Syllabus

B.b.a (b & i)

g.g.s indraprastha university

b.b.a (b & i): 111 principles of banking

l-4 t/p-0 credits-4

note: students are expected to have elementary knowledge of the topics specified in the syllabus

objective: the course aims to acquaint the student with a basic and elementary knowledge of the business and corporate laws.

course contents

unit i no. Of hrs: 10

money and banking- an overview; nature, functions and significance of money. Demand and supply of money-concepts and approaches; money and prices-quantity theory & money; inflation and it's control.

unit ii no. Of hrs: 10

evolution of banking; systems of banking-mixed,branch,unit,group,chain; brief structure of banks; rbi-organisation, functions, methods of credit control; commercial banking;balance sheet of a bank; credit creation.

unit iii no. Of hrs: 10

structure and charateristics of financial & banking system in india; indian money market indian capital market indian monetary policy & system

unit iv no. Of hrs: 10

sources and uses of funds in banks; value chain analysis in banking industry. Emergingtrends in banking: universal banking, venture capital, project financing, merchantbanking, e-banking, credit cards, banking ombudsman scheme.

Unit 1

money and banking- an overview

Possessions are assets required by human being for a healthy life which needs money. Money is required for purchasing any goods or services. There are many forms of money in the world. Most countries have their own symbols of money, such as the Indian Rupees.in India.In India government prints paper money and makes coins at a special place called a Mint, Metro also issue coins of 1, 2,5 and 10.so there are so many metals which were used for making money gold, silver, or other metal in pieces of suitable form marked by public authority like reserve bank of India, government of India and used commonly as a medium of exchange and assess of value.

In ancient time,barter system was prevailing. People did not exchange with money. Instead, they traded one commodity for another to get what they wanted or needed. One person who owned many goats could trade with another person who owned many Horses. Each would trade a little of what he had with the other, and hold up the people on his farm. In barter system there were many problems but the main problem faced in this was divisibility like 2 goats are exchanged for 1 horse but if somebody wants to exchange his 1 goat for horse then it is not possible. so people required things lasting as a medium.

In **metal coin** pictured lion history credit goes to the western part country Turkey earlier called **Lydia** 650 BC. Clam shells, blocks of salts etc, were also used as coin money in some countries. Paper money introduction was given by **China** then by Sweden but common use of **paper money** started when in 1690 Massachusetts Bay Colony printed it. But now a day's money does not mean only coins or paper money but it is stored in different bank accounts. so money is the article a durative one passing from hand to hand in a community, and completing its use in turn to each holder of it only as he parts with it in replace for rather else.

The applicability of money is of such public substance that it would be impossible for modern industrial humanity to exist without it. The argument of money touches many interests; it raises many questions of an opinionated and of a moral nature. There are perhaps more admired errors on this than on any other one subject in economics, but the general principles of money are as entirely unstated and as firmly recognized as are any parts of economics.

Meaning of Money: Money means a material way of imbursement and standard of trade, fleeting from hand to hand and generally accepted as the most common price-good.

Banking supposed to being originated equal to money origination at barter system period grain-money and food cattle-money used from at least 9000 BC.The word bank is assumed to be come from the Italian word banque which means desk/bench where transactions were performed on a bench having green tablecloth. Some assumptions are also from Ancient Roman Empire using word bancu which became banco and now bank

In India RBI works as regulator of all bank which was established in 1935 by Britishers in their rule.Earlier to this Imperial bank of India Was performing this function. After independence as first Public sector bank SBI was established on July 1, 1955 as A major development by transformation of Imperial Bank of India into State Bank of India. following that many associate banks came into existence. establishment phase can be considered to cover 1950s and 1960s till the nationalization of banks in 1969 a further appraisal of the banking was undertaken during 1966 as the private banks were still not extending the required maintain in the form of credit disbursal, more particularly to the unorganized sector. Each top business house in the country at that time was closely associated with the sponsorship and be in charge of of one or more banking companies. The volume of the deposits collected, were being deployed in organized sectors of industry and trade, while the farmers, sole proprietors, small partnership firms, professionals and self-employed etc. had to depend on financers who used to exploit them by charging higher attention rates. In February 1966, a system of Social power was set-up whose main task was to occasionally judge the claim for collection credit from various sectors of the nation to decide the priorities for providing loans and advances so as to ensure most favorable and efficient deployment of resources. The scheme was unable to provide any remedy. despite the fact that a no. of twigs were opened in countryside area but the lending Actions of the private banks were not leaning towards reunion the acknowledgment chuck of the priority/weaker sectors.

Nationalization of banks Promulgated Banking Companies (Acquisition and Transfer of Undertakings) Ordinance 1969 On July 19, 1969, to acquire 14 bigger commercial bank with paid up capital of Rs.28.50 cr, deposits of Rs.2629 cr, loans of Rs.1813 cr and with 4134 branches accounting for 80% of advance. afterward in 1980, 6 more banks were nationalized which brought 91% of the deposits and 84% of the advances in Public Sector Banking. During December 1969, RBI introduced the Lead Bank Scheme on the recommendations of FK Nariman Committee.

Consolidation phase started in 1985 when a series of policy initiatives were taken by RBI which saw marked slowdown in the branch expansion. Reforms phase The macro-economic crisis faced by the country in 1991 paved the way for extensive financial sector reforms which brought deregulation of interest

rates, more competition, technological changes, prudential guidelines on asset classification and income recognition, capital adequacy, autonomy packages etc. Source:http://www.bankingindiaupdate.com/general.html

2. Nature of Money:

Money may be stated as a piece of material taken into the hand to be relevant force to other things, to shape them or move them.

Where the free exchange of goods and services is unknown, money is not wanted. In a state of civilization in which the division of labor was a purely domestic matter and production and consumption were consummated within the single household it would be just as useless as it would be for an isolated man. however even in an economic order based on distribution of labor, money would still be needless if the way of creation is socialized, the control of production and the distribution of the finished product were in the hands of a central body, and individuals are not allowed to exchange the consumption goods allotted to them for the consumption goods allotted to others.

The fact of money presupposes an financial order in which production is based on division of labor and in which private belongings consists not only in produce of the first order (consumption goods), but also in goods of upper orders (production goods). In such a society, there is no orderly centralized control of production, for this is incredible without centralized removal over the means of production. What is to be produced, and how it is to be produced, is decided in the first place by the owners of the means of production, who produce, however, not only for their own needs, but also for the needs of others, and in their valuations take into account, not only the use-value that they themselves attach to their products, but also the use-value that these hold in the belief of the other members of the community.nature of money can be understood by following points:

- **Medium of exchange:**

The balancing of production and consumption takes place in the market, where the diverse producers get together to barter goods and services by bargaining together. Money acts as medium of exchange for facilitating this bargaining.

- **Marketability :** money is most accepted form form sale or to market product & services. That is the necessary quality that made everybody ready to accept it.
- **Transportability:** the money stuff must be easy to carry; it must have a large value in small bulk and weight. To carry a bag of wheat on one's back a few miles requires as great an effort ordinarily as does the raising of the wheat; and the cost of carriage for one bag, even by wagon, will often equal the whole value of the wheat. In India by use of note of Rs. 1,000 millions on money can be transported in one bag.

- **Cognoscibility:** the money-good must be easy to know, and to judge as to quality. If expert knowledge or special apparatus is needed to test it in order to avoid counterfeits, few could be ready to take it, and trading would be a costly process. There are simple steps to know the originality of notes of Rs. 1,000 and Rs. 500 issued by RBI, with the help of these instruction even a layman can understand and check the originality of notes.
- **Durability:** the money-good must be trouble-free to keep for long periods in terms of perishability if stored for a purpose.
- **Divisibility:** Money should be divisible in smaller units to facilitate free exchange. in India coins of Rs 1,2,5 and 10 and notes of Rs. 1,2,5,10,50,100,500 and 1000 are commonly used. So money enhances the value of the goods that it buys and sells by dividing them into quantities convenient for use and by making them available at the right time
- **Tool**:money serves as a tool or agent to facilitate trade and business. It has been said that the service performed by money is to overcome the difficulty in barter of the double coincidence of wants and possessions. For example, a man may possess a horse that he is willing to sell, and he wants in place of it not just one thing, but a group of things, say a cow, a bag of flour, a pair of shoes, and several other small commodities, perhaps preferring not to have them all at once, but distributed over a period of some days or some weeks. Evidently, when the "possession" is one large thing and the "wants" are many (or vice versa), the coincidence required is much more than double. In the light of the principles of diminishing indulgence and of time-preference, it is clear that the amounts in which and the times at which goods are available have an essential bearing on their values. Money is the most successful device ever discovered for distributing the supplies of a journey along its course and the goods of daily need over a period of time.
- ORIGINAL

2

Diffrence between direct and indirect exchange

Direct exchange	Indirect exchange
Take, for instance, the payment of wages in kind, which is a case of direct exchange so long on the one hand as the employer uses the labor for the immediate satisfaction of his own	If there are more than two individuals and more than two kinds of commodity in the market, indirect exchange also is possible

needs and does not have to procure through exchange the goods in which the wages are paid, and so long on the other hand as the employee consumes the goods he receives and does not sell them.	
Suppose that A and B exchange with each other a number of units of the commodities *m* and *n.* A acquires the commodity *n* because of the use-value that it has for him. He intends to consume it. The same is true of B, who acquires the commodity *m* for his immediate use. This is a case of direct exchange.	Let us take, for example, the simple case in which the commodity *p* is desired only by the holders of the commodity *q,* while the commodity *q* is not desired by the holders of the commodity *p* but by those, say, of a third commodity *r,* which in its turn is desired only by the possessors of *p.* No direct exchange between these persons can possibly take place. If exchanges occur at all, they must be indirect;
Such payment of wages in kind is still widely prevalent in agriculture, although even in this sphere its importance is being continually diminished by the extension of capitalistic methods of management and the development of division of labor.	In quite early times, sooner in some places than in others, the extension of indirect exchange led to the employment of the two precious metals gold and silver as common media of exchange.

Indirect exchange is distinguished from direct exchange according as a medium is involved or not.

. A may then acquire a commodity *p,* not because he desires to consume it, but in order to exchange it for a second commodity *q* which he does desire to consume. Let us suppose that A brings to the market two units of the commodity *m,* B two units of the commodity *n,* and C two units of the commodity *o,* and that A wishes to acquire one unit of each of the commodities *n* and *o,* B one unit of each of the commodities *o* and *m,* and C one unit of each of the commodities *m* and *n.* Even in this case a direct exchange is possible if the subjective valuations of the three commodities permit the exchange of each unit of *m, n,* and *o* for a unit of one of the others. But if this or a similar hypothesis does not hold good, and in by far the greater number of all exchange transactions it does not hold good, then indirect exchange becomes necessary,

and the demand for goods for immediate wants is supplemented by a demand for goods to be exchanged for others.

as, for instance, if the possessors of the commodity *p* exchange it for the commodity *q* and then exchange this for the commodity *r* which is the one they desire for their own consumption. The case is not essentially different when supply and demand do not coincide quantitatively; for example, when one indivisible good has to be exchanged for various goods in the possession of several persons.

Indirect exchange becomes more necessary as division of labor increases and wants become more refined. In the present stage of economic development, the occasions when direct exchange is both possible and actually effected have already become very exceptional. Nevertheless, even nowadays, they sometimes arise.

Thus along with the demand in a market for goods for direct consumption there is a demand for goods that the purchaser does not wish to consume but to dispose of by further exchange. It is clear that not all goods are subject to this sort of demand. An individual obviously has no motive for an indirect exchange if he does not expect that it will bring him nearer to his ultimate objective, the acquisition of goods for his own use. The mere fact that there would be no exchanging unless it was indirect could not induce individuals to engage in indirect exchange if they secured no immediate personal advantage from it. Direct exchange being impossible, and indirect exchange being purposeless from the individual point of view, no exchange would take place at all. Individuals have recourse to indirect exchange only when they profit by it; that is, only when the goods they acquire are more marketable than those which they surrender.

Now all goods are not equally marketable. While there is only a limited and occasional demand for certain goods, that for others is more general and constant. Consequently, those who bring goods of the first kind to market in order to exchange them for goods that they need themselves have as a rule a smaller prospect of success than those who offer goods of the second kind. If, however, they exchange their relatively unmarketable goods for such as are more marketable, they will get a step nearer to their goal and may hope to reach it more surely and economically than if they had restricted themselves to direct exchange.

It was in this way that those goods that were originally the most marketable became common media of exchange; that is, goods into which all sellers of other goods first converted their wares and which it paid every would-be buyer of any other commodity to acquire first. And as soon as those commodities that

were relatively most marketable had become common media of exchange, there was an increase in the difference between their marketability and that of all other commodities, and this in its turn further strengthened and broadened their position as media of exchange.

Thus the requirements of the market have gradually led to the selection of certain commodities as common media of exchange. The group of commodities from which these were drawn was originally large, and differed from country to country; but it has more and more contracted. Whenever a direct exchange seemed out of the question, each of the parties to a transaction would naturally endeavor to exchange his superfluous commodities, not merely for more marketable commodities in general, but for the *most* marketable commodities; and among these again he would naturally prefer whichever particular commodity was the most marketable of all. The greater the marketability of the goods first acquired in indirect exchange, the greater would be the prospect of being able to reach the ultimate objective without further maneuvering. Thus there would be an inevitable tendency for the less marketable of the series of goods used as media of exchange to be one by one rejected until at last only a single commodity remained, which was universally employed as a medium of exchange; in a word, money.

This stage of development in the use of media of exchange, the exclusive employment of a single economic good, is not yet completely attained. But then there was a long interruption in the steady contraction of the group of goods employed for that purpose. For hundreds, even thousands, of years the choice of mankind has wavered undecided between gold and silver The chief cause of this remarkable phenomenon is to be found in the natural qualities of the two metals. Being physically and chemically very similar, they are almost equally serviceable for the satisfaction of human wants. For the manufacture of ornaments and jewelry of all kinds the one has proved as good as the other. (It is only in recent times that technological discoveries have been made which have considerably extended the range of uses of the precious metals and may have differentiated their utility more sharply.) In isolated communities, the employment of one or the other metal as sole common medium of exchange has occasionally been achieved, but this short-lived unity has always been lost again as soon as the isolation of the community has succumbed to participation in international trade.

Economic history is the story of the gradual extension of the economic community beyond its original limits of the single household to embrace the nation and then the world. But every increase in its size has led to a fresh duality of the medium of exchange whenever the two amalgamating communities have not had the same sort of money. It would not be possible for

the final verdict to be pronounced until all the chief parts of the inhabited earth formed a single commercial area, for not until then would it be impossible for other nations with different monetary systems to join in and modify the international organization.

Of course, if two or more economic goods had exactly the same marketability, so that none of them was superior to the others as a medium of exchange, this would limit the development toward a unified monetary system. We shall not attempt to decide whether this assumption holds good of the two precious metals gold and silver. The question, about which a bitter controversy has raged for decades, has no very important bearings upon the theory of the nature of money. For it is quite certain that even if a motive had not been provided by the unequal marketability of the goods used as media of exchange, unification would still have seemed a desirable aim for monetary policy. The simultaneous use of several kinds of money involves so many disadvantages and so complicates the technique of exchange that the endeavor to unify the monetary system would certainly have been made in any case.

The theory of money must take into consideration all that is implied in the functioning of several kinds of money side by side. Only where its conclusions are unlikely to be affected one way or the other, may it proceed from the assumption that a single good is employed as common medium of exchange. Elsewhere, it must take account of the simultaneous use of several media of exchange. To neglect this would be to shirk one of its most difficult tasks.

3.Functions & Significance of Money

The simple statement, that money is a commodity whose economic function is to facilitate the interchange of goods and services, does not satisfy those writers who are interested rather in the accumulation of material than in the increase of knowledge. Many investigators imagine that insufficient attention is devoted to the remarkable part played by money in economic life if it is merely credited with the function of being a medium of exchange; they do not think that due regard has been paid to the significance of money until they have enumerated half a dozen further "functions"—as if, in an economic order founded on the exchange of goods, there could be a more important function than that of the common medium of exchange.

After Menger's review of the question, further discussion of the connection between the secondary functions of money and its basic function should be unnecessary. Nevertheless, certain tendencies in recent literature on money make it appear advisable to examine briefly these secondary functions—some of them are coordinated with the basic function by many writers—and to show

once more that all of them can be deduced from the function of money as a common medium of exchange.

This applies in the first place to the function fulfilled by money *in facilitating credit transactions.* It is simplest to regard this as part of its function as medium of exchange. Credit transactions are in fact nothing but the exchange of present goods against future goods. Frequent reference is made in English and American writings to a function of money as a standard of deferred payments. But the original purpose of this expression was not to contrast a particular function of money with its ordinary economic function, but merely to simplify discussions about the influence of changes in the value of money upon the real amount of money debts. It serves this purpose admirably. But it should be pointed out that its use has led many writers to deal with the problems connected with the general economic consequences of changes in the value of money merely from the point of view of modifications in existing debt relations and to overlook their significance in all other connections.

