CHAPTER 6

INDIAN FINANCIAL SYSTEM
MONEY MARKET

In this Chapter, I will learn

- RESERVE BANK OF INDIA (RBI) AND ITS FUNCTIONS
- COMPOSITION OF MONEY MARKET
- BANKING SCHEMES

The financial system of India refers to the institutions of borrowing and lending of funds or demand for and the supply of funds of all individuals, institutions, and companies and of the government.[1] The Indian financial system can be classified into two broad categories.

1. Money Market
2. Capital Market

Money Market

The Money Market is the market for borrowing and lending of short – term funds say up to 3 yrs. The commercial banks, Regional Rural banks, Bill markets form money market.

Capital Market

The Capital Market is the market for borrowing and lending of medium and long term funds say above 3 yrs. Stock exchanges, development financial institutions form capital market.

This chapter covers Reserve Bank of India and its functions, composition of money market, banking schemes and sub markets.

RESERVE BANK OF INDIA (RBI) AND ITS FUNCTIONS

It is the apex regulatory body of Indian banking system. It keeps the cash reserves of all scheduled banks and hence is known as the "Reserve Bank". It is also called the central bank. It was established in 1935 under RBI Act 1934. It was owned by Private with Government share. It was nationalised in 1949.

General Superintendence and direction are carried by Central Board of directors. Apart from central board, RBI has four local Boards (Chennai, Mumbai, Calcutta, and New Delhi).

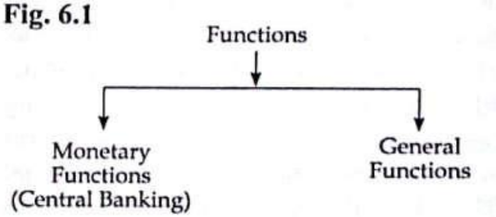
Functions of RBI

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"...to regulate the issue of Bank Notes and 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."[2]

The functions of RBI can be classified as in Figure 6.1.

Fig. 6.1



Monetary Functions

Monetary functions are those concerned duly with money like issue of money, quantity of money, control of money supply etc. The following are the monetary functions.

1 http://www.rbi.org.in

2 http://www.rbi.org.in/scriptsAboutusDisplay.aspx#EP1

1. Bank of Issue

Issue of new money is the exclusive right of RBI. All notes except ₹ 1 note and coins are issued by RBI. One rupee note and coins are issued by Ministry of Finance but circulated by RBI. It also exchanges or destroys old damaged currencies.

To issue money, RBI keeps ₹ 115 Cr in gold and ₹ 85 Cr in foreign securities as a backup. This is called Minimum Reserve System. This system is followed from 1957. The amount of new money is based on the prevailing economic condition, the need of the economy etc. RBI ensures that issue of new money does not lead to inflation.

2. Banker and debt manager to government

RBI acts as a banker to governments both centre and state (except Jammu and Kashmir and Sikkim).[3] It keeps deposits of governments and lends to governments. RBI carries out lending and borrowing operations by issuing government securities on behalf of the government. Though RBI is not a banker to Sikkim and Jammu and Kashmir it manages their public debt to some extent.

3. Banker's Bank

RBI is the banker of all banks. It keeps the reserves of banks like Cash Reserve Ratio (CRR) with it. It provides financial assistance to banks against mortgaged securities. It rediscounts bills of exchange.

Usually, banks and other financial institutions borrow and lend among themselves when there is enough liquidity (money supply) in the market. RBI facilitates and regulates it. Suppose, if there is liquidity crunch, the only avenue is RBI to borrow money. RBI provides enough money to banks. So it is called Lender of the Last resort. This happens very rarely in the economy of any country.

4. Custodian and manager of Foreign exchange

RBI is responsible for keeping the foreign exchange (foreign currency) that flows into the country and keeps the foreign exchange rate stable to certain extent.

5. Controller of Credit

RBI acts as controller of credit. Control of credit means control of lending and deposit creating capacity of the banks. These controls results in control of money supply. Control of money supply is essential to control inflation and thereby promote economic growth because both partly depend on money supply.

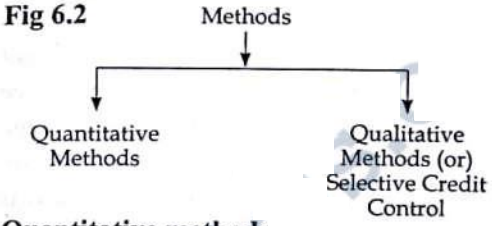
Methods of credit control

The methods of credit control are of two types. One is Quantitative methods and another one is Qualitative Methods as shown in figure 6.2. Both methods use conventional and non-conventional measures or tools.

The conventional tools or measures are those which are being used for a long time. Non-conventional measures are those which have been introduced recently, say after the 1990s reform.

3 Reserve Bank of India: Functions and Working, p.34

Fig 6.2



Quantitative methods

Quantitative methods aim at controlling the cost and quantity of credit. It does not discriminate between different sectors and end use of credit. These measures are applicable for the whole of the economy.

Conventional measures

The conventional tools used are Bank Rate, Open Market Operation, and Variable Reserve Ratio.

1. Bank rate Policy (or) Discount Rate Policy

Before learning what is bank rate and its operation, it is better to know what is bill of exchange and discount.

Bill of exchange means a written document that assures payment of money by purchaser to seller for the goods purchased, at a future date.

Discount means the process of converting a bill into money at an earlier date than that is mentioned in bill of exchange(maturity date). The discount is carried if the receiver of bill of exchange needs money urgently. In this process, the receiver can approach a bank. The bank accepts the bill of exchange and pays. For that, it deducts some percentage of money as interest. For example, for a bill of exchange of ₹ 1000 the bank may pay ₹ 920 after deducting 8% interest.

The bank will receive full amount from purchaser , on the maturity date. Otherwise, the bank will convert these into money at a lesser discount rate from RBI. For example, at 6% and will receive ₹ 940. The profit for bank is ₹ 20. This is called rediscount. This rate is called bank rate or discount rate. Apart from bills of exchange, the commercial banks get their government securities discounted from RBI.

To be precise, the bank rate or the discount rate is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by commercial banks.

