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History of Banking: Important points:

- The story of banking starts from **Bank of Hindusthan** established in 1779 and it was first bank at Calcutta under European management. In 1786 General Bank of India was set up. Since Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, it became a banking center.
- Three Presidency banks were set up under charters from the British East India Company- Bank of Calcutta, Bank of Bombay and the Bank of Madras. These worked as quasi central banks in India for many years. The Bank of Calcutta established in 1806 immediately became Bank of Bengal. In 1921 these 3 banks merged with each other and Imperial Bank of India got birth. It is today's State Bank of India. The name was changed after India's Independence in 1955. So State bank of India is the oldest Bank of India. In 1839, there was a fruitless effort by Indian merchants to establish a Bank called Union Bank. It failed within a decade. Next came Allahabad Bank which was established in 1865 and working even today.
- The oldest Public Sector Bank in India having branches all over India and serving the customers for the last 145 years is Allahabad Bank. Allahabad bank is also known as one of India's Oldest Joint Stock Bank.
- The Oldest Joint Stock bank of India was Bank of Upper India established in 1863 and failed in 1913. The first Bank of India with Limited Liability to be managed by Indian Board was Oudh Commercial Bank. It was established in 1881 at Faizabad. This bank failed in 1958.
- The first bank purely managed by Indian was Punjab National Bank, established in Lahore in 1895. The Punjab national Bank has not only survived till date but also is one of the largest banks in India.
- However, **the first Indian commercial bank which was wholly owned and managed by Indians was Central Bank of India** which was established in 1911. So this bank is called India's First Truly Swadeshi bank. Central Bank of India was dreams come true of **Sir Sorabji Pochkhanawala**, founder of the Bank. Sir Pherozesha Mehta was the first Chairman of this Bank.
- Many more Indian banks were established between 1906-1911. This was the era of the Swadeshi Movement in India. Some of the banks are Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India.
- **Bank of India was the first Indian bank to open a branch outside India in Londo**n in 1946 and the first to open a branch in continental Europe at Paris in 1974. The Bank was founded in September 1906 as a private entity and was nationalized in July 1969. Since the logo of this Bank is a star, its head office in Mumbai is located in Star House, Bandra East, Mumbai.
- There was a district in Today's Karnataka state called South Canara under the British empire. It was bifurcated in 1859 from Canara district , thus making Dakshina Kannada and Udupi district. It was the undivided Dakshina Kannada district. It was renamed as Dakshina Kannada in 1947. Four banks started operation during the period of Swadeshi Movement and so this was known as "Cradle of Indian Banking. This was the first phase of Indian banking which was a very slow in

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development. This era saw many ups and downs in the banking scenario of the country. The Second Phase starts from 1935 when Reserve bank of India was established. Between the period of 1911-1948, there were more than 1000 banks in India, almost all small banks. The Reserve Bank of India was constituted in 1934 as an apex Bank, however without major government ownership. Government of India came up with the Banking Companies Act 1949. This act was later changed to Banking Regulation (Amendment) Act 1949. The Banking Regulation (Amendment) Act of 1965 gave extensive powers to the Reserve Bank of India. The Reserve Bank of India was made the Central Banking Authority.

- The banking sector reforms started immediately after the independence. These reforms were basically aimed at improving the confidence level of the public as most banks were not trusted by the majority of the people. Instead, the deposits with the Postal department were considered safe.
- The first major step was Nationalization of the **Imperial Bank of India** in 1955 via State Bank of India Act.
- State Bank of India was made to act as the principal agent of RBI and handle banking transactions of the Union and State Governments.
- In a major process of nationalization, 7 subsidiaries of the State Bank of India were nationalized by the Indira Gandhi regime. In 1969, 14 major private commercial banks were nationalized. These 14 banks Nationalized in 1969 are as follows:
    1. Central Bank of India
    2. Bank of Maharastra
    3. Dena Bank
    4. Punjab National Bank
    5. Syndicate Bank
    6. Canara Bank
    7. Indian Bank
    8. Indian Overseas Bank
    9. Bank of Baroda
    10. Union Bank
    11. Allahabad Bank
    12. Union Bank of India
    13. UCO Bank
    14. Bank of India.

The above was followed by a second phase of nationalization in 1980, when 7 more banks were nationalized. After the two major phases of nationalization in India, the 80% of the banking sector came under the public sector / government ownership. 1971 saw the creation of the Credit Guarantee Corporation. 1975 saw the creation of Regional Rural Banks in India. In 1980, there was a Nationalization of 7 more banks with deposits over Rs. 200 Crore. The result was outstanding. The public deposits in these banks increased by 800%, as the government ownership gave the public faith and trust. The third phase of development of banking in India started in the early 1990s when India started its economic liberalization.

What is a Bank?

In India, the definition of the business of banking has been given in the Banking Regulation Act, (BR Act), 1949. According to Section 5(c) of the BR Act, 'a banking company is a company which transacts the business of banking in India.' Further, Section 5(b) of the BR Act defines banking as, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, order or otherwise.' This definition points to the three primary activities of a commercial bank which distinguish it from the other financial institutions as follows:

1. Maintaining deposit accounts including current accounts,
2. Issue and pay cheques
3. Collect cheques for the bank's customers

Who compete with Banks?

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*). Some of them are as follows:

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. 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

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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.

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.

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.

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.

Structure of Banking in India

The banking structure in India has the following components.

1. Banking Regulator RBI
2. Scheduled Banks

The competitive landscape for banking Industry has the following players in picture:

1. Term Landing Institutions
2. Non Banking Financial Companies
3. Insurance Companies
4. Mutual Funds.

Reserve Bank of India:

The RBI established by RBI Act 1934 in 1935 and nationalized in 1949 is the central banking and monetary authority of India. It acts as a regulator and supervisor of the Banks.

- ✓ Every country has its own central bank such as Federal Reserve of United States.
- ✓ Please note that most of the central banks of the world were established during the early 20th century and RBI was one of them. Following is the list of the establishment of some of the major banks in the world.
- ✓ Federal Reserve Bank of United States was established via Federal Reserve Act 1913
- ✓ Bank of England is the oldest established central bank among the major countries. It was established in 1694 as a private entity and remained so till 1946 when it was nationalized.
- ✓ The central Bank of China is People's Bank of China and it was established in 1948
- ✓ One more older bank is *Banque de France* , the central Bank of France which was established in 1800.

Following are major functions of RBI:

1. Currency authority
2. Control of Money supply and credit
3. Management of Forex
4. As banker to the government
5. Maintenance of India's financial infrastructure
6. Banker of the banks
7. Supervision of the Banks.

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In the commercial Banking system, the two functions of RBI viz. Banker of the Banks and Supervision are very important. As the Banker's Bank , RBI carries out the following functions:

1. Holds a part of the Cash Reserves of the banks
2. Short term lending
3. Centralized clearing facilities.

Why RBI is LORL?

- ✓ RBI is known as Lender of Last Resort because, banks are supposed to meet their shortfalls of cash from other sources and if the other sources don't meet the demand, then they approach RBI.

Supervisory Functions:

These functions are related to banking license, branch expansion, liquidity, management and working methods, amalgamation, reconstruction and liquidation.

Scheduled Banks of India

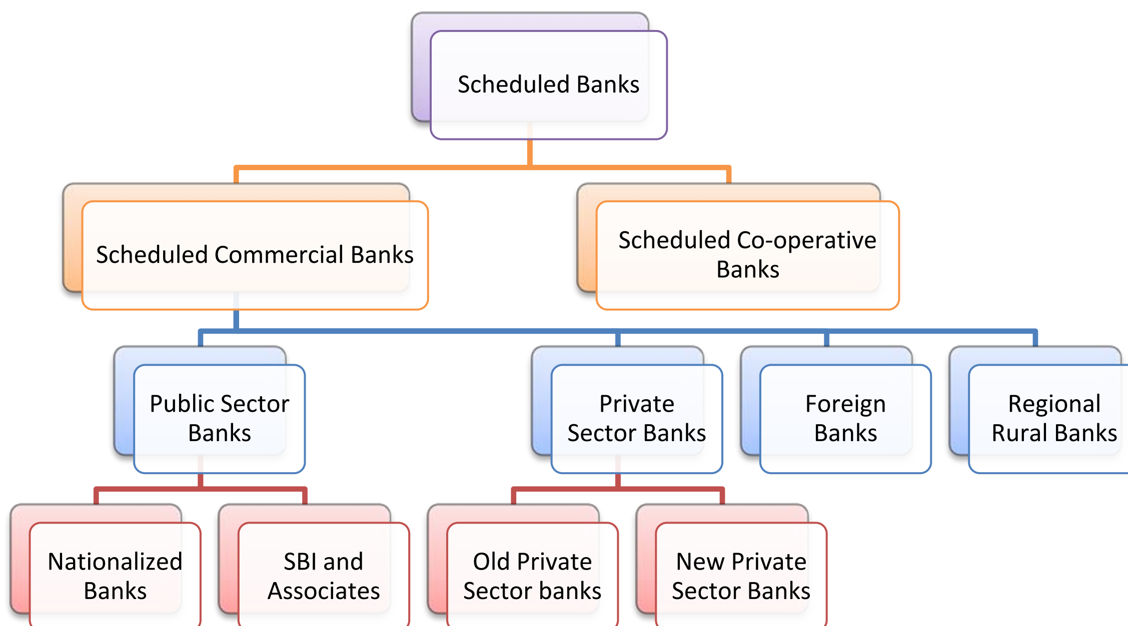
Scheduled Banks in India constitute those banks which have been included in **the Second Schedule of Reserve Bank of India**(RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42 (6) (a) of the Act. The banks included in this schedule list should fulfil two conditions.

1. The paid capital and collected funds of bank should not be less than Rs. 5 Lakh
2. Any activity of the bank will not adversely affect the interests of depositors.

Every Scheduled bank enjoys the following facilities.

1. Such bank becomes eligible for debts/loans on bank rate from the RBI
2. Such banks automatically acquire the membership of clearing house.

Scheduled Banks have been classified as follows:



Current Number of Nationalized Banks:

There are **26 Nationalized Banks** in the country at present. They are as follows:

1. Allahabad Bank
2. Andhra Bank
3. Bank of Baroda
4. Bank of India
5. Bank of Maharashtra
6. Canara Bank
7. Central Bank of India
8. Corporation Bank
9. Dena Bank
10. IDBI Bank Ltd.
11. Indian Bank
12. Indian Overseas Bank
13. Oriental Bank of Commerce
14. Punjab & Sind Bank
15. Punjab National Bank
16. Syndicate Bank
17. UCO Bank
18. Union Bank of India
19. United Bank of India
20. Vijaya Bank

State Bank Group

21. State Bank of Bikaner & Jaipur
22. State Bank of Hyderabad
23. State Bank of India

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24. State Bank of Mysore
25. State Bank of Patiala
26. State Bank of Travancore

Private Sector Scheduled Banks

The Private sector scheduled banks are as follows:

Private Sector Banks

Old Private sector Bank	New Private Sector Banks
1. Catholic Syrian Bank Ltd.	1. Axis Bank Ltd.
2. City Union Bank Ltd.	2. Development Credit Bank Ltd.
3. Dhanalakshmi Bank Ltd.	3. HDFC Bank Ltd.
4. Federal Bank Ltd.	4. ICICI Bank Ltd.
5. ING Vysya Bank Ltd.	5. IndusInd Bank Ltd.
6. Jammu and Kashmir Bank Ltd.	6. Kotak Mahindra Bank Ltd.
7. Karnataka Bank Ltd.	7. Yes Bank Ltd.
8. Karur Vysya Bank Ltd.	
9. Lakshmi Vilas Bank Ltd.	
10. Nainital Bank Ltd.	
11. Ratnakar Bank Ltd.	
12. SBI Commercial and International Bank Ltd.	
13. South Indian Bank Ltd.	
14. Tamilnad Mercantile Bank Ltd	
Source: Handbook of Banking Information, 2011 RBI	

- ✓ Please note that under the WTO agreements, the Reserve bank of India has to allow a minimum of 12 Branches of all the foreign banks to be opened in a year.

Number of Branches and ATMs

Please note that if we count the number of the bank branches including the cooperative and local area banks, the number is around 82000.

Out of this, the share of the Scheduled Commercial Banks is shown in the following table.

(As at end-March 2011)

Sr. No.	Name of the Bank	Branches					ATMs			Per cent of Off-site to total ATMs	Per cent of ATMs to Branches
		Rural	Semi-urban	Urban	Metro-politan	Total	On-site	Off-site	Total		
	Scheduled Commercial Banks	21,705	19,800	16,945	15,680	74,130	40,729	33,776	74,505	45.3	100.5
	Public Sector Banks	20,387	15,978	13,569	12,277	62,211	29,795	19,692	49,487	39.8	79.5
	Nationalised Banks	14,185	10,561	10,154	9,398	44,298	15,691	9,145	24,836	36.8	56.1
	Private Sector Banks	1,311	3,814	3,315	3,162	11,602	10648	13003	23651	55.0	203.9
	Foreign Banks	7	8	61	241	317	286	1081	1367	79.1	431.2

Kinds of Deposits

The nationalization of the banks was a turning point in the financial history of the country. It boosted the faith of the public and since then the banks have been able to mobilize a considerable size of financial savings of the household sector in India. Today, bank deposits are the dominant instrument of savings in India.

Who decides Interest rates on bank Deposits?

Before 1992, banks had no freedom to decide the deposit interest rates. After the process of deregulation of interest rates started in April 1992, almost all the interest rates have now been deregulated and the banks have the freedom to fix their own deposit rates.

Types of Deposits accounts:

There are two types of deposits:

1. **Demand deposits:** The money we keep in our saving accounts is like a medium of exchange and this is called Demand deposits. This is because ownership of this deposit may be transferred from one person to another via cheques or electronic transfers. There is no fixed term to maturity for Demand Deposits.
2. **Time Deposits:** If we deposit our money has an FD in the bank it becomes a Time Deposit on which NO cheque is drawn. They are paid on maturity at a particular time.

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Current Account and Savings Accounts

A ***current account is always a Demand Deposit*** and the bank is obliged to pay the money on demand. The Current accounts bear no interest and they account for the smallest fraction among the current, saving and term deposits. They provide the convenient operation facility to the individual / firm. The cost to maintain the accounts is high and banks ask the customers to keep a minimum balance.

On the other hand, Savings deposits , which are also demand deposits, are 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.

Difference between Current Account and Saving Accounts:

The basic objective of a Savings Bank Account is to enable the customer save his / her liquid assets and also earn money on that saving. The Savings banks Accounts are preferred by individuals and provide liquidity for private and small businesses sometimes. On the other hand the current account is basically a transactional account which is preferred by business people. The basic objective of the current accounts is to provide flexible payment methods to the business people and entities. These payment methods include special arrangements such a overdraft facility, accommodation of standing orders, direct debits, offset mortgage facility.

1. **Transactions:** Usually saving accounts have low transactions while current accounts have large transactions.
2. **Handling:** Savings accounts involve personal handling of assets, while current accounts are aimed to make the account holder free of personal handling of liquid funds. The current account facility helps the business to run without hurdles due to non availability of funds and short term deficits.
3. **Interest Income:** Usually the current accounts don't earn interests. The saving accounts earn interest **which are defined by the bank themselves at present in India.** The interest is compounded half yearly. (Please note that in case of death of the current account holder his legal heirs are paid interest at the rates applicable to Savings bank deposit from the date of death till the date of settlement)
4. **Overdrafts:** As discussed above saving accounts have no overdraft facility, current accounts have. The money can be borrowed for short term and to be paid back with interest.
5. **Minimum Balance:** Usually saving accounts need a minimum balance in the banks to keep the account active (however No Frill accounts require either nil or low minimum balance to be maintained). In current accounts there are no minimum balance requirements.

CASA Deposits:

CASA Deposits refers to Current Account Saving Account Deposits. As an aggregate the CASA deposits are low interest deposits for the Banks compared to other types of the deposits. So banks tend to increase the CASA deposits and for this they offer various services such as salary accounts to companies, and encouraging merchants to open current accounts, and use their cash-management facilities.

The Bank is High CASA ratio (CASA deposits as % of total deposits) are in a more comfortable position than the Banks with low CASA ratios , which are more dependent on term deposits for their funding, and are vulnerable to interest rate shocks in the economy, plus lower spread they earn.

Term Deposits:

Term Deposits are of three kinds:

1. **Fixed deposits:** A fixed rate of interest is paid at fixed, regular intervals
2. **Re-investment deposits:** Interest is compounded quarterly and paid on maturity, along with the principal amount of the deposit. In the Flexi Deposits amount in savings deposit accounts beyond a fixed limit is automatically converted into term-deposits.
3. **Recurring deposits:** 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.

NRO, NE(E)RA and FCNA(A) Accounts

There are several kinds of accounts available for non resident Indians , Persons of Indian Origin and Overseas Citizens of India. They are as follows:

1. Non Resident Ordinary Accounts: (NRO):

Any person resident outside of India can open this account. Normally, when a resident becomes a non resident, his domestic rupee account gets converted into the NRO account. This helps the NRI to get his credits which accrue in India, for example rent or interest from investments.

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2. **Non-Resident (External) Rupee Account: (NR(E)RA**
This account was introduced as NRE scheme in 1970. It's a Rupee account and the NRI can remit money to India from the funds abroad. This means that depositor is exposed to the Currency rates risk.

3. **Foreign Currency Non-Resident Account: (FCNR)**
Foreign Currency Non-Resident Account Bank or FCNR (B) was first introduced in 1993. It replaced the existing FCNR (A) scheme. This account is opened by the NRIs in **6 designated currencies** as follows:
    1. US Dollar (USD)
    2. Great Britain Pound (GBP)
    3. Euro (EUR)
    4. Japanese Yen (JPY)
    5. Canadian Dollar (CAD)
    6. Australian Dollar (AUD)

- Please note that FCNR account is opened **ONLY in the form of Term Deposits** and NOT in the form of Demand Deposits.
- The term is from 1 year to 5 years.
- Repatriation of the principal and interest is allowed for repatriation after maturity.
- Interest is paid on maturity, in the same currency of the deposit. For deposits of tenure up to one year simple interest is paid and for deposits of tenure beyond one year the interest is compounded at half yearly rests. The maturity proceeds inclusive of interest is fully reparable.
- The banks may decide the interest rates after approval from RBI and within the limits fixed by RBI.
- If a person has NRE account and wishes to transfer to FCNR, it is permissible without prior approval of the RBI.

Deregulation of Saving Banks Accounts Interest Rates

Recently, the Reserve Bank of India has completely deregulated the interest rates. The Interest on Savings Banks Account **was the last administered pricing imposed by the banking regulator** and now the savings bank account interest rates have been deregulated.

This will set a stage among the banks to attract more deposits by offering attractive interest rates to consumers. Up till now, the SB account fetched account holders a measly 4%. The system was there in place since 1978. Yes Bank became the first bank to react to the RBI Mandate and it immediately increased the return on its SB accounts to 6%.

What are Implications (Important)?

It is estimated that there are Rs. 13 lakh crore of funds parked in SB (savings bank) in India.

The existing system **since 1978**, was causing the deposits receives negative real returns because the interest on these accounts has been fixed at 4% even as inflation was two-and-a-half times that level.

The deregulation of the savings banks rates would give the customers an opportunity to shift to banks that come up with better deals.

Up till now the rate of 4% on saving Banks Account was being prescribed by RBI. **Now Banks themselves decide the interest rates** and are free to offer whatever returns they wish.

Please note that banks can also withdraw the savings deposits without notice as per new regulations by RBI.

The interest rates are to be calculated on daily basis, this is because part of these deposits is perpetual. Partly because amounts withdrawn are replenished by monthly earnings and partly because banks mandate a minimum balance ranging between Rs 5,000 to Rs 10,000 on savings account.

The RBI has also tried its best so that the banks may not be able to discriminate between large and small depositors. RBI says that the **same rate will be applicable to all depositors up to ₹ 1 lakh.** However, for larger deposits banks can offer differential rates. At the same time, Reserve Bank of India has said two customers having the same amount should get the same rate.

How it will affect the banks?

An increase in SB rates will put pressure on bank margins. Banks will have to offer higher rates and then they also have to make up the extra costs. To do that they may revise charges in respect of accounts where they are losing money. But we know that RBI has already frozen charges on ATM usage. So, there is possibility that banks may hike branch service charges to compensate for the savings rate outgo.

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Concept of Deposit Insurance

The idea behind the Deposit Insurance is to boost the faith of the public in the banking system, and provides protection against the loss of deposits to a significant extent. In India, the bank deposits are covered under the insurance scheme provided by **Deposit Insurance and Credit Guarantee Corporation (DICGC).** DGCIC is a wholly owned subsidiary of the Reserve Bank of India. So, Banks are insured by the DICGC.

Please note that :

- ✓ All commercial banks including branches of foreign banks functioning in India, local area banks and regional rural banks **are insured** by the DICGC.
- ✓ All State, Central and Primary cooperative banks, also called urban cooperative banks, functioning in States / Union Territories **are covered under** the Deposit Insurance System.
- ✓ At present all co-operative banks **other than** those from Meghalaya, Chandigarh, Lakshadweep and Dadra and Nagar Haveli **are covered** under the deposit insurance system of DICGC.
- ✓ **Primary cooperative societies** (PACS) , which are village level cooperatives and disburse short term credits in the country are **NOT insured** by the DICGC. So around 95000 PACS in the country are out of coverage of the DICGC.

The DICGC insures all deposit accounts including savings, fixed, current, recurring, except:

1. Deposits of the Foreign Governments
2. Deposits of the Central and State Governments.

Please note that the maximum amount per depositor insured is ₹ 1 Lakh including Principal and Interest. This means that

- ✓ If a person has principal amount of ₹ 91000 and interest ₹ 7,000 then the amount isured by DICGC is ₹ 98000.
- ✓ However, if the same person has deposits ₹ 98000 and interest ₹ 8000 then , the amount insured by the DICGC would be ₹ 1 Lakh.
- ✓ The insurance cost is borne by the bank which is insured. The DGCIC charges 10 paise per ₹ 100 as insurance premium.