The functions of money as a *transmitter of value through time and space* may also be directly traced back to its function as medium of exchange. Menger has pointed out that the special suitability of goods for hoarding, and their consequent widespread employment for this purpose, has been one of the most important causes of their increased marketability and therefore of their qualification as media of exchange. As soon as the practice of employing a certain economic good as a medium of exchange becomes general, people begin to store up this good in preference to others. In fact, hoarding as a form of investment plays no great part in our present stage of economic development, its place having been taken by the purchase of interest-bearing property. On the other hand, money still functions today as a means for transporting value through space. This function again is nothing but a matter of facilitating the exchange of goods. The European farmer who emigrates to America and wishes to exchange his property in Europe for a property in America, sells the former, goes to America with the money (or a bill payable in money), and there purchases his new homestead. Here we have an absolute textbook example of an exchange facilitated by money.

Particular attention has been devoted, especially in recent times, to the function of money *as a general medium of payment.* Indirect exchange divides a single transaction into two separate parts which are connected merely by the ultimate intention of the exchangers to acquire consumption goods. Sale and purchase thus apparently become independent of each other Furthermore, if the two parties to a sale-and-purchase transaction perform their respective parts of the bargain at different times, that of the seller preceding that of the buyer (purchase on credit), then the settlement of the bargain, or the fulfillment of the seller's

part of it (which need not be the same thing), has no obvious connection with the fulfillment of the buyer's part. The same is true of all other credit transactions, especially of the most important sort of credit transaction—lending. The apparent lack of a connection between the two parts of the single transaction has been taken as a reason for regarding them as independent proceedings, for speaking of the payment as an independent legal act, and consequently for attributing to money the function of being a common medium of *payment.* This is obviously incorrect. "If the function of money as an object which facilitates dealings in commodities and capital is kept in mind, a function that includes the payment of money prices and repayment of loans...there remains neither necessity nor justification for further discussion of a special employment, or even function of money, as a medium of payment."

The root of this error (as of many other errors in economics) must be sought in the uncritical acceptance of juristical conceptions and habits of thought. From the point of view of the law, outstanding debt is a subject which can and must be considered in isolation and entirely (or at least to some extent) without reference to the origin of the obligation to pay. Of course, in law as well as in economics, money is only the common medium of exchange. But the principal, although not exclusive, motive of the law for concerning itself with money is the problem of payment. When it seeks to answer the question, What is money? it is in order to determine how monetary liabilities can be discharged. For the jurist, money is a medium of payment. The economist, to whom the problem of money presents a different aspect, may not adopt this point of view if he does not wish at the very outset to prejudice his prospects of contributing to the advancement of economic theory.

CHAPTER 2

On the Measurement of Value

1

The Immeasurability of Subjective Use-Values

Although it is usual to speak of money as a measure of value and prices, the notion is entirely fallacious. So long as the subjective theory of value is accepted, this question of measurement cannot arise. In the older political economy, the search for a principle governing the measurement of value was to a certain extent justifiable. If, in accordance with an objective theory of value, the possibility of an objective concept of commodity values is accepted, and exchange is regarded as the reciprocal surrender of equivalent goods, then the conclusion necessarily follows that exchange transactions must be preceded by measurement of the quantity of value contained in each of the objects that are to be exchanged. And it is then an obvious step to regard money as the measure of value.

But modern value theory has a different starting point. It conceives of value as the significance attributed to individual commodity units by a human being who wishes to consume or otherwise dispose of various commodities to the best advantage. Every economic transaction presupposes a comparison of values. But the necessity for such a comparison, as well as the possibility of it, is due only to the circumstance that the person concerned has to choose between several commodities. It is quite irrelevant whether this choice is between a commodity in his own possession and one in somebody else's possession for which he might exchange it, or between the different uses to which he himself might put a given quantity of productive resources. In an isolated household, in which (as on Robinson Crusoe's desert island) there is neither buying nor selling, changes in the stocks of goods of higher and lower orders do nevertheless occur whenever anything is produced or consumed; and these changes must be based upon valuations if their returns are to exceed the outlay they involve. The process of valuation remains fundamentally the same whether the question is one of transforming labor and flour into bread in the domestic bakehouse, or of obtaining bread in exchange for clothes in the market. From the point of view of the person making the valuation, the calculation whether a certain act of production would justify a certain outlay of goods and labor is exactly the same as the comparison between the values of the commodities to be surrendered and the values of the commodities to be acquired that must precede an exchange transaction. For this reason it has been said that every economic act may be regarded as a kind of exchange.

Acts of valuation are not susceptible of any kind of measurement. It is true that everybody is able to say whether a certain piece of bread seems more valuable to him than a certain piece of iron or less valuable than a certain piece of meat. And it is therefore true that everybody is in a position to draw up an immense list of comparative values; a list which will hold good only for a given point of time, since it must assume a given combination of wants and commodities. If the individual's circumstances change, then his scale of values changes also.

But subjective valuation, which is the pivot of all economic activity, only arranges commodities in order of their significance; it does not measure this significance. And economic activity has no other basis than the value scales thus constructed by individuals. An exchange will take place when two commodity units are placed in a different order on the value scales of two different persons. In a market, exchanges will continue until it is no longer possible for reciprocal surrender of commodities by any two individuals to result in their each acquiring commodities that stand higher on their value scales than those surrendered. If an individual wishes to make an exchange on an economic basis, he has merely to consider the comparative significance in his

own judgment of the quantities of commodities in question. Such an estimate of relative values in no way involves the idea of measurement. An estimate is a direct psychological judgment that is not dependent on any kind of intermediate or auxiliary process.

(Such considerations also provide the answer to a series of objections to the subjective theory of value. It would be rash to conclude, because psychology has not succeeded and is not likely to succeed in measuring desires, that it is therefore impossible ultimately to attribute the quantitatively exact exchange ratios of the market to subjective factors. The exchange ratios of commodities are based upon the value scales of the individuals dealing in the market. Suppose that A possesses three pears and B two apples; and that A values the possession of two apples more than that of three pears, while B values the possession of three pears more than that of two apples. On the basis of these estimations an exchange may take place in which three pears are given for two apples. Yet it is clear that the determination of the numerically precise exchange ratio 2 : 3, taking a single fruit as a unit, in no way presupposes that A and B know exactly *by how much* the satisfaction promised by possession of the quantities to be acquired by exchange exceeds the satisfaction promised by possession of the quantities to be given up.)

General recognition of this fact, for which we are indebted to the authors of modern value theory, was hindered for a long time by a peculiar sort of obstacle. It is not altogether a rare thing that those very pioneers who have not hesitated to clear new paths for themselves and their followers by boldly rejecting outworn traditions and ways of thinking should yet shrink sometimes from all that is involved in the rigid application of their own principles. When this is so, it remains for those who come after to endeavor to put the matter right. The present is a case in point. On the subject of the measurement of value, as on a series of further subjects that are very closely bound up with it, the founders of the subjective theory of value refrained from the consistent development of their own doctrines. This is especially true of Böhm-Bawerk. At least it is especially striking in him; for the arguments of his which we are about to consider are embodied in a system that would have provided an alternative and, in the present writer's opinion, a better, solution of the problem, if their author had only drawn the decisive conclusion from them.

Böhm-Bawerk points out that when we have to choose in actual life between several satisfactions which cannot be had simultaneously because our means are limited, the situation is often such that the alternatives are on the one hand one big satisfaction and on the other hand a large number of homogeneous smaller satisfactions. Nobody will deny that it lies in our power to come to a rational decision in such cases. But it is equally clear that a judgment merely to the

effect that a satisfaction of the one sort is greater than a satisfaction of the other sort is inadequate for such a decision; as would even be a judgment that a satisfaction of the first sort is *considerably* greater than one of the other sort. Böhm-Bawerk therefore concludes that the judgment must definitely affirm how many of the smaller satisfactions outweigh one of the first sort, or in other words how many times the one satisfaction exceeds one of the others in magnitude.

The credit of having exposed the error contained in the identification of these two last propositions belongs to Cuhel. The judgment that so many small satisfactions are outweighed by a satisfaction of another kind is in fact *not* identical with the judgment that the one satisfaction is so many times greater than one of the others. The two would be identical only if the satisfaction afforded by a number of commodity units taken together were equal to the satisfaction afforded by a single unit on its own multiplied by the number of units. That this assumption cannot hold good follows from Gossen's law of the satisfaction of wants. The two judgments, "I would rather have eight plums than one apple" and "I would rather have one apple than seven plums," do not in the least justify the conclusion that Böhm-Bawerk draws from them when he states that therefore the satisfaction afforded by the consumption of an apple is more than seven times but less than eight times as great as the satisfaction afforded by the consumption of a plum. The only legitimate conclusion is that the satisfaction from one apple is greater than the total satisfaction from seven plums but less than the total satisfaction from eight plums.

This is the only interpretation that can be harmonized with the fundamental conception expounded by the marginal-utility theorists, and especially by Böhm-Bawerk himself, that the utility (and consequently the subjective use-value also) of units of a commodity decreases as the supply of them increases. But to accept this is to reject the whole idea of measuring the subjective use-value of commodities. Subjective use-value is not susceptible of any kind of measurement.

The American economist Irving Fisher has attempted to approach the problem of value measurement by way of mathematics. His success with this method has been no greater than that of his predecessors with other methods. Like them, he has not been able to surmount the difficulties arising from the fact that marginal utility diminishes as supply increases, and the only use of the mathematics in which he clothes his arguments, and which is widely regarded as a particularly becoming dress for investigations in economics, is to conceal a little the defects of their clever but artificial construction.

Fisher begins by assuming that the utility of a particular good or service, though dependent on the supply of that good or service, is independent of the supply of

all others. He realizes that it will not be possible to achieve his aim of discovering a unit for the measurement of utility unless he can first show how to determine the proportion between two given marginal utilities. If, for example, an individual has 100 loaves of bread at his disposal during one year, the marginal utility of a loaf to him will be greater than if he had 150 loaves. The problem is, to determine the arithmetical proportion between the two marginal utilities. Fisher attempts to do this by comparing them with a third utility. He therefore supposes the individual to have B gallons of oil annually as well, and calls that increment of B whose utility is equal to that of the 100th loaf of bread. In the second case, when not 100 but 150 loaves are available, it is assumed that the supply of B remains unchanged. Then the utility of the 150th loaf may be equal, say, to the utility of b/2. Up to this point it is unnecessary to quarrel with Fisher's argument; but now follows a jump that neatly avoids all the difficulties of the problem. That is to say, Fisher simply continues, as if he were stating something quite self-evident: "Then the utility of the 150th loaf is said to be half the utility of the 100th." Without any further explanation he then calmly proceeds with his problem, the solution of which (if the above proposition is accepted as correct) involves no further difficulties, and so succeeds eventually in deducing a unit which he calls a "util." It does not seem to have occurred to him that in the particular sentence just quoted he has argued in defiance of the whole of marginal-utility theory and set himself in opposition to all the fundamental doctrines of modern economics. For obviously this conclusion of his is legitimate only if the utility of b is equal to twice the utility of b/2. But if this were really so, the problem of determining the proportion between two marginal utilities could have been solved in a quicker way, and his long process of deduction would not have been necessary. Just as justifiably as he assumes that the utility of is equal to twice the utility of b/2, he might have assumed straightaway that the utility of the 150th loaf is two-thirds of that of the 100th.

Fisher imagines a supply of B gallons that is divisible into n small quantities b, or 2*n* small quantities b/2. He assumes that an individual who has this supply B at his disposal regards the value of commodity unit *x* as equal to that of b and the value of commodity unit *y* as equal to that of b/2. And he makes the further assumption that in both valuations, that is, both in equating the value of *x* with that of b and in equating the value of *y* with that of b/2, the individual has the same supply of B gallons at his disposal.

He evidently thinks it possible to conclude from this that the utility of b is twice as great as that of b/2. The error here is obvious. The individual is in the one case faced with the choice between *x* (the value of the 100th loaf) and b = 2b/2. He finds it impossible to decide between the two, i.e., he values both equally. In the second case he has to choose between *y* (the value of the 150th loaf) and b/2.

Here again he finds that both alternatives are of equal value. Now the question arises, what is the proportion between the marginal utility of b and that of b/2? We can determine this only by asking ourselves what the proportion is between the marginal utility of the *n*th part of a given supply and that of the 2*n*th part of the same supply, between that of b/*n* and that of b/2*n*. For this purpose let us imagine the supply B split up into 2*n* portions of b/2*n*. Then the marginal utility of the (2*n*-1)th portion is greater than that of the 2*n*th portion. If we now imagine the same supply B divided into *n* portions, then it clearly follows that the marginal utility of the nth portion is equal to that of the (2*n*-1)th portion plus that of the 2*n*th portion in the previous case. It is not twice as great as that of the 2*n*th portion, but more than twice as great. In fact, even with an unchanged supply, the marginal utility of several units taken together is not equal to the marginal utility of one unit multiplied by the number of units, but necessarily greater than this product. The value of two units is greater than, but not twice as great as, the value of one unit.

Perhaps Fisher thinks that this consideration may be disposed of by supposing b and b/2 to be such small quantities that their utility may be reckoned infinitesimal. If this is really his opinion, then it must first of all be objected that the peculiarly mathematical conception of infinitesimal quantities is inapplicable to economic problems. The utility afforded by a given amount of commodities, is either great enough for valuation, or so small that it remains imperceptible to the valuer and cannot therefore affect his judgment. But even if the applicability of the conception of infinitesimal quantities were granted, the argument would still be invalid, for it is obviously impossible to find the proportion between two finite marginal utilities by equating them with two infinitesimal marginal utilities.

Finally, a few words must be devoted to Schumpeter's attempt to set up as a unit the satisfaction resulting from the consumption of a given quantity of commodities and to express other satisfactions as multiples of this unit. Value judgments on this principle would have to be expressed as follows: "The satisfaction that I could get from the consumption of a certain quantity of commodities is a thousand times as great as that which I get from the consumption of an apple a day," or "For this quantity of goods I would give at the most *a thousand times this apple."* Is there really anybody on earth who is capable of adumbrating such mental images or pronouncing such judgments? Is there any sort of economic activity that is actually dependent on the making of such decisions? Obviously not. Schumpeter makes the same mistake of starting with the assumption that we need a measure of value in order to be able to compare one "quantity of value" with another. But valuation in no way consists in a comparison of two "quantities of value." It consists solely in a comparison

of the importance of different wants. The judgment "Commodity *a* is worth more to me than commodity *b"* no more presupposes a measure of economic value than the judgment *"A* is dearer to me—more highly esteemed—than *B"* presupposes a measure of friendship.

2

Total Value

If it is impossible to measure subjective use-value, it follows directly that it is impracticable to ascribe "quantity" to it. We may say, the value of this commodity is greater than the value of that; but it is not permissible for us to assert, this commodity is worth *so much.* Such a way of speaking necessarily implies a definite unit. It really amounts to stating how many times a given unit is contained in the quantity to be defined. But this kind of calculation is quite inapplicable to processes of valuation.

The consistent application of these principles implies a criticism also of Schumpeter's views on the total value of a stock of goods. According to Wieser, the total value of a stock of goods is given by multiplying the number of items or portions constituting the stock by their marginal utility at any given moment. The untenability of this argument is shown by the fact that it would prove that the total stock of a free good must always be worth nothing. Schumpeter therefore suggests a different formula in which each portion is multiplied by an index corresponding to its position on the value scale (which, by the way, is quite arbitrary) and these products are then added together or integrated. This attempt at a solution, like the preceding, has the defect of assuming that it is possible to measure marginal utility and "intensity" of value. The fact that such measurement is impossible renders both suggestions equally useless. Mastery of the problem must be sought in some other way.

Value is always the result of a process of valuation. The process of valuation compares the significance of two complexes of commodities from the point of view of the individual making the valuation. The individual making the valuation and the complexes of goods valued, that is, the subject and the objects of the valuation, must enter as indivisible elements into any given process of valuation. This does not mean that they are necessarily indivisible in other respects as well, whether physically or economically. The subject of an act of valuation may quite well be a group of persons, a state or society or family, so long as it acts in this particular case as a unit, through a representative. And the objects thus valued may be collections of distinct units of commodities so long as they have to be dealt with in this particular case as a whole. There is nothing to prevent either subject or object from being a single unit for the purposes of one valuation even though in another their component parts may be entirely independent of each other The same people who, acting together through a

representative as a single agent, such as a state, make a judgment as to the relative values of a battleship and a hospital, are the independent subjects of valuations of other commodities, such as cigars and newspapers. It is just the same with commodities. Modern value theory is based on the fact that it is not the abstract importance of different kinds of need that determines the scales of values, but the intensity of specific desires. Starting from this, the law of marginal utility was developed in a form that referred primarily to the usual sort of case in which the collections of commodities are divisible. But there are also cases in which the total supply must be valued as it stands.