By varying bank rate, the RBI controls the credit. If RBI offers discount at a higher rate (increases the bank rate) the bank's profit may be affected. So, it will not approach RBI for discounting or will charge higher discount rate from customer. So the customer may not discount his bill. Hence, the money supply will be low. The reverse is the case when RBI reduces the bank rate. So, depending on the economic condition, RBI alters the bank rate. If there is high inflation, the bank rate will be high and vice versa.

2. Open Market Operations

This method refers to the sale and purchase of securities, bills and bonds of government as well as private financial institutions by the Central bank. The financial instruments like securities, bills and bonds are written documents that are issued to banks and public against money given by them. If the central bank sells these instruments, banks and public will buy it and pay money to the Central bank. If the Central bank buys these instruments from instrument holders, it will pay money to the latter.

Through buying of financial instruments, the money supply is increased. The banks will have more money with them. The public who sold will deposit the money with the banks. So the resource of banks increases that helps to increase their lending capacity. When there is more money supply, the interest will come down. Therefore, more people will borrow from banks. The reverse is the case when Central bank sells financial instruments.

3. Variable Reserve Ratio

In these methods, the reserves that scheduled banks have to maintain are varied to control the credit creation. There are two types of reserves.

i. Cash Reserve Ratio (CRR)

Scheduled banks are required to keep certain percentage of their Net Time and Demand Deposits with RBI under RBI Act 1934. It can be shown in a formula.

Cash reserve ratio = Cash reserve/Net time and demand deposits X 100

This is aimed to have control over banks credit. The ratio was 3 – 15%. Within this range, RBI fixed the CRR. If this ratio is increased, the banks have to deposit more money with RBI. So, the resource available to banks for lending will come down. The money supply will come down. The reverse is the case when the ratio is decreased. As per RBI (Amendment) Bill 2006 enacted in June 2006, the Floor and Ceiling condition of 3-15% was removed.

ii. Statutory Liquidity Ratio (SLR)

Scheduled banks are required to keep certain percentage of their net time and demand deposits in their vault itself. It need not be deposited with RBI. This reserve is a precautionary measure. It prevents bank from lending all its deposits which is too risky and it is mandatory under Banking Regulation Act 1949. The ratio is 25 – 40% of Net Time and Demand Deposits. This reserve has to be kept in the form of cash, gold, and bond. As in the case of CRR, this reserve is varied to control the credit.

Non-Conventional Measures

The non-conventional measures are liquidity adjustment facility (LAF), marginal standing facility (MSF) and market stabilisation scheme (MSS).

1. Liquidity Adjustment Facility (LAF)

It is a short term credit control measure. It is to absorb the excess Liquidity (money

supply). It has two instruments, namely Repo rate and Reverse Repo rate.

i. Repo Rate

It is the rate at which commercial banks borrow from RBI by mortgaging their dated Government securities and Treasury bills. If repo rate is increased, the banks have two options either to reduce the borrowing from RBI or borrow at higher rate from RBI and charge higher interest rate from customer. If banks borrow fewer amounts, the credit creating capacity of banks will come down and money supply will come down. If bank borrows and charges higher interest rate, the customer will borrow less. The money supply will come down. If the repo rate is decreased the reverse will be the case.

Take an example; the repo rate is 6.5 % and the banks borrow from RBI at this rate of 6.5 % and raise deposits at 4.0% of interest from customers. Deposit is also a source of fund for banks to lend. Assume that the average of repo rate and deposit rate result in 6% of cost to banks. This is called cost of fund. And the bank lends to its customer at 10%. In this the banks earn 4.0% profit. Now, the RBI raises repo rate from 6.5% to 7.5%. The banks will reduce or stop its borrowing from RBI because if it borrows at 7.5% and lend at 10% its profit will come down. Otherwise, it will borrow at 7.5% from RBI and may lend at 11% to its customer to keep its profit at 4.0% level. It means the interest rate is increased. Now the customer will not borrow at this higher rate or will reduce his borrowings. Hence, the money supply will come down.

ii. Reverse Repo Rate

It is the rate at which RBI borrows from commercial Banks by mortgaging its dated Government securities and Treasury bills. If the reverse repo rate is increased, the banks have two options either to lend to RBI or lend to customer at higher interest rate. If banks lend to RBI, the money available with the bank to lend to its customer will come down. The credit creating capacity of banks and money supply will come down. If the banks raise interest rate on loans to customers at higher rate, the customer will borrow lesser amount. So, the money supply will come down.

Take an example; the reverse repo rate is 8.0 %. The banks lend at 10% to its customer when its cost of fund is 7% and earns 3% profit. Now, RBI raises the reverse repo rate from 8% to 9%. The bank will shift its lending from customer to RBI because it can earn higher interest rate of 2 %. Though the profit in lending to RBI is less than lending to customers, the banks will prefer RBI. This is because banks have an advantage in lending to RBI, as it is an reliable customer and loan is of short term nature and can lend in bulk. It can earn profit quickly. In this situation, if customers want to get loan from banks, it will charge higher interest from customer because it involves risk and cost. So, it will lend to customer only if it can get higher return than the return it gets from RBI. So, the interest rate to customer may increase from 10 to 11%. It means, the interest rate is increased. Now the customer will not borrow at this higher rate or will reduce his borrowings. So, the money supply will come down.

2. Marginal standing facility

It is a loan facility given by RBI to banks which have current and SGL (Subsidiary General Ledger) account with RBI. It is a loan for overnight (one day). This facility is available from May 9, 2011. It is more similar to Liquidity Adjustment Facility (Repo and Reverse Repo), but there are many differences.

The loan is given against the mortgage of eligible securities. The eligible securities are Government dated securities, Treasury bills and State Development Loans. The maximum amount of loan is 1% of Net Demand and Time Liabilities (NDTL). The loan size will be minimum one Crore and further amount is in multiples of one Crore. The interest rate for MSF is Repo rate plus 1%.Usually, the Reverse Repo rate is Repo rate minus 1%. Therefore, the Repo rate act as an anchor rate. The Repo rate stands in the middle. The MSF rate stands above and Reverse Repo rate stands below the Repo Rate

3. Market Stabilisation Scheme

It is not a pure monetary instrument. It is a fiscal cum monetary instrument. It is a facility to control liquidity due to excess foreign exchange flow into the country. In this facility, the RBI issues government securities to absorb excess liquidity. The interest is paid by Ministry of Finance, Government of India. The amount of issue and date of issue is decided by RBI in consultation with Ministry of Finance, Government of India.