Negotiable Instruments Act 1881

Negotiable Instruments Act 1881 had been passed in 1882 and was modified in 1989 and 2002, as some more sections were added into the age old law. This act is applicable in entire India , including Jammu & Kashmir. J & K was brought in the ambit of the act in 1956.

The act has provisions of Negotiable Instruments such as Promissory Notes, Checks, Drafts , Bills of exchanges etc.

What is a Negotiable Instrument?

Negotiability means transfer of an instrument from a person / entity to another person / entity. The transfer should be without restriction and in good faith.

Before we move ahead , please note the following:

- ✓ The NI Act has 147 sections.
- ✓ **Draft was not included and was made included in the Section 85(a).**
- ✓ Currency Note is not a negotiable instrument as per section 21 of the Indian Currency Act .
- ✓ Section 4 deals with promissory notes
- ✓ Section 5 deals with Bill of Exchange
- ✓ Section 6 deals with Cheque
- ✓ Section 9 deals with holder and holder in Due course.
- ✓ Section 15 deals with Endorsements
- ✓ Various other sections such as 123-131 deal with crossing of cheques.

Here we discuss the salient features of the NI Act 1881.

Holder:

Holder is the person who is entitled in his own name to the possession of a negotiable instrument.

- ✓ Normally a payee or endorsee is a holder.
- ✓ **Please note that holder may be or may not be with possession of the Instrument**.
- ✓ If the payee or endorsee dies, then the legal heir is the holder .
- ✓ If there is a forged endorsement then , last endorsee is the holder.
- ✓ If it is a bearer cheque, the person in whose name it is made is a holder.
- ✓ If it is damaged the payee or last endorsee is the holder.
- ✓ If it is stolen, then also payee or last endorsee is holder because a thief cannot become holder.
- ✓ The holder has the right to obtain a duplicate of instrument is lost.

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- ✓ A holder can cross a cheque if it is not already crossed.

Holder in Due Course:

Holder in due course means a person who **must have the possession of the instrument**. This is the basic difference between the Holder and Holder in Due course.

- ✓ Holder in Due course must obtain the instrument in Good Faith.
- ✓ If the instrument bears not-negotiable crossing , then the NO person can be a holder in due course.
- ✓ If the instrument bears A/C payee crossing and restricted endorsement then NO person can be a holder in due course.
- ✓ Forgery / theft / deceit do not convey any title.

Promissory Note

PN means a paper with a writing which as a promise. But it does not mean that we write "I owe You" and it becomes a PN.

- ✓ PN is always in writing
- ✓ PN has an unconditional undertaking called promise
- ✓ The promise is to pay money
- ✓ The money has to be paid to the certain person.
- ✓ Please note that when a person issues a promissory note, he/ she would have to stamp it as per the Indian Stamp Act and normally a revenue stamp is affixed on the PN signed by the promissory.

The PN can be Demand Promissory Note or Usance Promissory Note. Demand Promissory Note has to be paid immediately on demand and Usance Promissory Note has to be paid after certain time period.

✓ There are two parties in the PN. The maker is who promises to pay and the payee is who is promised to pay.

Is a currency Note a promissory note?

The currency Notes bear the following note signed by Governor Reserve Bank of India (for more than ₹ 1) and Finance Secretary (₹ 1) :

I promise to pay the bearer a sum of _______Rupee/ Rupees.

However, Currency notes are money and they don't fulfil the conditions of the PN. The currency is excluded from NI act and governed by Indian Currency Act. So Currency notes are Not promissory Notes.

Bill of Exchange

☞ There are **3 parties in the bill of Exchange**.

BEO is a written negotiable Instrument which contains an unconditional order which is

1. Signed by the **Maker**
2. Directs a certain person to pay
3. Certain sum of Money only to
4. Certain person or the bearer.

The parties are **Drawer, Drawee** and **Payee.**

- ✓ **Drawer:** The person who orders to pay
- ✓ **Drawee:** The person who is directed to pay
- ✓ **Payee:** The person who is authorized to obtain a payment

Please note that A minor can be a Drawer but not a Drawee because he can not incur liability.

Once the Drawee accepts the BOE, he becomes acceptor.

Inland Bill & Foreign Bill

A bill that is **drawn in India** and **paid in India or out of India** to a person, who is **in India,** whether **Indian or Foreigner, is** Inland Bill. Simply, a bill drawn in India and paid in India is a Inland Bill.

A bill which is NOT drawn in India but is payable in India to a person, who is **in India and is Indian or a foreigner** is a Foreign Bill.

Hundi:

Hundi is the Desi version of a bill of Exchange.

They are used conventionally, not stamped and a vernacular language is written on them. They are still in use and are governed by local practices only.

- ✓ **Darshani Hundi** is akin to a Demand Promissory Note
- ✓ **Miadi Hundi** is akin to a Usance Promissory Note
- ✓ **Khoka** is also a Hundi which refers to a bill of exchange that has been paid and canceled.

BOE , as per the NI act are charged at the rate of 18% per annum interest.

Cheque

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- **A cheque is also a Bill of Exchange**

  A cheque is a bill of exchange in which one party (Drawee) is a Bank. So a Drawer (account Holder) draws the Cheque on the (Drawee bank) in the name of a Payee.
    - The Drawer has to write the amount in both in figures and words.
    - If different values are written in Figures and words, the value of words can be paid as per section 18 NI act. This means that if a person writes a check with the following :

- Figures : ₹ 5000
- Words: Rupees Five Lakh Only
- This means that amount of Five lakhs is to be paid.
    - If the amount is written in words only and NOT in figure than NO payment will be made because it would be **Inchoate**. This means that a person writes a check with the following:
- Figures: ________ (Left Blank)
- Words: Rupees Five Lakh Only
- No payment would be made (Section 20 NI Act)

Bearer Cheque:

Bearer cheque is payable to the bearer. Sometimes "Self" is written, that is also a bearer cheque payable to the account holder.

Dating:

- If a check does not bear a date, it will be returned.
- The holder / bearer can fill a date , if there is no date written
- If the date filled is a holiday, it can be paid only after that Holiday.
- If a person opens an account on November 10, 2010 and gives a check to somebody with date say October 25, 2010, **then it is Valid** and will be paid. This is called "Ante dated Cheque".
- Normal validity is 6 months but can be restricted by the account holder.
- The check older than 6 months is called Stale Cheque and is NOT paid and will be returned.
- After the state Cheque is returned , it can be revalidated for any number of times ☺ and each time it becomes valid for next 6 months.
- A post dated check can bear any date of future and the payment can be stopped.

Crossing:

Crossing provides an additional security. Crossing means that sum of that cheque can only recovered from a specified banker and it will be credited to the holders account. The crossed cheques are not paid at the counter. Crossing is applicable in case of cheques only and not in case of Bill of Exchange or promissory notes.

- Crossing may be General crossing or Special crossing. General crossing (NI Act Section 123) is where a cheque bears two parallel lines with words such as a/c payee etc.
- In Special crossing (NI Act Section 124) the cheque bears the name of the banker also. Section 126 directs that such cheques shall be paid to the banker to whom it is crossed specially or to his agent for collection.

Endorsement:

The section 15 of the Negotiable Instruments Act 1881 defines endorsing as "signing on the face or an instrument for the purpose of negotiating a negotiable instrument (such as Cheque)."

Endorsing is signing in the instrument either on face or on back, for the purpose of negotiation of a NI. The person who signs is called endorser. The person in whose favor the instrument has been transferred is called Endorsee.

- The holder of the instrument endorses the instrument.
- If he signs only and does not mention anything else it is called Blank Endorsement.
- If he endorses and adds a direction to pay the amount to a specified person it is called Endorsement in full.
- If he signs and adds direction for restriction on further negotiability, then it is called Restrictive Endorsement.
- Partial endorsement is NOT valid. This means that if Suresh issues you a check of ₹ 10000 and endorses on the backside of the check that "Pay Ramesh ₹ 5000" it is NOT a Valid endorsement. Again if Suresh issues you a check of ₹ 10000 and endorses with a direction that " Pay Ramesh when he passes his examination", this is again NOT a valid endorsement. Both these conditions are called partial endorsements.
- A minor is NOT a valid endorser.

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Difference between a Crossed cheque and A/C Payee cheque

A person who signs the cheque and transfers the instrument is an endorser and in whose favor it is transferred is endorsee. The endorsee acquires a right to negotiate the instrument to anyone he / she likes. By making an endorsement the endorser promises that in case of dishonor, he / she provides a guarantee to compensate the holder.

Crossing a cheque by making two parallel lines with or without such words as ___& company is general crossing. Section 126 of the NI Act says that this is a direction to the bank to not to pay the cheque across the counter.

This crossed cheque is no more a bearer cheque where anyone can negotiate and get payment across the counter.

In case of a crossed cheque, the payee is free to make further endorsements.

For example, Ayesha receives a check from Rohan which has been crossed, Ayesha can get this payment in her account only and not across the counter. But in this case Ayesha is free to endorse the cheque in favor of Suresh and further Suresh is free to endorse the instrument in favor of Mukesh and so on...This means that crossing a cheque does not put restrictions on endorsements. In case the cheque gets dishonored, Mukesh can sue Suresh and Suresh can sue Ayesha and Ayesha can sue Rohan.

Now let's discuss A/C Payee cheques. The NI act does not talk about the A/C payee crossing. There is no definition of A/C payee crossing in the NI act and it is a child of banking practice. Making a cheque A/C Payee is a result of custom, use and practice and is now accepted legally.

But, the A/C payee cheque cannot be further endorsed. This means that if the cheque in the above example which is in favor of Ayesha bears "A/C Payee", payment can be collected in Ayesha's account only. The paying bank makes sure that amount is being credited to the account of the payee only

Cheque Truncation:

The NI act was amended in 2002 and after that Cheque also means a Cheque in electronic form. The clearing of checks on the basis of electronic checks is called Cheque Truncation.

The Electronic image is generated and it is used for clearing, thus at that point the Physical Movement of the Cheque is stopped. So simply, Cheque Truncation is a system of cheque clearing and settlement between banks based on electronic data/ images or both without physical exchange of instrument.

This results in faster clearance, (T+0) in local and T+1 in intercity clearing. Faster realization is accompanied by a reduction in costs for the customers and the banks. Banks can also offer innovative products and services based on CTS and there is an additional advantage of reduced reconciliation and clearing fraud.

In cheque truncation, at some point in the flow of the cheque, the physical cheque is replaced with an electronic image of the cheque and that image moves further. The processing is done on the basis of this truncated cheque and physical cheque is stored. MICR data is very useful in check truncation. The electronic cheques are issued in electronic form with digital signatures / biometric signatures / encrypted data. The negotiable Instruments (Amendment) Act of 2002 gives constitutional validity to the electronic cheques.

Demand Drafts

Demand draft is discussed in section 85(A) of the NI Act. A Demand draft is an order to pay money drawn at one office of a Bank upon another office of the **same bank** for a sum of money payable to order on demand.

- A Demand Draft is payable on demand
- A Demand Draft can NOT be paid t a bearer
- A DD is negotiable and its features are similar to Bill of Exchange and NOT a Check.
- If a Bank fails to honor the Draft, the Bank is liable and not the person.
- If there are wrong signatures on the Bank Draft, the Bank is liable.
- If there is a prior arrangement , the DD can be payable by different bank also.

A person reaches the Bank with a **Demand Draft** payable to his account. At this situation, the Bank works as which of the following?

A. Creditor
B. Debtor
C. Beneficiary
D. Trustee

Answer to the above question is D (Trustee). This means that when a Bank draft is purchased, the relations between the purchaser and bank are that of a debtor and creditor , and as soon as this bank reaches the Payee, the Payee becomes beneficiary and the Bank becomes trustee.

Please note that once, the payee gets a DD, the payment CANNOT be stopped unless there is an order by a competent court. So,

- When a draft reaches a payee, the relationship between the purchaser and Bank comes to an end.

Please note these points:

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- A demand draft can be prepared with cash payment if the value is less than ₹ 50,000.
- For a value of ₹ 50,000 or more, only paid through bank account.

Draft is valid for 6 months. On expiry of this date, the draft can be revalidated by the Bank.

Difference between a Cheque and Draft:

Cheque has been defined in Negotiable Instruments Act 1881 section 6. A cheque is a bill of exchange drawn on a specified bank and not expressed to be payable otherwise than on demand.

A demand draft has been defined by Negotiable Instruments Act 1881 in section 85. A demand draft is an order to pay money drawn by one office of a bank upon another office of the same bank bank for a sum of money payable to order on demand.

Following are some more differences:

- A cheque can be made payable to bearer but a Demand Draft cannot.
- A demand draft can be cleared in a specified branch of the issuer bank
- A cheque can get dishonored but Demand draft is always honored.
- An issuer party of the cheque is liable to the cheque and not backed by a Bank Guarantee, A demand draft is backed by a bank guarantee

Initial Banking Reforms in India

The decade of 1990s is known for far reaching reforms in all the sectors of Indian Economy. During the first half of decade of 1990s, the most important committee was Narasimham Committee on banking Sector Reforms. It was set up in 1991. There was another Narsimhmam committee set up in late 90s with same person as chairman and both related to Banking Sector Reforms. First Narasimham committee submitted its report in November 1991. It recommended the following:

Reduction in SLR

As most of you know, SLR means statutory Liquidity Ratio. SLR and CRR have been defined by the Banking Regulation Act 1949.

- SLR means that every bank (including private, public, scheduled, cooperative, commercial or whatever) in India has to maintain equivalent to an amount at least 24% of the total of its **net demand and time liabilities** as cash in hand.
    - Example: If bank as Rs. 100 as Demand Liabilities such as saving accounts deposits and
- The components of SLR are Cash in hand, Gold owned by the bank, Balance with RBI, Net balance in current account & Investment in Government securities. SLR has to be maintained at the close of business on every day.
- Please note that First Narasimham Committee defined for the first time that SLR should be reduced to 25% over the period of time.

Reduction in Cash Reserve Ratio (CRR)

- In terms of Section 42(1) of the RBI Act 1934, Scheduled Commercial Banks are required to maintain with RBI an average cash balance, the amount of which shall not be less than three per cent of the total of the Net Demand and Time Liabilities (NDTL) in India, on a fortnightly basis and RBI is empowered to increase the said rate of CRR to such higher rate not exceeding twenty percent of the Net Demand and Time Liabilities (NDTL) under the RBI Act, 1934**. At present, CRR is 4.75 per cent of the NDTL.**
- First Narasimham committee had recommended that CRR should be **reduced to 10%** over the period of time.

Other Recommendations

- Interest rate in **CRR Balances**
- **Redefining the priority sector**
    - The Narasimham Committee recommended that the Priority sector should be redefined and it should include the following:
        - Marginal farmers
        - Tiny sector
        - Small business and transport operators
        - Village and Cottage Industries
    - Narasimham Committee recommended that there should be a target of 10% of the aggregate credit fixed for the Priority Sector at least.
- **Deregulation of the Interest Rates.**
- **Asset Classification and defining the Non Performing Assets.**
- Improve transparency in the banking system
- **Tribunals for recovery of Loans.**
- Tackling doubtful debts

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- Restructuring the banks
- Allow entry of the new private Banks
- Please note these memorable Points:
- The Narasimham Committee had recommended that the SLR should be reduced to 25% over the period of time.

✍ The impact of reducing the CRR and SLR was that now more funds of the banks could be deployed to some more remunerative loan assets.

Comparison of SLR and CRR

- SLR → Bank keep liuid assets with themselves
- CRR → Bank keep Cash Balance with RBI

Impact of reducing SLR and CRR

When CRR / SLR is reduced, more funds are available to banks for deploying in other business as they have to keep fewer amounts with RBI. This means that the banks would have more money to play and this leads to **reduction of interest rates on Loans provided by the Banks.**

Impact of Hiking SLR / CRR

RBI uses the method of CRR / SLR hike to drain out the excess liquidity from the banks. This is because; the banks will now have to keep more money with the Reserve Bank of India. On this money banks don't earn any / much interest. Since they don't earn any interest, the banks are left with an option to increase the interest rates. If RBI hikes this rate substantially, banks will have to increase the loan interest rates. The home loans, car loans and EMI of floating Rate loans increase.

Incremental Credit-Deposit (ICDR) ratio

ICDR indicates how much banks are lending for every rupee received as deposits. For every Rs 100 deposit, banks have to set aside Rs 28.75 in the form of the cash reserve ratio and the statutory liquidity ratio, which are 4.75 per cent and 24 per cent, respectively. So, for every Rs 100 deposit, banks can only lend up to Rs . 71.25. Apart from deposits, banks can use borrowed funds for lending. This means that if a bank which without borrowing can lend Rs. 71.25, borrows 31.75 more for lending, its ICDR will stand at 103%. This would be indicating that banks were supporting their loan growth by borrowing one-day money from the repo window of RBI. The high ICDR is mainly on account of lower deposit growth as compared to credit growth.

Capital Adequacy Norms

We all know that Capital refers to the assets which are capable of generating income and which have themselves been produced. This is one of the four factors of production and consists of Machine, Plant and Building, Land and Labour. But in Banking Industry, Capital refers to the **stock of Financial Assets** which is capable of generating income. The Capital Adequacy Ratio is a thermometer of Bank's health, because it is the ratio of its capital to its risk.

So simply, **Capital Adequacy Ratio = Capital ÷Risk**

✍ So, the Capital Adequacy can indicate the capacity of the Bank's ability to absorb the possible losses.

✍ The Regulators check CAR to monitor the health of the Bank, because a good CAR protects the depositors and maintains the faith and confidence in the banking system.

CRAR System

CRAR is the acronym for capital to risk weighted assets ratio, a standard metric to measure balance sheet strength of banks. BASEL I and BASEL II are global capital adequacy rules that prescribe a minimum amount of capital a bank has to hold given the size of its risk weighted assets. The old rules mandate banks to back every ₹ 100 of commercial loans with ₹ 9 of capital irrespective of the nature of these loans. The new rules suggest the amount of capital needed depends on the credit rating of the customer.

Basel Committee on Banking Supervision

Basel Committee on Banking Supervision is an institution of Governors of the Central Banks of "G-10" nations and was formed in 1974. It has 27 members viz. Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

✍ Out of them 12 are permanent members and its headquarters are located at Basel Switzerland.

This Basel Committee on Banking Supervision works on strengthening the soundness and stability of the banking system, internationally.

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- In July 1988, it had released the guidelines on Capital Measures and Capital standards, which were called **Basel-I.** These guidelines were accepted by RBI also and were implemented w.e.f 1992.
- In June 2006, it again issued the revised guidelines which are called Basel II. In line with the Basel II, RBI had issued the detailed guidelines from 2007.
- At Present Basel III is under development.

Tier I and Tier II Capital

The Basel-I defined two tiers of the Capital in the banks to provide a point of view to the regulators. The Tier-I Capital is the core capital while the Tier-II capital can be said to be subordinate capitals. The following table shows the 2 tiers of the Capital Fund under the Basel II.

Tier-I Capital	Tier-II Capital
Paid up Capital	Undisclosed reserves and cumulative perpetual preference shares.
Statutory Reserves	Revaluation Reserves
Other disclosed free reserves	General Provisions and loss reserves
Capital Reserves which represent surplus arising out of the sale proceeds of the assets.	Hybrid debt capital instruments such as bonds.
Investment Fluctuation Reserves	Long term unsecured loans
Innovative Perpetual Debt Instruments (IPDIs)	Debt Capital Instruments.
Perpetual Noncumulative Preference Shares.	Redeemable cumulative Preference shares
Minus:	Perpetual cumulative preference shares.
Equity Investment in subsidiaries.	
Intangible assets.	
Losses (Current period + past carried forward)	

- Please note that as of **March 2012,** RBI has proposed Tier-I capital of at least seven per cent and has stipulated that total capital be kept at **least nine per cent**. It has also proposed a capital conservation buffer in the form of common equity of 2.5 per cent of RWAs or Risk Weighted Assets.

Risk weighted Assets

The Risk weighted assets refer to the fund based assets such as Cash, Loans, Investments and other assets. This means that they are the total assets owned by the Banks, however, the value of each asset is assigned a risk weight (for example 100% for corporate loans and 50% for mortgage loans) and the credit equivalent amount of all off-balance sheet activities. Each credit equivalent amount is also assigned a risk weight.

The degree of risk expressed % weights assigned by **the Reserve Bank of India.** The following table shows the Risk weights for some important assets assigned by RBI in an increasing order.

Asset	Weighted Risk
Cash	0%
Balance with Reserve Bank of India	0%
Central/ state Government Guaranteed advances	0%
SSI advances up to CGF guarantee	0%
Loans against FD (Fixed Deposits), LIC Policy	0%
Government approved Securities	2.5%
Balance with Banks other than RBI which maintain the 9% CRAR	20%
Secured Loan to the Staff Members	20%
Housing Loans <₹ 30 Lakh	50%
Housing Loans >₹ 30 Lakhs	75%
Loans against Gold and Jewellery <₹ 1 Lakh	50%
Retail Lending up to ₹ 5 crore	75%
Loans Guaranteed by DGCGC / ECGC	50%
Loans to Public Sector Undertakings	100%
Foreign Exchange and Gold in Open Position	100%
Claims on unrated corporates	100%
Commercial Real estate	100%

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Consumer Credit	125%
Credit Cards	125%
Exposure to Capital Markets	125%
Venture Capital Investment as a part of Capital Market exposure	150%

In the above table we can have a broad idea that the assets which are in the form **of Cash, Government Guaranteed securities, against the LIC policies etc*. are safest assets with 0% Risk weighted assigned to them***. On the other hand, the venture Capital Investment as a part of Capital Market exposure has the maximum risk weight assigned to them.

Illustration:

Let's take this example, For a AAA client, the risk weight is 20%, which means banks have to set aside its own capital of ₹ 1.80 for every Rs 100 loan (this means 20% of 9% of ₹ 100). Similarly, in case of 100% risk weight (such as capital markets exposures) , banks have to keep aside its own capital of Rs 9 on the loan.

Calculation of the Capital:

The following formulas are used for calculating the Tier I and total Capital fund as per the Basel II guidelines.