Suppose that an economically isolated individual possesses two cows and three horses and that the relevant part of his scale of values (that item valued highest being placed first) is as follows: 1, a cow; 2, a horse; 3, a horse; 4,a horse; 5, a cow. If this individual has to choose between one cow and one horse he will rather be inclined to sacrifice the cow than the horse. If wild animals attack one of his cows and one of his horses, and it is impossible for him to save both, then he will try to save the horse. But if the whole of his stock of either animal is in danger, his decision will be different. Supposing that his stable and cowshed catch fire and that he can only rescue the occupants of one and must leave the others to their fate, then if he values three horses less than two cows he will attempt to save not the three horses but the two cows. The result of that process of valuation which involves a choice between one cow and one horse is a higher estimation of the horse. The result of the process of valuation which involves a choice between the whole available stock of cows and the whole available stock of horses is a higher estimation of the stock of cows.

Value can rightly be spoken of only with regard to specific acts of appraisal. It exists in such connections only; there is no value outside the process of valuation. There is no such thing as abstract value. Total value can be spoken of only with reference to a particular instance of an individual or other valuing "subject" having to choose between the total available quantities of certain economic goods. Like every other act of valuation, this is complete in itself. The person making the choice does not have to make use of notions about the value of units of the commodity. His process of valuation, like every other, is an immediate inference from considerations of the utilities at stake. When a stock is valued as a whole, its marginal utility, that is to say, the utility of the last available unit of it, coincides with its total utility, since the total supply is one indivisible quantity. This is also true of the total value of free goods, whose separate units are always valueless, that is, are always relegated to a sort of limbo at the very end of the value scale, promiscuously intermingled with the units of all the other free goods.

Money as a Price Index

What has been said should have made sufficiently plain the unscientific nature of the practice of attributing to money the function of acting as a measure of price or even of value. Subjective value is not measured, but graded. The problem of the measurement of objective use-value is not an economic problem at all. (It may incidentally be remarked that a measurement of efficiency is not possible for every species of commodity and is at the best only available within separate species, while every possibility, not only of measurement, but even of mere scaled comparison, vanishes as soon as we seek to establish a relation between two or more kinds of efficiency. It may be possible to measure and compare the calorific value of coal and of wood, but it is in no way possible to reduce to a common objective denominator the objective efficiency of a table and that of a book.)

Neither is objective exchange value measurable, for it too is the result of the comparisons derived from the valuations of individuals. The objective exchange value of a given commodity unit may be expressed in units of every other kind of commodity. Nowadays exchange is usually carried on by means of money, and since every commodity has therefore a price expressible in money, the exchange value of every commodity can be expressed in terms of money. This possibility enabled money to become a medium for expressing values when the growing elaboration of the scale of values which resulted from the development of exchange necessitated a revision of the technique of valuation.

That is to say, opportunities for exchanging induce the individual to rearrange his scales of values. A person in whose scale of values the commodity “a cask of wine” comes after the commodity “a sack of oats” will reverse their order if he can exchange a cask of wine in the market for a commodity that he values more highly than a sack of oats. The position of commodities in the value scales of individuals is no longer determined solely by their own subjective use-value, but also by the subjective use-value of the commodities that can be obtained in exchange for them, whenever the latter stand higher than the former in the estimation of the individual. Therefore, if he is to obtain the maximum utility from his resources, the individual must familiarize himself with all the prices in the market.

For this, however, he needs some help in finding his way among the confusing multiplicity of the exchange ratios. Money, the common medium of exchange, which can be exchanged for every commodity and with which every commodity can be procured, is preeminently suitable for this. It would be absolutely impossible for the individual, even if he were a complete expert in commercial matters, to follow every change of market conditions and make the corresponding alterations in his scale of use-values and exchange values, unless

he chose some common denominator to which he could reduce each exchange ratio. Because the market enables any commodity to be turned into money and money into any commodity, objective exchange value is expressed in terms of money. Thus money becomes a price index, in Menger's phrase. The whole structure of the calculations of the entrepreneur and the consumer rests on the process of valuing commodities in money. Money has thus become an aid that the human mind is no longer able to dispense with in making economic calculations. If in this sense we wish to attribute to money the function of being a measure of prices, there is no reason why we should not do so. Nevertheless, it is better to avoid the use of a term which might so easily be misunderstood as this. In any case the usage certainly cannot be called correct—we do not usually describe the determination of latitude and longitude as a "function" of the stars.

4. Demand of Money: Concepts & Approaches

The Demand for Money

The demand for money is affected by several factors, including the level of income, interest rates, and inflation as well as uncertainty about the future. The way in which these factors affect money demand is usually explained in terms of the three motives for demanding money: the **transactions**, the **precautionary**, and the **speculative** motives.

Transactions motive. The **transactions motive** for demanding money arises from the fact that most transactions involve an exchange of money. Because it is necessary to have money available for transactions, money will be demanded. The total number of transactions made in an economy tends to increase over time as income rises. Hence, as income or GDP rises, the **transactions demand** for money also rises.

Precautionary motive. People often demand money as a *precaution* against an uncertain future. Unexpected expenses, such as medical or car repair bills, often require *immediate payment.* The need to have money available in such situations is referred to as the **precautionary motive** for demanding money.

Speculative motive. Money, like other stores of value, is an asset. The demand for an asset depends on both its **rate of return** and its **opportunity cost.** Typically, money holdings provide *no* rate of return and often depreciate in value due to inflation. The opportunity cost of holding money is the interest rate that can be earned by lending or investing one's money holdings. The **speculative motive** for demanding money arises in situations where holding money is perceived to be *less risky* than the alternative of lending the money or investing it in some other asset.

For example, if a stock market crash seemed imminent, the speculative motive for demanding money would come into play; those expecting the market to crash would sell their stocks and hold the proceeds as money. The presence of a

speculative motive for demanding money is also affected by *expectations of future interest rates and inflation.* If interest rates are expected to rise, the opportunity cost of holding money will become greater, which in turn diminishes the speculative motive for demanding money. Similarly, expectations of higher inflation presage a greater depreciation in the purchasing power of money and therefore lessen the speculative motive for demanding money.

Approaches to Demand

1. The Classical Approach
2. The Keynesian Approach or Liquidity Preference

The above are the two approaches for ascertaining the demand for money.

1. **The Classical Approach**

The classical economists did not unambiguously devise demand for money thesis but their outlooks are intrinsic in the volume of thesis of money. They highlighted the transactions demand for money of exchange and smooth the progress of the exchange of goods and services. In Fisher's Equation of Exchange,

MV = PT

Where M is the total volume of money, V is its velocity of circulation, P is the price level and T is the aggregate amount of goods and services exchanged for money.

The right hand side of this equation PT represents the demand for money which actually based on the value of the transactions. MV represents the supply of money which is specified and in symmetry parities the demand for money. Thus the equation becomes

MV = PT

This transaction demand for money, in turn is ascertained by the level of full employment earnings. This is due to the classicists assumed in Say's Law whereby supply created its own demand, presuming the full employment level of earnings. Thus the demand for money in Fisher's approach is invariable ration of the level of transactions which in turn abides an invariable association to the level of national earnings. Moreover, the demand for money is connected to the quantity of business going on in a fiscal system at any point of time. Therefore, its underlying hypothesis is that people keep money to buy goods.

However, people also keep money for other causes such as to earn interest and to provide against unanticipated proceedings. It is therefore, not feasible to say that V will remain invariable where, M is variable. The most significant thing about money in Fisher's Thesis is that it is shift able.

However, it does not describe fully why people possess money. It does not elucidate whether to add as money such items as time deposits or savings

deposits that are not right away accessible to pay debts without first being rehabilitated into currency.

Cambridge Demand Equation for money is as follows:

$$Md = kPY$$

Where Md is the demand for money which should parity the supply of money (Md = Ms) in symmetry in the fiscal system. k is the fraction of the actual money earnings (PY) which people wish to keep in cash and demand deposits or the ratio of money stock to earnings, P is the price level and Y is the aggregate actual earnings.

This equation tells us that "other things being equal, the demand for money in normal terms would be in ration to the nominal level of earnings for each individual and hence for the total fiscal system as well."

5. Supply of Money:

Investopedia explains 'Money Supply'

The various types of money in the money supply are generally classified as "M"s such as M0, M1, M2 and M3, according to the type and size of the account in which the instrument is kept. Not all of the classifications are widely used, and each country may use different classifications. M0 and M1, for example, are also called narrow money and include coins and notes that are in circulation and other money equivalents that can be converted easily to cash. M2 included M1 and, in addition, short-term time deposits in banks and certain money market funds.

An increase in the supply of money typically lowers interest rates, which in turns generates more investment and puts more money in the hands of consumers, thereby stimulating spending. Businesses respond by ordering more raw materials and increasing production. The increased business activity raises the demand for labor. The opposite can occur if the money supply falls or when its growth rate declines.

7**. Quantity theory of money:**

Definition of 'Quantity Theory Of Money'

The Quantity Theory of Money was first developed by Irving Fisher in the inter-war years as is a basic theoretical explanation for the link between money and the general price level. The quantity theory rests on what is sometimes known as the **Fisher identity** or the **equation of exchange**. This is an identity which relates total aggregate demand to the total value of output (GDP).

$$M \times V = P \times Y$$

Where

1. M is the money supply
2. V is the velocity of circulation of money

3. P is the general price level
4. Y is the real value of national output (i.e. real GDP)

The **velocity of circulation** represents the number of times that a unit of currency (for example a £10 note) is used in a given period of time when used as a medium of exchange to buy goods and services. The velocity of circulation can be calculated by dividing the money value of national output by the money supply.

In the **basic theory of monetarism** expressed using the **equation of exchange**, we assume that the velocity of circulation of money is predictable and therefore treated as a constant. We also make a working assumption that the real value of GDP is not influenced by monetary variables. For example the growth of a country's productive capacity might be determined by the rate of productivity growth or an increase in the capital stock. We might therefore treat Y (real GDP) as a constant too.If V and Y are treated as constants, then changes in the rate of growth of the money supply will equate to changes in the general price level. Monetarists believe that the direction of causation is from money to prices . So it can be said that An economic theory which proposes a positive relationship between changes in the money supply and the long-term price of goods. It states that increasing the amount of money in the economy will eventually lead to an equal percentage rise in the prices of products and services. The calculation behind the quantity theory of money is based upon Fisher Equation:This theory originated in the sixteenth century as European economists noticed higher levels of inflation associated with importing gold or silver from the Americas. According to how the formula is derived, holding the transaction volume and velocity of money constant, any increases in the money supply will yield a proportional increase in the average price level.The experience of targeting the growth of the money supply as part of the monetarist experiment during the 1980s and early 1990s is that the velocity of circulation is not predictable – indeed it can suddenly change, partly as a result of changes to people's behaviour in their handling of money. During the 1980s it was found that direct and predictable links between the growth of the money supply and the rate of inflation broke down. This eventually caused central banks in different countries to place less importance on the money supply as a target of monetary policy. Instead they switched to having exchange rate targets, and latterly they have become devotees of **inflation targets** as an anchor for the direction of monetary policy.

Measuring the money supply

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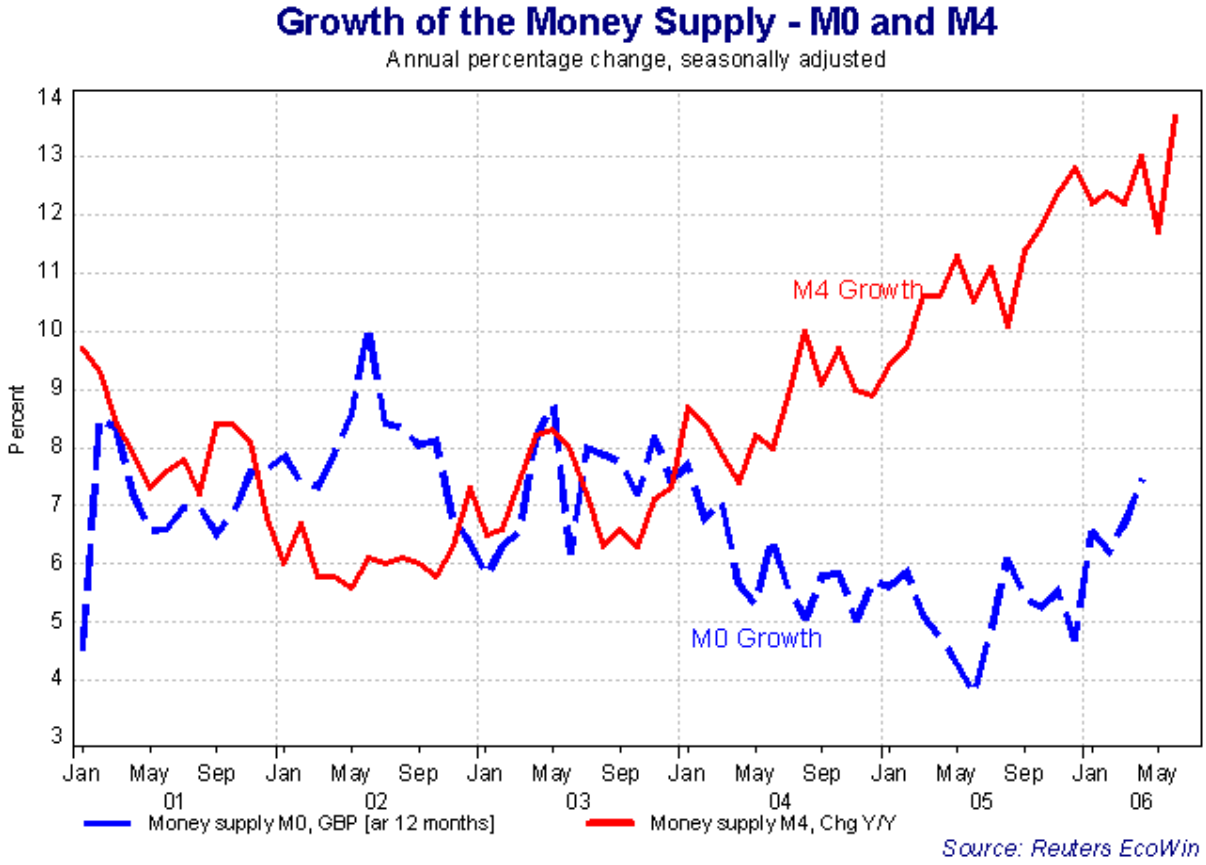

Source: Reuters EcoWin

There is no unique measure of the money supply because it is used in such a wide variety of ways: **M0 (Narrow money)** - comprises notes and coins in circulation banks' operational balances at the Bank of England. Over 99% of M0 is made up of notes and coins as cash is used mainly as a medium of exchange for buying goods and services. Most economists believe that changes in the amount of cash in circulation have little significant effect on total national output and inflation. At best M0 is seen as a co-incident indicator of consumer spending and retail sales. If people increase their cash balances, it is mainly a sign that they are building up these balances to fund short term increases in spending. M0 reflects changes in the economic cycle, but does not cause them. **M4 (Broad money)** is a wider definition of what constitutes money. M4 includes deposits saved with banks and building societies and also money created by lending in the form of loans and overdrafts. M4 = M0 plus sight (current accounts) and time deposits (savings accounts). When a bank or another lender grants a loan to a customer, bank liabilities and assets raise by the same amount and so does the money supply. Again M4 is a useful background indicator to the strength of demand for credit. The Bank takes M4 growth into account when assessing overall monetary conditions, but it is not used as an intermediate target of monetary policy. Its main value is as a signpost

of the strength of demand which can then filter through the economy and eventually affect inflationary pressure.

This explanation of the effect of changes in the quantity of money in a country upon prices (the general scale of prices) is known as the quantity theory of money. This theory has, for a century, been very generally accepted by competent students of the money problem. It may be summed up thus: other things being equal, the value of the monetary unit, expressed in terms of all other commodities, falls as the quantity of money increases, and vice versa. That is, prices rise and fall in direct proportion to changes in the total quantity. This is a simple explanation of a complex and difficult set of conditions. The phrase, "other things being equal," betokens the statement of a tendency where there are several factors. The quantity theory explains what happens when there is a change in one of the factors - the number of pieces of money. There are three large sets of facts to be brought into relationship with each other in the quantity theory:

(1) the amount of business, or the number of trades effected;

(2) the rapidity of circulation, depending on the methods by which business is done; (3) the amount of money available. According to the quantity theory, we must expect that, when conditions (1) and (2) remain fixed, prices (the general price level) will vary directly, and the value of money will vary inversely as the quantity of money. This quantity theory may be expressed in the formula P = M/R when MR N P is the symbol for price, or the general price level, N is (1) above, R is (2), and M is (3). P, therefore, changes directly with either M or R, or inversely with N.4

Interpretation of the quantity theory. The quantity theory must be carefully interpreted to avoid various misunderstandings of it that have appeared again and again in economic discussion.

(1) It does not mean that the price level changes with the absolute quantity of money, independently of growth of population and of the corresponding growth in the volume of exchanges.