Qualitative (or) Selective Credit Controls

These methods control the use and direction of credit. These methods discriminate between sectors. They control the credit flow to particular sector or to particular end use.

As of now RBI is not using this method for control of credit. It mostly uses quantitative control method.

1. Regulation of Margin Requirements

Margin is the amount that has to be contributed by borrower towards the purpose for which she/he borrows. For example, if someone wants to buy a machine she/he cannot get full amount as loan. She/he has to contribute a certain amount to purchase the machine.

By varying this amount, the off take of loan can be controlled. If the margin is high the off take of loan will be low and vice versa. Different margin is fixed for different sector. If RBI wants to control flow of credit to particular sector, it will fix high margin and vice versa. This is primarily aimed to prevent excessive use of credit to purchase or carry securities by Speculators.

2. Regulation of Consumer Credit

Consumer credit refers to credit to consumer to purchase durable consumer goods on installments and hire purchase. Two devices are available under this method. They are

i) Minimum down payment

ii) Period of repayment

Minimum down payment means the amount initially to be paid by the purchaser. If this amount is fixed high, the purchase will come down and vice versa. So is the demand for credit. If the number of installment is reduced, the consumer has to pay more money per installment. This will discourage credit off take and vice versa. Therefore, higher minimum down payment and less number of installments reduce money supply and vice versa.

3. Rationing of Credit

In this method, the maximum amount of credit flow to a particular sector is controlled. There are two methods of rationing of credit. They are,

a. Variable Portfolio Ceiling

b. Variable Capital – Risk Weighted Asset Ratio

a. Variable Portfolio Ceiling

The maximum amount of credit for various portfolios (various sector) is fixed. Different ceiling for different sector is fixed.

b. Variable Capital – Risk Weighted Asset Ratio

Capital to Risk Weighted Asset Ratio (CRAR) is also called **Capital Adequacy Ratio (CAR)**. It means the availability of sufficient capital as a percentage of risk weighted assets. It is expressed in formulaic form as follows:

CRAR = Capital / Risk Weighted assets X 100.

The Balance sheet of banks that shows the financial position of banks consists of two sides. One side shows the liabilities and the other shows assets. Liabilities mean the amount of money the bank has to pay to others. So the shareholders money, that is capital, which the bank is liable to pay if claimed by shareholders, is shown on the liabilities side. The assets mean the amount of money that has to be paid by others to bank. So, the loans lent by banks are listed on the asset side.

The RBI in its monetary policy assigns some risk to loans. This is based on the likely chance of a loan be repaid or not repaid. For example, a bank can expect surely that a loan paid to rice vendor will be repaid but cannot expect a loan paid to stock broker because stock exchange trading is a risky one. It means, lending to stock broker is highly risky. So, the loan to rice vendor may be assigned a risk of 100% and the loan to stock broker may be assigned a weight of 150%. So, a loan of ₹ 1000 to rice vendor will be considered as ₹ 1000 (100/100*1000=1000) but loan to stock broker will be considered as ₹ 1500 (150/100*1000=1500). This is called risk weighted asset.

The capital is more or less fixed. If the capital to risk weight ratio is changed by RBI, only the asset has to be adjusted. That is the amount of loan has to be changed. So, credit can be controlled.

If the risk assigned to a particular sector is high, it will reach the ceiling with low amount of credit and vice versa. So, by varying the ceiling and **Capital to Risk Weighted Asset Ratio (CRAR)** the flow of credit can be controlled.

RBI uses this Capital to Risk Weighted Asset Ratio as norm to ensure that banks do not lend beyond its capacity. This ratio is fixed under the Basel norm. It is elaborated later.

4. Direct Action

In this case, the Central bank issues certain policy decisions from time to time based on prevailing situation in the economy. For example, the central bank may require scheduled banks to send proposals for loans beyond a certain amount to be scrutinised by the central bank. This has to be followed by the scheduled banks.

5. Moral Suasion

Moral suasion means methods of persuasion, method of request, method of informal suggestion and method of advice to commercial banks, about dos and don'ts by calling a meeting. The banks are morally bound to follow this but it is not mandatory.

6. Publicity

Publicity means the publication of weekly or monthly statements of assets and liabilities of commercial banks through periodicals and websites. This brings greater transparency. It puts moral pressure on erring banks not to violate norms. So, banks abide by credit control measures.

Non-Monetary Functions

Non-monetary functions are aimed at general regulation of banking system to ensure a vibrant and prudent banking system. These functions are classified as Supervisory Functions and Promotional Functions.

Supervisory Functions

Under supervisory function, RBI issues license to banks. It issues policies and guidelines for management and method of working, amalgamation, reconstruction and liquidation of the banks. It calls for returns and information from the banks. It carries out periodical inspection of players in the money market.

As a part of supervisory function, RBI ensures transparency in the working of banking system. The recent initiative in this regard is **Base rate**. This was introduced from 1st July, 2010. Base rate is the minimum rate below which banks cannot lend. For example, if IOB announces its base rate as 8%, it cannot lend below 8% to any of its customers. But each bank has right to fix its own Base rate. The condition

is that the banks have to provide verifiable method of calculation used to arrive at the rate announced. The exception to this are the loans to Diffrential Interest Rate (DIR) scheme, loans to banks' own employees and loans to banks' depositors against their own deposits can be lent below the Base rate.

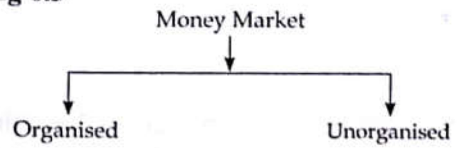
Promotional functions

RBI works towards promotion of Indian financial system. It takes care of branch expansion and promotes banking habit of people. It establishes and promotes new specialized agencies.