Tier I CRAR: = $\frac{\text{Eligible Tier I Capital Funds}}{\text{Total Risk Weighted Assets}} \times 100$

Total CRAR = $\frac{\text{Eligible Total Capital Funds}}{\text{Total Risk Weighted Assets}} \times 100$

Three Pillars of Basel II

The Basel II Guidelines are based upon 3 very important aspects which are called 3 pillars of the Basel II. These 3 pillars are as follows:

1. Minimum Capital Requirement
2. Supervisory review Process
3. Market Discipline

First Pillar: Minimum Capital Requirement

The first pillar Minimum Capital Requirement has been discussed above. This mainly for total risk including the credit risk, market risk as well as Operational Risk .

Second Pillar: Supervisory Review Process

The second pillar i.e. Supervisory Review Process is basically intended to ensure that the banks have adequate capital to support all the risks associated in their businesses.

In India , the RBI has issued the guidelines to the banks that they should have an **internal** supervisory process which is called **ICAAP or Internal Capital Adequacy Assessment Process**. With this tool the banks can assess the capital adequacy in relation to their risk profiles as well as adopt strategies for maintaining the capital levels.

Apart from that, there is another process stipulated by RBI which is actually the Independent assessment of the ICAAP of the Banks. This is called **SREP or Supervisory Review and Evaluation Process.**

The independent review and evaluation may suggest prudent measures and supervisory actions whatever is needed.

✓ **ICAAP** is conducted by Banks themselves and **SREP** is conducted RBI which is along with the RBI's Annual Financial Inspection (AFI) of the bank.

Third Pillar: Market Discipline

The idea of the third pillar is to complement the first and second pillar. This is basically a discipline followed by the bank such as disclosing its capital structure, tier-I and Tier –II Capital and approaches to assess the capital adequacy.

In the above discussion, we could understand that the Basel II and forthcoming Basel III are basically guidelines which focus upon adequate capital in the banks and minimize the risk to the customers or depositors. The idea is to make a sound financial system which not only helps the banks and but the entire economy of the country to maintain the trust and faith, as transparency in the business. The centrepieces are "**Capital Adequacy**" and "**Risks**".

Let's have a view on the risks associated with the banking business.

There are three kinds of Risks associated with the Banking:

1. Credit Risk
2. Market Risk
3. Operational Risk

The above words are self explanatory. The Basel II guidelines have stipulated approaches to assess the risks involved.

Credit Risk:

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Credit risk is risk of loss arising from a borrower who does not make payments as promised. This event would be called "Default" and the person/ company/ entity would be called "Defaulter".

✓ So credit risk can also be called "Default Risk".

The banks have two approaches for risks assets calculations in Basel II and as stipulated by the RBI accordingly:

- **Standardized Approach:** The risk weightage are assigned by the RBI as mentioned in the table above. The Banks have to follow it without any discretion to modify. The approach is based upon the external rating agencies. The Reserve Bank of India has identified 4 external domestic agencies for this approach. They are as follows:
    1. CRISIL
    2. ICRA
    3. Care
    4. Fitch

Apart from this, there are international agencies such as Moody's, Fitch, Standard and Poor's etc.

- **Internal rating based Approach :**

This is basically an alternative to standardized approach. The Banks do the internal assessment of the Counterparties and exposures. Banks need RBI's nod to do this.

Market Risk:

Market risk is the possible losses due to movement in the market prices. There are four standard market risk factors viz**. stock prices, interest rates, foreign exchange rates, and commodity prices**. Apart from there are associated market risks as follows:

1. Equity risk, the risk that stock prices and/or the implied volatility will change.
2. Interest rate risk, the risk that interest rates and/or the implied volatility will change.
3. Currency risk, the risk that foreign exchange rates and/or the implied volatility will change.
4. Commodity risk, the risk that commodity prices (e.g. corn, copper, crude oil) and/or implied volatility will change.

Here again, the Basel committee has suggested two broad methodologies for computation of the capital charges of the market risks. They are standardized and internal. The standardized approach involves two methods viz. maturity method and duration method.

Operation Risk:

Operational Risk refers to the risk of loss from inadequate or failed internal processes, people, systems or external events including

1. Incompetent management
2. Improper planning
3. Staff fraud
4. Noncompliance
5. Programming errors
6. System Failure
7. Increased competition
8. Deficiency in loan documentations.

Some issues in moving to Basel III

- Basel III guidelines seek to improve the ability of banks to withstand periods of economic and financial stress by prescribing more stringent capital and liquidity requirement, by raising minimum core capital stipulation. Introduction of counter cyclical measures will enhance banks' ability to conserve core capital in the event of stress through a capital conservation buffer.
- In March 2012 , RBI has issued the guidelines on Liquidity Risk Management and Basel III Framework on Liquidity Standards. As per these guidelines, Banks will need to adhere to these norms from the month or quarter ending June 2012.
- Indian banks currently need to meet RBI-set requirements of cash reserve ratio (CRR), and statutory liquidity ratio (SLR). The CRR, or the share of deposits that banks must set aside in cash with the RBI, is 4.75 per cent, and SLR, or the minimum amount of investments that banks need to make mostly in government securities, is 24 per cent.
- As part of the guidelines, banks are expected to maintain "high-quality" liquid assets, which includes cash and government bonds, which can be converted into cash to meet liquidity needs for a 30-day period under a stress situation.
- To qualify as high-quality, the cash reserves and government bond holdings need to be in excess of the mandated levels of CRR as well as SLR.

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International Financial Reporting Standards (IFRS)

IFRS is principles based set of accounting standards developed by the International Accounting Standards Board (IASB), an independent group of 15 experts. IFRS is steadily becoming the global standard for the preparation of financial statements of public companies.

The IFRS establishes broad rules and dictate specific treatments in financial reporting.

International Accounting Standards Board

International Accounting Standards Board (ISAB) is **based at London** and was **founded in 2001** as a **successor** to the International Accounting Standards Committee (IASC). The IASB has continued to develop standards calling the new standards IFRS.

Financial Statements as per IFRS

The objective of the Financial Statements is to provide information about the financial position performance and changes in the financial position of a company or entity, which is useful for wide range of stake holders. As per the revised standrad which is known as IFRS Financial Statement, the presentation of the Financial Statements after January 1 2009 involves the following:

1. Balance sheet which is to be known as "**Statement of Financial Position**"
2. Income Statement which is to be known as "**Statement of Comprehensive Income**"
3. Cash Flow Statement which is to be known as "**Statement of Cash Flows**"
4. **Notes:** These would include a summary of the significant accounting policies.

Countries that follow IFRS:

Around 20 nations require IFRS for their domestic listed companies. Out of them, around 90 countries have made it compulsory for their domestic companies to follow IFRS, while in the rest , it is optional for companies to either follow IFRS or the domestic accounting norms.

What is position in India?

In India, the ICAI (Institute of Chartered Accountants of India, Statutory Body; Set up by Act 1949) and National Commission for Accounting Standards have affirmed that India will transit into the new IFRS soon. At present the companies in India don't require to follow the IFRS.

- However, In the G-20 September 2009 summit India had already made a commitment that India will converge its domestic accounting standards with IFRS in a phased manner starting April 1, 2011.
- The current position is that
- All the BSE and NSE listed entities and companies which have a net-worth over ₹ 500 crore, are required to converge with IFRS from April 2011.
- The date for the **insurance companies** was extended to April 1, 2012 and the date for **banks** was extended to April 1, 2013.

What is the relevancy of IFRS?

The IFRS is relevant to the extent that the financial statements as per the international standards would make the comparisons of the Indian companies and their international competitors / stakeholders/ partners easier. So, the basic idea is to increase the trust and reliance placed by the investors, stakeholders and analysts in the companies. For the companies, which are subsidiary to the foreign companies, it would be mandatory if their parent company uses IFRS. To a great extent, the IFRS documents would help the domestic companies to raise the capital abroad.

What are the Costs involved in this transition?

The costs are as follows:

1. Identification and mapping the differences in the accounting standards
2. Staff Training
3. Implementation which would require the system and software's
4. Adjustments in the data storage and availability.

Will the costs ultimately increase?

No, ultimately the costs of the capital and financial reporting should come down. The challenge is transition from Indian system to IFRS.

Are there any regulatory hurdles?

Yes, there are. India would be requiring to amend some provisions (which are key provisions) of the Companies Act 1956, SEBI Act, IrDA Act apart from the RBI Regulations. Out of them, the new Companies Bill has been provided with the changes. Since the deadline for Banking & Insurance, is a little away, the necessary amendments will be carried out later.

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Credit Rating Agencies

Credit rating is an opinion of a Credit Rating Agency (CRA) on the **likelihood of timely payment of interest and principal** (credit risk) on the rated debt instrument.

- It is an unbiased, objective, and independent assessment of the issuer's capacity to meet its financial obligations and is conveyed with alphanumeric symbols.
- Credit rating is not a recommendation to buy, sell or hold a debt instrument. It is a comment on the probability of the interest and principal of a debt instrument being paid or not paid on time (credit risk). Rating is an additional input; however investors are required to make your their independent and objective analysis before arriving at an investment decision.

Please note that each credit rating agency has its own set of criteria and different weightage for each component for assigning the ratings. The indicative list of factors that are taken into consideration for credit rating are issuer company's operational efficiency, its strengths and weakness, level of technological development, financials, competence and effectiveness of management, past record of debt servicing, etc. The issuer pays for the credit rating.

Each rating symbol is an alphanumeric representation of the degree of repayment risk associated with debt instruments.

AAA	↔	Highest Safety
AA	↔	High Safety
A	↔	Adequate Safety
BBB	↔	Moderate Safety
BB	↔	Inadequate Safety
B	↔	High Risk
C	↔	Substantial Risk
D	↔	Default

CRISIL

CRISIL is India's first credit rating agency, incorporated in 1987 and was promoted by the erstwhile ICICI Ltd, along with UTI and other financial institutions.

It commenced operations from 1988 onwards. In 1995, in partnership will National Stock Exchange, CRISIL developed **CRISIL500 Equity Index**. In 1996, it made a strategic alliance with the Standard & Poor's (S&P) Ratings Group and in the following year Standard & Poor's (S&P) Ratings Group acquired 9.68% shares in it.

In services Industry, the CRISIL in 1998 set up the Indian Index Services Ltd as a joint venture with the NSE and in 1999, it developed a Risk Assessment Model (RAM) which became a banking industry standard. S&P acquired the majority stake in the company in 2005 and so today CRISIL is a S&P company.

ICRA

India's second credit rating agency is ICRA (Investment Information and Credit Rating Agency) which was set up in 1991. It was promoted by Industrial Finance Coroporation of India (IFCI), other leading financial/investment institutions, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA Limited is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

CARE:

The third Credit rating Agency in India was CARE, that started working in 1993. It was mainly promoted by the IDBI.

ONICRA:

Later another Credit rating agency ONICRA was established which now Onicra Credit Rating Agency Of India Ltd. This is a private sector agency set up by Onida Finance. Today it has a niche market and provides assessment, grading and rating models for individuals & MSMES (micro, small and medium enterprises.

Role of SEBI in Credit Rating

- The Credit rating market take a definite shape in India after the SEBI made it mandatory for any debenture that has maturity of more than 18 months maturity.
- Please note that CRAs are registered and regulated by SEBI. However, SEBI does not play any role in the assessment made by the rating agency. The rating is an independent
- professional opinion of the CRA.

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Rating of Banks in India:

The first step towards rating of banks in India was taken up in 1995, when the Reserve Bank of India established the **S Padmanabhan Committee** to take a fresh look at the banking Supervision.

S Padmanabhan Committee recommended that Banking supervision should focus on the parameters of the Financial Soundness, Managerial and Operational Efficiency and firmness. The Padmanabhan Committee recommended 5 points rating, which was based upon the CAMELS Model.

CAMELS Rating

CAMELS ratings is a Banks rating used in United States. The 6 alphabets in CAMELS denote the following:

1. C : Capital Adequacy Ratio
2. A: Asset Quality
3. M: Management Effectiveness
4. E: Earning (profitability)
5. L : Liquidity (using the ALM Asset Liability Mismatch Considerations)
6. S: Sensitivity to market risk

Padmanabhan Committee Rating

The Padmanabhan Committee recommended the following ratings:

A:	**Fundamentally sound in every aspect**
B:	Fundamentally sound but with moderate weakness
C:	Financial, Operational and / or compliance weakness and raises supervisory concerns.
D :	Serious or moderate Financial , operational and / or managerial weaknesses that could impair the future viability.
E:	Critical Financial Weakness that has the possibility of failure

Internal rating: Latest Developments:

In May 2010, the RBI has told the banks that they should be ready with a new methodology of internal rating of Capital Requirement. This is called **Advanced Internal Rating Based** (AIRB) approach. As of now the banks had been following the standardized approach, wherein banks assign risk to the asset based on the rating given by external rating agencies. This makes the banks a step closer to becoming Basel II compliant institution.

- Since the minimum CAR required is 9%, it is low for the borrowers with best rating and higher for lower rating. RBI now wants banks to develop their own methodology to rate borrowers rather than rely on external agencies.

Asset Liability Mismatch

Asset Liability Mismatch or ALM is considered to be a comprehensive and dynamical framework for measurement, monitoring and managing the market risk of the Banks. Asset Liability Mismatch arises in the following situation:

- The Primary source of funds for the banks is deposits, and most deposits have a short- to medium-term maturities, thus need to be paid back to the investor in 3-5 years. In comparison, the banks usually provide loans for a longer period to borrowers. Out of them, the home loans and Infrastructure projects loans are of longest maturity. So when a bank provides the long term loans from much shorter maturity funds, the situation is called asset-liability mismatch.
- ALM creates Risk and Risk has to be managed. This is called **Asset Liability Management.**

Consequences of the Asset Liability Mismatch

The Interest rate risks (due to fluctuation) and Liquidity Risk (due to long maturity of loans) are two typical consequences of Asset Liability Mismatch.

1. **Interest Rate Risk:** The banks would require to reprice the deposits faster than the loans and during this process if the bank has to pay a higher rate, the adjustment is difficult.
2. **Liquidity Risk:** The banks would have to repay the depositors when their funds mature. But when they repay, the cannot recall their loans. In this situation, bank would require the new deposits. This may create a acute situation if there are no deposits available. In some cases, the bank may also need to be paying higher interests on new deposits.

Asset Liability Management (ALM)

This is basically management of the structure of the balance sheet (which comprises the assets and liabilities) in such a way that interest gain is maximized and risk is minimized. Most of the banks have an elaborate institutional arrangement to manage the Asset liability Mismatch. They manage the above as follows:

1. Pricing large percentage of loans at variable (**Floating Rate Regime**) interest rates which actually move in tandem with the markets.
2. Pricing the fixed interest rate loans at a **huge markup**, this is usually done so that borrower is enticed to go for floating rate regime.

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The above two generally take care of the Asset liability mismatch situation.

In April 2010, the RBI has expressed a deep concern over the asset-liability mismatches (ALMs) in banks, which mainly arising out of lending to the infrastructure projects.

According to bankers present in a meeting, the main concern of the regulator is the huge pipeline of sanctions on which banks are sitting, mostly for core sector projects.

☞ Infrastructure loans are of 10-15 years duration, while most bank deposits have a tenure of one-two years. In the last financial year, not much disbursement took place, and now every bank is sitting on huge sanctions waiting to be disbursed. This is going to create a major problem, as banks won't have deposits of equal maturity.

Takeout Financing Scheme

We all know that Infrastructure projects have a very long **gestation period**, sometimes more than 20 years. These projects involve a heavy investment and the repayment period for the loans taken on these projects is very long, generally 8 to 10 years.

So in long term infrastructure finance there are two main factors:

- Huge amount is involved.
- Long gestation period.
- Huge Risk, which is higher in the beginning (construction phase) and comparatively lower in later (operation Phase).

In India, the Banks have cannot go beyond an **exposure limit**, which refers to limits for arrangements for providing funds or credit including loans and advances, debt and equity securities, loan substitute securities, and financial leases. This **exposure limit is fixed by the Reserve Bank of India.**

Keeping in view the above factors, Infrastructure Financing in India has the following limitations

1. The Banks have usually **smaller balance sheets**, as compared to the size of the Infrastructure Projects. The exposure limit prescribed by the RBI can easily breached by two or three large projects.
2. The Commercial banks **usually provide short term finance**, the Financial Institutions such as Insurance Firms and pension Funds **provide long term finance**, but they are subject to control by the IRDA and other regulators.
3. **A loan should have liabilities of the matching maturity**. For example, the commercial banks may have fixed deposits etc. for a period of around 5-7 years , but the infrastructure projects need a loan for a period which is almost double than this period. This is called "**Asset Liability Mismatch**".

Takeout financing is a way around the above limitations.

We know that financing generally has two parties:

1. Project Company : Which needs to borrow for its project
2. Lending Company: Which may be a commercial bank as well as FI (Financial Institution) : which lends to the above project company

But in Take Out Financing, there are **Three parties**:

1. Project Company
2. Lending Company (which may be a commercial bank as well as FI (Financial Institution)
3. A taking over institution (Which may be a leading Bank, Consortium of banks or Financial Institution) In India IIFCL is a Taking Over institution.

The job of the **third party** mentioned above (IIFCL or other FI) is to **enter into an agreement which makes a provision that the Lending Company will transfer the part/ whole of the outstanding to the taking over institution on a predetermined basis.** This means that the loan provided by the leading bank / consortium of banks to the project company are **taken over after a certain period by the taking over institution.** This saves the lending firm from a possibility of default and **Asset Liability Mismatch** or **ALM considerations in Takeout Financing**

In the Union Budget 2009-10, the Finance Minister Pranab Mukherjee had made this statement:

To stimulate the public investment in Infrastructure, we had set up the **Indian Infrastructure Finance Company Ltd** (It was established in 1956) as a special purpose vehicle for providing long term financial assistance to the infrastructure projects. We will ensure that IIFCL is given greater flexibility to aggressively fulfill its mandate. *Takeout financing is an accepted international practice of releasing long-term funds for financing infrastructure projects. It can be used to effectively address Asset-Liability mismatch of commercial banks arising out of financing infrastructure projects and also to free up capital for financing new projects.* IIFCL would, in consultation with banks, evolve a takeout financing scheme, which could facilitate incremental lending to the infrastructure sector.

As a follow up to the above, the Take Out Financing Scheme was launched and it came into existence from **April 16, 2010.**

The Objectives are:

1. Boost the availability of longer tenure debt finance for infrastructure projects.

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2. To address sectoral / group / entity exposure issues and asset-liability mismatch concerns of Lenders, who are providing debt financing to infrastructure projects.
3. To expand sources of finance for infrastructure projects by facilitating participation of new entities i.e. medium / small sized banks, insurance companies and pension funds.

The Projects:

The IIFCL extends the Takeout Financing scheme for the following kind of projects:

1. Road and bridges, railways, seaports, airports, inland waterways and other transportation projects;
2. Power Projects
3. Urban transport, water supply, sewage, solid waste management and other physical infrastructure in urban areas;
4. Gas pipelines projects
5. Infrastructure projects in Special Economic Zones
6. International convention centers and other tourism infrastructure projects

Extent of Takeout Financing:

The IIFCL provides the takeout financing to individual Lender(s) to the extent of 100% of the residual amount of the loan on the Scheduled Date of Occurrence of Takeout. In the case of Lead Bank, IIFCL provides takeout finance to the extent of 75% of residual amount of loan. However, the total Takeout Amount cannot exceed 50% of the total residual loan of the infrastructure project on the Scheduled Date of Occurrence of Takeout.

Agreement:

IIFCL, the identified Lender(s) and the Borrower enter into a tripartite agreement i.e. Takeout Agreement pursuant to the Takeout Finance Scheme. The Scheduled Date of Occurrence of Takeout is 1 year after the scheduled Commercial Operation Date (COD) of the project. In case, the COD gets changed with the concurrence of the Lenders, the Scheduled Date of Occurrence of Takeout is changed accordingly.

Tenure of the take out amount:

The tenor of the Takeout Amount with IIFCL shall be up to 15 years. The amortization schedule of taken out loan by IIFCL will be structured to ensure that the last loan repayment is not scheduled beyond 80% of the Project Term.

Why Takeout Financing is a Viable Option for Infrastructure Finance?

In the above discussion we can understand that Take out financing is a viable option for long term high value projects financing. It involves selling the loan portfolio at a premium or discount depending on market condition and the risk perception of the investor. Apart from this, **most Indian Banks and FIs are in public sector** and they **are answerable to Parliament through CAG (Comptroller and Auditor General)** and subject to scrutiny / vigilance by CVC (Central Vigilance Commission) , so financing the high risk projects invites the **twin swords of CWG and CVC** to them. Take out financing helps them to save themselves from these swords.

Infrastructure in 12th Five year Plan:

Please note that during the Eleventh Five Year Plan (2007-12), estimated investment requirements of the infrastructure sector was 514 billion dollars. In the 12th Plan period, infrastructure investment of **one trillion dollars** has been envisaged.

First major Takeout Finance Agreement:

IIFCL, on October 12, 2010 has issued the sanction letters for the first takeout finance transaction to UBI involving taking out of over Rs.1500 crore in 7 different projects from power and road sector

Bancassurance

In India, ever since espousing of financial reforms following the recommendations of First Narasimham Committee, the contemporary financial landscape has been reshaped steadily.

Banks have been striding into several new areas and offer innovative products, viz., merchant banking, lease and term finance, capital market / equity market related activities, hire purchase, real estate finance and so on.

So, banking business has become far more diversified than ever before. Therefore, their entering into insurance business is only a natural corollary and is fully justified too as ‘insurance’ is another financial product required by the bank customers.

Definition of Bancassurance

Bancassurance or Bank Insurance Model refers to the distribution of the insurance and related financial products by the Banks whose main business is NOT insurance. So, simply Bancassurance, i.e., banc + assurance, refers to banks selling the insurance products. Bancassurance term first appeared in France in 1980, to define the sale of insurance products through banks’ distribution channels.

Benefits:

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It helps both the banks and Insurance Companies as follows:

1. This is a referral business in which the banks tend to leverage the existing clientele.
2. Insurance companies get the benefit because they can have distribution relationships with multiple insurers.