(2) It is not a mere per capita rule to be applied at a certain moment to different countries. For example, Mexico may have $9 per capita and the United States $35, while average prices may not differ in anything like that proportion. But in these two countries not only the amounts of exchanges per capita but the methods of exchange and the rapidity of the circulation of money differ greatly.5

(3) It cannot be applied as a per capita rule to the same country through a series of years, without taking account of the many changing factors. It is estimated that in 1800 the money stock was about $5 per capita in the United

States, and in 1914 about $35 6 but average prices have not necessarily changed in the same ratio. In a period of years a country may change in a multitude of ways, in complexity of industry, modes of exchange, transportation, wealth, and income. These changes require some larger, others smaller, per capita amounts of money to maintain the same level of prices. For example, the substitution of cash payments for book-credit in retail trade is equivalent to increasing N in the formula; whereas an increased use of banks and checking accounts, by economizing the use of money, enables a smaller amount of money to maintain the same level, and may be considered as increasing R in the formula.
Practical application of the quantity theory. Despite the number of changing factors affecting the methods of exchange and the amount of business, the quantity theory is a rule usable at any moment. These various factors change slowly, and the quantity theory answers the question: What general change occurs in prices as a result of the increase or decrease of the money in a given community at a given moment? Like the law of gravitation and the law of projectiles, the theory must be interpreted with relation to actual conditions.

8. **Inflation and its Control**
In simple words inflation means standard index used to measure the rise in the general price during a particular period of time of an economy for goods and services.
Inflation means a considerable and persistent rise in the general level of prices of goods and services in an economy over a period of time.

Inflation has been defined in several ways by different economists.

According to Keynes, 'Inflation is the form of taxation which the public finds hardest to evade.'

According to Samuelson, 'Inflation denotes a rise in general level of prices'.

According to Milton Friedman, 'Inflation is always and everywhere a monetary phenomenon.'
According to Gregory,` it is an increase in the quantity of purchasing power`.
Johnson defines inflation,` as the increase in the quantity of money faster than the national output is expanding`

Inflation can be described as a decline in the real value of money—a loss of purchasing power in the medium of exchange. When the general price level rises, each unit of currency buys fewer goods and services.

In simple terms, inflation is a situation where too much money chases too few goods .

Types of Inflation

There are different types inflation which are explained below:

Creeping Inflation: This is also known as mild inflation or moderate inflation. This type of inflation occurs when the price level persistently rises over a period of time at a mild rate. When the rate of inflation is less than 10 per cent annually, or it is a single digit inflation rate, it is considered to be a moderate inflation.

Galloping Inflation: If mild inflation is not checked and if it is uncontrollable, it may assume the character of galloping inflation. Inflation in the double or triple digit range of 20, 100 or 200 percent a year is called galloping inflation . Many Latin American countries such as Argentina, Brazil had inflation rates of 50 to 700 percent per year in the 1970s and 1980s.

Hyperinflation: It is a stage of very high rate of inflation. While economies seem to survive under galloping inflation, a third and deadly strain takes hold when the cancer of hyperinflation strikes. Nothing good can be said about a market economy in which prices are rising a million or even a trillion percent per year . Hyperinflation occurs when the prices go out of control and the monetary authorities are unable to impose any check on it. Germany had witnessed hyperinflation in 1920's.

Stagflation: It is an economic situation in which inflation and economic stagnation or recession occur simultaneously and remain unchecked for a period of time. Stagflation was witnessed by developed countries in 1970s, when world oil prices rose dramatically.

Deflation: Deflation is the reverse of inflation. It refers to a sustained decline in the price level of goods and services. It occurs when the annual inflation rate falls below zero percent (a negative inflation rate), resulting in an increase in the real value of money. Japan suffered from deflation for almost a decade in 1990s

There are broadly two ways of controlling inflation in an economy:

1). Monetary measures and

2). Fiscal measures

I).Monetary Measures

The most important and commonly used method to control inflation is monetary policy of the Central Bank. Most central banks use high interest rates as the traditional way to fight or prevent inflation. Classical economists are of the view that inflation can be checked by controlling the supply of money. Some of the important monetary measures to check the inflation are as under: Control over money- It is suggested that to check inflation government should put strict restrictions on the issue of money by the central bank. Credit control- Central bank should pursue credit control policy .In order to control the credit it should increase the bank rate ,raise minimum cash reserve ratio etc. It can also issue notice to other banks in order to control credit

Monetary measures used to control inflation include:

(i) bank rate policy
(ii) cash reserve ratio and
(iii) open market operations.

Bank rate policy is used as the main instrument of monetary control during the period of inflation. When the central bank raises the bank rate, it is said to have adopted a dear money policy. The increase in bank rate increases the cost of borrowing which reduces commercial banks borrowing from the central bank. Consequently, the flow of money from the commercial banks to the public gets reduced. Therefore, inflation is controlled to the extent it is caused by the bank credit.

Cash Reserve Ratio (CRR) : To control inflation, the central bank raises the CRR which reduces the lending capacity of the commercial banks. Consequently, flow of money from commercial banks to public decreases. In the process, it halts the rise in prices to the extent it is caused by banks credits to the public.

Open Market Operations: Open market operations refer to sale and purchase of government securities and bonds by the central bank. To control inflation, central bank sells the government securities to the public through the banks. This results in transfer of a part of bank deposits to central bank account and

reduces credit creation capacity of the commercial banks.

II). Fiscal Measures

Measures taken by the government to control inflation. A: Decrease in public expenditure- One of the main reasons of inflation is excess public expenditure like building of roads ,bridges etc. Government should drastically scale down its non essential expenditure . B-Delay in payment of old debts: Payment of old debts that fall due should be postponed for sometime so that people may not acquire extra purchasing power. C-Increase in taxes : Government should levy some new direct taxes and raise rates of old taxes. D-Over valuation of money : To control the over valuation of money it is essential to encourage imports and discourage exports Fiscal measures to control inflation include taxation, government expenditure and public borrowings. The government can also take some protectionist measures (such as banning the export of essential items such as pulses, cereals and oils to support the domestic consumption, encourage imports by lowering duties on import items etc.).

Other measures:1 Increase in the production- One of the major causes of the inflation is the excess of demand over supply ,so those goods should be produced more whose prices are likely to rise rapidly .In order to increase production public sector should be expanded and private sector should be given more incentives. 2 Proper commercial policy- Those goods which are in scarcity should be imported as much as possible from other countries and their export should be discouraged. 3 Encouragement to savings – During inflation government should come out with attractive saving schemes. It may issue 5 or 10 year bonds in order to attract savings.

4 Proper investment policy- Investment in those industries should be increased wherein more production of goods can be generated over a short period of time .Less investment should be made in industries having long production period. 5 Marginal requirements- It is the difference between the value of security and loan advanced .

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Unit 2

Evolution of Banking

The Evolution of Banking begins with the first prototype banks of traders of the ancient world, which made grain loans to farmers and traders who carried goods between cities. This began around 2000 BC in Assyria and Babylonia. Later, in ancient Greece and during the Roman Empire, lenders based in temples made loans and added two important innovations: they accepted deposits and changed money. Archaeology from this period in ancient China and India and, also shows evidence of money lending activity.

The original banks were merchant banks that Italian grain merchants first invented in the Middle Ages. As Lombardy merchants and bankers grew in stature based on the strength of the Lombard plains cereal crops, many displaced Jews fleeing Spanish persecution were attracted to the trade. They brought with them ancient practices from the Middle and Far East silk routes. Originally intended to finance long trading journeys, they applied these methods to finance grain production and trading.

Jews could not hold land in Italy, so they entered the great trading piazzas and halls of Lombardy, alongside local traders, and set up their benches to trade in crops. They had one great advantage over the locals. Christians were strictly forbidden the sin of usury, defined as lending at interest (Islam makes similar condemnations of usury). The Jewish newcomers, on the other hand, could lend to farmers against crops in the field, a high-risk loan at what would have been considered usurious rates by the Church; but the Jews were not subject to the Church's dictates.[*citation needed*] In this way they could secure the grain-sale rights against the eventual harvest. They then began to advance payment against the future delivery of grain shipped to distant ports. In both cases they made their profit from the present discount against the future price. This two-handed trade was time-consuming and soon there arose a class of merchants who were trading grain debt instead of grain.

The Jewish trader performed both financing (credit) and underwriting (insurance) functions. Financing took the form of a crop loan at the beginning of the growing season, which allowed a farmer to develop and manufacture (through seeding, growing, weeding, and harvesting) his annual crop. Underwriting in the form of a crop, or commodity, insurance guaranteed the delivery of the crop to its buyer, typically a merchant wholesaler. In addition,

traders performed the merchant function by making arrangements to supply the buyer of the crop through alternative sources—grain stores or alternate markets, for instance—in the event of crop failure. He could also keep the farmer (or other commodity producer) in business during a drought or other crop failure, through the issuance of a crop (or commodity) insurance against the hazard of failure of his crop.

Merchant banking progressed from financing trade on one's own behalf to settling trades for others and then to holding deposits for settlement of "billette" or notes written by the people who were still brokering the actual grain. And so the merchant's "benches" (*bank* is derived from the Italian for bench, *banca*, as in a counter) in the great grain markets became centers for holding money against a bill (*billette*, a note, a letter of formal exchange, later a bill of exchange and later still a cheque).

These deposited funds were intended to be held for the settlement of grain trades, but often were used for the bench's own trades in the meantime. The term bankrupt is a corruption of the Italian *banca rotta*, or broken bench, which is what happened when someone lost his traders' deposits. Being "broke" has the same connotation.

Development of central banking

The Bank of Amsterdam became a model for the functioning of a bank in the capacity of monetary exchange and started the development of central banks.[189] The first such bank was the Sveriges Riksbank, established in 1668.[190] This was followed by the Bank of England which was established in 1694 and was initially founded specifically to assist the English government in funding the continued war against France.

However it was during the 18th century that important developments occurred that led to development in the role of central banks. In London the Bank of England had a monopoly over corporate banking, and even large partnerships were prohibited. But private banks, though relatively small, personal enterprises, continued to find profitable business in discounting merchants' bills. In the latter half of the century small banks in country towns grew rapidly in number and needed "correspondent" banks in London with which they could deposit and invest funds. The London banks in turn settled accounts in Bank of England notes, and by the end of the century many kept their own deposit accounts with the Bank of England.

World Bank and the development of payment technology

During the post second world war period and with the introduction of the Bretton Woods system in 1944, two organizations were created: the International Monetary Fund (IMF) and the World Bank. Encouraged by these

institutions, commercial banks started to lend to sovereign states in the third world. This was at the same time as inflation started to rise in the west. The Gold standard was eventually abandoned in **1971** and a number of the banks were caught out and became bankrupt due to third world country debt defaults.

Structure of banking

The bank traces its ancestry to British India, through the Imperial bank of India to the founding in 1806 of the Bank of Calcutta, making it the oldest commercial bank in the Indian subcontinent. Bank of Madras merged into the other two presidency banks—Bank of Calcutta and Bank of Bombay—to form the Imperial Bank of India, which in turn became the State Bank of India. The government of India nationalised the Imperial Bank of India in 1955, with the RBI taking a 60% stake, and renamed it the State Bank of India. In 2008, the government took over the stake held by the Reserve Bank of India.

The State Bank of India is the largest of the Big Four banks of India, along with ICICI Bank, Punjab National Bank and HDFC Bank—its main competitors.
List of banks in India
Nationalized Banks:As of now, there are 25 Nationalized Banks in India:
1) State Bank of India
2) State Bank of Bikaner & Jaipur
3) State Bank of Hyderabad
4) State Bank of Mysore
5) State Bank of Patiala
6) State Bank of Travancore
7) Allahabad Bank
8) Andhra Bank
9) Bank of Baroda
10) Bank of India
11) Bank of Maharashtra
12) Canara Bank
13) Central Bank of India
14) Corporation Bank
15) Dena Bank
16) Indian Bank
17) Indian Overseas Bank

18) Oriental Bank of Commerce
19) Punjab National Bank
20) Punjab and Sind Bank
21) Syndicate Bank
22) Uco Bank
23) United Bank of India
24) Union Bank of India
25) Vijaya Bank

Old Private Sector Banks/Societies

- Catholic Syrian Bank
- City Union Bank
- Dhanlaxmi Bank
- Federal Bank
- Jammu & Kashmir Bank
- Karnataka Bank
- Karur Vysya Bank
- Lakshmi Vilas Bank
- Nainital Bank
- South Indian Bank
- Tamilnad Mercantile Bank
- Bank of Rajasthan merged with ICICI Bank in 2010.
- Saraswat Bank

New private sector banks

- HDFC Bank
- ICICI Bank
- Axis Bank
- IndusInd Bank
- ING Vysya Bank
- Kotak Mahindra Bank
- Yes Bank

Foreign banks operating in India

- ABN AMRO Bank N.V. (Now merged with RBS)
- Abu Dhabi Commercial Bank
- American Express Bank
- Australia and New Zealand Bank
- Bank Internasional Indonesia
- Bank of America NA
- Bank of Bahrain and Kuwait
- Bank of Ceylon
- Bank of Nova Scotia (Scotia Bank)

- Bank of Tokyo Mitsubishi UFJ
- Barclays Bank PLC
- BNP Paribas
- Calyon Bank
- Chinatrust Commercial Bank
- Citibank N.A.
- Credit Suisse
- DBS Bank
- DCB Bank now RHB Bank
- Deutsche Bank AG
- FirstRand Bank
- HSBC
- JPMorgan Chase Bank
- Krung Thai Bank
- Mashreq Bank psc
- Mizuho Corporate Bank
- Royal Bank of Scotland
- Shinhan Bank
- Société Générale
- Sonali Bank
- Standard Chartered Bank
- State Bank of Mauritius
- UBS
- VTB

Mixed banking

Certain banks undertake both commercial and industrial banking. This system knows as mixed banking. The feature of mixed banking is to attract deposits and raise capital and loans from the public and make them available to industries for both short and long periods. The traditional view of banking was that commercial bank should strictly confine themselves to short term lending and maintain a high degree of liquidity as they are traders in other's deposits. But banks in some European countries activity lend to industries for long term and subscribe to share capital of new companies. Such banks in Germany are known as universal bank or mixed banks as they combine commercial banking with industrial finance

The need for mixed banking

1. The need for industrial revival was felt both by the government and the banks. Many industrial units to which the banks had supplied short-term loans were not in a position to repay. So the bank took a wise step to take debentures of such companies in view of short-term loans instead of writing them off

2. The deposits of commercial banks were fast increasing it was advisable for the banks to advance loans for long periods

3. The growth of big industries led to a decrease in the dependence of bank finance as they built up their own surplus funds to supplement their working capital. Thus banks were deprived of their best customers. So they were compelled to grant long-term loans to big industries and gradually start holding industrial securities

4. The government policy was for quick industrialization in countries like Germany and Japan. Bank undertook the responsibility of supplying long-term finance to industries for speedy industrialization

5. Stock exchange was increased for the marketability of securities of joint stock companies. The bank companies as they could sell them in the stock exchange at any time and convert them into cash.

Merits of mixed banking

1. It grants short-term loans for the purchase of raw materials and the payment of wages and salaries and also grants long term loans for the purchase of plant and machinery and other assets. Thus an industrial concern need not go to different types of banks for its different types of requirements.

2. A commercial bank raises large funds from the public by way of deposits. Many people do not like to subscribe shares and debentures of the industrial banks because they prefer to keep their money in various deposits. Thus if a commercial bank undertakes industrial banking, it will have large funds to provide substantial aid to industries.

3. A mixed bank appoints experts to access the soundness of industrial unit and to evaluate its securities. It can provide various other services to the industrial undertaking like management of capital issues. On the basis of the advice given by the experts it can subscribe to the shares and debentures of the companies and can appoint its nominees on their board of directors.

4. The banks can join together into groups to share the risk of industrial finance. The mixed bank s followed this practice and appointed their men on the board of directors of companies. This helps the banks to have personal knowledge of the working of the industrial enterprises.

5. Mixed bank provides valuable advice to its customers on investments in shares and debentures since it has a personal knowledge of the working of number industrial organizations. Thus mixed banking stimulates capital formation in the country.

6. Mixed banking facilities industrialization in developing countries. It does so by providing both short term and long-term financial accommodation.

Demerits of Mixed banking

1. It reduces liquidity of the bank. A large part of the funds of the bank is raised from deposits, which are repayable either on demand or after a short period.

2. When a bank grants long-term loans, its funds are locked up and consequently it may not be able to pay the depositors when they demand back their money.

3. During periods of depression, banks suffer heavy losses when the securities of companied lose their value because of fall in demand for the sale of securities held by it. Banks with poor reserves may fail. This is a serious drawback of mixed banking.

4. During periods of boom, banks are tempted to over invest their funds in industries beyond safe limits. The bank may indulge into speculation of shares in the hope of earning higher profits. This carries great results into huge losses.

