Rate and Bank Rate minus 3 percentage points depending on the individual bank's shortfall in lending to agriculture target of 18 per cent.

Check Your Progress:

1. What are the instruments of monetary policy?
2. Define CRR.

Lead Bank Scheme

The Reserve Bank introduced the Lead Bank Scheme in 1969. Here designated banks were made key instruments for local development and were entrusted with the responsibility of identifying growth centres, assessing deposit potential and credit gaps and evolving a coordinated approach for credit deployment in each district, in concert with other banks and other agencies. The Reserve Bank has assigned a Lead District Manager for each district who acts as a catalytic force for promoting financial inclusion and smooth working between government and banks.

Special Agricultural Credit Plan

With a view to augmenting the flow of credit to agriculture, Special Agricultural Credit Plan (SACP) was instituted and has been in operation for quite some time now. Under the SACP, banks are required to fix self-set targets showing an increase of about 30 per cent over previous year's disbursements on yearly basis (April – March). The public sector banks have been formulating SACP since 1994. The scheme has been extended to Private Sector banks as well from the year 2005-06.

Kisan Credit Cards

The Kisan Credit Card (KCC) Scheme was introduced in the year 1998-99 to enable the farmers to purchase agricultural inputs and draw cash for their production needs. On revision of the KCC Scheme by NABARD in 2004, the scheme now covers term credit as well as working capital for agriculture and allied activities and a reasonable component for consumption needs. Under the scheme, the limits are fixed on the basis of operational land holding, cropping pattern and scales of finance. Seasonal sub-limits may be fixed at the discretion of the banks. Limits may be fixed taking into account the entire production credit needs along with ancillary activities relating to crop production, allied activities and also non-farm short term credit needs (consumption needs). Limits are valid for three years subject to annual review. Security, margin and rate of interest are as per RBI guidelines issued from time to time.

Natural Calamities – Relief Measures

In order to provide relief to bank borrowers in times of natural calamities, the Reserve Bank has issued standing guidelines to banks. The relief measures include, among other things, rescheduling / conversion of short-term loans into term loans; fresh loans; relaxed security and margin norms; treatment of converted/rescheduled agriculture loans as 'current dues'; non-compounding of interest in respect of loans converted / rescheduled; and moratorium of at least one year.

XI – Policy Research and Data dissemination

The Reserve Bank has over time established a sound and rich tradition of policy-oriented research and an effective mechanism for disseminating data and information. Like other major central banks, the Reserve Bank has also developed its own research capabilities in the field of economics, finance and statistics, which contribute to a better understanding of the functioning of the economy and the ongoing changes in the policy transmission mechanism.

DATA AND RESEARCH DISSEMINATION

The Reserve Bank releases several periodical publications that contain a comprehensive account of its operations as well as information of the trends and developments pertaining to various areas of the Indian economy. Besides, there are periodical statements on monetary policy, official press releases, and speeches and interviews given by the top management which articulate the Reserve Bank's assessment of the economy and its policies. The Reserve Bank is under legal obligation under The RBI Act to publish two reports every year: *the Annual Report* and *the Report on Trend and Progress of Banking in India.* Besides these and the regular periodical publications, it also publishes reports of various committees

appointed to look into specific subjects, and discussion papers prepared by its internal experts.

The Reserve Bank has also set up an enterprise-wide data warehouse through which data is made available in downloadable and reusable formats. Users now have access to a much larger database on the Indian economy through the Reserve Bank's website. This site has a user-friendly interface and enables easy retrieval of data through pre-formatted reports. It also has the facility for simple and advanced queries.

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Under the aegis of the Development Research Group in the Department of Economic Analysis and Policy, the Reserve Bank encourages and promotes policy-oriented research backed by strong analytical and empirical basis on subjects of current interest. The DRG studies are the outcome of collaborative efforts between experts from outside the Reserve Bank and the pool of research talent within. The annual Report on Currency and Finance has now been made into a theme-based publication, providing in-depth information and analysis on a topical subject. It has become a valuable reference point for research and policy formulation.

The Handbook of Statistics on the Indian Economy constitutes a major initiative at improving data dissemination by providing statistical information on a wide range of economic indicators. The Handbook was first published in 1996 and over the years, its coverage has improved significantly. The Reserve Bank's two research departments – Department of Economic Analysis and Policy and Department of Statistics and Information Management – provide analytical research on various aspects of the Indian economy.

SUMMARY

Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment. Monetary theory provides insight into how to craft optimal monetary policy. It is referred to as either being expansionary or contractionary, where an expansionary policy increases the total supply of money in the economy more rapidly than usual, and contractionary policy expands the money supply more slowly than usual or even shrinks it. Expansionary policy is traditionally used to try to combat unemployment in a recession by lowering interest rates in the hope that easy credit will entice businesses into expanding. Contractionary policy is intended to slow inflation in hopes of avoiding the resulting distortions and deterioration of asset values.

Monetary policy rests on the relationship between the rates of interest in an economy, that is, the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (to achieve policy goals). The beginning of monetary policy as such comes from the late 19th century, where it was used to maintain

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the gold standard.

ANSWERS TO CHECK YOUR PROGRESS

1. CRR and SLR
2. Cash Reserve Ratio indicates the quantum of cash that banks are required to keep with the Reserve Bank as a proportion of their net demand and time liabilities

Test yourself

1. What do you understand by Monetary Management?
2. How does monetary policy works in a country like India?
3. What are the various instruments of monetary policy?
4. Explain the framework of monetary policy that is operating in India.
5. Give a detailed account about the establishment of Reserve Bank of India.
6. Comment on the working machinery and legal framework of RBI.
7. How RBI does coin denomination and distribution?
8. What are the parameters on which RBI focuses on while acting as Banker to banks?
9. What are the various developmental roles that RBI undertakes?
10. How does RBI undertakes the activity of Financial Regulation and Supervision?

BANKING ARTICLE (CASE)

Inflation inching towards the 8% mark and the 10-year benchmark G-sec yield at 6.5% is not only worrying the debt markets in India. There are a lot of other sectors that are taking a hit because of this.

And, with the transporters' strike on, there is little respite. One sector that is directly feeling the heat of rising yields is the Indian banking sector.

Till recently banks had made merry as interest rates in the economy were falling leading to windfall treasury gains. The fact that most state government banks had more than 40% of their portfolios invested in government securities also helped the cause.

But now, with yields rising continuously over the past four months, the bond portfolio of banks is under pressure and markets fear the worst. It is for this reason that banking stocks have taken a beating in an already dull equity market. So, what is the future of banking stocks?

As always, there are two views. While some analysts believe that the earning pressures will weigh heavily on the stocks, there are others who are equally convinced that these worries have already been factored in into current valuations and this is an opportunity to buy into these stocks. We analyze the merits of both these arguments.