Business Model:

For Bancassurance, the Banks need to obtain a prior license from the IrDA or Insurance Regulatory and Development Authority, so that they can work as "Composite Corporate Agent" or may have "Referral Arrangement" with the Insurance Companies.

RBI Guidelines:

As per the Government of India Notification dated August 3, 2000, specifying 'Insurance' as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949. The RBI, in line with this issued its guidelines for the Bancassurance as follows:

Agent Business

1. Any scheduled commercial bank would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation.
2. The subsidiaries of banks will also be allowed to undertake distribution of insurance product on agency basis.

Joint venture:

Only the Banks which satisfy the eligibility criteria given below will be permitted to set up a joint venture company for undertaking insurance business with risk participation, subject to safeguards. The maximum equity contribution such a bank can hold in the joint venture company will normally be 50 per cent of the paid cup capital of the insurance company. On a selective basis the Reserve Bank of India may permit a higher equity contribution by a promoter bank initially, pending divestment of equity within the prescribed period:

1. The net worth of the bank should not be less than Rs.500 crore;
2. The CRAR of the bank should not be less than 10 per cent;
3. The level of non-performing assets should be reasonable;
4. The bank should have net profit for the last three consecutive years;
5. The track record of the performance of the subsidiaries, if any, of the concerned bank should be satisfactory.

JV with Foreign partners:

- In cases where a foreign partner contributes 26 per cent of the equity with the approval of Insurance Regulatory and Development Authority/Foreign Investment Promotion Board, more than one public sector bank or private sector bank may be allowed to participate in the equity of the insurance joint venture. As such participants will also assume insurance risk, only those banks which satisfy the criteria given above, would be eligible.
- A subsidiary of a bank or of another bank will not normally be allowed to join the insurance company on risk participation basis. Subsidiaries would include bank subsidiaries undertaking merchant banking, securities, mutual fund, leasing finance, housing finance business, etc.

Investment in Insurance:

Banks which are not eligible for 'joint venture' participant as above, can make investments up to 10% of the net worth of the bank or Rs.50 crore, whichever is lower, in the insurance company for providing infrastructure and services support. Such participation shall be treated as an investment and should be without any contingent liability for the bank.

The eligibility criteria for these banks will be as under:

1. The CRAR of the bank should not be less than 10%;
2. The level of NPAs should be reasonable;
3. The bank should have net profit for the last three consecutive years.

Prior Approval:

All banks entering into insurance business will be required to obtain prior approval of the **Reserve Bank** and have to be compliant with IrDA regulations. The Reserve Bank will give permission to banks on case to case basis keeping in view all relevant factors including the position in regard to the level of non-performing assets of the applicant bank so as to ensure that non-performing assets do not pose any future threat to the bank in its present or the proposed line of activity, viz., insurance business.

It should be ensured that risks involved in insurance business do not get transferred to the bank and that the banking business does not get contaminated by any risks which may arise from insurance business. There should be 'arms length' relationship between the bank and the insurance outfit.

Now, we know that **Banks have to follow RBI as well as IrDA regulations for Bancassurance Business.** The present regulations do not allow banks to sell insurance products of more than one insurance company.

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The current issue is that the Banks might get to tie up with multiple insurance companies to distribute their products if a panel set up by the industry regulator comes to a consensus on the issue. Following requests from various life and general insurance companies asking Insurance Regulatory and Development Authority (IRDA) to allow banks to have distribution relationships with multiple insurers, the regulator had formed a seven-member committee in Mid of 2009 to look into the matter.

These 7 members are the veterans of the market viz. Deepak Satwalekar, G V Rao, S V Mony, Sandeep Bakshi, R Krinshnamurthy, N M Govardhan and A Giridhar. The committee was given the job to examine the desirability for a differential treatment of insurance intermediation by banks under the Bancassurance model consistent with international best practices and modified suitably to meet domestic regulatory requirements.

Universal Banking

In simple words, Universal Banking means that Financial Institutions (FIs) and Banks are allowed to undertake all kinds of activity of banking , financing and related businesses. As per the World Bank, the definition of the Universal Bank is as follows:

In Universal banking, the large banks operate extensive network of branches, provide many different services, hold several claims on firms(including equity and debt) and participate directly in the Corporate Governance of firms that rely on the banks for funding or as insurance underwriters.

So we can say that Universal bank is a Financial Supermarket which provides all financial products under one roof.

☞ Apart from savings and loans, the Universal banks provides services such as investing in securities, credit cards, project finance, remittances, payment systems, project counselling, merchant banking, forex operations, insurance and so on.

In a nutshell, a **Universal Banking is a superstore for financial products** under one roof. Corporate can get loans and avail of other handy services, while can deposit and borrow. It includes not only services related to savings and loans but also investments.

☞ The second Narasimham committee of 1998 gave an introductory remark on the concept of the Universal banking, as a different concept than the Narrow Banking. Narsimham Committee II suggested that Development Financial Institutions (DFIs) should convert ultimately into either commercial banks or non-bank finance companies.

✍ However, the concept of Universal Banking conceptualized in India after the **RH Khan Committee** recommended it as a different concept. The Khan Working Group held the view that DFIs (Development Finance Institutions) should be allowed to become banks at the earliest.

Advantages:

1. Economies of Scale would result in greater economic efficiency in the form of lower cost, higher output and better products.
2. Increased diversions and increased profitability
3. Better Resource Utilization.
4. Brand name leverage
5. Existing clientele leverage
6. Value added services
7. 'one-stop shopping' saves a lot of transaction costs

Hurdles:

1. Different regulatory framework for Financial Institutions and Banks
2. No expertise in both the fields as both need domain expertise.
3. Long gestation of Infrastructure Financing

RBI Guidelines on Universal Banking:

Some of the guidelines are as follows:

1. Once the FI becomes a universal Bank, it would be compliant with the CRR and SLR requirements of the RBI.
2. The activity which is permissible for the FI but NOT permissible for Bank would have to be stopped.
3. Any immovable property acquired by the FI would have to be disposed of in 7 years time.
4. The composition of the Board of Directors would be required to be changed so that it is compliant with the Section 10 (A) of the Banking Regulation Act which requires at least 51% of the total number of directors to have special knowledge and experience.
5. If there is any floating charge on any of its assets, it would have to be ratified by the RBI since a banking company is not allowed to create a floating charge on the undertaking or any property of the company unless duly certified by RBI as required under the Section 14 (A) of B R Act.
6. If there is any subsidiary that is engaged in an activity which is not permissible under the B R Act, then the subsidiary will have to be delinked.

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7. Banks cannot hold shares in the companies in excess of 30% of the paid up share capital of that company or 30 per cent of its own paid-up share capital and reserves as per the B R act, so , the FI after becomes a Universal Bank shall divert the excess of the equity.
8. Section 20 of the B. R. Act prohibits grant of loans and advances by a bank on security of its own shares or grant of loans or advances on behalf of any of its directors or to any firm in which its director/manager or employee or guarantor is interested. The compliance with these provisions would be mandatory after conversion of an FI to a universal bank.
9. The FI would require obtaining a license from RBI to carry business of banking in India and has to comply with the applicable conditions.
10. The FI would need to comply with the existing branch licensing policy of RBI which requires allotting at least 25 per cent of their total number of branches in semi-urban and rural areas.
11. At the close of business on the last Friday of every quarter, the FI after becomes a Universal Bank, would make sure that its total assets held in India are not less than 75 per cent of its total demand and time liabilities in India, as required of a bank under Section 25 of the B R Act.
12. Publishing annual Financial reports as per requirements of the B R Act

Narrow Banking:

The Narrow Banking is very much an antonym to the Universal Banking. In Narrow Banking, the Bank places its funds under the risk free assets and the maturity of the liabilities match the assets and there is No possibility of the Asset Liability Mismatch.

- Narrow Banking means Narrow in the sense of engagement of funds and not in activity.

So, simply, Narrow Banking involves mobilizing the large part of the deposits in Risk Free assets such as Government Securities. Now, please note the following:

- Banks in India partially implement the Narrow banking.
- The RBI prescribes a 24% SLR Statutory Liquidity Ratio, but Banks invest much more than that in Government securities which provides them a low return.
- The Government securities have a 0% risk weightage and the Government approved Securities have a risk weightage of 2.5% , compared to the loan assets which have around 50-75%.
- Narrow Banking, in Narrow sense helps the Banks to reduce the Non Performing Assets (NPA) as the engagement brings them some returns also.

Narrow Banking and Tarapore Committee:

The Tarapore Committee had recommended that to bring down the NPAs, the incremental sources of the banks (called narrow banks) should be restricted only to investments in Government Securities.

- Thus Tarapore Committee is best known for giving the Concept of Narrow Banking as a solution to the problem of Non Performing Assets.

Non Performing Assets (NPA):

In simple words, the assets of the Banks which don't perform (means don't bring any return) are called Non Performing Assets. In more general sense they are "bad Loans".

- Any asset, including a leased asset, becomes non performing when it ceases to generate income for the bank.

However, there is a prescribed definition by the RBI which defines the NPAs as:

- Terms Loans on which interest and / or installment of principal remain overdue for a particular quarter for a period of **more than 90 days** from the end of that particular quarter.
- The Bills those remain overdue for a period of More than 90 Days from the end of a quarter.
- Any amount to be received remains overdue for a period of more than 90 days.
- The Cash Credit account remains out of order for a period of more than 90 days. Out of order means over the sanctioned limit.
- This period of 90 Days for the above categories was 180 days prior to 2004.

So 90 Days is the thumb rule in the deciding the NPAs. However, there is an exception to this.

A farmer has taken a loan for a paddy crop in the beginning of the Rabi Season and has not made a repayment. In which of the following situations, if Installment or interest is not paid for this loan, it would become a NPA (Non Performing Asset)?

A. 90 Days from the due date
B. 90 Days from the end of the Rabi Season
C. 1 crop season from the due date
D. 2 crop seasons from the due date

The answer of the above question is D i.e. 2 crop seasons from the due date. Please note the following:

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- For short duration crop agriculture loans such as paddy, Jowar, Bajra etc. if the loan (installment / interest) is NOT paid for 2 crop seasons (means Kharif, and next Rabi in the above question) , it would be termed as a NPA.
- For Long Duration Crops, the above would be 1 Crop season from the due date.

Classification of the NPAs:

The above is a general definition of the Non Performing Assets. Here, please note that the Banks are required to classify nonperforming assets further into three main categories based on the period for which the asset has remained non performing.

The three categories are:

A. Substandard Assets,
B. Doubtful Assets
C. Loss Assets.

The transition from the Standard asset to Loss Asset takes place as follows:

• Regular Asset / Standard Asset	Any Period
• Special Mention Account as NPA	90 Days
• Substandard Asset	12 Months
• Doubtful	Next 12 Months
• Loss	Uncertain

A loss asset is uncertain but it must be identified as a loss. So, as a thumb rule, an account remains NPA for a period of 12 months it is classified under Substandard, if it remains Substandard for 12 months it is classified as Doubtful. A Loss Asset is one where loss has been identified by the internal or external auditors.

Now, let take a simple example:

We suppose that a party is disbursed a loan on January 1, 2012. Its due date is June 1, 2012. But the party does not make a payment. So

- ✓ It will be an Standard Asset from January 1, 2012 till June 1, 2012 (Due Date)
- ✓ It will be a Special Mention Account From June 2, 2012 till August 29, 2012 (90 days)
- ✓ It will be Substandard from August 30, 2012 till August 29, 2013
- ✓ It will be doubtful from August 30, 2013 till August 29, 2014

It may remain doubtful Asset for a period of 3 years, beginning from 12 months of being an NPA, but once the auditors identify it as a loss, it will be assigned a loss asset; however, the period may be anything above 3 years.

Implications:

1. The most important implication of the NPA is that a bank can neither credit the income nor debit to loss, unless either recovered or identified as loss.
2. If a borrower has multiple accounts, all accounts would be considered NPA if one account becomes NPA.

Gross NPA and Net NPA:

The NPA may be Gross NPA or Net NPA. In simple words, Gross NPA is the amount which is outstanding in the books, regardless of any interest recorded and debited. However, Net NPA is Gross NPA less interest debited to borrowal account and not recovered or recognized as income. RBI has prescribed a formula for deciding the Gross NPA and Net NPA.

Extra Funds:

- Please note that the Banks have to keep aside extra funds for standard and NPA, called provisioning in banking parlance.
- As per the norms, banks have to make a general provision of 0.40% for all loans and advances except that given towards agriculture and small and medium enterprise (SME) sector.
- In case of NPAs, provisioning needs to be done as per the NPA category. For substandard loans, a general provisioning of 10% on the total outstanding amount is made if the loan is secured, for unsecured loans the total provisioning that needs to be done is 20% on the outstanding balance.

NPA and SARFAESI Act :

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provisions for the banks to take legal recourse to recover their dues.

Here is how this process is takes place:

1. A borrower makes any default in repayment and his account is classified as NPA.
2. The secured creditor has to issue notice to the borrower giving him 60 days to pay his dues.
3. If the dues are not paid, the bank can take possession of the assets and can also give it on lease or sell it.

Reselling of NPAs:

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The NPAs can be resold as well. The purchasers are called Asset Reconstruction Companies such as Asset Reconstruction Company (India) (ARCIL).

- A bank can sell NPA from its books to asset reconstruction companies such only if it has remained NPA for at least two years.
- These sales are only on Cash Basis and the purchasing bank/ company would have to keep the accounts for at least 15 months before it sells to other bank.
- Once the NPA is purchased, it is classified as Standard for a period of 90 days.

Wilful Default

Wilful default means that a party does not make a payment out of its will. The Wilful default is defined as follows:

- The party defaults in meeting its payment obligations even if it has capacity to repay.
- The party defaults in meeting its payment obligations and diverts the finance away from the purpose it was availed for.
- The funds are available with the firm in other form of assets and has not made a payment
- The party defaults in meting its payment and also disposed off the removable assets / immovable property which was used for the purpose of secured loan, without the knowledge of the Bank.

Willful Default and SS Kohli Commitee

The SS Kohli Committee had recommended some penal measures against the willful defaults. Some of them are as follows:

- The willful defaulters are not able to access the markets, so a copy of the list of the willful defaulters are shared by the RBI to SEBI.
- No facility is provided by a Bank / FI to a willful defaulter till 5 years from the date of publishing its name in the list of willful defaulters.
- Expeditious legal action is initiated against for the recovery of the amount.
- The banks and FIs are required to compile the list of the suit filed willful defaulters and submit the same to the Credit Information Bureau of India Ltd. every quarter, provided the outstanding amount is ₹ 25 Lakh or more.

Financial Activities Tax

'The Financial Activities Tax' and 'Financial Stability Contribution' were propsoed by G-20. The Interim Report of the G-20 on Fair and Substantial Contribution by the Financial Sector of April 2010 for 'financial stability contribution' proposed a flat rate levy on all financial institutions and 'financial activities tax' levied on profits and remuneration.

- Purpose of these taxes is to help pay for future financial clean-ups and reduce systemic risk by shrinking the size of the financial sector.

The proposal was recently discussed at the G-20 meeting at Busan,Republic of Korea in June 2010, which called for implementation of levy taking each nations 'circumstance and options'. India's view was that there was need for better and well placed regulation rather than imposing levy on bank balance sheets.

Retail Banking

The main characteristic of retail banking , very much similar to retail trade, is that banks directly execute transactions with consumers rather than other banks or corporations. The retail banking is characterized by multiple products, multiple delivery channels and multiple customer segments.

- The multiple products may include financial products such as deposits, insurance products (agency) , investments etc.
- The multiple delivery channels may include customer service centers, internet kiosks etc.
- Multiple customer segments may include the individual customers, small businessmen and corporates.
- The main products of the retail banking in India are as follows:
- Deposits products such as flexi deposits.
- Loan products such as housing, auto, education and personal loans
- Card products such as credit cards
- Travel products such as traveler's cheques etc.
- The objective of the retail banking is to increase the penetration. The delivery channels have got various names such as home banking, internet banking, mobile banking, ATM Cards and so on .
- Retail banking provides the banks an opportunity to do cross selling and provide the ancillary services.

What lures the Banks to Retail banking?

The Retail banking offers a promise of low transaction costs, more sale productivity and more convenience in the business. The older banks have already a vast network, but new entrants in the markets have a disadvantage against the established banks. So, retail banking gives them an opportunity to create a customer base and optimum leverage of the resources.

Cross Selling

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When an existing customer is offered and sold ancillary / additional services it is cross selling. Cross selling is taken as a transaction based activity but more as a relationship building exercise by the banks.

1. Serving an existing customer is a low cost affair than serving a new customer.
2. Better leverage of of the available resources and existing clientele base.
3. Improvement of the Brand value.

Retail Banking has in recent years emerged as a rapidly growing opportunity for bankers all over the country. The Banks are lured by the low cost retail deposits which are more stable in comparison to the corporate deposits.

Apart from that, the retail loan products such as home loans, commercial vehicle loans, two wheeler loans, personal loans, credit cards, loan against time deposits and shares are becoming popular. The smaller value personal loans provide banks a wider margin spread.

The Credit Card Business has now-a-days become an important component of lending to the retail segment.

Credit Card Business

Credit card allows its holder to buy goods and services based on the holder's promise to pay for these goods and services.

- Its usage started in 1920s in US for selling the fuel to the automobile owners and became usable by the customers when **Diners Club** was launched in early 1950s.
- In 1958, the Bank of America issued the ***BankAmericard*** in the California state and this is known to be the **first successful modern credit card**.

Credit Card v/s Debit Card:

Both Debit card and credit card and other cards like smart card are plastic money which play the role of medium of payment. In credit cards the customer (credit card holder) can avail the facility of buying goods and services at a Point of Sale (POS) from merchant establishments (provided such arrangements exist) without making a prior payment. This credit facility is provided by the issuer bank to the customer for a specific period.

- However, in the case of debit cards, the customer (debit card holder) can buy goods and services by automatically debiting the payments to card holder's banks account.
- In case of a credit card, the card holder uses credit line by making drawings within a specified or sanctioned limit and makes payment on receiving the bill along with the applicable charges and interests.
- In case of debit cards, the card holder uses the balance in his / her own bank account and payment is made immediately on purchases.

How Credit Card Works:

The entire process has the following parties:

1. **Cardholder** is the authorized user of a credit or debit card.
2. **Merchant** is any business entity that is authorized to accept cards for the payment of goods and services; it can be a brick and mortar shop or a website.
3. **Merchant Bank or Acquirer** is a financial institution that provides card processing services to the merchant.
4. **Credit Card Network** or **Association** is a membership organization of financial institutions that issue payment cards and/or sign merchants to accept such cards for payment of goods and services. There are two Credit Card Associations – Visa's and MasterCard's.
5. **Card Issuer** is a financial institution that issues payment cards and contracts with its cardholders for billing and payment of transactions.

The process can be divided into two parts viz. **authorization** and **Clearing & Settlement**.

Authorization:

We understand this by the following example:

Rama is a Credit card Holder who purchases Jewellery worth ₹ 20 thousand from a Jeweler who accepts both Visa and MasterCard. The card was issued to her by her bank which is ICICI Bank.

1. Once Rama finalizes choosing jewellery, she presents her card to the jeweler who plays as **merchant**.
2. The Merchant processes the card and the transaction information and requests an authorization from the **Merchant Bank** which may be ICICI or some other company.
3. The Merchant Bank submits the authorization request to MasterCard or VISA, which plays as **Credit Card Network**.
4. The Credit card network sends the request to the **Card Issuer** which is ICICI bank.
5. The Card Issuer approves or declines the transaction.
6. If the Issuer authorizes, the Credit Card Network forwards this authorization to merchant bank.
7. Merchant bank forwards this response to the **Merchant**

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8. Merchant once receiving this authorization completes the transaction.

Clearing and Settlement:

9. The merchant deposits the transaction receipt with the merchant bank.
10. The merchant Bank credits the Merchant's account and submits this transaction to Credit Card Network for settlement.
11. Credit card Network pays the Merchant Bank and debits the account of Card Issuer.
12. The Card Issuer posts the transaction to the account of Card holder.
13. The cardholder received monthly statement from the Issuer
14. The Cardholder pays as per the conditions.

Size of the Credit Card:

- The shape and size of the Credit and Debit Cards is specified by the **ISO/IEC 7810** (ID-1).
- ISO/IEC 7810 is the international standard which defines the shape and size of the I-Cards.
- ID1 is commonly used for banking cards (ATM cards, credit cards, debit cards, etc.).
- ID2 is used only in a few countries.
- ID-3 is used for Passports.
- ID-000 is for SIM Cards.
- The size of the Credit Cards has been fixed by ISO/IEC 7810 (ID-1) as 85.60 × 53.98 mm.

Swipe Card:

Swipe card or magstripe or Magnetic stripe card has a band of magnetic material on the card and is capable of storing data.

- It was first developed by IBM for a US Government security system.
- IBM engineer Forrest Parry is known to have discovered Swipe Card, thanks to his wife (search Google)
- The data on the strips can be read by the most point-of-sale hardware.

Credit Card Number:

The credit Card Numbers are governed by the **ISO/IEC 7812** which is a numbering system for the identification of issuers of cards that require an issuer identification number (IIN) to operate in international, inter-industry and/or intra-industry interchange.

- The Length of the number is from 14 to 19.
- The first 6 digits are known as the Issuer Identification Number (IIN). Out of them, the first 2 or more digits identify the Card network. For example:
  - The card number that begins with 34, 35, 36 or 37 is an American Express Card.
  - The card number which begins with 51,52,53,54 or 55 is a MasterCard.
  - The card number which begins with 4 is a Visa card.
  - 4026, 417500, 4508, 4844, 4913, 4917 are the IIN numbers of Visa electron.

Recent Trends in Credit Card Business in India

In the recent years, the amount spent on cards as increased steadily. The amount spent on cards has also come down , however the amount spend online grows on. The drastic fall in the credit card business in India was because of the stringent rules released by RBI to curb the menace of default in the credit cards and banks reorienting their business strategy.