Thus the system of mixed banking has serious evils despite the fact that it has several advantages. Many banks failed in France, America and other countries due to industrial finance. The central bank of the country must be strong enough to guide and control the operations of the mixed banks. In countries like India, mixed banking should be under taken with great care.

In a nutshell it is a system of banking under which commercial banks provide both short and long-term loans for commerce and industries.

Trade requires both short term loans whereas industries requires short and long term loans. Under the mixed banking system the commercial banks meet the short as well as long term requirements of industries. Therefore, it is know as mixed banking. The German banking system falls under this category. They are also referred to as universal banks.

The banks help the industrial units to appoint experts in various departments. There is efficiency and economy in the operations. These banks also help the companies in mobilizing larger financial resources by selling their shares to the public. Due to its long term accommodation to industries there is a wide spread industrial development in the country.

Thus in case of specialized banking a commercial bank is not in a position to give a sound advice for the purchase of securities. Thus mixed banking stimulated capital formation in the country.

Branch Banking vs Unit Banking

Unit banking refers to a single bank which renders services and operates without any branches anywhere. This kind of banking system is common in the USA. Restrictive branching laws encourage large numbers of small, independently owned state banks, and large multibank holding companies owning numerous unit banks. Branching laws in most states have been eased in the last several years; permitting geographic expansion and branch banking .Unit banking operate one full banking service.

Branch banking center or financial center refers to a single bank which operates through various branches in a city or in diferent locations or out of the cities. This kind of banking system is common in India. e.g. State Bank of India. It offers a wide array of face to face service to its customers.Historically, branches were housed in imposing buildings, often in a neoclassical architecture style. Today, branches may also take the form of smaller offices within a larger complex, such as a shopping mall.Services provided by a branch include cash withdrawals and deposits from a demand account with a bank teller, financial advice through a specialist, safe deposit box rentals, bureau de change, insurance sales (where it is allowed by law), etc.Other financial institutions reduce their costs by having no branches and are sometimes known as virtual banks.

	Branch Banking	**Unit Banking**
Deposits and assets:	Deposits and assets are diversified,scattered and hence risk is spead at various places.	Deposits and assets are nt diversified and are at one place,hence risk is not spread.
Operational freedom:	Less Operational freedom.	More Operational freedom.
Loans and advances:	Loans and advances are based on merit,irrespective of the status .	Loans and advances can be influenced by authority and power.
Financial resources:	Larger financial resources in each branch.	Larger financial resources in one branch
Decision-making:	Delay in Decision-making as they have to depend on the head office.	Time is saved as Decision-making is in the same branch.
Funds:	Funds are transferred from one branch to another.Underutilisation of funds by a branch would lead to regional imbalances	Funds are allocated in one branch and no support of other branches.During of financial crisis,unit bank has to close down.hence lead to regional imbalances or no balance growth
Cost of supervision:	High	Less
Mismanagement:	Exists as improper use of power and authority exist	Proper checks are taken up.no misuse of Mismanagement
Concentration of power in the hand of few people:	Yes	No
Specialisation:	Division of labour is possible and hence specialisation possible	Specialisation not possible due to lack of trained staff and knowledge
Competition:	High competiton with the branches	Less competition within the bank
Locality/Resources/Funds/Profits:	Shared by the bank with its	Used for the development of

	branches	the bank
Specialised knowledge of the local borrowers:	Not possible and hence bad debits are high	Possible and less risk of bad debts
Distribution of Capital:	Proper distribution of capital and power.	No proper distribution of capital and power.
Rate of interest:	Rate of interest is uniformed and specified by the head office or based on instructions from RBI.	Rate of interest is not uniformed as the bank has own policies and rates.

Group banking

In finance, "group banking" can refer either to banking provided to a specific group of people with customized services for their needs or to the formation of a holding company in control of several banks. The type of banking is usually evident from the context, as the two concepts are very different.

In the first sense, group banking often comes up in the context of employees who join a bank or credit union together. The employer works with the bank to create an incentive program encouraging people to sign up. Members of the group may get discounts on fees, access to special services, and greater control over retirement accounts along with offers for insurance and other products. While people are not required to participate in group banking, the benefits of the program are often a compelling argument to join.

For banks, group banking provides a ready-made group of customers, a distinct benefit. The bank does not have to recruit customers, because they sign up on their own. In addition, bureaucratic costs associated with things like direct deposit of paychecks are greatly reduced when employers and employees bank in the same location. Banks get access to capital through the deposits of group banking participants and the participants get benefits like special interest rates, account features like free traveler's checks, and so forth.

Cooperatives involved in group banking do not have to be employees of the same company. Housing cooperatives may use similar systems and people can also bank as a group affiliated with a church or another organization. Bank

policies vary, and people interested in the possibility of setting up a group banking program should make arrangements to meet with a bank representative to find out about available options and requirements, such as a minimum number of members.

Group banking in the sense of holding companies in control of banks consists of a holding company with a majority share in two or more banks. The banks have their own boards and are run as independent entities, but the holding company controls their activities and has the power to outvote other shareholders. Depending on regional laws and the percentage of shares owned, the holding company's ownership may need to be approved by government regulators to address concerns about the potential for creating a banking monopoly, where free market competition is limited by having a single company control the bulk of the companies offering banking services.

Chain banking

Chain banking is a situation in which three or more banks that are independently chartered are controlled by a small group of people. The mechanisms used to establish this type of arrangement normally involve securing enough stock between the individuals to have a controlling interest in each of the bank corporations involved. The arrangement can also be managed with the establishment of interlocking directorates or boards of directors that effectively create a network between the banks without the need for some type of central holding company.

The concept of chain banking is different from group banking, in that the entities involved in the chain bank arrangement remain autonomous and are not owned by a single holding company. By contrast, the group banking model requires a holding company to own all the banks involved, effectively creating an umbrella under which all the banks operate. Chain banking is also different from branch banking, a situation where all local branches of a bank are owned by a single banking institution.

In years past, chain banking afforded several benefits for investors. The strategy made it possible to earn steady returns from several banks that operated in the

same community, without any fears of a great deal of competition from other banks in the area. The network approach made it possible for investors to use their cumulative influence to keep bank services and their attendant fees similar from one enterprise to another, thus ensuring that returns remained consistent. The chain banking process also made it possible for investors to create a network where each bank in the chain served a different part of the market within the area. For example, one bank may focus on business accounts while another specialize in personal accounts, and the third bank in the chain provided services related to the purchase and sale of securities.

Over time, the chain banking approach has become less popular in a number of nations. This is due to changes in banking laws in many places that helped to redefine the process of interstate banking as well as international banking. This redefinition has made it possible for some banks that were once somewhat restricted in what they could offer customers to be able to offer a wider range of services. With more liberalized banking laws in many jurisdictions, the benefits afforded by the chain banking model can now be realized using other approaches, sometimes with a greater degree of efficiency and without the need for establishing this type of investor network.

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934.

The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated.

Though originally privately owned, since nationalisation in 1949, the Reserve Bank is fully owned by the Government of India.

Preamble

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

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

Legal Framework

Umbrella Acts

- Reserve Bank of India Act, 1934: governs the Reserve Bank functions
- Banking Regulation Act, 1949: governs the financial sector

Acts governing specific functions

- Public Debt Act, 1944/Government Securities Act (Proposed): Governs government debt market
- Securities Contract (Regulation) Act, 1956: Regulates government securities market
- Indian Coinage Act, 1906:Governs currency and coins
- Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999: Governs trade and foreign exchange market
- "Payment and Settlement Systems Act, 2007: Provides for regulation and supervision of payment systems in India"

Acts governing Banking Operations

- Companies Act, 1956:Governs banks as companies
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980: Relates to nationalisation of banks
- Bankers' Books Evidence Act
- Banking Secrecy Act
- Negotiable Instruments Act, 1881

Acts governing Individual Institutions

- State Bank of India Act, 1954
- The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
- The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
- National Bank for Agriculture and Rural Development Act
- National Housing Bank Act
- Deposit Insurance and Credit Guarantee Corporation Act

Top

Main Functions

Monetary Authority:

- Formulates, implements and monitors the monetary policy.
- Objective: maintaining price stability and ensuring adequate flow of credit to productive sectors.

Regulator and supervisor of the financial system:

- Prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- Objective: maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

Manager of Foreign Exchange

- Manages the Foreign Exchange Management Act, 1999.
- Objective: to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

Issuer of currency:

- Issues and exchanges or destroys currency and coins not fit for circulation.
- Objective: to give the public adequate quantity of supplies of currency notes and coins and in good quality.

Developmental role

- Performs a wide range of promotional functions to support national objectives.

Related Functions

- Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks: maintains banking accounts of all scheduled banks.

Top

Offices

- Has 19 regional offices, most of them in state capitals and 9 Sub-offices.

Training Establishments

Has five training establishments

- Two, namely, College of Agricultural Banking and Reserve Bank of India Staff College are part of the Reserve Bank
- Others are autonomous, such as, National Institute for Bank Management, Indira Gandhi Institute for Development Research (IGIDR), Institute for Development and Research in Banking Technology (IDRBT)

For details on training establishments, please check their websites links which are available in Other Links.

Subsidiaries

Main Functions

Monetary Authority:

- Formulates, implements and monitors the monetary policy.
- Objective: maintaining price stability and ensuring adequate flow of credit to productive sectors.

Regulator and supervisor of the financial system:

- Prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- Objective: maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

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Credit creation by RBI;

The Reserve Bank of India is the central bank of the country entrusted with monetary stability, the management of currency and the supervision of the financial as well as the payments system.

Established in 1935, its functions and focus have evolved in response to the changing economic environment. Its history is not only intrinsically interwoven with the economic and financial history of the country, but also gives insights

into the thought processes that have helped shape the country's economic policies. Here we present some facets of the Bank's history for the layperson.

14. Commercial banking:

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

All these details and many more is discussed over here. The banks and its relation with the customers, their mode of operation, the names of banks under different groups and other such useful informations are talked about.

One more section has been taken note of is the upcoming foreign banks in India. The RBI has shown certain interest to involve more of foreign banks than the existing one recently. This step has paved a way for few more foreign banks to start business in India.A commercial bank (or business bank) is a type of bank that provides services, such as accepting deposits, giving business loans and basic investment products.

Commercial bank can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to individual members of the public (retail banking).

In the US the term commercial bank was often used to distinguish it from an investment bank due to differences in bank regulation. After the great depression, through the Glass–Steagall Act, the U.S. Congress required that commercial banks only engage in banking activities, whereas investment banks were limited to capital markets activities. This separation was mostly repealed in the 1990s.

Origin of the word[edit]

The name *bank* derives from the Italian word *banque* "desk/bench", used during the Renaissance era by Florentine bankers, who used to make their transactions above a desk covered by a green tablecloth.[1] However, traces of banking activity can be found even in ancient times.

Some have suggested, the word traces its origins back to the Ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed courtyards called *macella* on a long bench called a *bancu*, from which the words *banco* and *bank* are derived. As a moneychanger, the merchant at the *bancu* did not so much invest money as merely convert the foreign currency into the only legal tender in Rome – that of the Imperial Mint.

The role of commercial banks

Commercial banks engage in the following activities:

- processing of payments by way of telegraphic transfer, EFTPOS, internet banking, or other means
- issuing bank drafts and bank cheques
- accepting money on term deposit
- lending money by overdraft, installment loan, or other means
- providing documentary and standby letter of credit, guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposures
- safekeeping of documents & other items in safe deposit boxes
- sales, distribution or brokerage, with or without advice, of: insurance, unit trusts and similar financial products as a “financial supermarket”
- cash management and treasury
- merchant banking and private equity financing
- traditionally, large commercial banks also underwrite bonds, and make markets in currency, interest rates, and credit-related securities, but today

large commercial banks usually have an investment bank arm that is involved in the mentioned activities[*clarify*].

Types of loans granted by commercial banks[edit]

Secured loans[edit]

A secured loan is a loan in which the borrower pledges some asset (e.g. a car or property) as collateral for the loan, which then becomes a secured debt owed to the creditor who gives the loan. The debt is thus secured against the collateral — in the event that the borrower defaults, the creditor takes possession of the asset used as collateral and may sell it to regain some or all of the amount originally lent to the borrower, for example, foreclosnted a portion of the bundle of rights to specified property. If the sale of the collateral does not raise enough money to pay off the debt, the creditor can often obtain a deficiency judgment against the borrower for the remaining amount. The opposite of secured debt/loan is unsecured debt, which is not connected to any specific piece of property and instead the creditor may only satisfy the debt against the borrower rather than the borrower's collateral and the borrower.

A mortgage loan is a very common type of debt instrument, used to purchase real estate. Under this arrangement, the money is used to purchase the property. Commercial banks, however, are given security - a lien on the title to the house - until the mortgage is paid off in full. If the borrower defaults on the loan, the bank would have the legal right to repossess the house and sell it, to recover sums owing to it.

In the past, commercial banks have not been greatly interested in real estate loans and have placed only a relatively small percentage of assets in mortgages. As their name implies, such financial institutions secured their earning primarily from commercial and consumer loans and left the major task of home financing to others. However, due to changes in banking laws and policies, commercial banks are increasingly active in home financing.

Changes in banking laws now allow commercial banks to make home mortgage loans on a more liberal basis than ever before. In acquiring mortgages on real estate, these institutions follow two main practices. First, some of the banks maintain active and well-organized departments whose primary function is to

compete actively for real estate loans. In areas lacking specialized real estate financial institutions, these banks become the source for residential and farm mortgage loans. Second, the banks acquire mortgages by simply purchasing them from mortgage bankers or dealers.

In addition, dealer service companies, which were originally used to obtain car loans for permanent lenders such as commercial banks, wanted to broaden their activity beyond their local area. In recent years, however, such companies have concentrated on acquiring mobile home loans in volume for both commercial banks and savings and loan associations. Service companies obtain these loans from retail dealers, usually on a nonrecourse basis. Almost all bank/service company agreements contain a credit insurance policy that protects the lender if the consumer defaults.

Unsecured loan[edit]

Unsecured loans are monetary loans that are not secured against the borrower's assets (no collateral is involved). There are small business unsecured loans such as credit cards and credit lines to large corporate credit lines. These may be available from financial institutions under many different guises or marketing packages:

- bank overdrafts
- corporate bonds
- credit card debt
- credit facilities or lines of credit
- personal loans

A corporate bond is a bond issued by a corporation. It is a bond that a corporation issues to raise money in order to expand its business. The term is usually applied to longer-term debt instruments, generally with a maturity date falling at least a year after their issue date. (The term "commercial paper" is sometimes used for instruments with a shorter maturity.)

Sometimes, the term "corporate bonds" is used to include all bonds except those issued by governments in their own currencies. Strictly speaking, however, it

applies only to bonds issued by corporations, not to bonds of local authorities and supranational organizations.

Corporate bonds are often listed on major exchanges (bonds there are called "listed" bonds) and ECNs like Bonds.com and MarketAxess and the coupon (or interest payment) is usually taxable. Sometimes, this coupon can be zero, with a high redemption value. However, despite being listed on exchanges, the vast majority of trading volume in corporate bonds in most developed markets takes place in decentralized, dealer-based, over-the-counter markets.

Some corporate bonds have an embedded call option that allows the issuer to redeem the debt before its maturity date. Other bonds, known as convertible bonds, allow investors to convert the bond into equity.

Corporate credit spreads may alternatively be earned in exchange for default risk through the mechanism of credit default swaps, which give an unfunded synthetic exposure to similar risks on the same 'Reference Entities'. However, quite volatile credit default swaps 'basis' make the spreads on credit default swaps and the credit spreads on corporate bonds be significantly different.

CREDIT CREATION

Central bank is the first source of money supply in the form of currency in circulation. The Reserve Bank of Indian is the note issuing authority of the country. The RBI ensures availability of currency to meet the transaction needs of the economy. The Total Volume of money in the economy should be adequate to facilitate the various types of economic activities such as production, distribution and consumption.

The commercial banks are the second most important sources of money supply. The money that commercial banks supply is called credit money.

The process of 'Credit Creation' begins with banks lending money out of primary deposits. Primary deposits are those deposits which are deposited in banks. In fact banks cannot lend the entire primary deposits as they are required to maintain a certain proportion of primary deposits in the form

of reserves with the RBI under RBI & Banking Regulation Act. After maintaining the required reserves, the bank can lend the remaining portion of primary deposits. Here bank's lend the money and the process of credit creation starts.

Suppose there are a number of Commercial Banks in the Banking System - Bank 1, Bank 2, Bank 3, & So on.