COMPOSITION OF MONEY MARKET

Money market of India has participants both from organised and unorganised sector as shown in figure 6.3. The organised sector is characterised by registration, approval and license from market regulators and proper maintenance of accounts. The unorganised sector is devoid of these aspects.

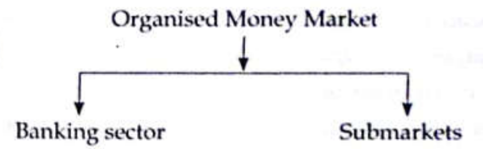
Fig 6.3



Organised sector

Organised sector consists of banking and sub markets as shown in figure 6.4. Banking sector carries out both, deposit taking and lending operations. The sub markets do the money transaction among banks and generate necessary capital for banking sector and commercial sector.

Fig 6.4



Banking Sector

Banking Sector consists of commercial banks, Regional Rural Banks and Cooperative banks. It is shown in figure 6.5 in the next page.

Commercial Banks

Commercial banks are run on commercial basis. They accept deposits, give loans and provide other financial services to earn profit. These are regulated under Banking regulation act 1949. Commercial banks consist of both public sector and private sector banks.

Public Sector Banks

Public sector banks are those banks in which the majority of ownership is with government. The majority of ownership means, shareholding of more than 51%.

All the public sector banks were not started by Government of India. Some banks which were in the hands of private were nationalised and made public sector banks.

State Bank Group

State Bank group means State Bank of

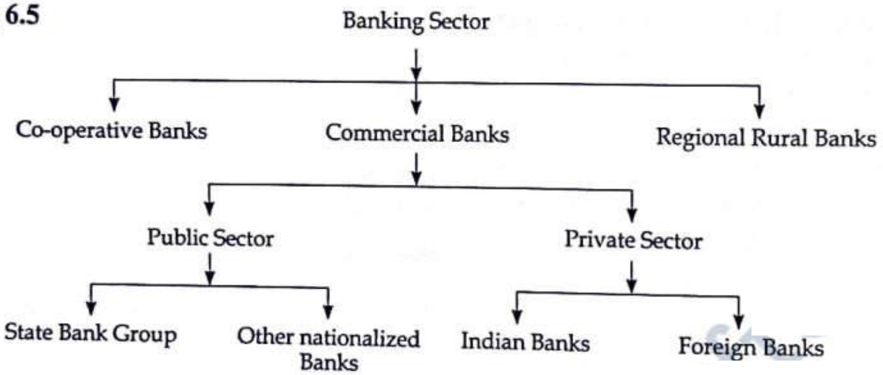
India (SBI) and its Associates. Previous name of SBI was Imperial Bank of India. It was created in 1921 by amalgamating the three Presidency Banks of Bengal (1806), Bombay (1840) and Madras (1843). Imperial Bank of India was partially nationalized on July 1, 1955 and renamed as State Bank of India (SBI). In 1959, eight banks of former princely states were brought under SBI as its associates.

They are:

1. State Bank of Bikaner
2. State Bank of Jaipur
3. State Bank of Hyderabad
4. State Bank of Indore
5. State Bank of Mysore
6. State Bank of Saurashtra
7. State Bank of Patiala and
8. State Bank of Travancore

Among these banks State Bank of Bikaner and State Bank of Jaipur were merged and called as state bank of Bikaner and Jaipur. State Bank of Saurashtra was merged with parent bank State Bank of India on October 2008. Now the associate banks are six. SBI is the largest public sector Bank in the country. Previously major part of SBI's share was held by RBI. To endow RBI with only the regulatory functions, and to unload its administrative work, RBI's shareholding transferred to Government of India.

Fig 6.5



Other Nationalised Banks

Before nationalization, the banks were mainly concentrated in the urban area, while the rural areas lacked the banking facility. Though there were some bank branches in rural areas, they were used only to mobilize the deposits of rural area and that money was used to lend in the urban area. Even in the urban area, the banking facilities were enjoyed by rich people. The poor people were left out of the banking net. The banks were mainly owned by Industrialists. They used these banks to mobilize deposits of people and themselves got loan from these banks. To make the banking facilities available to all,

private banks were nationalised.

The nationalisation was carried out in two stages. On 19th July1969 fourteen large Commercial Banks which had reserves more than ₹ 50 Crores were first nationalized. They are:

1. Central Bank of India
2. Bank of India
3. Punjab National Bank
4. Canara Bank
5. United Commercial Bank
6. Syndicate Bank
7. Bank of Baroda
8. United Bank of India
9. Union Bank of India
10. Dena Bank
11. Allahabad Bank
12. Indian Bank
13. Indian Overseas Bank
14. Bank of Maharashtra

Secondly, 6 banks were nationalized on April 15, 1980 which had reserves more than ₹ 200 Cr.

1. Andhra Bank
2. Punjab and Sindh Bank
3. New Bank of India
4. Vijaya Bank
5. Corporation Bank
6. Oriental Bank of Commerce

In September 1993, New Bank of India was merged with Punjab National Bank. Then the total nationalized Banks came to nineteen. Therefore, total number of public sector commercial banks are (1+6 + 19) twenty six.

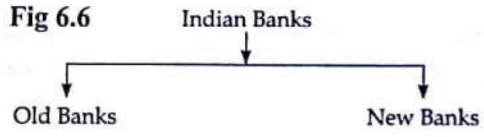
Private Sector Banks

Indian private sector banks consist of both Indian banks as well as foreign banks.

Indian Private Banks

Indian banks are classified as old and new private sector banks as shown in figure 6.6. This classification is done by RBI for the convenience of comparing performance of all Indian banks.

Fig 6.6



Old Banks

The banks except those were nationalised, continued to be in the hands of privates. These private banks and those Banks which were set up before 1990s are called Old Banks.

New Banks

Banks set up in the private sector in 1990s and after are called new banks. Latest by 2014 RBI issued license for new banks.