The Reserve Bank of India had issued its first guidelines in 2005 regarding the Credit card Business. This was basically a response to the aggressive marketing policy of the credit card issuers. A summary of these guidelines is as follows:

1. The banks should assess the credit limit for a customer on the basis of information provided by the customer (self declaration) or credit information.
2. The banks would be solely responsible for the KYC (Know Your Customer) requirements.
3. The card issuers should indicate the annual percentage rates (called APR) on card products and also indicate clearly the late payment charges and number of days.
4. Bank will not levy any charge that was NOT mentioned / indicated at the time of issue of the card.
5. If there is any change in the charges, the Issuer will give a proper notice 1 month prior to change.
6. The issuer will not make wrongful bills, if by mistake they do it, the customer protest would be addressed within 60 days with relevant documents.
7. If unsolicited card is issued and activated by the bank / issuer and the customer is billed for the same, the issuer would have to reverse the billed charges and pay penalty, which is twice to amount they charged.
8. The time limit is 60 days for the customer to make / register complaints.
9. The grievance has to be addressed in 30 days and after that the customer will be free to approach banking Ombudsmen.

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10. The result of these tighter norms was that now the banks issue the cards very selectively and only to those customers with whom they have long lasting relationships. The days of unsolicited cards now over and now actually it is bit difficult to get a credit card.

IVR Route for Credit Cards:

- In May 2010, the RBI made it mandatory for banks and credit card companies to put in place an additional security measure for credit card transactions through the interactive voice response (IVR) route from January 1, 2011.This was a sequel to the August 2009 directive of the Reserve Bank of India, in which it had asked banks to introduce an additional security feature for online credit card transactions but had excluded interactive voice response transactions then.

National Payments Corporation of India's (NPCI)

National Payments Corporation of India's (NPCI) was established in 2008 and is being promoted by State Bank of India, Punjab National Bank, Canara Bank, Bank of Baroda, Union Bank of India, Bank of India, ICICI Bank, HDFC Bank, Citibank and HSBC. NPCI is an umbrella organization for all retail payment systems in the country owned and operated by banks. Its National Financial Switch (NFS) is linked to 61702 ATMs (September 2010). The relevant data is released by NPCI.

- Cumulative monthly transaction volumes recorded by the National Payments Corporation of India's (NPCI) crossed the 10-crore mark for the first time in August 2010. The Switch recorded 7.32 crore ATM transactions in July 2010.

Some Typical Words:

- **Floor Limit v/s Card Limit:** Please note that floor limit is the discretion to the merchant establishment up to which it can accept the card for payment. The Card limit is the limit up to which a holder can use the card. This is restored on making the previous payments.
- **Hot Card v/s Hot List:** A hot card is a lost or stolen card. A hot list is the list of caution against the use of a credit card by a defaulter holder.

Kisan Credit Card

- KCC scheme was introduced in the Banks in August 1998.

The aim of Kisan Credit Card Scheme (KCC) is to provide adequate and timely support from the banking system to the farmers for their short-term credit needs during their cultivation for purchase of inputs etc., during the cropping season. Credit card scheme proposed to introduce flexibility to the system and improve cost efficiency.

- This scheme was announced in Budget speech of Finance Minister in 1998-99 (Yashwant Sinha was India's Finance Minister , in the NDA Government)
- In the speech it was stated that NABARD would formulate a Model scheme for issue of Kisan Credit Cards to farmers, on the basis of their land holdings, for uniform adoption by banks, so that the farmers may use them to readily purchase agricultural inputs such as seeds, fertilizers, pesticides, etc. and also draw cash for their production needs.
- NABARD formulated a Model Kisan Credit Card Scheme in consultation with major banks. Model Scheme circulated by RBI to commercial banks and by NABARD to Cooperative. Banks and RRBs in August 1998, with instructions to introduce the same in their respective area of operation.
- Please note that Model Scheme was prepared by NABARD on recommendations of **R V Gupta Committee.**
- As a pioneering credit delivery innovation, Kisan Credit Card Scheme aims at provision of adequate and timely support from the banking system to the farmers for their cultivation needs including purchase of inputs in a flexible and cost effective manner.
- Beneficiaries covered under the Scheme are issued with a credit card and a pass book or a credit card cum pass book incorporating the name, address, particulars of land holding, borrowing limit, validity period, a passport size photograph of holder etc., which may serve both as an identity card and facilitate recording of transactions on an ongoing basis.

Benefits:

1. Simplifies disbursement procedures
2. Removes rigidity regarding cash and kind
3. No need to apply for a loan for every crop
4. Assured availability of credit at any time enabling reduced interest burden for the farmer.
5. Helps buy seeds, fertilizers at farmer's convenience and choice
6. Helps buy on cash-avail discount from dealers
7. Credit facility for 3 years – no need for seasonal appraisal
8. Maximum credit limit based on agriculture income
9. Any number of withdrawals subject to credit limit
10. Repayment only after harvest

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11. Rate of interest as applicable to agriculture advance
12. Security, margin and documentation norms as applicable to agricultural advance
13. Access to adequate and timely credit to farmers
14. Full year's credit requirement of the borrower taken care of.
15. Minimum paper work and simplification of documentation for drawal of funds from the bank.
16. Flexibility to draw cash and buy inputs.
17. Assured availability of credit at any time enabling reduced interest burden for the farmer.
18. Flexibility of drawals from a branch other than the issuing branch at the discretion of the bank.

Features:

1. Farmers eligible for production credit of ₹ 5000 or more are eligible for issue of Kisan Credit Card.
2. Eligible farmers to be provided with a Kisan Credit Card and a pass book or card-cum-pass book.
3. Revolving cash credit facility involving any number of drawals and repayments within the limit.
4. Limit to be fixed on the basis of operational land holding, cropping pattern and scale of finance.
5. Entire production credit needs for full year plus ancillary activities related to crop production to be considered while fixing limit.
6. Sub-limits may be fixed at the discretion of banks.
7. Card valid for 3 years subject to annual review. As incentive for good performance, credit limits could be enhanced to take care of increase in costs, change in cropping pattern, etc.
8. Each drawals to be repaid within a maximum period of 12 months.
9. Conversion/re-scheduling of loans also permissible in case of damage to crops due to natural calamities.
10. Security, margin, rate of interest, etc. as per RBI norms.
11. Operations may be through issuing branch (and also PACS in the case of Cooperative Banks) through other designated branches at the discretion of bank.
12. Withdrawals through slips/cheques accompanied by card and passbook.

Benefits to Banks:

1. Reduction in work load for branch staff by avoidance of repeat appraisal and processing of loan papers under Kisan Credit Card Scheme.
2. Minimum paper work and simplification of documentation for drawal of funds from the bank.
3. Improvement in recycling of funds and better recovery of loans.
4. Reduction in transaction cost to the banks.
5. Better Banker - Client relationships.

Important Data: (Please remember these facts)

- As per Government data, Till **October, 2011**, 10.78 crore KCC were issued to eligible farmers since the inception of the KCC Scheme in August 1998.
- Out of total KCCs issued and total amount sanctioned under the scheme since its inception, **commercial banks accounted for the maximum share followed by cooperative banks**.
- However, the number of cards issued by cooperative banks witnessed a declining trend since 2001-02, while the commercial banks more or less had a rising trend in the number of KCCs issued.
- Consequently, the share of cooperative banks in total amount sanctioned under KCC scheme also exhibited a declining trend.
- As of October 2011, **Uttar Pradesh accounted for the maximum number of KCCs issued** so far **followed by Andhra Pradesh**. Thus, **these two States** together accounted for **one third of the total KCCs** issued so far.

Insurance Under KCC:

Please note that KCC holders are covered by a personal accident insurance. This cover is available when the person enters the scheme. The cover is as follows:

- Death : ₹ 50,000
- Disability: ₹ 25000
- Maximum Age to enter : 70 years.

Priority Sector Lending

Priority sector was first properly defined in 1972, after the **National Credit Council** emphasized a few years back that there should be a larger involvement of the commercial banks in the priority sector.

- First of all in 1974, the banks were given a target of **33.33 % as share** of the priority sector in the total bank credit.

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- This was later revised on the recommendation of the **Dr. K S Krishnaswamy** committee and the target was **raised to 40%.**
- The latest working group on this segment was **C S Murthy Committee** in 2007, on whose recommendations, RBI revised the guidelines.

What is Priority Sector?

Broadly, priority sector includes the Agriculture Finance, Small Enterprises, Retail Trade, Micro Credit, Education Loans and housing loans. The definition came out from the **Dr. K S Krishnaswamy Committee**. As per Reserve Bank of India, Priority sector includes the following:

1. Agriculture
2. Small scale industries (including setting up of industrial estates)
3. Small road and water transport operators (owning up to 10 vehicles).
4. Small business (Original cost of equipment used for business not to exceed ₹ 20 lakh)
5. Retail trade (advances to private retail traders up to ₹ 10 lakh)
6. Professional and self-employed persons (borrowing limit not exceeding ₹ 10 lakh of which not more than ₹ 2 lakh for working capital; in the case of qualified medical practitioners setting up practice in rural areas, the limits are ₹ 15 lakh and ₹ 3 lakh respectively and purchase of one motor vehicle within these limits can be included under priority sector)
7. State sponsored organizations for Scheduled Castes/Scheduled Tribes
8. Education (educational loans granted to individuals by banks)
9. Housing [both direct and indirect – loans up to ₹ 5 Lakhs (direct loans upto Rs 10 lakh in urban/ metropolitan areas), Loans upto ₹ 1 lakh and ₹ 2 lakh for repairing of houses in rural/ semi-urban and urban areas respectively].
10. Consumption loans (under the consumption credit scheme for weaker sections)
11. Micro-credit provided by banks either directly or through any intermediary; Loans to self help groups(SHGs) / Non Governmental Organizations (NGOs) for on lending to SHGs
12. Loans to the software industry (having credit limit not exceeding Rs 1 crore from the banking system)
13. Loans to specified industries in the food and agro-processing sector having investment in plant and machinery up to Rs 5 crore.
14. Investment by banks in venture capital (venture capital funds/ companies registered with SEBI)

Under the above, the following have been defined by RBI have weaker sections of the society:

1. Small and marginal farmers with land holding of 5 acres and less and landless laborers, tenant farmers and share croppers.
2. Artisans, village and cottage industries where individual credit limits do not exceed Rs. 50,000/-
3. Beneficiaries of Swarnjayanti Gram Swarojgar Yojana (SGSY)
4. Scheduled Castes and Scheduled Tribes
5. Beneficiaries of Differential Rate of Interest (DRI) scheme
6. Beneficiaries under Swarna Jayanti Shahari Rojgar Yojana (SJSRY)
7. Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavangers (SLRS).
8. Self Help Groups (SHGs)

Current Targets:

- At present the domestic banks have to disburse 40% of the Net Bank Credit to Total Priority sector, out of which 18% should be total agricultural advances.
- The Foreign banks have been given a target of 32% of the Net Bank Credit to priority sector, however, there is no lower limit fixed for agriculture.

Category	Domestic banks (public sector and private sector)	Foreign banks operating in India
Total Priority Sector advances	40 percent of NBC	32 percent of NBC
Total agricultural advances	18 percent of NBC	No target
SSI advances	No target	10 percent of NBC
Export credit	Export credit does not form part of priority sector	12 percent of NBC
Advances to weaker sections	10 percent of NBC	No target

Please note this important point:

- Net Bank Credit is the figure reported in the fortnightly return submitted to RBI by the Banks. But, the outstanding deposits under the FCNR (B) and NRNR (Non-Resident Non-Reptriable Term Deposit Account) Schemes are excluded from net bank credit for computation of priority sector lending target/ sub-targets.

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RBI Guidelines:

RBI keeps issuing guidelines for the Priority sector lending. Here are a few important points:

- The overall target set by the RBI for the priority sector lending is 40% of the adjusted net bank credit (ANBC) out of which 18% is fixed for agriculture sector and 10% for weaker sections of the society.
- Target Credit to women beneficiaries is 5%.
- Banks are supposed to give acknowledgement for loan applications received from weaker sections. The application should be disposed off as follows:

• Loans up to ₹ 25000	2 weeks
• Loans above ₹ 25000	8-9 weeks

- For SSI

• Loans up to ₹ 25000	2 weeks
• 25000 up to 5,00,000	4 weeks
• Above ₹ 5 Lakh	8-9 weeks

The loans applications of the priority sector can be rejected by the branch manager provided the rejection is later verified by the Divisional Manager / regional manager

- However, in case of SC/ ST, a branch manager can not reject the application. In this case, only a divisional manager / regional manager can do so.
- Commercial banks have been advised to link the tenor of loans to Housing Finance Companies (HFCs) in line with the average portfolio maturity of housing loans up to ₹20 lakh extended by HFCs to individual borrowers, otherwise such loans would not be eligible for classification under priority sector.
- Banks have been advised to ensure the end-use of funds strictly as per the guidelines on lending to priority sector.

Objective of Priority sector lending:

The basic objective of setting priority sector targets has been to ensure greater flow of credit to certain sectors where credit would normally not flow to the desired extent.

Should the 40% limit extended:

There was a demand from various stake holders of the society that banks should be given a higher than current 40% target of the Priority sector. As of now the targets have not been revised. The reason is that out of total deposits, banks have to keep certain amount to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) and from the remaining disposable amount 40 per cent is dedicated for the priority sector, so increasing the amount reserved for priority sector lending from present 40 per cent is not possible.

Who provides Microcredit?

1. Domestic Commercial Banks: Public Sector Banks; Private Sector Banks & Local Area Banks
2. Regional Rural Banks
3. Co-operative Banks
4. Co-operative Societies
5. Registered NBFCs
6. Unregistered NBFCs
7. Other providers like Societies, Trusts, etc.

Are there any targets fixed by RBI?

No. For microcredit, there are no fixed targets and banks are free to formulate their own models. Banks are also free to design their products for promotion of microfinance. However, banks have been asked by the RBI to devise and integrate the microcredit plans in their block level, district level and state level credit plans

- Banks are free to choose intermediaries, suitable branches, pockets, areas for implementation of microcredit programme. They are also free to devise appropriate lending and saving products. However banks have been instructed to include micro credit, in their branch, block and district & state credit plans. This has to be reviewed on quarterly basis.

Self Help Groups

What is SHG?

Self Help Groups means a group which represents a financial intermediation, but the financial intermediation is not the only primary objective of the groups. The idea is to combine the access to low-cost financial services with a process of self management and development. They are ussually formed and supported by NGOs or Government agencies.

- SHGs **may or may NOT** be registered.

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- Number of members is between 10-25. But, **for irrigation projects** there is no upper ceiling.
- One person from one family can become a member.
- There are regular weekly or fortnightly meetings.
- These members save the amount and this amount is used as loans.

SHG Bank Linkage Programme

The Self-Help Group-Bank Linkage Programme (SBLP), which started as a pilot programme in **1992** has developed with rapid strides over the years.

SHG-Bank Linkage Programme was started on the basis of recommendation of **S K Kalia Committee.**

Under the SBLP, the following three different models have emerged:

1. Model I: SHGs promoted, guided and financed by banks.
2. Model II: SHGs promoted by NGOs/ Government agencies and financed by banks.
3. Model III: SHGs promoted by NGOs and financed by banks using NGOs/formal agencies as financial intermediaries.

Model II has emerged as the most popular model under the SBLP programme. Commercial banks, co-operative banks and the regional rural banks have been actively participating in the SBLP.

SHG-Post office Linkage Programme

A pilot SHG-post office linkage programme was launched by NABARD in December 2003. This programme envisaged credit linking 200 SHGs in select **5 districts of Tamil Nadu**, viz., Sivaganga, Pudukottai, Tiruvannamalai, Tanjavur and Tiruvarur.

The objectives of the pilot programme were to

1. Examine the feasibility of utilizing the vast network of post offices in rural areas for disbursement of credit to rural poor on agency basis; and
2. To test the efficacy of Department of Posts in providing micro finance services to rural clientele.

The salient features of the scheme are:

1. Post offices open savings accounts in the name of SHGs promoted by identified NGOs.
2. The SHGs with savings accounts in the post office and which are six months old are provided loan by the post office, in multiples of their savings, based on the rating exercise on the lines of those adopted by banks.
3. Post offices provide term loans to SHGs repayable within two years in 24 monthly installments.
4. **Post offices charge an interest of 9 per cent per annum** on the loans given to SHGs using a reducing balance method.
5. Post offices do not collect any loan processing charges or any other charges from SHGs.
6. Project Implementation and Monitoring Committee (PIMCs) at district and State level are constituted by the post office.
7. The district PIMC is responsible for smooth grounding of the project, sorting out operational issues and identification of appropriate NGOs. The PIMC meets on a quarterly basis.
8. State level PIMCs review overall implementation of the project, suggest new initiatives and recommend release of funds by NABARD to the Department of Posts.
9. Department of Posts maintain separate books of accounts for all transactions relating to utilization and operations of Revolving Fund Assistance (RFA) from NABARD.

- Under the project, NABARD provides financial support for capacity building programmes of postal officials. While loans are given at interest rates of 9 per cent per annum to SHGs by post offices, post offices would be allowed to retain an interest margin of 3 per cent. The amount of actual interest collected from the SHGs would be shared between NABARD and post offices in the ratio of 2:1.
- Please note that NABARD is facilitator and promoter of the SHGs. 100% refinance is provided by the NABARD to banks for SHG refinance.

Lead Bank Scheme

Prior to the Nationalization of the Banks, a National Credit Council was set up in **Dec. 1967** to determine the priorities of bank credit among various sectors of the economy. The NCC appointed a study group on the organizational framework for the implementation of social objectives in Oct.'68 under the Chairmanship of Prof. D R Gadgil. This is known as **Gadgil Committee**.

The study group found that the:

1. Commercial Banks had penetrated only 5000 villages as of June'67 and out of the institutional credit to agriculture, at 39%, the share was negligible at 1%, the balance being met by the co-operatives.

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2. The Banking needs of the rural areas in general and backward in particular were not taken care of by the Commercial Banks.
3. Besides, the credit needs of Agriculture, SSI and allied activities remained neglected.
4. Therefore, the group recommended the adoption of an **area approach** for bridging the spatial and structural credit gaps. Later, All India Rural Credit Review Committee 1969 endorsed the view that CBs should increasingly come forward to finance activities in rural areas.

- **Lead Bank Scheme** was first of all adopted in 1969 on the recommendations of **"Organizational Framework for implementation of Social Objectives"** known as **Gadgil Committee,** which recommended an **area approach** for the appropriate credit arrangements as per the local conditions.
- Another committee known as Banker's committee, headed by **F. S. Nariman**, concluded that districts would be the units for area approach and each district could be allotted to a particular bank which will perform the role of a Lead Bank. Thus the scheme was named as "Lead Bank Scheme".

Under the Scheme, each district had been assigned to different banks (public and private) to act as a **consortium leader** to coordinate the efforts of banks in the district particularly in matters like branch expansion and credit planning. The Lead Bank **was** to act as a consortium leader for coordinating the efforts of all credit institutions in each of the allotted districts for expansion of branch banking facilities and for meeting the credit needs of the rural economy.

How the scheme progressed?

All the districts in the country excepting the metropolitan cities of Mumbai, Kolkata, Chennai and Union Territories of Chandigarh, Delhi and Goa were allotted among public sector banks and a few private sector banks. Later on, the Union Territories of Goa, Daman and Diu as also the rural areas of the Union Territories of Delhi and Chandigarh have been brought within the purview of LBS.

The next important development in the history of LBS was the constitution of District Consultative Committees (DCCs) in all the districts, in the early seventies to facilitate co-ordination of activities of all the Banks and the financial institutions on the one hand and Government departments on the other. The DCCs were constituted in the lead districts during 1971– 73.

The second and most important phase of the LBS was formulation of District credit plan (DCP) and their implementation. Although certain structural credit gaps were identified earlier, positive measures were introduced only after nationalization of the banks. Certain sectors which were hitherto neglected were given a priority status and banks were asked to provide credit to these sectors in a more concerted way.

Later, under **Village Adoption scheme** (VAS), bank adopted some villages in their command area for intensive lending. The area approach was not so much aimed at development of a chosen area as for avoiding the pitfalls of scattered and unsupervised lending. In the initial stages of VAS, RBI has encouraged banks to adopt villages as well as to avoid scattered lending.

Nationalization of banks was not able to bridge the entire credit gap in the rural areas. A vast majority of the small and marginal farmers and rural artisans remained untouched by the banking system.

Therefore, the range of institutional alternatives was widened in 1975 by adding **Regional Rural Banks (RRBs)** to the banking scene which would exclusively cater to the credit demands of the hitherto neglected segment of the rural economy. Thus, with Co-operatives. Commercial Banks and RRBs, a multi-agency approach was adopted in the rural credit system.

Objectives of Lead Bank Scheme:

1. Eradication of unemployment and under employment
2. Appreciable rise in the standard of living for the poorest of the poor
3. Provision of some of the basic needs of the people who belong to poor sections of the society

What went wrong with the Scheme?

The scheme could not fully achieve its targets due to

1. Shift in policies, complexities in operations and issues shifting to the Financial Inclusion.
2. Lack of coordination between district planning authorities and banking institutions operating in a district on one side and between NABARD and the Lead Bank on the other.
3. Duplication of efforts in credit plan preparation.

So, over the period the system of lead bank scheme and associated district-level coordination committees of bankers has apparently become inactive.

In last few years, there was a strong need felt to revitalize the scheme with clear guidelines on respecting the bankers' commercial judgments even as they fulfill their sectoral targets. Various committees like Block Level Bankers Committee, District Coordination Committee and District Review Committee seldom function with all seriousness.

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Usha Thorat Committee:

In 2009, Government of India constituted a High-Power Committee headed by Mrs Usha Thorat, Deputy Governor of the RBI, to suggest reforms in the LBS.

The task of this penal was recommend how to revitalize the LBS, given the challenges facing the banking sector, especially in an era of increasing privatization and autonomy.

1. The committee recommended the enhancing the scope of the scheme and suggests a sharper focus on facilitating financial inclusion rather than a mere review of the government sponsored credit schemes.
2. The committee said that most forums to monitor the implementation of LBS are being used for routine review of the government-sponsored schemes, credit deposit ratio, recovery performance, among others.
3. Lending under such schemes constitute 0.4 per cent of the total priority sector lending. As such, the State Level Bankers' Committee (SLBC) / District Consultative Committee (DCC) could utilize its time to discuss specific issues inhibiting and enabling financial inclusion rather than those concerning government-sponsored schemes.