To begin with let us suppose that an individual "A" makes a deposit of Rs. 100 in bank 1. Bank "1" is required to maintain a Cash Reserve Requirement of 5% (Prevailing Rate) which is decided by the RBI's Monetary Policy from the deposits made by 'A'. Bank "1" is required to maintain a cash reserve of Rs. 5 (5% of 100). The bank has now lendable funds of Rs. 95(100 - 5). Let the Bank "1" lend Rs. 95 to a borrower; say B. the method of lending is the same that is bank 1 opens an account in the name of the borrower cheque for the loan amount. At the end of the process of deposits & lending, the balance sheet of bank reads as given below:-

Balance Sheet of Bank "1"

Liabilities

Amount

Assets

Amount

A's deposits

100

Cash Reserve

5

Loan to "B"

95

Total

100

Total

100

Now suppose that money that borrowed from bank "1" is paid to individual "C" in settlement of his past debts. The individual "C" deposits the money in his bank say, bank 2. Now bank 2 carries out its banking transaction. It keeps a cash reserve to the extend of 5%, that is Rs. 4.75 (5% of 95) and lend Rs. 90.5 to a borrower D. at the end of the process the balance sheet of Bank 2 will be look like:-

Balance Sheet of Bank "2"

Liabilities

Amount

Assets

Amount

B's deposits

95

Cash Reserve

4.75

Loan to "C"

90.5

Total

95

Total

95

The amount advanced to D will return ultimately to the banking system, as described in case of B and the process of deposits and credit creation will continue until the reserve with the banks is reduced to zero. The final picture that would emerge at the end of the process of deposit & credit creation by the banking system is presented in the consolidated balance sheet of all banks are as under:-

The combined Balance sheet of Banks

Bank

Liabilities Deposits

Assets Credits

Reserve

Total Assets

Bank 1

100

95

5

100

Bank 2

95

90.5

4.75

95

Bank 3

90.5

85.98

4.52

90.5

-

-

-

-

-

-

-

-

-

-

Bank n

00

00

00

00

Total

2,000

1,900

100

2,000

It can be seen from the combined balance sheet that a primary deposits of Rs. 100 in a bank 1 leads to the creation of the total deposit of Rs. 2,000. The combined balance sheet also shows that the banks have created a total credit of Rs. 2,000. And maintained a total cash reserve of Rs.100.Which equals the primary deposits. The total deposit created by the commercial banks constitutes the money supply by the banks.

17. Structure of Indian Financial System

The structure of the Indian financial system may be summarized in the following way:

Broadly the Indian Financial System may be divided into organized and unorganized segments. The organized market consist of commercial banks, developmental banks, co-operation bank, post banks, office saving banks, stock marketing etc.

Unorganized marketing operations consist of: Hundies, Money lending, Chit funds etc. They operate mainly in rural areas also unrecognized money market activity are quite significant.

There is no precise estimate of the size of the generally expected that the estimate of the size of the unorganized money market transactions would decline over time.

As per the figure the Indian financial system consist of an impressive network

of banks and financial institutions and a wide range of financial instruments. There has been a considerable unending and deeding of the Indian financial system, participation the as tow decades.

Banking operations in India are controlled by the Reserve Bank of India (which, as we have instructed is also the official central banks of government). The primary role of RBI is to maintain a monetary equilibrium balance in the economy by formulating various policies from time to time and contradictory the financial instrument of the economy.

The balance sheet identifies for the RBI is as follows:

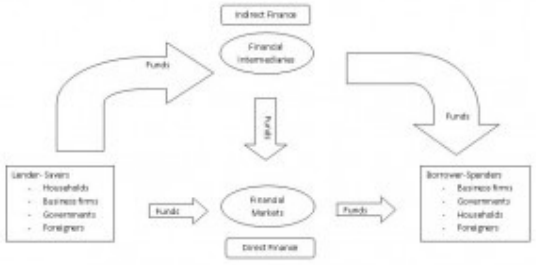
"Monetary liabilities (ML) + Non monitorial liabilities (NML) = Financial assets (FA) + other assets".

If net Non Monetary liabilities (NNML) = NML - other assets.

Then the ML = FA - NNML. The monetary liabilities of RBI are also called as Reserve Monetary.

The financial system is complex in structure and function through the world, it was created in purpose to facilitate the flow of funds from savers to investors. It includes many different types of institutions: Financial intermediaries (banks, insurance companies and mutual funds), Financial markets (stock and bond markets).

Flow of Funds Through Financial System



Financial Markets Categories

1. Primary market: is a financial market in which new issues of a security, such as a bond or a stock, are sold to initial buyers by the corporation or government agency. This market is not well known to the public because the selling of securities to initial buyers often takes place behind closed doors. An important financial institution that assists in the initial sale of securities in the primary market is the investment bank. It does this by underwriting securities: It guarantees a price for a corporation's securities and then sells them to the public.

2. Secondary market: is a financial market in which securities that have been previously issued can be resold. The New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotation System (NASDAQ) are the best-known examples for secondary markets.

3. Money market: is a financial market in which only short-term debt instruments (generally those with original maturity of less than one year) are traded. Shorter term securities have smaller fluctuations in prices than long-term securities, making them safer to invest. As a result, corporations and banks actively use the money market to earn interest on surplus working capital and to finance for shortage working capital. Money market instruments includes: U.S Treasury bill, Commercial Paper, Bank Certification of Deposit etc.

4. Capital market: is a financial market in which longer-term debt (generally those with original maturity of one year or greater) and equity instruments are traded. Long term securities are often held by financial intermediaries such as insurance companies and pension funds, which

have little uncertainty about the amount of funds they will have available in the future. Capital market instruments includes: Stock, U.S Treasury bond, Corporate bond, Mortgage etc.

Direct Finance: Funds are flew through institutions that provide brokerage services including investment banking such as Bank of America, and investment brokerage firms etc. They work as a channel of direct financing, in which businesses can raise funds directly from lenders in financial markets especially during initial public offering (IPO).

Indirect Finance: Funds are flew through financial intermediaries - including depository institutions, financing companies, insurance companies and mutual funds. They work as a channel of indirect financing by pooling saver funds then invest those funds through to businesses that want to spend them. Currently, majority of financing capital are made through indirect finance as securities have been bought primarily by financial intermediaries especially insurance companies, pension funds and mutual funds.

Why are financial intermediaries and indirect finance so important in financial markets?

1. Transaction cost is the time and money spent in carrying out financial transactions. Financial intermediaries can substantially reduce transaction costs because they have developed expertise in lowering them, and because their large size allows them to take advantage of economies of scale.

2. Risk sharing : Financial intermediaries sell assets with risk characteristics that people are comfortable with and then use the funds to purchase other assets that may have far more risk. This process of risk sharing is called asset transformation, risky assets are turned into safer assets for investors. Another way of risk sharing provided was through diversification; financial intermediaries invest in a collection of assets whose return do not always move together, with the result that overall risk is lower than for individual assets.

3. Asymmetric information : Financial intermediaries usually equip with a better credit risk screening than individuals, therefore reducing losses due to wrong investment decision making. They have developed expertise in monitoring the parties they lend to, thus reducing losses due to moral hazard.

Regulation of Financial System

Financial markets have important effect not only to domestic but whole global economy, thus financial system usually is the most heavily regulated sectors by governments. Two primary reasons in which government needs to regulate financial system are:

- Increasing information available to investors, and protecting them from the abuse of financial market. Securities and Exchange Commission (SEC) requires corporations issuing securities to disclose certain information about their sales, assets and earnings to the public and restricts insider tradings in the corporations.
- Ensuring the soundness of financial intermediaries, the widespread collapse of financial intermediaries encourage investors pull back funds from financial market, thus can drag down the whole financial system. Regulators such as SEC and Federal Reserve System have implemented regulations including restriction on entry, restriction on assets and activities of financial intermediaries, and disclosure requirements etc.

18. Indian Money Market

- Money market is concerned with the supply and the demand for investible funds. Essentially, it is a reservoir of short-term funds. Money market provides a mechanism by which short-term funds are lent out and borrowed; it is through this market that a large part of the financial transactions of a country are cleared. It is place where a bid is made for short-term investible funds at the disposal of financial and other institutions by borrowers comprising institutions, individuals and the Government itself.

- Thus, money market covers money, and financial assets which are close substitutes for money. The money market is generally expected to perform following three broad functions:2
- (i) To provide an equilibrating mechanism to even out demand for and supply of short term funds.
- (ii) To provide a focal point for Central bank intervention for influencing liquidity and general level of interest rates in the economy.
- (iii) To provide reasonable access to providers and users of short-term funds to fulfill their borrowing and investment requirements at an efficient market clearing price.

19. Indian Capital Market

The capital market is the place where the medium-term and long-term financial needs of business and other undertakings are met by financial institutions which supply medium and long-term resources to borrowers. These institutions may further be classified into investing institutions and development banks on the basis of the nature of their activities and the financial mechanism adopted by them. Investing institutions comprise those financial institutions which garner the savings of the people by offering their own shares and stocks, and which provide long-term funds, especially in the form of direct investment in securities and underwriting capital issues of business enterprises. These institutions include investment banks, merchant

- banks, investment companies and the mutual funds and insurance companies. Development banks include those financial institutions which provide the sinews of development, i.e. capital, enterprise and know-how, to business enterprises so as to foster industrial growth.
- 21.Sources and uses of funds in banking
-
- SOURCES OF BANK FUNDS
  A bank is a business firm. Its main aim is to earn profit. In order to achieve this objective it provides services to the customers. It offers a

variety of interest bearing obligations to the public. These obligations are the sources of funds for the bank and are shown on the liability side of the balance sheet of a commercial bank. The main sources which supply funds to a bank are as follows:

- A Bank's Own Funds.
- B Borrowed Funds.

1. Bank's own funds. Bank's own funds are mainly of three types; (a) Paid up capital, (b) Reserve fund and (C) Portion of undistributed profit.

(A) Banks Own Funds.
Bank's own paid up capital. The amount with which a banking company is registered is called nominal or authorized capital. It is the maximum amount of capital which is mentioned in the capital clause of the memorandum of association of the company. Capital is further divided into (i) paid up capital and (ii) subscribed capital. The banks in Pakistan raise authorized capital by issuing ordinary shares of Rs. 10 each which are fully paid up.

2. Reserve fund. Reserve is another source of fund which is maintained by all commercial banks. At the time of declaring dividend, a certain portion of the profit is transferred to the reserve fund. This reserve belongs to the .shareholders and at the time of liquidation, the Shareholders are entitled to these reserves along with the capital.

The main purpose of setting aside part of profit is to meet unforeseen expenses of the bank. The Banking Companies Ordinance has made it obligatory (binding) for every banking company incorporated in Pakistan to create a reserve fund.

3. Profit. Profit is another source to a bank for the purpose of business. Profits signify the credit balance of the profit and loss account which has not been distributed. The accumulated profits over the years increase the working capital of the bank and strengthens its financial position.

(B) Borrowed Funds.

The borrowed capital is a major and an important source of fund for any banking business. It mainly comes from deposits which are accepted on varying terms in different accounts.

Bank's borrowing is mostly in the form of deposits. Bank collects three kinds of deposits from its customers (1) current or demand deposits (2) saving deposits and (3) fixed or time deposits. The larger the deposits of bank, the larger will be its (use) fund for employment and so higher are its profit.

1. Borrowing from central bank. The commercial banks in times of emergency borrow loans from the central bank of the country. The central bank extends help as and when financial help is required by the commercial banks.

2. Other sources. Bank also raise funds by issuing bonds, debentures, cash certificates etc. etc. Though it is not common but is a dependable source of borrowing.

3. Deposits. Public deposits are a powerful source of funds to a bank. There are' three types of bank deposits (i) current deposits (ii) saving deposits and (iii) time deposits. Due to the spread of literacy, banking habits and growth in the volume of business operations, there is a marked increase in deposit money with banks

22. VALUE CHAIN ANALYSIS in Banking:

The first step is to analyze how the upgrading opportunity impacts investment, working capital (cash flows), and profitability. It is important to take a multi-year perspective and include not just the investment in year 1, but also the additional working capital requirements linked to the investment in sub-sequent years. Profitability needs to first be assessed in the without financing scenario to make sure the upgrading opportunity is profitable in its own right (Net Present Value >0). Credit options can then be considered by the borrower if the loan

cost is lower than the return on investment of the opportunity without financing. If credit is needed to realize the upgrading, then it has to be profitable from the perspective of the lender as well. There has to be a sufficiently large market to warrant developing and marketing a savings, credit or risk management product. In terms of the broader value chain it is important to consider what the upgrading by one value chain actor implies in terms of the need for increased finance for other actors in the value chain.

24.Definition of 'Universal Banking'

A banking system in which banks provide a wide variety of financial services, including both commercial and investment services. Universal banking is common in some European countries, including Switzerland. In the United States, however, banks are required to separate their commercial and investment banking services. Proponents of universal banking argue that it helps banks better diversify risk. Detractors think dividing up banks' operations is a less risky strategy.

Investopedia explains 'Universal Banking'

Universal banks may offer credit, loans, deposits, asset management, investment advisory, payment processing, securities transactions, underwriting and financial analysis. While a universal banking system allows banks to offer a multitude of services, it does not require them to do so. Banks in a universal system may still choose to specialize in a subset of banking services.

Universal banking is a combination of Commercial banking, Investment banking, Development banking, Insurance and many other financial activities. It is a place where all financial products are available under one roof. So, a universal bank is a bank which offers commercial bank functions plus other functions such as Merchant Banking, Mutual Funds, Factoring, Credit cards, Housing Finance, Auto loans, Retail loans, Insurance, etc.

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Universal banking is done by very large banks. These banks provide a lot of finance to many companies. So, they take part in the Corporate Governance (management) of these companies. These banks have a large network of branches all over the country and all over the world. They provide many different financial services to their clients.

ln India, two reports in 1998 mentioned the concept of universal banking. They are, the Narasimham Committee Report and the S.H. Khan Committee Report. Both these reports advised to consolidate (bring together) the banking industry through mergers and integration of financial activities. That is, they advised a combination of all banking and financial activities. That is, they suggested a Universal banking.

In 2000, ICICI asked permission from RBI to become a universal bank. RBI wants some big domestic financial institutions to become universal banks.

Advantages of Universal Banking

The benefits or advantages of universal banking are:-

1. Investors' Trust : Universal banks hold stakes (equity shares) of many companies. These companies can easily get other investors to invest in their business. This is because other investors have full confidence and

faith in the Universal banks. They know that the Universal banks will closely watch all the activities of the companies in which they hold a stake.

2. Economics of Scale : Universal banking results in economic efficiency. That is, it results in lower costs, higher output and better products and services. In India, RBI is in favour of universal banking because it results in economies of scale.

3. Resource Utilisation : Universal banks use their client's resources as per the client's ability to take a risk. If the client has a high risk taking capacity then the universal bank will advise him to make risky investments and not safe investments. Similarly, clients with a low risk taking capacity are advised to make safe investments. Today, universal banks invest their client's money in different types of Mutual funds and also directly into the share market. They also do equity research. So, they can also manage their client's portfolios (different investments) profitably.

4. Profitable Diversification : Universal banks diversify their activities. So, they can use the same financial experts to provide different financial services. This saves cost for the universal bank. Even the day-to-day expenses will be saved because all financial services are provided under one roof, i.e. in the same office.

5. Easy Marketing : The universal banks can easily market (sell) all their financial products and services through their many branches. They can ask their existing clients to buy their other products and services. This requires less marketing efforts because of their well-established brand name. For e.g. ICICI may ask their existing bank account holders in all their branches, to take house loans, insurance, to buy their Mutual funds, etc. This is done very easily because they use one brand name (ICICI) for all their financial products and services.

6. One-stop Shopping : Universal banking offers all financial products and services under one roof. One-stop shopping saves a lot of time and

transaction costs. It also increases the speed or flow of work. So, one-stop shopping gives benefits to both banks and their clients.

Disadvantages of Universal Banking

The limitations or disadvantages of universal banking are:-

1. Different Rules and Regulations : Universal banking offers all financial products and services under one roof. However, all these products and services have to follow different rules and regulations. This creates many problems. For e.g. Mutual Funds, Insurance, Home Loans, etc. have to follow different sets of rules and regulations, but they are provided by the same bank.

2. Effect of failure on Banking System : Universal banking is done by very large banks. If these huge banks fail, then it will have a very big and bad effect on the banking system and the confidence of the public. For e.g. Recently, Lehman Brothers a very large universal bank failed. It had very bad effects in the USA, Europe and even in India.

3. Monopoly : Universal banks are very large. So, they can easily get monopoly power in the market. This will have many harmful effects on the other banks and the public. This is also harmful to economic development of the country.

4. Conflict of Interest : Combining commercial and investment banking can result in conflict of interest. That is, Commercial banking versus Investment banking. Some banks may give more importance to one type of banking and give less importance to the other type of banking. However, this does not make commercial sense

25.Venture Capital

Nature and Scope

- Merchant hankers can assist venture proposals of technocrats, with high technology which are new and high risk, to seek assistance from venture capital funds or companies. Venture capital is an important source of funds for technology based industries which contribute significantly to growth process. Public issues are not available for such green filed ventures.
- Venture capital refers to organized private or institutional financing that can provide substantial amounts of capital mostly through equity purchases and occasionally through debt offerings to help growth oriented firms to develop and succeed. The term venture capital denotes institutional investors that provide equity financing to young business and play an active role advising their managements.
- Venture Capital in India
- Venture capital funds (VCFs) are part of the primary market. There are 35 venture capital funds registered with SEBI apart form one foreign venture capital firm registered with SEBI. Data available for 14 firms indicate that total funds available with them at the end of 1996 was Rs. 1402 crores, which Rs.672.85 crores had been invested in 622 projects in 1996. Venture capital which was originally restricted to risk capital has become now „private equity". Venture capital represent funds invested in new enterprises which are risky but promise high returns. VCFs finance equity of units which propose to use new technology and are promoted by technical and professional entrepreneurs. They also provide technical, financial and managerial services and help the company to set up a track record. Once the company meets the listing requirements of the OTCEI or stock exchange, VCF can disinvest its shares.