It also came up with proposal for small banks and payment banks. The RBI observes "Both, payments banks and small banks are "niche" or "differentiated" banks; with the common objective of furthering financial inclusion. While small banks will provide a whole suite of basic banking products, such as, deposits and supply of credit, but in a limited area of operation, payments banks will provide a limited range of products, such as, acceptance of demand deposits and remittances of funds, but will have a widespread network of access points particularly to remote areas, either through their own branch network or through Business Correspondents (BCs) or through networks provided by others. They will add value by adapting technological solutions to lower costs." [4]

Local Area Bank in Private Sector

Privates were allowed to set up banks to operate in limited area. These are called Local Area Banks (LAB). The branches can be set up within the limits of geographically 3 contiguous districts. Backward and less developed districts are considered for area of operation of LABs These were set up to meet the local credit needs by exploiting local resources itself.

They are registered under The Companies Act 1956.The required minimum paid up capital is ₹ 5 Crore. The promoter should contribute at least ₹ 2cr. These Local Area Banks are regulated under RBI Act 1934, Banking regulation Act 1949 and Regional rural Bank (RRB) Act 1976.

Foreign banks

After 1991 economic reforms, India opened the door for foreign banks. They set up either branches or subsidiaries. Citi bank, Barclays, and ABN Ambro are few foreign banks to be mentioned.

Indian Banks Abroad

Like foreign banks set up in India, Indian banks set up their branches or subsidiaries in foreign countries. Both Public and Private sector banks have branches abroad. Off shore banking units are located in Bahamas, Cayman Islands, Channel Islands and Mauritius. Off shore banks are banks located in a country that has more generous tax laws.

Amas Bank, Geneva, Switzerland is the first Private Bank established in Europe by Indian nationals (by Hinduja Group).

Classification of Banks

Banks are classified into scheduled and non-scheduled banks. All commercial banks, regional rural banks, and state co-operative banks are classified like this.

1. Scheduled Banks

Scheduled banks are those listed in the 2nd schedule of RBI Act 1934. A bank to be included in this list has to fulfill the following two conditions.

i. The paid up capital and collected funds of bank should not be less than ₹ 5 lakh.

ii. Any activity of the bank will not adversely affects the interest of depositors.

Any bank which fulfilled these conditions and got listed in the second schedule if violates these conditions will be de-

4 http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=31646

scheduled. Scheduled bank enjoys the following facilities:

They are eligible for obtaining debts / loans on bank rate from RBI.

They get automatic membership of clearing house.

They can avail the facility of rediscount of first class exchange bills from RBI.

2. Non Scheduled Banks

The banks which are not included in the second schedule are called non scheduled banks. Like scheduled banks, these banks also have to follow the conditions regarding Cash Reserve Ratio (CRR) but can keep it with itself. These banks are not eligible for loan from RBI, but become eligible under emergency conditions.

The Regional Rural Banks (RRB)

These banks were established since 1975, under RRBs Act 1976. RRBs were set up in all states except Sikkim and Goa. Totally 196 Banks were set up. These banks were set up by public sector banks. The public sector bank which set up a particular RRB is called sponsor bank of that RRB. For example Pandian Gram bank, a RRB, was set up by Indian Overseas Bank. Indian Overseas Bank is called sponsor bank of Pandian Gram bank.

The purpose is to further increase credit flow to rural areas. RRBs were established to lend to weaker section called target group like landless labour, artisan and craftsmen at concessional rate. From 1997, RRBs were freed to lend outside the target group.

Since April 1987, no new RRBs have been opened due to the Kelkar committee's recommendations. Many of the RRBs became unviable or less profitable. To solve the problem, weak banks are being merged with the efficient banks. The merging of RRBs is going on. Now, they gain more autonomous power also.

Co-Operative Banks

Cooperative banks are established by State laws. These banks are called as cooperative banks because these have cooperation of stake holders as motive. If some individuals come together, they can establish a cooperative bank. Cooperative banks are established with the aim of funding agriculture and allied sectors and to finance village and cottage industries. Along with lending, cooperative banks accept deposits. They operate on the principle "one person one vote" in decision making. NABARD (National Bank for Agriculture and Rural Development) is the apex body of cooperative sector in India.

NABARD

NABARD is also called as the National bank. Previously, the functions of NABARD viz., financing of agriculture and refinancing of cooperative banks and RRBs was done by Agriculture Refinance Development Corporation (ARDC) of RBI. NABARD was set up in July 1982. It took over the functions of Agriculture

Refinance Development Corporation (ARDC).

The Composition of Cooperative Banks

The cooperative banks are divided into urban and rural. Further, they are divided into short term and long term structure. It is shown in figure 6.7.

Short Term Structures

Short term structures lend up to one year. They lend for cultivation activities and provide working capital to buy seeds, fertilisers etc. The short term structure cooperative banks have a 3 tiered set up. They are:

a. State Co-operative Bank

b. Central or District Co-operative Bank

c. Primary Agricultural Credit Societies

State Co-operative Bank (SCB)

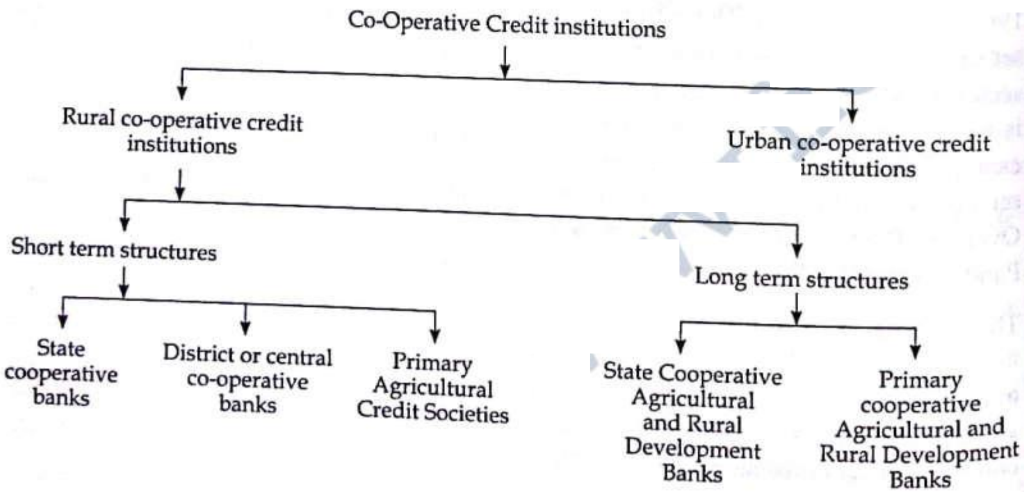
Each state has its own State Co-operative Bank. It is the Apex body for cooperative banks in a particular state. They act as a mediator or as an intermediary between RBI and NABARD on the one side and Central or District Co-operative Bank and Primary Agricultural Credit Societies on the other side. They get loan from RBI at concessional rate. It gives grants to co-operative banks in the state.