The following were main recommendation of Usha Thorat Committee:

1. LBS should be continued to accelerate financial inclusion in the unbanked areas of the country.
2. Private sector banks should be given a greater role in LBS action plans, particularly in areas of their presence.
3. Enhance the business correspondent model, making banking services available in all villages having a population of above 2,000, and relaxation in KYC (know your customer) norms for small value accounts.

"The review on LBS has been made with a focus on financial inclusion and in view of the recent developments in the banking sector. The scheme has been found useful to promote financial inclusion in the country. Hence it should be continued" - Usha Thorat May 22, 2009

Current Position of Lead Bank Scheme:

The Usha Thorat committee recommended that Lead Bank Scheme should prevail and continue. In this context, after a long period, in March 2010, RBI released the guideline for Lead Bank Scheme. Some important features of these Guidelines is as follows:

1. **Conduct of DCC Meetings**: The Lead Banks may convene the District Consultative Committee (DCC) meeting at quarterly intervals. Appropriate sub committees may be set up to work intensively on issues.
2. Agenda items : The Lead Banks are expected to address the problems of the particular districts.

Some important areas have been classified by RBI and they are as follows:

1. Periodical assessmenent and evaluation of the progress made to provide banking services.
2. Identification of unbanked/under banked areas for providing banking services in a time bound manner with a view to achieve 100% financial inclusion.
3. Addressing the special issues that inhibit the 100% Financial Inclusion Goals.
4. Addressing the IT enabled Financial Inclusion.
5. Facilitating enables and removing minimizing the impediments for banking development for inclusive growth.
6. Review of the performance of the Banks.
7. Emphasis on priority sector advances.

1. Assistance under Government Sponsored Schemes.
2. Grant of educational loans

Overall we can say, RBI's guidelines to revitalize the lead bank scheme that to achieve the goal of 100% Financial Inclusion and Inclusive Growth. RBI has given a greater role to play by the private sector banks by advising that private sector banks should involve themselves more actively by bringing in their expertise in strategic planning and leveraging on Information Technology. The Lead Banks, on their part, should also ensure that private sector banks are more closely involved in the LBS, both while drawing up and in implementing the ACP.

Regional Rural Banks

We all know that the first stage of nationalization that took place in 1969 boosted the confidence of the public in the Banking system of the country.

However, in the early 1970s, there was a feeling that even after nationalization there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers. This issue was taken up by the government and it set up a working group to suggest the alternatives for institutional finances to the rural sector.

☞ The committee was **Narasimham Working Group 1975**.

On the basis of this committee's recommendations, a **Regional Rural Banks Ordinance was promulgated in September 1975,** which was replaced by the **Regional Rural Banks Act 1976**.

✍ RRBs started their development process on 2nd October 1975 with the formation of a single bank viz. Prathama Grameen Bank.

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- So, **Prathama Grameen Bank** is India's first Regional Rural Bank.
- The making of RRB **started with an ordinance** which later was upgraded to an act.
- The Regional Rural Banks Act 1976 allowed the government to set up banks from time to time wherever it considered necessary.
- The regional rural banks (RRBs) were owned by the central government, the state government and the sponsor bank who held shares in the ratio as follows (**important**)
  - Central Government : 50%
  - State Government : 15%
- Public Sector Commercial banks (Sponsor Banks): 35%

Initially, there was an expansion of the RRBs which is evident from the following table:

Year	Banks	Branches
Dec. 1975	6	17
Dec. 1980	85	3279
Dec. 1985	188	12606
Mar. 1990	196	14443

But after 1990, they were soon became a victim of a folly in assumption.

What went wrong with RRBs?

Originally, the Regional Rural Banks were conceived as low cost institutions having a rural ethos, local feel and pro poor focus, but these original assumptions were belied as within a very short time, most banks were making losses.

In the initial decade of their existence the regional rural banks were operating on the basis of a policy frame work that they will lend only to the weaker sections of rural society, charging lower interest rates, opening branches in remote and rural areas and keep a low cost profile.

RRBs had been allowed 100 per cent refinance on their lending so incentives for internal resource mobilization were, therefore, absent.

- Expansion of Business without making any analysis of margins available in each segment of the banking business also proved to be an imprudent practice.

Initially the branch network of RRBs expanded very fast. By the end of year 1985 RRBS had opened 12606 branches. During this period their credit deposit Ratio (C.D.R) expanded very fast. In 1976 it was 165% and gradually declined to 104 & December 1986. The Credit Deposit Ratio continuously declined thereafter.

- First Committee to raise a question on the RRBs was the **Khusrau Committee of 1989**, which was of the view that "the weaknesses of RRBs are endemic to the system and non-viability is built into it, and the only option was to **merge the RRBs with the sponsor banks**.
- The objective of serving the weaker sections effectively could be achieved **only by self-sustaining credit institutions.**
- The Khusrau Committee which was also known as **Agricultural Credit Review Committee** made an argument that **RRBs have no justifiable cause for continuance** and recommended their mergers with sponsor banks.

But, this was a challenging and politically risky move for the government, so the government dumped the report and no issues were debated publically.

Once again, the **Committee on Financial Systems** which is called **First Narasimham Committee** again raised the question on the financial viability of the RRBs and highlighted the poor financial health of the RRBs.

- By 1993, 172 of the 196 RRBs were recorded unprofitable. The paid up capital which was ₹ 25 Lakh at that time was not able to absorb the loan losses of most of the RRBs. The loan recovery was around 40%.

The First Narasimham Committee recommended that -

- RRBs should be permitted to engage in all types of banking business and should not be forced to restrict their operations to the target groups.

This proposal was readily accepted by the government.

In the same report, there was a reiteration of the **Khusrau Committee** recommendations but now in a slightly modified form.

- The **first Narasimham committee** recommended that there should be mergers of the RRBs with their sponsor bank, **BUT** the "sponsor banks might decide whether to retain the identities of sponsored RRBs or to merge them with rural subsidiaries of commercial banks to be set up on the recommendation of the committee".

However, this recommendation was put on hold for the moment.

Some Measures to make the RRBs viable:

Some of the very important measures to improve the Financial Viability of RRBs since 1990s till 2009 are as follows:

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1. In 1993, RBI gave permission to RRBs to relocate branches that were consistently making losses for more than three years.
2. RRBs were allowed to finance non-target groups to the extent not exceeding 40 percent of their incremental lending. This limit was subsequently enhanced to 60 percent in 1994. As a result, the RRBs diversified into a range of non-priority sector (NPS) advances, including jewel and deposit-linked loans, consumer loans and home loans
3. The lending restrictions were removed and space and options to invest their funds were expanded.
4. NABARD with funding support of the Swiss Development Corporation (SDC) took a number of HR and Organizational Development in these banks.

This started a new thought of RRB reforms. A close look was given on the RRBs and Government of India with consultation with the RBI and NABARD started the reform process through a very comprehensive package.

Issues with the Business principles of RBI:

Though some of the reforms led the rise in the number of the profit making RRBs to certain high but they were having a low credit deposit ratio. This was coupled with the decreasing percentage of loans to small and marginal farmers out of the total loans disbursed by the RRBs. The Parliamentary Estimates Committee (2002-03 found that many of the RRBs were charging the compound interest on agricultural loans and even on subsidy part.

- The RRBs NPA level were high which had declined only marginally from 1996-2002.
- In the early 2000s there was no prescribed CRAR (capital to risk weighted asset ratio) for the RRBs.
- In 2005, based upon the recommendation of an internal working group the RRBs were asked to maintain a capital to risk weighted asset ratio at **5%** and over the period of time they were expected to align themselves to Basel I standards.
- **This led to turnaround in the regional Rural Banks**. The RRBs got merged with the sponsor banks.

What is the Current Number of RRBs in India?

The establishment of regional rural banks (RRBs) was initiated in 1976 for the development of agriculture, trade, commerce, industry and other productive activities in rural areas and also to offer credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs. Each RRB has a sponsor bank and its capital is shared by the central government, the state government and the sponsor bank in the ratio of 50:15:35. Even as the number of RRBs grew to 196 in the initial 12 years, the government began a process of consolidation and amalgamation in 2005, bringing the number down to 82 in 2010.

- Prior to the process of amalgamation, 196 RRBs sponsored by 27 SCBs and one State Cooperative Bank were operating in the country with a network of 14,484 branches spread over 523 districts as on March 31, 2005. Consequent upon the amalgamation, the number of RRBs declined to 82 operating in 26 States and in one Union Territory covering 619 districts with a network of 15,475 branches as on March 31, 2010.

Currently going on Reforms on RRBs:

CRAR & Recapitalization: Kelkar Committee Report

The Government had constituted a Committee in September 2009 (Chairman: Dr. K. C. Chakrabarty) to study the current level of Capital-to-Risk-Weighted Assets Ratio (CRAR) of RRBs and to suggest a roadmap for achieving a CRAR of 9 per cent by March 2012. The Committee was also required to suggest the required capital structure for RRBs given their business level, so that their CRAR is sustainable and provides for future growth and compliance with regulatory requirements. The Committee submitted its Report to the Government of India on April 30, 2010. The Committee carried out an assessment of capital requirement for all 82 RRBs to enable them

to have CRAR of at least 7 per cent as on March 31, 2011 and at least 9 per cent from March 31, 2012 onwards. The recapitalization requirement would be Rs.2, 200 crore for 40 out of the 82 RRBs. This amount may be released in two installments, i.e., Rs.1,338 crore in 2010-11 and Rs.863 crore in 2011-12. The remaining 42 RRBs will not require any capital and will be able to maintain CRAR of at least 9 per cent as on March 31, 2012 and thereafter on their own.

Technological Upgradation: G. Sriniwasan Committee

In order to prepare RRBs to adopt appropriate technology and migrate to Core Banking Solutions (CBS), a Working Group was constituted by the Reserve Bank (Chairman: Shri G. Srinivasan) for technology up-gradation of RRBs. The report, inter alia, set September 2011 as the target date for all RRBs to move towards CBS. It was also stipulated that all branches of RRBs opened after September 2009 to be CBS compliant from day one. As per the status report received from sponsor banks, 22 RRBs have implemented CBS in full and for the remaining 60 RRBs, CBS is under implementation (September 2010).

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Current Issues (October 2011)

There is, reportedly, another round of amalgamation on the cards that will aim to make these banks financially stronger with greater business volume. There has been a steady increase in the branch network to around 16,000 branches in 2010. And RRBs have been directed to increase their branch network by 10 per cent every year till March 2013 as part of the Financial Inclusion Plan. The two states with the highest rural population – Uttar Pradesh and Bihar – lead in the number of branches. However, West Bengal and Maharashtra, the next two states with large rural populations, have proportionately lower branch networks. Andhra Pradesh and Karnataka perform relatively better on this parameter.

According to Reserve Bank of India (RBI) data, a large segment of credit provided by RRBs goes towards agriculture (about 54 per cent in 2010) as direct finance. About 16 per cent of the total RRB credit goes towards loans for personal purposes, like housing, consumer durables, vehicles, education and so on, while nine per cent is used for wholesale- and retail-trade activities. Overall, although agricultural credit of RRBs has been on the rise since 2006, it contributes only 11 per cent to the total agricultural credit disbursed by Scheduled Commercial Banks.

State-wise variations in the role and number of RRBs

	% of agricultural credit by RRBs out of total agricultural credit of SCBs, 2010	No. of RRB branches as of March 2010
All India	**11**	**15,480**
Bihar	31	1,514
Mizoram	27	61
Uttar Pradesh	24	3,034
Tripura	22	111
Rajasthan	21	1,052
Meghalaya	19	55
Karnataka	18	1,201
Orissa	18	875
Jharkhand	16	404
Haryana	15	367
Kerala	15	406
Assam	14	398

Financial Inclusion

Financial Inclusion or **Inclusive Finance** refers to the delivery of financial services (Not only Banking) at an affordable cost to the vast sections of the disadvantaged and low profile groups of the society.

So, Financial Inclusion helps vulnerable groups such as low income groups, weaker sections, etc., to increase incomes, acquire capital, manage risk and work their way out of poverty through secure savings, appropriately priced credit and insurance products, and payment services.

Financial Inclusion should not be seen as a social responsibility of the Governments and the banking system, but it is a potentially viable business proposition today which provides the poor with opportunities to build savings make investments and get credit. The upcoming Tech solutions such as UID project have a potential to make a difference.

Rangarajan Committee on Financial Inclusion

Despite of the efforts made so far by the successive governments a sizeable majority of our population; in particular the vulnerable groups continue to remain excluded from the opportunities and services provided by the financial sector.

In 2006, Government of India constituted a "**Committee on Financial Inclusion**" which was headed by **Dr C Rangarajan**, Chairman, Economic Advisory Council to the Prime Minister. The members of this committee were the stalwarts of the Finance & Banking system in the country.

The terms of reference to this committee were as follows:

1. To study the pattern of exclusion from access to financial services disaggregated by region, gender and occupational structure.

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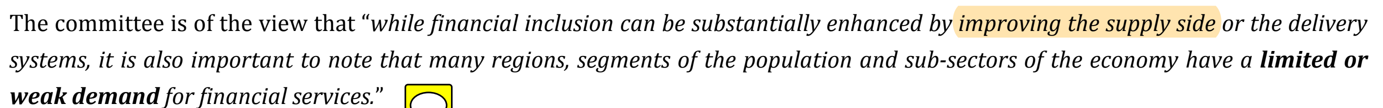
2. To identify the barriers confronted by vulnerable groups in accessing credit and financial services, including supply, demand and institutional constraints.
3. To review the international experience in implementing policies for financial inclusion and examine their relevance / applicability to India.
4. The committee was asked to recommend:
5. A strategy to extend financial services to small and marginal farmers and other vulnerable groups, including measures to streamline and simplify procedures,
6. Reduce transaction costs and make the operations transparent;
7. Measures including institutional changes to be undertaken by the financial sector to implement the proposed strategy of financial inclusion
8. A monitoring mechanism to assess the quality and quantum of financial inclusion including indicators for assessing progress.

Viewpoint of the Committee:

The committee is of the view that "*while financial inclusion can be substantially enhanced by improving the supply side or the delivery systems, it is also important to note that many regions, segments of the population and sub-sectors of the economy have a* ***limited or weak demand*** *for financial services.*"



In order to improve their level of inclusion, **demand side efforts need to be taken including improving human and physical resource endowments, enhancing productivity, mitigating risk and strengthening market linkages**. However, the primary focus is on improving the delivery systems, both conventional and innovative.

Whose Inclusion?

The essence of Financial Inclusion is to ensure that **a range of** appropriate financial services is available to every individual of the country. This should include:

1. Regular financial Intermediation such as Banking which includes basic no frills accounts for sending and receiving money.
2. Saving Products which are suitable to the pattern of cash flow of the poor household.
3. Availability of the Money transfer facilities
4. Availability of small loans and overdrafts for productive , personal and other uses.

Does it mean that every individual should use the above services?

No. Financial Inclusion does mean that every eligible person uses these services but they should be able to choose to use them if they desire so. This requires the strategies which create a flexible, appropriate to the national situation and nationally owned (if required) infrastructure.

What is Difference between Financial Exclusion and Social Exclusion?

By Financial Inclusion, we refer to addressing the exclusion of people who desire the use of financial services but are denied access to the same. However, social Inclusion is a bigger face of the exclusion where, people don't get fair share in the normal facilities available to the common people thorough out their lives and often the disadvantage they face at their birth get transmitted from generation to generation. It includes the unemployment, discrimination, poor skills, low incomes, poor housing and poor healthcare.

- ONLY access to credit or banking is NOT financial Inclusion.

- Financial Inclusion includes the
  - Bank accounts
  - Financial Advice
  - Insurance
  - Payment and Remittance
  - Affordable Credit
  - Savings

Does it mean that Bankers extend credit to all those who approach to them?

No. It does not mean that banks are advised to extend credit to everyone who approached them. It means that all cases of genuine credit requirement are not excluded. The approach of the financial inclusion has to be make the "institutionally excluded" the bankable and credit worthy. However, there is also a need to the "Once Included" segment which was excluded because of a reason or another.

Is Financial Exclusion a problem of India only?

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Financial exclusion is a worldwide problem today. In 2006, United Nations had released a book titled "Building Inclusion Financial Sectors for Development". This book is called "Blue Book" The Blue book raised a simple but comprehensive question. "Why so many bankable people are left unbanked?"

Financial Inclusion is relevant in all of developed, developing & underdeveloped economies of the world today.

Summary of the Rangarajan Committee Report

The report of the Rangarajan Committee is summarized as follows:

Extent of Exclusion:

- ✓ As per the NSSO data, 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not accesses credit, either from institutional or non-institutional sources.
- ✓ Only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources).
- ✓ Farm households not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively.
- ✓ Thus, apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.

Demand Side

- ✓ While financial inclusion can be substantially enhanced by improving the supply side or the delivery systems, it is also important to note that many regions, segments of the population and sub-sectors of the economy have a limited or weak demand for financial services.
- ✓ In order to improve their level of inclusion, demand side efforts need to be undertaken including improving human and physical resource endowments, enhancing productivity, mitigating risk and strengthening market linkages.
- ✓ However, the primary focus of the Committee has been on improving the delivery systems, both conventional and innovative.

National Mission on Financial Inclusion

- ✓ The Committee feels that the task of financial inclusion must be taken up in a mission mode as a financial inclusion plan at the national level.
- ✓ A National Mission on Financial Inclusion (NaMFI) comprising representatives from all stakeholders may be constituted to aim at achieving universal financial inclusion within a specific time frame.
- ✓ The Mission should be responsible for suggesting the overall policy changes required for achieving the desired level of financial inclusion, and for supporting a range of stakeholders – in the domain of public, private and NGO sectors - in undertaking promotional initiatives.

National Rural Financial Inclusion Plan (NRFIP)

- ✓ A National Rural Financial Inclusion Plan (NRFIP) may be launched with a clear target to provide access to comprehensive financial services, including credit, to at least 50% of financially excluded households, say 55.77 million by 2012 through rural/semi-urban branches of Commercial Banks and Regional Rural Banks.
- ✓ The remaining households, with such shifts as may occur in the rural/urban population, have to be covered by 2015.
- ✓ Semi-urban and rural branches of commercial banks and RRBs may set for themselves a minimum target of covering 250 new cultivator and non-cultivator households per branch per annum, with an emphasis on financing marginal farmers and poor non-cultivator households.

Handling Cost through Funds:

- ✓ There is a cost involved in this massive exercise of extending financial services to hitherto excluded segments of population. Such costs may come down over a period of time with the resultant business expansion.
- ✓ However, in the initial stages some funding support is required for promotional and developmental initiatives that will lead to better credit absorption capacity among the poor and vulnerable sections and for application of technology for facilitating the mandated levels of inclusion.
- ✓ The Committee has, therefore, proposed the constitution of two funds with NABARD – the Financial Inclusion Promotion & Development Fund and the Financial Inclusion Technology Fund with an initial corpus of Rs. 500 crore each to be contributed in equal proportion by GoI / RBI / NABARD. This recommendation has already been accepted by GoI.

Business Correspondent Model

- ✓ **The Rangarajan Committee** recommended that extending outreach on a scale envisaged under NRFIP would be possible only by leveraging technology to open up channels beyond branch network.
- ✓ Adoption of appropriate technology would enable the branches to go where the customer is present instead of the other way round. This, however, is in addition to extending traditional mode of banking by targeted branch expansion in identified districts.

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- ✓ The Business Facilitator/Business Correspondent (BF/BC) models riding on appropriate technology can deliver this outreach and should form the core of the strategy for extending financial inclusion.
- ✓ The Committee has made some recommendations for relaxation of norms for expanding the coverage of BF/BC. Ultimately, banks should endeavour to have a BC touch point in each of the 6, 00,000 villages in the country.

Procedural Simplification:

- ✓ Procedural Changes like simplifying mortgage requirements, exemption from Stamp Duty for loans to small and marginal farmers and providing agricultural / business development services in the farm and non-farm sectors respectively will help in extending financial inclusion.

New Role of RRBs:

- ✓ RRBs, post-merger, represent a powerful instrument for financial inclusion. Their outreach vis-à-vis other scheduled commercial banks particularly in regions and across population groups facing the brunt of financial exclusion is impressive.
- ✓ RRBs account for 37% of total rural offices of all scheduled commercial banks and 91% of their workforce is posted in rural and semi-urban areas.
- ✓ They account for 31% of deposit accounts and 37% of loan accounts in rural areas.
- ✓ RRB's have a large presence in regions marked by financial exclusion of a high order.
- ✓ They account for 34% of all branches in North-Eastern, 30% in Eastern and 32% in Central regions.
- ✓ Out of the total 22.38 lakh SHGs credit linked by the banking industry as on 31st March 2006, 33% of the linkages were by RRBs which is quite impressive to say the least.
- ✓ Significantly the more backward the region the greater is the share of RRBs which is amply demonstrated by their 56% share in the North-Eastern, 48% in Central and 40% in Eastern region.
- ✓ RRBs are, thus, the best suited vehicles to widen and deepen the process of financial inclusion. However, there has to be a firm reinforcement of the rural orientation of these institutions with a specific mandate on financial inclusion.

With this end in view, the Committee recommended that the process of merger of RRBs should not proceed beyond the level of sponsor bank in each State. The Committee has also recommended the recapitalization of RRBs with negative Net Worth and widening of their network to cover all unbanked villages in the districts where they are operating, either by opening a branch or through the BF/BC model in a time bound manner. Their area of operation may also be extended to cover the 87 districts, presently not covered by them.

SHG – Bank Linkage Scheme

There are a large number of SHGs in the country which are well established in their savings and credit operations. The members of such groups want to expand and diversify their activities with a view to attain economies of scale. Many of the groups are organising themselves into federations and other higher level structures. To achieve this effectively, resource centres can play a vital role. Federations of SHGs at village and taluk levels have certain advantages. Federations, if they emerge voluntarily from amongst SHGs, can be encouraged. However, the Committee felt that they cannot be entrusted with the financial intermediation function.