Characteristics of Venture Capital

- The three primary characteristics of venture capital funds which make them eminently suitable as a source of risk finance are:

- (1) that it is equity or quasi equity investment;
- (2) it is long-term investment; and
- (3) it is an active from of investment. First, venture capital is equity or quasi equity because the investor assumes risk. There is no security for his investment. Venture capital institutionalize the process of risk taking which promotes successful domestic technology development.
-
- Secondly, venture capital is long-term investment involving both money and time. Finally, venture capital investment involves participation in the management of the company. Venture capitalist participates in the Board and guides the firm on strategic and policy matters. The features of venture capital generally are, financing new and rapidly growing companies; purchase of equity shares; assist in transformation of innovative technology based ideas into products and services; add value to the company by active participation; assume risks in the expectation of large rewards; and posses a long-term perspective. These features of venture capital render it eminently suitable as a source of risk capital for domestically developed technologies.

27. MERCHANT BANKING.

Merchant Banking Meaning

Merchant Banking is a combination of Banking and consultancy services. It provides consultancy, to its clients, for financial, marketing, managerial and legal matters. Consultancy means to provide advice, guidance and service for a fee. It helps a businessman to start a business. It helps to raise (collect) finance. It helps to expand and modernise the business. It helps in restructuring of a business. It helps to revive sick business units. It also helps companies to register, buy and sell shares at the stock exchange.

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In short, merchant banking provides a wide range of services for starting until running a business. It acts as Financial Engineer for a business.

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Merchant banking was first started in India in 1967 by Grindlays Bank. It has made rapid progress since 1970.

Functions of Merchant Banking

The important functions of merchant banking are depicted below.

The functions of merchant banking are listed as follows:

1. Raising Finance for Clients : Merchant Banking helps its clients to raise finance through issue of shares, debentures, bank loans, etc. It helps its clients to raise finance from the domestic and international market. This finance is used for starting a new business or project or for modernization or expansion of the business.

2. Broker in Stock Exchange : Merchant bankers act as brokers in the stock exchange. They buy and sell shares on behalf of their clients. They conduct research on equity shares. They also advise their clients about which shares to buy, when to buy, how much to buy and when to sell.

Large brokers, Mutual Funds, Venture capital companies and Investment Banks offer merchant banking services.

3. Project Management : Merchant bankers help their clients in the many ways. For e.g. Advising about location of a project, preparing a project report, conducting feasibility studies, making a plan for financing the project, finding out sources of finance, advising about concessions and incentives from the government.

4. Advice on Expansion and Modernization : Merchant bankers give advice for expansion and modernization of the business units. They give expert advice on mergers and amalgamations, acquisition and takeovers, diversification of business, foreign collaborations and joint-ventures, technology upgradation, etc.

5. Managing Public Issue of Companies : Merchant bank advice and manage the public issue of companies. They provide following services:

   i. Advise on the timing of the public issue.

   ii. Advise on the size and price of the issue.

   iii. Acting as manager to the issue, and helping in accepting applications and allotment of securities.

   iv. Help in appointing underwriters and brokers to the issue.

   v. Listing of shares on the stock exchange, etc.

6. Handling Government Consent for Industrial Projects : A businessman has to get government permission for starting of the project. Similarly, a company requires permission for expansion or modernization activities. For this, many formalities have to be completed. Merchant banks do all this work for their clients.

7. Special Assitance to Small Companies and Entreprenuers : Merchant banks advise small companies about business opportunities, government policies, incentives and concessions available. It also helps them to take advantage of these opportunities, concessions, etc.

8. Services to Public Sector Units : Merchant banks offer many services to public sector units and public utilities. They help in raising long-term capital, marketing of securities, foreign collaborations and arranging long-term finance from term lending institutions.

9. Revival of Sick Industrial Units : Merchant banks help to revive (cure) sick industrial units. It negotiates with different agencies like banks, term lending institutions, and BIFR (Board for Industrial and Financial Reconstruction). It also plans and executes the full revival package.

10. Portfolio Management : A merchant bank manages the portfolios (investments) of its clients. This makes investments safe, liquid and profitable for the client. It offers expert guidance to its clients for taking investment decisions.

11. Corporate Restructuring : It includes mergers or acquisitions of existing business units, sale of existing unit or disinvestment. This requires proper negotiations, preparation of documents and completion of legal formalities. Merchant bankers offer all these services to their clients.

12. Money Market Operation : Merchant bankers deal with and underwrite short-term money market instruments, such as:

    i. Government Bonds.

    ii. Certificate of deposit issued by banks and financila institutions.

    iii. Commercial paper issued by large corporate firms.

    iv. Treasury bills issued by the Government (Here in India by RBI).

13. Leasing Services : Merchant bankers also help in leasing services. Lease is a contract between the lessor and lessee, whereby the lessor allows the use of his specific asset such as equipment by the lessee for a certain period. The lessor charges a fee called rentals.

14. Management of Interest and Dividend : Merchant bankers help their clients in the management of interest on debentures / loans, and dividend on shares. They also advise their client about the timing (interim / yearly) and rate of dividend.

:

Generally merchant banking refers the entire range of financial services such as organizing and extending finance for investment in projects, assistance in financial Management, acceptance of house business, raising Eurodollar loans and issues of foreign currency bonds, financing local authorities, financing export of capital goods, ships, hydropower installation, valuation of assets etc. In India the merchant banking services were recognised due to the increase in the volume of financial services

Merchant bankers (Category I) however are mandated by SEBI to manage public issues (as lead managers). Issue management activity has a big fall out on the integrity of the market. It affects investors interest and hence transparency has to be ensured.. There are also areas where compliance can be monitored and enforced.

BANKING COMMISSION REPORT,1972:

The Banking Commission in its report in 1972 has indicated the necessity of merchant banking service in view of the wide industrial base of the Indian Economy. The Commission was in favour of a

separate institution (different form commercial banks and term lending institutions) to provide merchant banking services. The commission suggested that they should offer investment management and advisory services particularly to the medium and small savers. The commission also suggested that they should be able to manage provident funds, pension funds and trusts of various types.

MERCHANT BANKING IN INDIA:

In India Grind lays Bank was authorized to carry merchant banking services and obtained a license form Reserve Bank of India in 1967.Grindlays which started with management of capital issues, recognised the needs of an emerging class of entrepreneurs for diverse financial services ranging from production planning and systems design to market research.. Apart form meeting specially the needs of small-scale units, it provided management consultancy, services to large and medium sized companies.

Following Grind lays Bank, Citibank set up its merchant banking division in 1970.The division took up the task of assisting new entrepreneurs and existing units in the evaluation of new projects and raising funds through borrowing and equity issues. Management consultancy services were also offered. Merchant bankers are permitted to carry-on activities of primary dealers in government securities.

Consequent to the recommendations of Banking Commission in 1972, that Indian banks should offer merchant banking services as part of the multiple services they could provide their clients, State Bank of India started the Merchant Banking Division in 1972. In the initial years the SBIs objective was to render corporate advice and assistance to small and medium entrepreneurs.

The commercial banks that followed State Bank of India were Central Banks of India, Bank of India and Syndicate Bank in 1977: Bank of

Baroda, Standard Chartered Bank and Mercantile Bank in 1978, and United bank of India. United Commercial Bank, Punjab National Bank, Canara bank and Indian overseas Bank in late „70s and early „80s. Among the development banks, ICICI started merchant banking activities in 1973, followed by IFCI (1986) and IDBI (! 991).

ORIGION OF MERCHANT BANKING –ABROAD:

The origin of merchant banking is to be traced to Italy in late medieval times. And France during the seventeenth and eighteenth centuries. The Italian merchant bankers introduced in England not only the bill of exchange but also all the institutions and techniques connected with an organized money market. In France, during 17th and 18th centuries a merchant banker (le Merchant Banquer) was not merely a trader but an entrepreneur par excellence. He invested his accumulated profits in all kinds of promising activities . He added banking business to his merchant activities and became a merchant banker.

REGULATIONS OF MERCHANT BANKING:

Notifications of the Ministry of Finance and SEBI

Merchant bankers have to be organized as body corporates. They are governed by the Merchant Bankers Rules (MB Rules) issued by the Ministry of Finance

and Merchant Bankers Regulations (MB Regulations)issued by SEBI (22.12.1992)

Rationale of Notifications:

Investors confidence is a prerequisite for an orderly growth and development of the securities market. In the primary market, investors confidence dependence in a large measure on the efficiency of the issue management functions which covers drafting and issue of prospectus or letter of offer after submitting it to SEBI and timely dispatch of share certificates or refund orders. To ensure proper disclosure and to bring about transparency in the primary market with a view to protect investors interest. SEBI has issued MB Regulations

Objectives of the Merchant Bankers Regulations:

M B regulations which seek to regulate the raising of funds in the primary market would assure the issuer a market for raising resources effectively and easily, at a low cost, to ensure a high degree of protection of the interests of investors and provide for the merchant banker a dynamic and competitive market with high standard of professional competence, honesty, integrity and solvency. The regulations would promote a primary market which is fair, efficient flexible and inspires confidence.

The regulations stipulates that any person or body proposing to engage in the business of merchant banking or presently engaged as managers, consultants or advisors to issue would need authorisation by Securities and Exchange Board of India.

DEFINITION OF MERCHANT BANKER:

The notification of the Ministry of finance defines a merchant banker as “any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management”.

PROSPECTUS (FILING & REGISTRATION)

The Registrar of Companies has also been advised that prospectus for public issue can only be filed by merchant bankers who are authorized by SEBI and given a code number. Further the Registrar of Companies is required not to register a prospectus where he has been informed by SEBI that the contents of the prospectus are in contravention of the provisions of any law or statutory rules and regulations.

REGISTRATION OF MERCHANT BANKERS

SEBI abolished on 5-09-1997 all categories of merchant bankers below category I. Merchant bankers operating in the categories below I have

to apply for category I status or take up some other activity. Portfolio management requires separate registration. Underwriting could be done without any additional registration. Merchant bankers can carry on any activity of issue management, which will *inter alia* consist of preparation of prospectus and other information relating to the issue, determining the financial structure, tie up of financiers and final allotment and refund of subscription and act in the capacity of managers, adviser or consultant to an issue, portfolio manager and underwriter.

NETWORH

Minimum net worth is Rs.5 Crores. Registration fee is Rs.2.5 lakhs annually in the first two years and Rs.1 lakh in the third year and Rs.1 lakh to be paid annually.

Number of Lead Managers: Number of lead managers depends on the size of the issue. The guidelines stipulate that for an issue of Rs.50 crores, the no of lead managers should not exceed 2, for issues between Rs.50-100 crores maximum of 3, for issues between 100-200 crores 4 etc.

CODE OF CONDUCT

The code of conduct stipulates that in the performance of duties, merchant bankers should act in an ethical manner, inform the client that he is obliged to comply with the code of conduct, render high standard of service and exercise

due diligence, not to indulge in unfair practices, not to make misrepresentations, give best advise, not to divulge confidential information about the clients, endeavor to ensure that true and adequate information is provided to investors and to abide by all rules, regulations, guidelines, resolutions issued by the Government of India and SEBI from time to time.

30.Banking Ombudsman

IT is a quasi judicial authority functioning under India's Banking Ombudsman Scheme 2006, and the authority was created pursuant to the a decision by the Government of India to enable resolution of complaints of customers of banks relating to certain services rendered by the banks. The Banking Ombudsman Scheme was first introduced in India in 1995, and was revised in 2002. The current scheme became operative from 1 January 2006, and replaced and superseded the banking Ombudsman Scheme 2002. From 2002 until 2006, around 36,000 complaints have been dealt by the Banking Ombudsmen.

Type of complaints

- The type and scope of the complaints which may be considered by a Banking Ombudsman is very comprehensive, and it has been empowered to receive and consider complaints pertaining to the following:
- Non-payment or inordinate delay in the payment or collection of cheques, drafts, bills, etc.;
- Non-acceptance, without sufficient cause, of small denomination notes tendered for any purpose, and for charging of commission for this service;
- Non-acceptance, without sufficient cause, of coins tendered and for charging of commission for this service;
- Non-payment or delay in payment of inward remittances ;
- Failure to issue or delay in issue, of drafts, pay orders or bankers' cheques;
- Non-adherence to prescribed working hours;

- Failure to honour guarantee or letter of credit commitments;
- Failure to provide or delay in providing a banking facility (other than loans and advances) promised in writing by a bank or its direct selling agents;
- Delays, non-credit of proceeds to parties' accounts, non-payment of deposit or non-observance of the Reserve Bank directives, if any, applicable to rate of interest on deposits in any savings, current or other account maintained with a bank ;
- Delays in receipt of export proceeds, handling of export bills, collection of bills etc., for exporters provided the said complaints pertain to the bank's operations in India;
- Refusal to open deposit accounts without any valid reason for refusal;
- Levying of charges without adequate prior notice to the customer;
- Non-adherence by the bank or its subsidiaries to the instructions of Reserve Bank on ATM/debit card operations or credit card operations;
- Non-disbursement or delay in disbursement of pension to the extent the grievance can be attributed to the action on the part of the bank concerned, (but not with regard to its employees);
- Refusal to accept or delay in accepting payment towards taxes, as required by Reserve Bank/Government;
- Refusal to issue or delay in issuing, or failure to service or delay in servicing or redemption of Government securities;
- Forced closure of deposit accounts without due notice or without sufficient reason;
- Refusal to close or delay in closing the accounts;
- Non-adherence to the fair practices code as adopted by the bank; and
- Any other matter relating to the violation of the directives issued by the Reserve Bank in relation to banking or other services.

- complaints from Non-Resident Indians having accounts in India in relation to their remittances from abroad, deposits and other bank-related matters;[2]

26.Definition of 'Project Finance'

Defined by the International Project Finance Association (IPFA) as the following:

The financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cashflow generated by the project.

Investopedia explains 'Project Finance'

In other words, project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights, and interests held as secondary security or collateral.

Project finance is especially attractive to the private sector because they can fund major projects off balance sheet.

Project finance is the long term financing of infrastructure and industrial projects based upon the projected cash flows of the project rather than the balance sheets of the project sponsors. Usually, a project financing structure involves a number of equity investors, known as *sponsors*, as well as a *syndicate* of banks or other lending institutions that provide loans to the operation. The loans are most commonly non-recourse loans, which are secured by the project assets and paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors, a decision in part supported by financial modeling.[1] The financing is typically secured by all of the project assets, including the revenue-producing contracts. Project lenders are given a lien on all of these assets, and are able to assume control of a project if the project company has difficulties complying with the loan terms.

Generally, a special purpose entity is created for each project, thereby shielding other assets owned by a project sponsor from the detrimental effects of a project failure. As a special purpose entity, the project company has no assets other than the project. Capital contribution commitments by the owners of the project company are sometimes necessary to ensure that the project is financially sound, or to assure the lenders of the sponsors' commitment. Project finance is often more complicated than alternative financing methods. Traditionally, project financing has been most commonly used in the extractive (mining), transportation, telecommunications and energy industries. More recently, particularly in Europe, project financing principles have been applied to other types of public infrastructure under public–private partnerships (PPP) or, in the UK, Private Finance Initiative (PFI) transactions (e.g., school facilities) as well as sports and entertainment venues.

Risk identification and allocation is a key component of project finance. A project may be subject to a number of technical, environmental, economic and political risks, particularly in developing countries and emerging markets. Financial institutions and project sponsors may conclude that the risks inherent in project development and operation are unacceptable (unfinanceable). To cope with these risks, project sponsors in these industries (such as power plants or railway lines) are generally completed by a number of specialist companies operating in a contractual network with each other that allocates risk in a way that allows financing to take place. "Several long-term contracts such as construction, supply, off-take and concession agreements, along with a variety of joint-ownership structures, are used to align incentives and deter opportunistic behaviour by any party involved in the project."[2] The various patterns of implementation are sometimes referred to as "project delivery methods." The financing of these projects must also be distributed among multiple parties, so as to distribute the risk associated with the project while simultaneously ensuring profits for each party involved.

A riskier or more expensive project may require limited recourse financing secured by a surety from sponsors. A complex project finance structure may incorporate corporate finance, securitization, options (derivatives), insurance provisions or other types of collateral enhancement to mitigate unallocated risk.[2]

Project finance shares many characteristics with maritime finance and aircraft finance; however, the latter two are more specialized fields within the area of asset finance.