Now, the intermediation of these banks is abolished by a memorandum of under-standing between RBI and these banks. Now, RBI has direct dealing with low tier cooperative banks.

Central (or District) Co-operative Bank

This cooperative bank operates at district level. Its operational area is limited to one

Fig 6.7



district. There are two types of Central (or District) Co-op Banks.

They are:

a. Co-operative Banking Union

b. Mixed Central Co-operative Bank

The membership of Co-operative Banking Union is open only to co-operative societies. But, the membership of Mixed Central Co-operative Bank is open both to co-operative societies and individuals.

The Central (or District) Co-operative Banks get loan from SCBs (State Co-operative Bank). They grant loans to PACs (Primary Agricultural Credit Societies) and individuals.

Primary Agricultural Credit Societies

These cooperative banks operate at village level. They provide short term loan to agriculture (1 year sometimes 3 years). PACs give loans to its members that are individuals.

Long Term Structures

Long term structures lend to meet medium and long term fund requirements. It ranges from one and a half years to twenty five years. They lend for land development, construction of wells, purchase of pump sets, redemption of old debts etc. These banks initially were called as mortgage banks. Earlier they were called Land development banks. Now they are called Cooperative Agricultural and Rural Development Banks (CARDBs).

It is a two tiered structure. They are;

1. State Cooperative Agricultural and Rural Development Banks

2. Primary Cooperative Agricultural and Rural Development Banks

Urban Co-Operative Credit Institutions

The co-operative banks set up in the urban and semi urban areas are called Urban co-operative credit institutions. They mainly lend to small borrowers and businesses.

Sub Markets

Government, financial institutions and industries need resources for investment and to meet shortage if any in the money for regular activities. Sub markets are markets to generate resources needed to meet these needs.

Composition of Sub Markets

The sub market is divided into various segments. It is based on the financial instruments used in this market. It is diagrammatically shown in figure 6.8.

Call Money Market

It is also known as money at call and short notice market. It deals in loans for a period ranging from one to fourteen days. It is an inter- bank borrowing and lending market. One bank demands money from another bank to cover its cash reserve requirements with RBI every fortnight and to gain from foreign exchange market. The rate at which funds are borrowed in these markets is called call money rate.

It has two segments. They are as follow:

The Call Market (or) Overnight Market

It is a market for borrowing and lending of money between banks within one day.

Short Notice Market

It is a market, for borrowing and lending of money between banks up to fourteen days.

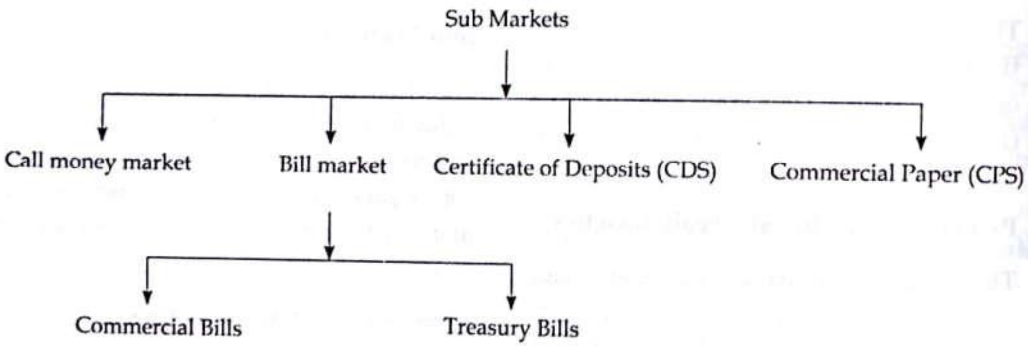
Bill Market (or) Discount Market

In bill market, short term funds (usually 90 days) are bought and sold. The bill market consists of two markets, one is commercial bill market and another is Treasury bill market as shown in figure 6.8

Commercial Bill Market

Commercial bills are bills other than

Fig 6.8



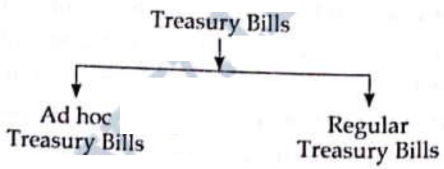
treasury bills. They are issued by industries and traders.

Treasury Bill

Treasury bills are securities issued by Government treasury. They are of short term in nature. In this regard, they differ from market loans. They are non-interest bearing (zero interest/ zero coupon). These kinds of bonds are called Zero coupon bonds. They are issued at a discount rate. For example, a security worth of ₹ 1,000 may be issued against receipt of amount lower than ₹ 1000. The purchaser of security can redeem the full ₹ 1,000 at a particular date (maturity date). This is called redemption at **par** (original value).

There were two types of Treasury Bills. They are shown in the following figure 6.9

Fig 6.9



Ad hoc Treasury Bills

It was issued for a particular end or case in hand. Till 1991-92, there was only Treasury bill of 91 days. It was called as

ad-hoc Treasury bill. It was discontinued from 1997-98. To replace it ways and means advance was introduced.

Regular Treasury Bills

These bills are issued regularly to meet budgetary expenditure. There are number of Treasury bills with differing maturity. In 1998-99, 182 days Treasury bills were introduced. But it was replaced by 364 days Treasury bills. Again 182 days treasury bills were reintroduced. 14 days Treasury bills were introduced in 1999-2000.

Dated Government Securities

The government securities with long term maturity are called Dated Government Securities. The government of India sells dated securities of 5 years maturity and 10 years maturity on an auction basis. There are dated Government securities with 30 years maturity period.

Certificates of Deposits (CDs)

Certificates of Deposits (CDs) are issued by Commercial Banks and Financial Institutions to raise additional fund. These are issued in multiples of ₹ 25 lakh, subject to a minimum amount of ₹ 1 crore. The maturity period range from 3 months to one year in the case of banks and one year to 3 years in the case of other financial institutions.