- ✓ The Committee has recommended amendment to NABARD Act to enable it to provide micro finance services to the urban poor.

Joint Liability Groups

- ✓ SHG-bank linkage has emerged as an effective credit delivery channel to the poor clients. However, there are segments within the poor such as share croppers/oral lessees/tenant farmers, whose loan requirements are much larger but who have no collaterals to fit into the traditional financing approaches of the banking system.
- ✓ To service such clients, Joint Liability Groups (JLGs), an upgradation of SHG model, could be an effective way. NABARD had piloted a project for formation and linking of JLGs during 2004-05 in 8 States of the country through 13 RRBs.

Based on the encouraging response from the project, a scheme for financing JLGs of tenant farmers and oral lessees has also been evolved. The Committee has recommended that adoption of the JLGs concept could be another effective method for purveying credit to mid-segment clients such as small farmers, marginal farmers, tenant farmers, etc. and thereby reduce their dependence on informal sources of credit.

Micro Finance Institutions - NBFCs

- ✓ The committee recommended a greater legitimacy, accountability and transparency for MFI which only enable MFIs to source adequate debt and equity funds, but also eventually enable them to take and use savings as a low cost source for on-lending.
- ✓ The committee also recommended that there was a need to recognize a separate category of Micro finance – Non Banking Finance Companies (MF–NBFCs), without any relaxation on start-up capital and subject to the regulatory prescriptions applicable for NBFCs. Such MF-NBFCs could provide thrift, credit, micro-insurance, remittances and other financial services up to a specified amount to the poor in rural, semi-urban and urban areas.

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- ✓ Such MF-NBFCs may also be recognized as Business Correspondents of banks for providing only savings and remittance services and also act as micro insurance agents.

Cooperative System:

In terms of number of agricultural credit accounts, the Short Term Cooperative Credit System (STCCS) has 50% more accounts than the commercial banks and RRBs put together.

- ✓ On an average, there is **one PACS for every 6 villages**; these societies have a total membership of more than 120 million rural people making it one of the largest rural financial systems in the world.
- ✓ However, the health of a very large proportion of these rural credit cooperatives has deteriorated significantly.

For this segment, the Rangarajan Committee reiterated the need to implement the recommendation of the **Vaidyanathan Committee Report**, which had suggested an implementable Action Plan with substantial financial assistance.

Micro Insurance

The Rangarajan Committee recommended the linking of micro credit with micro-insurance, which is the key element in the financial services package for people at the bottom of the pyramid.

Financial Inclusion: Recent Trends

The Rangarajan Committee had placed its report in mid 2008. In order to further financial inclusion, the Government, NABARD and the Reserve Bank are pursuing several initiatives.

1. Two funds namely **Financial Inclusion Fund (FIF)** (to meet the costs of developmental and promotional interventions towards financial inclusion) and **Financial Inclusion Technology Fund** (FITF)(to meet the costs of technology adoption) each having initial corpus of ₹ 500 crore have been constituted by the GOI and placed with NABARD .
2. Each fund is to be equally contributed by GOI, RBI and NABARD with annual accretions. Eligible organizations to avail the funds for greater financial inclusion.
3. In the Union Budget 2010-11, the Finance Minister announced that every village in the country with a population of over 2000 must have access to banking services by March 2012. Even as the brick and mortar branch presence will expand, the big driver going forward will be branchless banking based on the business correspondent (BC) model and leveraging on technology. In order to facilitate this, the RBI has also enlarged the types of entities that can be engaged as BCs.
4. Unique Identification Number (UID) Project of Government of India would be a powerful instrument for helping the poor establishes their identity to meet the banks' KYC norms. This will reduce cash and non-cash transaction costs, both to the banks and to the potential customers.
5. Every domestic commercial bank (public and private sector) has been asked by the Reserve Bank of India to prepare its own **Financial Inclusion Plan** (FIP) and have it approved by its Board. RBI has taken this step with a view that each bank should have ownership of its FIP and each bank should build on its comparative advantage. So banks have been given freedom as far as modus operandi is concerned, and they are supposed to be innovative and entrepreneurial and try out models and experiments consistent with their business models.
6. The **Financial Inclusion Plans** (FIPs)are basically meant to be rolled out over the next three years and are required to include indicators for performance evaluation. The RBI has regularly held meetings with the chairmen of banks to review the FIPs prepared by them. The recent meeting was held in June 2010, which was chaired by Deputy Governor, Dr Chakrabarty. These meetings have enabled a clearer understanding of issues in financial inclusion.
7. For the individual FIP to succeed there is an effort to put in place scalable technology solutions. The Regional Rural Banks would also be Core Banking System (CBS) enabled.
8. The Business Correspondent model has to be deployed exhaustively coupled with biometric technology.

Reserve Bank of India : History

In 1926, the Royal Commission on Indian Currency and Finance which is also known as the Hilton-Young Commission recommended the creation of a central bank. The idea was twofold:

1. To separate the control of currency and credit from the government
2. To augment banking facilities throughout the country.

The Reserve Bank of India Act of 1934 established the Reserve Bank as the banker to the central government and set in motion a series of actions culminating in the **start of operations on April 1, 1935.**

- ✍ RBI was started with a **Share Capital of ₹ 5 crore**, divided into shares of **₹ 100 each** fully paid up.
- ✍ In the beginning, **entire capital was owned by the private shareholders**.
- ✍ The British Government of India held shares of nominal value (₹ 2, 20,000) only.
- ✍ The Central office of RBI initially was Kolkata. It was shifted to Mumbai in 1937.

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But, since function of the Bank was of public nature, the RBI act of 1934 had provided the appointment of the Governor and two deputy Governors by the Central Government.

In 1949, RBI was nationalized and since then, its role and functions have undergone numerous changes—as the nature of the Indian economy has changed.

Important Landmarks

- In 1926, the Royal Commission on Indian Currency and Finance recommended creation of a central bank for India.
- In 1927, a bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.
- In 1933, the White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
- In 1934, the Bill was passed and received the Governor General's assent
- In 1935, Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders' bank with a paid up capital of rupees five crore.
- In 1942 Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
- In 1947, Reserve Bank stopped acting as banker to the Government of Burma.
- In 1948, Reserve Bank stopped rendering central banking services to Pakistan.
- In 1949, the Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.
- In 1949, Banking Regulation Act was enacted.
- In 1951, India embarked in the Planning Era.
- In 1966, the Cooperative Banks came within the regulations of the RBI.
- Rupee was devaluated for the first time.
- In 1969, Nationalization of 14 Banks was a Turning point in the history of Indian Banking.
- In 1973, the Foreign Exchange Regulation act was amended and exchange control was strengthened.
- In 1974, the Priority Sector Advance Targets started getting fixed.
- In 1975, Regional Rural Banks started
- In 1985, the Sukhamoy Chakravarty and Vaghul Committee reports embarked the era of Financial Market Reforms in India.
- In 1991, India came under the Balance of Payment crisis and RBI pledged Gold to shore up reserves. Rupee was devaluated.
- In 1991-92, Economic Reforms started in India.
- In 1993, Exchange Rate became Market determined.
- In 1994, Board for Financial Supervision was set up.
- In 1997, the regulation of the Non Banking Financial Companies (NBFC) got strengthened.
- In 1998, Multiple Indicator Approach for monetary policy was adopted for the first time.
- In 2000, the Foreign Exchange Management Act (FEMA) replaced the erstwhile FERA.
- In 2002, The Clearing Corporation of India Ltd Started operation.
- In 2003, Fiscal Responsibility and Budget Management Act (FRBMA) enacted.
- In 2004, Liquidity Adjustment Facility (LAF) started working fully.
- In 2004, Market Stabilization Scheme (MSS) was launched.
- In 2004 Real Time Gross Settlement (RTGS) started working.
- In 2006, Reserve Bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.
- In 2007, Reserve bank of India was empowered to regulate the Payment systems.
- In 2008-09, world under the grip of Global Financial Slowdown, RBI Proactive.
- India on the path of recovery. RBI plays a major role in developing India rising as a economic superpower.

Structure of RBI:

The Reserve Bank of India is wholly owned by the Government of India. Its structure is simply represented by the following:

1. **Central Board of Directors**
2. Committee of the central Board
3. Board for Financial Supervision
4. Board for Payment and Settlement Systems
5. Subcommittees of the Central Board
6. Local Boards.

Central Board of Directors

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RBI's business is overseen by Central Board of Directors, which delegates the functions to its committees and sub-committees. The Central Board of Directors is made up of the following:

- One **Governor**
- **Four Deputy Governors** (4 is the maximum number)
- **Four Non-official Directors** which are nominated by the Central Government. Each Non-official director represents the local Boards located in Delhi, Chennai, Kolkata and Mumbai representing 4 regions of India.
- **Ten Non-official Directors** nominated by the Reserve Bank of India. These 10 personalities have expertise in various segments of Indian Economy.
- **One Representative** of the central Government.

Please note:

- The Central Board of Directors holds minimum 6 meetings every year. Out of which, at least 1 meeting every quarter is held. Though, typically the committee of the central board meets every week (Wednesday).

Board for Financial Supervision

The Board of Financial Supervision (BFS) was constituted in November 1994 as a committee of the Central Board of Directors of the Reserve Bank of India with an objective to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies.

- The Financial Supervision functions are carried out by the Reserve Bank of India under the guidance of the Board for Financial Supervision (BFS).
- Board for Financial Supervision is chaired by the Governor of Reserve Bank.
  The chairman is supported by the 4 co-opted directors as members for a 2 year term. There is a Vice chairman of the board who is one of the Deputy Governors of the Bank. The Board meets typically every month.
- BFS Regulates and supervises commercial banks, Non-Banking Finance Companies (NBFCs), development finance institutions, urban co-operative banks and primary dealers.

Some typical functions are:

1. Restructuring of the system of bank inspections
2. Introduction of off-site surveillance,
3. Strengthening of the role of statutory auditors and
4. Strengthening of the internal defenses of supervised institutions.

Board for Payment and Settlement Systems

Board for Payment and Settlement Systems was constituted by the Reserve Bank in 2005 as a Committee of its Central Board. The functions are to regulate and supervise the payment and settlement systems.

- It is chaired by the Governor of Reserve Bank of India and its members are all the four Deputy Governors and two Non-Official Directors of the Central Board.

Some of the typical Functions of BPSS are as follows:

1. Lay down policies relating to the regulation and supervision of all types of payment and settlement systems.
2. Set standards for existing and future systems
3. Approve criteria for authorization of payment and settlement systems
4. Determine criteria for membership to these systems, including continuation, termination and rejection of membership.
5. With regard to the payment and settlement systems, BPSS is the highest policy making body in the country. Electronic, non-electronic, domestic and cross-border payment and settlement systems which affect the domestic transactions are regulated by BPSS.

Sub-committees of the Central Board

Includes those on Inspection and Audit; Staff; and Building. Focus of each subcommittee is on specific areas of operations.

Local Boards

Local Boards are located in Chennai, Kolkata, Mumbai and New Delhi and represent the country's four regions. Local board members, appointed by the Central Government for four-year terms, represent regional and economic interests and the interests of co-operative and indigenous banks

Departments, Regional Offices, Branches and Centers

Reserve Bank of India has **26 departments** which focus on policy issues in the Reserve Bank's functional areas and internal operations. There are **27 regional offices of RBI** and branches which work as its operational arms and customer interfaces, headed by Regional Directors. Smaller branches / sub-offices are headed by a General Manager / Deputy General Manager.

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The training centers of RBI are as follows:

1. The Reserve Bank Staff College, Chennai
2. College of Agricultural Banking at Pune
3. Zonal Training Centres, located at regional offices, train non-executive staff.

Apart from that following are RBI funded Research Institutions:

1. National Institute of Bank Management (NIBM) : Pune,
2. Indira Gandhi Institute of Development Research (IGIDR) : Mumbai
3. Institute for Development and Research in Banking Technology (IDRBT) : Hyderabad.

Reserve Bank of India : Subsidiaries

Deposit Insurance and Credit Guarantee Corporation (DICGC)

With a view to integrating the functions of deposit insurance and credit guarantee, the Deposit Insurance Corporation and Credit Guarantee Corporation of India were merged and the present Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence on July 15, 1978. Deposit Insurance and Credit Guarantee Corporation (DICGC), established under the DICGC Act 1961, is one of the wholly owned subsidiaries of the Reserve Bank. The DICGC insures all deposits (such as savings, fixed, current, and recurring deposits) with eligible banks except the following:

1. Deposits of foreign Governments;
2. Deposits of Central/State Governments;
3. Inter-bank deposits;
4. Deposits of the State Land Development Banks with the State cooperative bank;
5. Any amount due on account of any deposit received outside India;
6. Any amount, which has been specifically exempted by the corporation with the previous approval of Reserve Bank of India.

- Every eligible bank depositor is insured up to a maximum of ₹1,00,000 (Rupees One Lakh) for both principal and interest amount held by him.

National Housing Bank (NHB)

National Housing Bank was set up on July 9, 1988 under the National Housing Bank Act, 1987 as a wholly-owned subsidiary of the Reserve Bank to act as an apex level institution for housing. Some of the primary objectives were:

1. To promote a sound, healthy, viable and cost effective housing finance system to all segments of the population and to integrate the
2. housing finance system with the overall financial system.
3. To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
4. To augment resources for the sector and channelise them for housing.
5. To make housing credit more affordable.
6. To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
7. To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
8. To encourage public agencies to emerge as facilitators and suppliers of serviced land for housing.

Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)

The Reserve Bank established BRBNMPL in February 1995 as a wholly-owned subsidiary to augment the production of bank notes in India and to enable bridging of the gap between supply and demand for bank notes in the country. The BRBNMPL has been registered as a Public Limited Company under the Companies Act, 1956 with its Registered and Corporate Office situated at **Bengaluru.**

- The company manages two Presses, one at Mysore in Karnataka and the other at Salboni in West Bengal.

National Bank for Agriculture and Rural Development (NABARD)

In NABARD the majority stake is held by the Reserve Bank. NABARD is an apex Development Bank with a mandate for facilitating credit flow for promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts. It also has the mandate to support all other allied economic activities in rural areas, promote integrated and sustainable rural development and secure prosperity of rural areas.

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RBI as Issuer of Currency

As per the provisions of the Section 22 of the Reserve Bank of India Act 1934, Reserve Bank of India has the sole right to issue Bank notes of all denominations.

- Prior to this currency functions were carried out by the Controller of Currency. Please note that the Government of India was conferred upon the monopoly of note issue by the Paper Currency Act of 1861. Before that, a practice of private and presidency banks issuing notes was prevalent. Till 1935, Controller of Currency under the Government of India managed the issue of currency.

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.

- At present, notes in India are issued in the denomination of ₹ 5, ₹10, ₹20, ₹50, ₹100, ₹500 and ₹1,000.
- The printing of ₹1 and ₹2 denominations has been discontinued, though the notes in circulation are valid.
- Coins up to 50 paisa are called "small coins" and coins of Rupee one and above are called "Rupee coins".
    - Please note the RBI has been authorized to issue notes of Rs. 5000 and Rs. 10000 also.
    - In fact, RBI can issue any note of any denomination but NOT exceeding Rs. 10,000. The notes denomination is notified by Government and RBI acts accordingly.
    - This restriction is as per the RBI Act 1934 current provisions.
    - Similarly, RBI can issue coins up to the denomination of Rs. 1000.
    - This restriction is as per the provisions of Coinage Act 1906.
    - The distribution of Coins is undertaken by RBI as an agent of the Government, (coins are minted by the Government and NOT by RBI)

Proportional Reserve System v/s Minimum Reserve System

- Originally, the assets of the Issue department were to consist of not less than 2/5th of the Gold or sterling securities, provided Gold was NOT less than Rs. 40 Crores in value. Remaining 3/5th of the assets might be rupee coins. This was called "Proportional Reserve System".
- The system changed in 1956. Since then, RBI is required to maintain a Gold and Foreign Exchange Reserves of ` 200 Crore of which at least ` 115 Crore should be in Gold. This is called Minimum Reserve System. This system continues till date.

Issue Department:

Please note that RBI has a separate department called issue department whose assets and liabilities are kept separate from the Banking Department.

Currency Department:

Currency Management function of Reserve Bank is carried out at the "Department of Currency Management" located at Central Office Mumbai. There are 19 Issue offices. RBI authorizes selected branches of Banks to establish Currency Chests and Coin Deposits.

- At present there is a network of 4281 Curency Chests and 4044 Small Coin Deposits.

Currency Chests

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 Cash Reserve Ratio.

Locations of Note Printing Presses:

- The **Security Printing and Minting Corporation of India Limited** (SPMCIL) prints the notes. It is a wholly owned company of the Government of India.
- Its printing presses are located at Nasik (Maharashtra) and Dewas (Madhya Pradesh).
- Apart from that, the **Bharatiya Reserve Bank Note Mudran Pvt. Ltd**. (BRBNMPL), a wholly owned subsidiary of the Reserve Bank, also has set up printing presses.
- The presses of BRBNMPL are located at Mysore in Karnataka and Salboni in West Bengal.

Coins and notes as Legal Tenders:

- Please note that One Rupee Note and One Rupee coins are legal tenders for **unlimited amounts.**
- 50 Paisa coins are legal tender for any sum not above Rs. 10.
- The coins of smaller than 50 paisa value are legal tenders of a sum below Re. 1

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Security Printing and Minting Corporation of India Limited (SPMCIL) has 4 mints for coin production located at Mumbai, Noida, Kolkata and Hyderabad.

Star Series Notes:

- The Star series notes are currently issued in **Rs. 10, 20, 50 and ₹ 100**.
- These notes are issued to replace the defected printed notes at the printing press. They have an additional character of a star and the bundles are NOT in series. Rest all the features are same.

RBI's Role as Banker and Debt Manager to the Government

In 1935, Reserve Bank of India, on its inception became the Banker and Debt Manager to the Government and this is a very important function.

- As per the Reserve Bank of India Act 1934, the Central Government entrusts 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.
- However, Reserve Bank may also act as the banker to a State Governments. **This is by an Agreement.** 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.

Minimum Cash Balance of the central Government:

- 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.
- These provisions are as per the administrative arrangements (not as per any legislation).

Does RBI handle the banking of Individual Ministries ?

Previously yes, now no. Now every ministry has been given a public sector bank to manage its operations. But still RBI functions for the ministries for which it is **nominated t**o do so.

Ways and Means Advances: (WMA):

Now, we know that RBI works as a banker to the State Governments by agreement. But there is no fixed minimum reserve balance for the State Governments. All state Governments are required to maintain a minimum reserve balance with RBI, but it depends upon the size of the economy of the state and its budget.

However, there are times, when there is a temporary mismatch in the cash flow of the receipts and payments of the State Governments. To handle this mismatch, there is a WMA scheme / facility which refer to Ways and Means Advances.

- RBI makes WMA to the state governments for a **period of 90 Days.**
- If the state government take WMA against the collateral Government securities, it is called **Special WMA.**
- If they are not against the security, then they are provided WMA based upon the three-year average of actual revenue and capital expenditure of the state. This is called normal WMA.
- WMA limits are if exceeded, is called overdraft.
  - A state Government can withdraw an overdraft for maximum of 14 days consecutively.
  - A state Government can withdraw an overdraft for maximum 36 days in a quarter.
  - The rate of interest is linked to **repo rate**.

Management of Public Debt:

RBI helps both the central government and state governments to manage their public debt, float new loans, issue and retirement of rupee loans, interest payment on the loan and operational matters about debt certificates and their registration. RBI'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.

RBI as Banker of Banks:

RBI is bank of all banks in India. As per the Banking Regulations Act 1949, Banks have to keep 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.

- Earlier, (originally in the BR act) it was as follows – 5% of demand liabilities and 2% of time liabilities. But now it is the portion of Net Demand and Time Liabilities (NDTL).
- So, the RBI 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) of RBI at regional offices.

LORL:

The banks can borrow from the RBI on the basis of eligible securities or any other arrangement and at the time of need or crisis, they approach RBI for financial help. Thus RBI works as **Lender of the Last Resort** (LORL) for banks.

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Financial Supervision

RBI not only regulates 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.

- RBI derives its regulating powers for Indian Banking System from the provisions of the **Banking Regulation Act 1949.**
- For other entities it derives power from the **RBI act 1934**.
- The credit information companies are regulated under the provisions of Credit Information Companies (Regulation) Act, 2005.

The objectives of this function are to protect the interest of the depositors and maintain the safety and soundness of the banking and Financial System of the country.

Regulation of the Commercial Banks

To do a business of commercial banking in India, whether it is India or Foreign, a license from RBI is required.

Opening of Branches is handled by the Branch Authorization Policy. This policy was made easier in recent times and an important provision is that :

- Indian banks no longer require a license from the Reserve Bank for opening a branch at a place with population of below 50,000.

- **Corporate Governance:**

RBI policy ensures high quality corporate governance in banks.

- **CRR and SLR:**

These are called **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).

- **Interest Rates:**

The interest rates on most of the categories of deposits and lending transactions have been deregulated and are largely determined by banks. 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:**

Prudential Norms refers to ideal / responsible norms maintained by the banks. RBI issues "Prudential Norms" to be followed by the commercial banks to strengthen the balance sheets of banks. Some of them are related to income recognition, asset classification and provisioning, capital adequacy, investments portfolio and capital market exposures. RBI has issued its guidelines under the Basel II for risk management.

Apart from that, RBI issues the public disclosure norms to enforce the market disciplines. Now all banks are required to disclose in their annual reports about capital adequacy, asset quality, liquidity, earnings aspects and penalties, if any, imposed on them. Similarly, the KYC norms (Know Your Customer) Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) guidelines are some of the major issues on which RBI keeps issuing its norms and guidelines.

- **Annual Onsite Inspection:**

RBI 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 rating.

- **OSMOS:**

OSMOS refers to Off Site Surveillance and Monitoring System. The RBI requires banks to submit detailed and structured information periodically under OSMOS. On the basis of OSMOS, RBI analyzes the health of the banks.