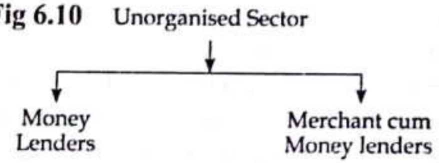
Commercial Papers (CPs)

IIt was introduced in 1990. Commercial Papers (CPs) are issued by Corporate, Primary Dealers (PDs) and the All-India Financial Institutions (FIs) to raise fund. These are issued in denominations of ₹ 5 lakh or multiples of it, subject to a minimum amount of ₹ 1Crore. The maturity period is 3 to 6 months.

Unorganised Sector

The unorganised sector banking is not a registered and regulated one. They do not maintain proper account. The unorganised sector has two types of participants. It is shown in the following figure 6.10.

Fig 6.10



The interest rate is usually high in un-organised sector. The lending and borrowing operation is less cumbersome because many of the procedures followed by banks are not followed in unorganised sector.

Money Lenders

The money lendersare exclusively engaged in money lending operations. It is their source of livelihood.

Merchant cum Money Lenders

The merchant cum money lenders are engaged in merchandising and money lending. They lend to producers of the product in which they merchandise. The producers have to sell their products only to the lender. In this case merchant cum money lenders usually purchase products at low price.

BANKING SCHEMES

Many schemes were launched in Banking Sector after nationalization of bank. These schemes were launched to enhance spread of banking services to all the regions of the country and to increase banking habit among people.

Lead Bank Scheme

In this scheme, any one public sector bank is selected in a district. That bank is designated as Lead bank of the district. It co-ordinates the activities of all banks in that district to avoid duplication of banking works, to ensure same person does not get loan from different banks, and to ensure the banking benefit to all sections of people.

Service Area Approach (1988)

It operated under Lead Bank Scheme. Each semi urban & rural branch allotted a specific area (cluster of village) to implement banking scheme.

Differential Rate of Interest Scheme (1972)

Public Sector banks were directed to grant at least 1% of their total deposits of previous year to weaker sections of society at a concessional rate of 4%. At least 40% loan under this scheme to SC/ST people is made compulsory.

Social Banking

Financing of poverty reduction and employment programme of government by banks is called social banking. Under this scheme, beneficiaries of government's self-employment programme and those who got training from government programme are provided with loan.

Priority Sector Lending

Priority sectors are those sectors which substantially contribute to National Income but get less credit from banking sector. The priority sector list is provided by the RBI. The list is being revised frequently. A target of 40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off- Balance Sheet Exposures (OBE), whichever is higher, had been stipulated for lending to the priority sector by domestic Scheduled Commercial Banks (SCBs) (both public and private sector). Within this, sub-targets of 18 per cent and 10 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated for lending to agriculture and the weaker sections respectively.[5]

The sub target of 18% for agriculture is further sub divided into 13.5% of direct lending and 4.5% of indirect lending. The loans provided to agriculture activities are considered as direct lending. The loans provided for personal consumption of rural mass and to agriculture allied activities like food processing are considered as indirect lending.

The priority sector lending target for RRBs is 60%. A target of 32 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated for lending to the priority sector by foreign banks having offices in India. Within this, sub-targets of 10 per cent and 12 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated for lending to micro and small enterprises and export sectors respectively.[6]

Shortfalls in the priority sector have to be deposited with NABARD's Rural Infrastructure Development Fund. NABARD lends this amount to state governments for rural development activities.

Adjusted Net Bank Credit (ANBC) means net bank credit plus non-SLR bonds held to maturity. Net bank credit means the difference between outstanding gross deployment of bank credit at the start of the financial year and end of the financial year.

ANBC = Credit outstanding at the end of financial year – Credit outstanding at the start of financial year

Non-SLR bond means the bonds which are not qualified to be invested for the purpose of Statutory Liquidity Ratio (SLR) stipulated by RBI. RBI classifies bonds which are eligible for SLR and other bonds are considered as non- SLR bonds. Investments in these bonds are considered equal to credit given to corporate sector by banks. Held to maturity means, the investment made with purpose to keep it invested till maturity date and not for trading purpose.

Off balance sheet exposure means assets and liabilities which are not qualified as assets and liabilities at present but likely to become so in future. RBI observes: "Off-Balance Sheet exposures refer to the business activities of a bank that generally do not involve booking assets (loans) and taking deposits. Off-balance sheet activities normally generate fees, but produce liabilities or assets that are deferred or contingent and thus, do not appear on the institution's balance sheet until and unless they become actual assets or liabilities." For example, a bank guarantee loan availed by someone from some other financial institution. Actually this is not the liability of the bank. But if the person who availed loan fails to repay, the bank becomes accountable and the loan become the liability of bank. These types of liabilities and assets are called off balance sheet exposure.

Financial Inclusion

Financial inclusion means including the people, hitherto excluded, into the financial system. The inclusion is to be done on both supplying end (saving account) and receiving end (loans from financial institutions). Towards this end the RBI started "No-frills account" drive. The banks were requested to open "No-frills account" with low or minimum balance.

No- frills means including only the basic features without anything unnecessary especially things added to make something

5 Economic Survey 2008-09.p.97

6 Economic Survey 2008-09.p.97

more attractive or comfortable.[7] No-frills account means accounts without premium services that are charged some amount. This reduces the cost of holding account. It enables even poor people to hold bank account.

In place of No-frill account Basic Savings Bank Deposit Account (BSBDA) was introduced. This account shall not have the requirement of any minimum balance. No charge will be levied for non-operation/ activation of in-operative 'Basic Savings Bank Deposit Account'. These accounts are now opened under Prime Minister Jan Dhan Yojana with the aim of opening at least two accounts per family.

Promotion of Micro Credit

Micro Credit is defined as provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their living standards. Micro Credit Institutions are those which provide these facilities.[8] The self-help group and bank linkage is a medium to promote micro credit.

RELATED TERMS

Basel Norms

Basel norms are fixed by Bank for International Settlements. It is located in Basel, Switzerland. It acts as a coordinating agency for Central Banks of various countries. It is necessitated by globalization. Many banks operate internationally. These norms are for individual banks and Systemically Important Financial Institutions (SIFI). Its implementation is done by Central Banks of the respective countries. In India it is by RBI.

SIFIs are whose "... failure may trigger a relatively large number of simultaneous failures within the financial sector, and as a result, large losses to the entire economy".[9] It defines these institutions from the point of failure. Does it mean we can identify these institutions only after failure? The answer is yes and no. There is no pre known definition. At the same time there are few indicators to identify them. The financial institutions which are big in size, receiving short term funds and lending for long term purpose are prone to failure. These are few indicators based on which it can be identified. But these are not exhaustive indicators.

These norms are developed by Basel Committee on Banking Supervision (BCBS). So far three set of norms were developed. They are called Basel I, Basel II and Basel III. Basel I and II were implemented the Basel III is on implementation.

BIS describes Basel III norms as follows:

" 'Basel III' is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks' transparency and disclosures."[10]

There are two components in Basel III. They are:

1. Capital
2. Liquidity

1. Capital

The capital consists of three pillars. They are:

Pillar 1: Capital, risk coverage and containing leverage

Pillar 2: Risk management and supervision

Pillar 3: Market Discipline

Pillar 1: Capital, risk coverage and containing leverage

Basel III norm fixed norms about type and quantum of each type of capital. This ensures the quality of capital. Capital is a liability the bank owes to investors. Capital norms are fixed in proportion to assets. Assets are the investments made by banks including loan. The total capital to risk weighted asset ratio must be at least 8% at all times.

The breakup of capital requirement is as follows:

1. Tier 1 Capital (6.0 %)
    a. Common Equity Tier 1 (4.5 %)
    b. Additional Tier 1(1.5 %)
2. Tier 2 Capital (2 %)

Tier 1 capital consists of the share capital and disclosed reserves or retained earnings. Share capital is the share investment made by public and others. Disclosed reserves or retained meanings means the undistributed profit. Common equity tier1 means the share capital held by common public.

Additional Tier 1 capital is investments that are debt in nature but do not have maturity period. It can be realised if the issuer wish to do so. Tier 2 capital is similar to additional Tier 1 capital but have maturity period of at least five years. Both of them have right to claim next to depositors and general creditors and they are neither secured nor guaranteed by issuer.

Over and above this 8 % there is a need to maintain Capital conservation buffer of 2.5 %. This capital can be withdrawn during financial stress but when the minimum capital requirement of the above said 8 % approaches the central bank can impose restriction regarding discretionary

7 Oxford Advanced Learners Dictionary
8 http://www.rbi.org.in
9 http://www.bis.org/bcbs/events/bhbibemoore.pdf
10 http://www.bis.org/bcbs/basel3.htm

distribution of capital in the form of dividend and bonus. Usually the banks have the habit of indulging in this kind of discretionary distribution to show as if they are in strong position. To avoid this, restriction can be imposed.

During the period of high credit growth, on a temporary basis, the central banks can stipulate additional capital requirement to avoid unfettered credit growth which may result in credit bubble. It is called **Counter cyclical capital buffer.** Normally it can be from 0 to 2.5 % and there can be an add-on of 2.5 % more, in total 5 %. During normal time it must be zero.[11]

Leverage Ratio is part of the Pillar 1. It is the ratio between capital measure and exposure measure.

Leverage Ratio = Capital measure / Exposure measure

Capital measure means Tier 1 capital. Exposure measure means the assets created by banks and financial institutions. The total assets are adjusted to take care of some unusual exposures and after adjustments this exposure measure is arrived for this purpose. The banks are expected to maintain a leverage ratio of at least 3%.

Pillar 2: Risk management and supervision

It calls the banks to have an internal assessment process to assess the capital adequacy, risk exposure and to device risk management technique. It also calls central banks to have a review process to review banks.

Pillar 3: Market Discipline

Market discipline warrants disclosure of certain details like capital adequacy, risk exposure and risk assessment procedure. The disclosure of details should be on the line of details submitted to regulatory authority. It will bring transparency and give confidence to market participants.

2. Liquidity

The liquidity consists of two key principles. They are:

a) Liquidity Coverage Ratio (LCR)

b) Net Stable Funding Ratio (NSFR)

a) Liquidity Coverage Ratio

As per this norm a bank has to have adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to withstand liquidity crisis, if it happens, for a period of 30 days. Here, assets mean the investments made by banks including loan. It has to be implemented from the year 2016 starting with 60% coverage to 100% by 2019.

b) Net Stable Funding Ratio (NSFR)

It is the ratio between required stable funding and available stable funding.

NSFR = Available amount of stable funding/Required amount of stable funding

11 http://www.sidley.com/securities_and_financial_institutions_update_122110/

The words stable funding indicates the maturity and certainty of funds. It should be of long term, stable and certain. Required fund indicates the liabilities and available funds indicate assets. It will require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It means there should be a match between the nature of funding and nature of assets. It tries to avoid the practice of creating long term assets while getting short term funds. In a situation of mismatch the banks and financial institutions cannot honour the short term fund givers like depositors. As on April 2014, the consultative process in this regard is going on.

Non-Performing Assets (NPA)

A loan or advance is asset of the bank. If its interest or principle or both remain overdue (unpaid) for a reasonable period then it is called Non-performing asset. The reasonable period varies for various types of loans and advances. The reasonable period is determined by RBI.

As per RBI guidelines Non- performing asset (NPA) is a loan or an advance where;

1. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

2. the account remains out of order' in respect of an Overdraft/Cash Credit (OD/CC),

3. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

4. the instalment of principal or interest there on remains overdue for two crop seasons for short duration crops,

5. the instalment of principal or interest there on remains overdue for one crop season for long duration crops,

6. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken.

7. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Mark-to-market value means of a derivative contract means the current market value of the derivative contract.

An asset which remained NPA for a period of 12 months or less is called **substandard asset**, an asset remained substandard asset for 12 months is called **doubtful assets.** A **loss asset** is one where loss has been identified by the bank or internal or external auditors of debtor or by RBI inspection as loss.