Regulations of Foreign Banks

There are 32 foreign banks present in the country with their little over 300 branches. This accounts for less than 0.5 per cent of about 72,000-branch overall network of all the banks operating in the country. RBI is looking for the gradual enhancement of the presence of foreign banks in a synchronized manner. Currently, Reserve Bank is considering changes in the rules governing the overseas players' banking operations in the country. In the possible new norms, RBI may ask the foreign banks to incorporate all their branches as their subsidiaries in India so that all of them are required to follow the rules governing capital adequacy ratio and sector-specific exposure limits and the Reserve Bank can have a greater regulatory oversight. Regarding the local incorporation of bank branches as wholly owned subsidiaries, the RBI has so far found favorable response from the foreign banks and their only concern has been regarding any possible tax implications arising out of the change of their existing branches into new structure.

Regulation of Rural Cooperative Banks

Rural Cooperative Banks were the first formal institutions established to provide credit to rural India. Rural cooperatives have been a key instrument of Financial Inclusion reaching out to the last mile.

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Framework of Rural Cooperative Banks

In India 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.

Rural cooperatives structure in India is bifurcated into **short-term** and **long-term** structure.

1. **Short Term Cooperative Structure:**

   The short-term cooperative structure is a three-tier structure

1. State Cooperative Banks at the apex (State) level,
2. District Central Cooperative Banks (DCCBs) at the intermediate (district) level
3. 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.

2. **Long Term Cooperative Structure:**

   The long-term cooperative structure has the

i. State Cooperative Agriculture and Rural Development Banks (SCARDBs) at the apex level
ii. Primary Cooperative Agriculture and Rural Development Banks (PCARDBs) at the district or block level.

SCARDB and PCARDB were conceived with the objective of meeting long-term credit needs in agriculture.

Number of Rural Cooperative Banks:

- In 2011, there were around 31 State Cooperative Banks, 371 DCCBs and 94,950 PACS. There were 717 Long Term Rural Cooperative Credit Institutions (LTCCIs) comprising 20 SCARDBs and 697 PCARDBs.

Regulatory Framework:

- The Rural Cooperative Structure in India is regulated by 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 State Cooperative Banks and DCCBs.
- A large number of StCBs as well as DCCBs are unlicensed as of now and and are allowed to function as banks till they are either granted license or their applications for licence are rejected.

Rural Co-operative Banks and Rakesh Mohan Committee:

The Rakesh Mohan Committee had recommended that there should be a roadmap to ensure that only licensed banks operate in the cooperative space and that banks which fail to obtain a license 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.

CRAR Norms for Rural Cooperative Banks:

Please note that currently CRAR norms are not applicable to StCBs and DCCBs. Since March 31, 2008, they are only 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.

Regulation of the Regional Rural Banks

RRBs are supervised by both RBI and NABARD. The financial regulation over RRBs is exercised by Reserve Bank and the supervisory powers have been vested with NABARD.

- CRAR Norms: At present there are no CRAR norms for RRBs.

Regulation of Urban Cooperative Banks

The Urban Cooperative Banks have to obtain a license 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 license. Further UCBs also have to obtain prior authorization of the Reserve Bank to open a new place of business. UCB have to follow the Prudential norms relating to income recognition, asset classification, provisioning and capital adequacy ratio.

Monetary Policy of RBI: Controlled Expansion v/s Tight Monetary Policy

We all know that India entered into the era of economic planning in 1951. The monetary and Fiscal Policies had to be adjusted to the requirements of the planned development in the country and accordingly, the economic policy of the Reserve Bank was emphasized on the following two major objectives.

1. To speed up the economic development of the nation and raise the national income and standard of living of the people.
2. Control and reduce the "Inflationary" pressure on the economy.

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The requirement was an adequate financing of the economic growth programmes, and at the same time containing the inflationary pressure and maintenance of price stability. Thus this was a period of "**Controlled Expansion**".

Since 1972, there is a rapid increase in the money supply with the public and banking system. The expansion of the Bank credit to trade and industry also increased. The early 1970s marked an era of serious inflationary situations. The frequent fluctuations in the agricultural productions, defective government polices and global inflationary pressures arising out of the oil prices etc. led the RBI to abandon the "controlled expansion" and adopt a policy that is most suitable for retraining the credits. This is called "**tight monetary**" policy and RBI has been successful with varying degree of success.

Objectives of the Monetary Policy

Objectives of the monetary policy in India have gone through a process of gradual evolution and have included price stability, ensuring adequate flow of credit to various productive sectors of the economy and achieving financial stability. The policy stance is based upon the assessment of the macroeconomic and financial conditions and monetary measures. The statements reflect the changing circumstances and priorities of the RBI and a thrust for the future.

- Reserve Bank of India announces Monetary Policy every year in the Month of April.
- This is followed by **three quarterly Reviews** in July, October and January.
- But, RBI at its discretion can announce the measures at any point of time.

The Annual Monetary Policy is made up of two parts

- Part A: macroeconomic and monetary developments
- Part B: Actions taken and fresh policy measures.

Monetary policy of the RBI deals with almost all other vital topics such as financial stability, financial markets, interest rates, credit delivery, regulatory norms, financial inclusion and institutional developments etc.

Monetary Aggregates

During the 1970s RBI introduced the Money Stock Measures. These were appropriately changed on the recommendation of the Y B Reddy Committee in the late 1990s.

Supply of Money

The supply of money or money in circulation is the money held by the individuals, institutions and business houses. This excludes the money lying in the Government treasury and money held with the reserve banking system. At any point of time, the money held with the public has two components

1. **Currency Component:** This consist of all the coins and notes in the circulation , as issued by the Reserve bank of India.
2. **Deposit Component:** Deposit component is the money of the general public with the banks, which can be withdrawn by them using cheques, withdrawals and ATMs.

Currency with the public:

The currency with the public has 4 components:

- Notes in Circulation (plus)
- Circulation of Rupee Coins (Plus)
- Circulation of small coins (minus)
- Cash on hand with Banks. = currency with the public.

The Deposit money of the public has two components:

- Demand deposits with the Banks
- Other deposits with the RBI

Monetary Aggregates:

The Reserve bank of India calculates the 4 concepts of Money supply in India. They are called **Money Stock Measures.** They are as follows:

- M_1: This is Currency with the public as mentioned above + **Demand Deposits** of the public as mentioned above. It is called **Narrow Money**.
- M_2 : This is Narrow Money i.e. M_1 + Post office Savings Deposits.
- M_3 : M_3 is Narrow Money i.e. M_1 + Aggregate Deposits of the Public which is made up of Demand Deposits and Time Deposits.
- M_4 : M_4 refers to M_3 and Post Office Deposits

Why M_2 and M_4 became irrelevant?

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Now, out of the above four , the M_2 & M_4 became irrelevant over the period of time. This is because, there is NOT much change in the money of people deposited with the Post office and RBI did not care to update this money. The other important reason assigned to this is as follows:

There was a time when the Reserve Bank used broad money (M_3) 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.

- **RBI started using the Multiple Indicator Approach since 1998**

So, now Narrow Money (M_1) and Broad Money (M_3) are relevant. The RBI in all its policy documents, monthly Bulletins and other documents shows these aggregates. To understand the latest situation we take the RBI's March 2012 Bulletin. This bulletin shows the following:

(₹ Billion)

March 31/ reporting Fridays of the month/last reporting Friday of the month	Currency with the Public: Notes in Circulation (1)	Circulation of Rupee Coins (2)	Circulation of Small Coins (2)	Cash on Hand with Banks	Total (1+2+3-4)	Deposit Money of the Public: Demand Deposits with Banks	'Other' Deposits with Reserve Bank (3)	Total (6+7)	M_1 (5+8)	Post Office Saving Bank Deposits	M_2 (9+10)	Time Deposits with Banks	M_3 (9+12)	Total Post Office Deposits	M_4 (13+14)
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
2008-09	6,811.0	84.9	15.7	257.0	6,654.5	5,886.9	55.3	5,942.2	**12,596.7**	50.4	**12,647.1**	35,351.0	**47,947.8**	259.7	**48,207.4**
2009-10	7,882.8	97.0	15.7	320.6	7,674.9	7,179.7	38.1	7,217.8	**14,892.7**	50.4	**14,943.1**	41,134.3	**56,027.0**	259.7	**56,286.7**
2010-11	9,369.4	111.6	15.7	354.6	9,142.0	7,176.6	36.5	7,213.1	**16,355.1**	50.4	**16,405.5**	48,639.8	**64,994.9**	259.7	**65,254.6**
January 14, 2011	9,144.4	108.1	15.7	350.8	8,917.3	6,441.2	29.1	6,470.3	**15,387.7**	50.4	**15,438.1**	46,701.7	**62,089.4**	259.7	**62,349.1**
January 28, 2011	9,125.1	109.1	15.7	368.4	8,881.5	6,650.2	133.3	6,783.5	**15,665.1**	50.4	**15,715.5**	46,894.8	**62,559.8**	259.7	**62,819.5**
September 2011	9,696.6	117.4	15.7	403.4	9,426.4	6,304.7	23.2	6,327.9	**15,754.3**	50.4	**15,804.7**	52,940.5	**68,694.8**	259.7	**68,954.5**
October 2011	9,840.4	120.5	15.7	438.5	9,538.1	6,385.8	11.4	6,397.3	**15,935.3**	50.4	**15,985.7**	53,718.2	**69,653.6**	259.7	**69,913.3**
November 2011	10,081.3	121.5	15.7	433.5	9,784.9	6,301.2	11.6	6,312.8	**16,097.8**	50.4	**16,148.2**	54,059.6	**70,157.4**	259.7	**70,417.1**
December 2011	10,067.6	121.5	15.7	424.8	9,779.9	7,093.9	22.9	7,116.8	**16,896.7**	50.4	**16,947.1**	55,090.1	**71,986.8**	259.7	**72,246.5**
January 13, 2012	10,257.0	121.5	15.7	388.1	10,006.0	6,699.1	21.4	6,720.6	**16,726.6**	50.4	**16,777.0**	55,199.2	**71,925.7**	259.7	**72,185.4**
January 27, 2012	10,245.7	121.5	15.7	416.4	9,966.5	6,645.4	26.8	6,672.2	**16,638.7**	50.4	**16,689.1**	54,956.0	**71,594.7**	259.7	**71,854.3**

- We can understand that the major distinction between the M_1 and M_3 is "**Treatment of deposits with the banks**". If we go a little deep, the **M3 is the treatment of "Time Deposits" of the public,** since demand deposits are available against cheques and ATMs.
- The "Time Deposits" are not liquid and they are earning assets.

But, for the last few years we have products like flexi deposits which allow partial or full convertibility of the time deposits into demand deposits. So, now-a-days, time deposits can also be considered liquid, at least partially.

Reserve Money:

The RBI table on monetary indicators has the Reserve Money as one of the heads. This Reserve Money is basically **Government Money** or the **Real Cash Money held with Both the Public and the Banks.** This has the following components:

- Currency with the Public
- Other Deposits with the RBI
- Cash Reserves of the banks held with themselves
- Cash Reserves of the Banks held with RBI

Concept of Credit creation

The question arises is that what is the difference between Narrow Money (M_1), Broad Money (M3) and Reserve Money? This is very important question. When we say that Reserve Money is the **Real Cash Money held with both the Public and the Banks this means that**

RM = C + OD + CR

Where:

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- C stands for Currency with Public
- OD means other deposits with the RBI
- CR means Cash Reserves

But by Narrow Money, we refer to

NM (M1) = C + DD

Where

- **C stands for Currency with Public**
- **DD means demand deposits.**

So, we can say that The Reserve Money has the Cash Reserve component of the Banks and other deposits with the RBI and this is the major difference between the RM and M1.

Again,

The Broad Money or M3 is denotes as follows:

BM (M3) = C + OD + DD + TD

Where:

- C stands for Currency with Public,
- OD stands for Other Deposits of the public with Banks
- DD stands for Demand Deposits
- TD refers to Time Deposits.

This means that C and OD are common in Broad Money and Reserve Money. The difference is of Cash Reserves.

But what is the relevancy of understanding this comparison?

This comparison is very much relevant. We take this example for understanding this interesting proposition. But before that we have to assume the following:

1. We assume that there is No Reserve bank or any other monetary authority.
2. We assume that there are only Demand Deposits.
3. We assume that a Bank has no excess reserves
4. We also assume that there is no other use of cash than the use mentioned in the following example.

Let's begin:

- We begin with a **XYZ Bank**. In this Bank **Suresh** approaches to open a demand deposit of ₹ 10,000. Once Suresh deposits the money with the Bank, Bank has now ₹ 10000 with it.
- **Ramesh** comes to the bank to get a loan and he is disbursed a Loan of ₹ 10000 by the Bank.
- Again **Ganesh** approaches the Bank and deposits ₹ 10000.
- **Mohan** comes to the Bank for a Loan and he is again disbursed a Loan of ₹ 10000.

The concept in which the commercial Banks expand the deposits and expand their loans and advances is called "Credit Creation". In the above theoretical example, the **XYZ Bank** can create unlimited credit. The bank Create Credits because this is source of their income.

But since in the above example, the depositors Suresh and Ganesh come together to get their money back (as these are demand deposits) what the Bank will do?

In other words, a bank may exploit its "Credit Creation" capability and Create Loans many times of the deposits they have with them. This leads to a bubble and probably, if such is the case, the Bank XYZ may fail sooner or later.

The solution of the above is that Bank XYZ is asked to keep a part of all the deposits it gets every time as Cash Reserves or Liquid Reserves , so that it can pay the depositors when the demand their money.

Now we take the same example. Here we assume that the bank as to keep 25% of its deposits as Reserves. So the rounds are as follows:

- **Suresh** approaches to open a demand deposit of ₹ 10,000. Once Suresh deposits the money with the Bank, Bank has now ₹ 10000 with it. Out of this the bank has ₹ 2500 reserved and now has an excess cash of ₹ 7500.
- **Ramesh** comes to the bank to get a loan and he is disbursed a Loan of ₹ 7500 by the Bank.
- Again **Ganesh** approaches the Bank and deposits ₹ 10000.
- **Mohan** comes to the Bank for a Loan and he is again disbursed a Loan of ₹ 7500.
- **The Bank has now ₹ 5000 with it as reserves.**
- After two more similar rounds, Bank can pay Suresh the amount if he comes back to get his money.

The number of times a bank can create a credit is called Bank Multiplier. It is denoted as follows:

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$$\text{Bank Multiplier} = \frac{1}{\textbf{Required Rerserve Ratio}}$$

The Required Reserve Ratio of 25% can create a credit equal to 4 times. Similarly a required reserve ratio 20% , the deposit multiplication will be for 5 times.

Now, in India, the Required Reserve Ratio is made up of two components.

- Cash Reserve Ratio : with RBI
- Statutory Liquidity Ratio : with themselves

RBI increases and decreases these ratios.

"By manipulating the Cash Reserve Ratio and Statutory Liquidity ratio, RBI can influence the total Volume of the Bank credit and Total Volume of the Bank deposits or bank Money in the country"

Open Market Operations

Open market Operation refers to the purchase and sale of the Government securities by the Reserve bank of India from / to public on its account. But in India, as of now the market for government securities is not well developed, still OMO plays very important role. Here is how OMO works:

- When RBI sells government security in the markets, the bank purchase them.
- When the banks purchase Government securities, they have a reduced ability to lend to the industrial houses or other commercial sectors.
- This reduced surplus cash, contracts the Credit supply.
- When RBI purchases the securities, the commercial banks find them with more surplus cash and this would create more credit in the system.

Liquidity Adjustment Facility

By Liquidity we simply mean to refer to the money floating in the system that is available to all stakeholders of the markets viz. Individuals, corporate entities and the government.

We know that liquidity is influenced by the demand and supply of money in the system. RBI can either inject liquidity in the system or absorb the liquidity in the system. However there are three ways the liquidity can get affected.

1. **Government Borrowings:** Government is the biggest borrower in India. It borrows in the form of the securities to fund the deficit that arises when its income falls short of expenses.
2. **Corporate Borrowings:** Increased borrowings by the corporate sector to fund the Capital expenditures and short term credit needs can affect the liquidity of the system.
3. **RBI Interference:** RBI may reduce the availability of the rupee by buying rupee and selling a foreign currency such as the US dollar. This is primarily done to maintain the value of rupee. RBI can withdraw excess liquidity from the financial market also when it sees that assets prices are approaching towards a bubble situation.

As far as monetary policy is concerned, RBI uses the weapons of **Repo Rate** and **Reverse Repo Rate** for 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 Repo Rate, Reverse Repo Rate, CRR and SLR are also known as Key Policy Indicators of the RBI.**

Repo Rate

Repo rate, or repurchase rate, is the rate at which RBI lends to banks for short periods. This is done by RBI buying government bonds from banks with an agreement to sell them back at a fixed rate. If the RBI wants to make it more expensive for banks to borrow money, it increases the repo rate. Similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate.

Please note that **Bank Rate and Repo Rate** seem to be similar terms because in both of them RBI lends to the banks. However,

- ✓ **Repo Rate** is a short-term measure and it refers to short-term loans and used for controlling the amount of money in the market, **Bank Rate** is a long-term measure and is governed by the long-term monetary policies of the RBI. In broader term, bank rate is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries. RBI uses this tool to control the money supply.

How Repo Rate Works?

When RBI reduces the Repo Rate, the banks can borrow more at a lower cost. This contributes to lowering of the rates. During the Global Financial crisis, RBI has decreased gradually the Repo rate from 9% to 4.75%. This was a mean to inject liquidity in the

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system. Once there are signs of recovery, the RBI increased the rates and moves towards a tight monetary policy. Current Repo Rate is 8.5%.

Reverse Repo Rate:

Reverse repo rate is the rate of interest at which the RBI borrows funds from other banks in the short term. This is done by RBI selling government bonds to banks with the commitment to buy them back at a future date. The banks use the reverse repo facility to deposit their short-term excess funds with the RBI and earn interest on it. RBI can reduce liquidity in the banking system by increasing the rate at which it borrows from banks. Hiking the repo and reverse repo rate ends up reducing the liquidity and pushes up interest rates. Current Reverse Repo Rate is 7.5%.

How Reverse Repo Rate Works:

When the RBI increases the Reverse Repo, it means that now the RBI will provide extra interest on the money which it borrows from the banks. An increase in reverse repo rate means that banks earn higher returns by lending to RBI. This indicates a hike in the deposit rates.

Marginal Standing Facility

The Reserve Bank of India in its monetary policy for 2011-12, introduced the marginal standing facility (MSF), under which banks could borrow funds from RBI at 8.25%, which is 1% above the liquidity adjustment facility-repo rate against pledging government securities. The MSF rate is pegged 100 basis points or a percentage point above the repo rate. Banks can borrow funds through MSF when there is a considerable shortfall of liquidity. This measure has been introduced by RBI to regulate short-term asset liability mismatches more effectively. In the annual policy statement, RBI says: "The stance of monetary policy is, among other things, to manage liquidity to ensure that it remains broadly in balance, with neither a large surplus diluting monetary transmission nor a large deficit choking off fund flows."

Difference between liquidity adjustment facility-repo rate and marginal standing facility rate

Banks can borrow from the Reserve Bank of India under LAF-repo rate by pledging government securities over and above the statutory liquidity requirement of 24%. Though in case of borrowing from the marginal standing facility, banks can borrow funds up to one percentage of their net demand and time liabilities, at 1% above Repo Rate. However, it can be within the statutory liquidity ratio of 24%.

Quantitative Measures v/s Qualitative Measures

The above measures quantitative measures of the RBI. There are some qualitative measures also. Here is a brief description of the qualitative and quantitative measures.

The **quantitative measures** of credit control are :

- ✓ **Bank Rate Policy:** The bank rate is the Official interest rate at which RBI rediscounts the approved bills held by commercial banks. For controlling the credit, inflation and money supply, RBI will increase the Bank Rate.
- ✓ **Open Market Operations:** OMO The Open market Operations refer to direct sales and purchase of securities and bills in the open market by Reserve bank of India. The aim is to control volume of credit.
- ✓ **Cash Reserve Ratio:** Cash reserve ratio refers to that portion of total deposits in commercial Bank which it has to keep with RBI as cash reserves.
- ✓ **Statutory Liquidity Ratio:** It refers to that portion of deposits with the banks which it has to keep with itself as liquid assets(Gold, approved govt. securities etc.)
- If RBI wishes to control credit and discourage credit it would increase CRR & SLR.

Qualitative credit is used by the RBI for selective purposes. Some of them are

- ✓ **Margin requirements:** This refers to difference between the securities offered and and amount borrowed by the banks.
- ✓ **Consumer Credit Regulation:** This refers to issuing rules regarding down payments and maximum maturities of installment credit for purchase of goods.
- ✓ **RBI Guidelines**: RBI issues oral, written statements, appeals, guidelines, warnings etc. to the banks.
- ✓ **Rationing of credit:** The RBI controls the Credit granted / allocated by commercial banks.
- ✓ **Moral Suasion:** psychological means and informal means of selective credit control.
- ✓ **Direct Action:** This step is taken by the RBI against banks that don't fulfill conditions and requirements. RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyong a limit.

Base Rate System

Base Rate is the minimum lending rate that banks can charge their customers from July 1, 2010. Prior to this all lending rates were pegged to a Bank's Prime Lending Rate or PLR. The banks were charging the customers an interest rate which was either above PLR

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or below PLR, thus PLR serving as an anchor rate. From July 1, 2010, the Base Rate has not only replaced the PLR as a benchmark rate but has also become the new floor rate below which no bank can lend.

- Please note that the outstanding loans that are linked to PLR would be continuing to be linked with the PLR, but the new loans and renewed loans would be linked to the sole benchmark that is Base Rate. The existing customers have been given a choice to migrate to Base Rate.

Objectives:

The introduction of the Base Rate aims at bringing the transparency in the lending market. The reasons were also to end the bargaining in the loans. For example, the banks charged much above the PLR from the risky and no bargaining customers, while the customers who have bargaining power were given loans well below the PLR. In some cases, at the PLR of 12-13%, the bargaining customers were given loans at 6-7%.

After fixing the floor rate i.e. the Base Rate, no bank would be able to lend below the Base Rate and this promises to bring transparency in the loan markets of the country.

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