Parties to a Project Financing

There are several parties in a project financing depending on the type and the scale of a project. The most usual parties to a project financing are;

1. Project company
2. Sponsor
3. Borrower
4. Financial Adviser
5. Technical Adviser
6. Lawyer
7. Debt financiers
8. Equity Investors
9. Regulatory agencies
10. Multilateral Agencies
11. Host government / grantor
12. Introduction

    Project financing is an innovative and timely financing technique that has been used on many high-profile corporate projects, including Euro Disneyland and the Eurotunnel. Employing a carefully engineered financing mix, it has long been used to fund large-scale natural resource projects, from pipelines and refineries to electric-generating facilities and hydro-electric projects. Increasingly, project financing is emerging as the preferred alternative to conventional methods of financing infrastructure and other large-scale projects worldwide.

13. Project Financing discipline includes understanding the rationale for project financing, how to prepare the financial plan, assess the risks, design the financing mix, and raise the funds. In addition, one must understand the cogent analyses of why some project financing plans have succeeded while others have failed. A knowledge-base is required regarding the design of contractual arrangements to support project financing; issues for the host government legislative provisions, public/private infrastructure partnerships, public/private financing structures; credit requirements of lenders, and how to determine the project's borrowing capacity; how to prepare cash flow projections and use them to measure expected rates of return; tax and accounting considerations; and analytical techniques to validate the project's feasibility

14. Project finance is finance for a particular project, such as a mine, toll road, railway, pipeline, power station, ship, hospital or prison, which is repaid from the cash-flow of that project. Project finance is different from traditional forms of finance because the financier principally looks to the assets and revenue of the project in order to secure and service the loan. In contrast to an ordinary borrowing situation, in a project financing the financier usually has little or no recourse to the non-project assets of the borrower or the sponsors of the project. In this situation, the credit risk associated with the borrower is not as important as in an ordinary loan transaction; what is most important is the identification, analysis, allocation and management of every risk associated with the project.

15. The purpose of this paper is to explain, in a brief and general way, the manner in which risks are approached by financiers in a project finance transaction. Such risk minimisation lies at the heart of project finance.

16. In a no recourse or limited recourse project financing, the risks for a financier are great. Since the loan can only be repaid when the project is operational, if a major part of the project fails, the financiers are likely to lose a substantial amount of money. The assets that remain are usually highly specialised and possibly in a remote location. If saleable, they may have little value outside the project. Therefore, it is not surprising that

financiers, and their advisers, go to substantial efforts to ensure that the risks associated with the project are reduced or eliminated as far as possible. It is also not surprising that because of the risks involved, the cost of such finance is generally higher and it is more time consuming for such finance to be provided.

17. Risk minimisation process

Financiers are concerned with minimising the dangers of any events which could have a negative impact on the financial performance of the project, in particular, events which could result in: (1) the project not being completed on time, on budget, or at all; (2) the project not operating at its full capacity; (3) the project failing to generate sufficient revenue to service the debt; or (4) the project prematurely coming to an end.

18. The minimisation of such risks involves a three step process. The first step requires the identification and analysis of all the risks that may bear upon the project. The second step is the allocation of those risks among the parties. The last step involves the creation of mechanisms to manage the risks.

19. If a risk to the financiers cannot be minimised, the financiers will need to build it into the interest rate margin for the loan.

20. STEP 1 - Risk identification and analysis

The project sponsors will usually prepare a feasibility study, e.g. as to the construction and operation of a mine or pipeline. The financiers will carefully review the study and may engage independent expert consultants to supplement it. The matters of particular focus will be whether the costs of the project have been properly assessed and whether the cash-flow streams from the project are properly calculated. Some risks are analysed using financial models to determine the project's cash-flow and hence the ability of the project to meet repayment schedules. Different scenarios will be examined by adjusting economic variables such as inflation, interest rates, exchange rates and prices for the inputs

and output of the project. Various classes of risk that may be identified in a project financing will be discussed below.

21. STEP 2 - Risk allocation

Once the risks are identified and analysed, they are allocated by the parties through negotiation of the contractual framework. Ideally a risk should be allocated to the party who is the most appropriate to bear it (i.e. who is in the best position to manage, control and insure against it) and who has the financial capacity to bear it. It has been observed that financiers attempt to allocate uncontrollable risks widely and to ensure that each party has an interest in fixing such risks. Generally, commercial risks are sought to be allocated to the private sector and political risks to the state sector.

22. STEP 3 - Risk management

Risks must be also managed in order to minimise the possibility of the risk event occurring and to minimise its consequences if it does occur. Financiers need to ensure that the greater the risks that they bear, the more informed they are and the greater their control over the project. Since they take security over the entire project and must be prepared to step in and take it over if the borrower defaults. This requires the financiers to be involved in and monitor the project closely. Such risk management is facilitated by imposing reporting obligations on the borrower and controls over project accounts. Such measures may lead to tension between the flexibility desired by borrower and risk management mechanisms required by the financier.

23. Types of risks

Of course, every project is different and it is not possible to compile an exhaustive list of risks or to rank them in order of priority. What is a major risk for one project may be quite minor for another. In a vacuum, one can just discuss the risks that are common to most projects and possible avenues for minimising them. However, it is helpful to categorise the risks according to the phases of the project within which they may arise: (1) the design and construction phase; (2) the operation

phase; or (3) either phase. It is useful to divide the project in this way when looking at risks because the nature and the allocation of risks usually change between the construction phase and the operation phase.

24.1. Construction phase risk - Completion risk

Completion risk allocation is a vital part of the risk allocation of any project. This phase carries the greatest risk for the financier. Construction carries the danger that the project will not be completed on time, on budget or at all because of technical, labour, and other construction difficulties. Such delays or cost increases may delay loan repayments and cause interest and debt to accumulate. They may also jeopardise contracts for the sale of the project's output and supply contacts for raw materials.

25. Commonly employed mechanisms for minimising completion risk before lending takes place include: (a) obtaining completion guarantees requiring the sponsors to pay all debts and liquidated damages if completion does not occur by the required date; (b) ensuring that sponsors have a significant financial interest in the success of the project so that they remain committed to it by insisting that sponsors inject equity into the project; (c) requiring the project to be developed under fixed-price, fixed-time turnkey contracts by reputable and financially sound contractors whose performance is secured by performance bonds or guaranteed by third parties; and (d) obtaining independent experts' reports on the design and construction of the project. Completion risk is managed during the loan period by methods such as making pre-completion phase drawdowns of further funds conditional on certificates being issued by independent experts to confirm that the construction is progressing as planned.

26. 2. Operation phase risk - Resource / reserve risk
This is the risk that for a mining project, rail project, power station or toll road there are inadequate inputs that can be processed or serviced to produce an adequate return. For example, this is the risk that there are insufficient reserves for a mine, passengers for a railway, fuel for a power station or vehicles for a toll road.

27. Such resource risks are usually minimised by: (a) experts' reports as to the existence of the inputs (e.g. detailed reservoir and engineering reports which classify and quantify the reserves for a mining project) or estimates of public users of the project based on surveys and other empirical evidence (e.g. the number of passengers who will use a railway); (b) requiring long term supply contracts for inputs to be entered into as protection against shortages or price fluctuations (e.g. fuel supply agreements for a power station); (c) obtaining guarantees that there will be a minimum level of inputs (e.g. from a government that a certain number of vehicles will use a toll road); and (d) "take or pay" off-take contacts which require the purchaser to make minimum payments even if the product cannot be delivered.

28. Operating risk

These are general risks that may affect the cash-flow of the project by increasing the operating costs or affecting the project's capacity to continue to generate the quantity and quality of the planned output over the life of the project. Operating risks include, for example, the level of experience and resources of the operator, inefficiencies in operations or shortages in the supply of skilled labour. The usual way for minimising operating risks before lending takes place is to require the project to be operated by a reputable and financially sound operator whose performance is secured by performance bonds. Operating risks are managed during the loan period by requiring the provision of detailed reports on the operations of the project and by controlling cash-flows by requiring the proceeds of the sale of product to be paid into a tightly regulated proceeds account to ensure that funds are used for approved operating costs only.

29. Market / off-take risk

Obviously, the loan can only be repaid if the product that is generated can be turned into cash. Market risk is the risk that a buyer cannot be found for the product at a price sufficient to provide adequate cash-flow to service the debt. The best mechanism for minimising market risk before

lending takes place is an acceptable forward sales contact entered into with a financially sound purchaser.

30.3. Risks common to both construction and operational phases Participant / credit risk

These are the risks associated with the sponsors or the borrowers themselves. The question is whether they have sufficient resources to manage the construction and operation of the project and to efficiently resolve any problems which may arise. Of course, credit risk is also important for the sponsors' completion guarantees. To minimise these risks, the financiers need to satisfy themselves that the participants in the project have the necessary human resources, experience in past projects of this nature and are financially strong (e.g. so that they can inject funds into an ailing project to save it).

31. Technical risk

This is the risk of technical difficulties in the construction and operation of the project's plant and equipment, including latent defects. Financiers usually minimise this risk by preferring tried and tested technologies to new unproven technologies. Technical risk is also minimised before lending takes place by obtaining experts reports as to the proposed technology. Technical risks are managed during the loan period by requiring a maintenance retention account to be maintained to receive a proportion of cash-flows to cover future maintenance expenditure.

32. Currency risk

Currency risks include the risks that: (a) a depreciation in loan currencies may increase the costs of construction where significant construction items are sourced offshore; or (b) a depreciation in the revenue currencies may cause a cash-flow problem in the operating phase. Mechanisms for minimising resource include: (a) matching the currencies of the sales contracts with the currencies of supply contracts as far as possible; (b) denominating the loan in the most relevant foreign currency; and (c) requiring suitable foreign currency hedging contracts to be entered into.

33. Regulatory / approvals risk

These are risks that government licenses and approvals required to construct or operate the project will not be issued (or will only be issued subject to onerous conditions), or that the project will be subject to excessive taxation, royalty payments, or rigid requirements as to local supply or distribution. Such risks may be reduced by obtaining legal opinions confirming compliance with applicable laws and ensuring that any necessary approvals are a condition precedent to the drawdown of funds.

34. Political risk

This is the danger of political or financial instability in the host country caused by events such as insurrections, strikes, suspension of foreign exchange, creeping expropriation and outright nationalisation. It also includes the risk that a government may be able to avoid its contractual obligations through sovereign immunity doctrines. Common mechanisms for minimising political risk include: (a) requiring host country agreements and assurances that project will not be interfered with; (b) obtaining legal opinions as to the applicable laws and the enforceability of contracts with government entities; (c) requiring political risk insurance to be obtained from bodies which provide such insurance (traditionally government agencies); (d) involving financiers from a number of different countries, national export credit agencies and multilateral lending institutions such as a development bank; and (e) establishing accounts in stable countries for the receipt of sale proceeds from purchasers.

35. Force majeure risk

This is the risk of events which render the construction or operation of the project impossible, either temporarily (e.g. minor floods) or permanently (e.g. complete destruction by fire). Mechanisms for minimising such risks include: (a) conducting due diligence as to the possibility of the relevant risks; (b) allocating such risks to other parties as far as possible (e.g. to

the builder under the construction contract); and (c) requiring adequate insurances which note the financiers' interests to be put in place.

36. Conclusion

This paper only gives a brief overview of the common risks and methods of risk minimisation employed by financiers in project finance transactions. As stated previously, each project financing is different. Each project gives rise to its own unique risks and hence poses its own unique challenges. In every case, the parties - and those advising them - need to act creatively to meet those challenges and to effectively and efficiently minimise the risks embodied in the project in order to ensure that the project financing will be a success.

28. What is E-Banking ? Online Banking ↓

E-banking refers to electronic banking. It is like e-business in banking industry. E-banking is also called as "Virtual Banking" or "Online Banking".

E-banking is a result of the growing expectations of bank's customers.

Image Credits © Jochem Koole.

E-banking involves information technology based banking. Under this I.T system, the banking services are delivered by way of a Computer-Controlled System. This system does involve direct interface with the customers. The customers do not have to visit the bank's premises.

Popular services covered under E-Banking ↓

The popular services covered under E-banking include :-

1. Automated Teller Machines,
2. Credit Cards,
3. Debit Cards,
4. Smart Cards,
5. Electronic Funds Transfer (EFT) System,
6. Cheques Truncation Payment System,
7. Mobile Banking,
8. Internet Banking,
9. Telephone Banking, etc.

Advantages of E-Banking ↓

The main advantages of E-banking are :-

1. The operating cost per unit services is lower for the banks.
2. It offers convenience to customers as they are not required to go to the bank's premises.
3. There is very low incidence of errors.
4. The customer can obtain funds at any time from ATM machines.
5. The credit cards and debit cards enables the Customers to obtain discounts from retail outlets.
6. The customer can easily transfer the funds from one place to another place electronically.

31. Microfinance is usually understood to entail the provision of financial services to micro-entrepreneurs and small businesses, which lack access to banking and related services due to the high transaction costs associated with serving these client categories. The two main mechanisms for the delivery of financial services to such clients are (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group.

In some regions, for example Southern Africa, microfinance is used to describe the supply of financial services to low-income employees, which however is closer to the retail finance model prevalent in mainstream banking.

For some, microfinance is a movement whose object is "a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but

also savings, insurance, and fund transfers."[1] Many of those who promote microfinance generally believe that such access will help poor people out of poverty. For others, microfinance is a way to promote economic development, employment and growth through the support of micro-entrepreneurs and small businesses.

Microfinance is a broad category of services, which includes microcredit. Microcredit is provision of credit services to poor clients. Although microcredit is one of the aspects of microfinance, conflation of the two terms is endemic in public discourse. Critics often attack microcredit while referring to it indiscriminately as either 'microcredit' or 'microfinance'. Due to the broad range of microfinance services, it is difficult to assess impact, and very few studies have tried to assess its full impact

Microfinance is the provision of financial services such as loans, savings, insurance, and training to people living in poverty. It is one of the great success stories in the developing world in the last 30 years and is widely recognized as a just and sustainable solution in alleviating global poverty.

The industry began by providing small loans to emerging entrepreneurs to start or expand businesses. Opportunity International was one of the first nonprofit organizations to recognize the benefits of providing capital to people struggling to work their way out of poverty. Over the years, with Opportunity leading the way, the microfinance sector has expanded its financial service offerings to better meet client needs. Along with providing more flexible loan products and business and personal development training, Opportunity offers savings and insurance to help clients effectively navigate the daily hardships they face. Without these services, clients are continually at risk of slipping back into poverty because of unforeseen circumstances.

Microfinance organizations make it a priority to serve the particular needs of women, since a staggering 70 percent of all those living in extreme poverty are female. Women are often excluded from education, the workplace, owning property and equal participation in politics. They produce one half of the world's food, but own just one percent of its farmland. Nearly 85 percent of Opportunity's loan clients are women. While Opportunity gladly extends loans to men, the organization believes the greatest opportunity for interrupting cycles

of extreme poverty come from microfinance programs that target female entrepreneurs. When women improve their circumstances, they also improve the lives of their children. By investing in nutrition and education, they help to create a better future for their children and their communities.

Despite the success of life-transforming microfinance services, the World Bank says that the industry is not close to meeting the demand. Five hundred million people living in poverty could benefit from a small business loan and only one-third of the world's population has access to any kind of bank account. The lack of access is particularly severe in sub-Saharan Africa where the World Bank estimates that microfinance is reaching only a small percentage of the economically active population. In sub-Saharan Africa's poorest countries, less than 10 percent of the population has an account with a financial institution. In response, Opportunity has committed to building scalable, sustainable and accessible banks throughout the developing world to provide loans, training, savings and insurance products tailored to the specific needs of each region.

As the microfinance industry continues to mature, there is a danger that it will drift toward a more secure client base. It is critical that microfinance organizations continue to focus on those with the greatest needs–those who have been displaced, those in rural areas, those who traditional institutions consider unbankable–the most marginalized people. Maintaining that focus, microfinance can help create a world in which the underserved have fair access to economic opportunities and the hope to move beyond poverty.

Micre financing in India

Introduction

Microfinancing is the provision of financial services to poor and low income households without access to formal financial institutions.

As defined by the Asian Development Bank (ADB), it is - A provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises. In the late 90s, numerous agencies involved in micro-

financing operations in India started adding other financial services, including micro-insurance to its micro-finance operations.

The situation of micro-financing in India has thereby improved with certain steps taken by the government and now, the private players, banks etc as well.

Need for Micro - Financing

Since independence, various governments in India have experimented with a large number of grant and subsidy based poverty alleviation programmes. These programmes were based on grant/subsidy and the credit linkage was through commercial banks only. As a result, these programmes became unsustainable, perpetuated a dependant status on the beneficiaries and depended ultimately on the govt. employees for delivery. This not only led to misuse of both credit and subsidy but banks never looked at it as a profitable and commercial activity as well.

Hence was adopted the concept of micro-credit in India. Success stories in neighboring countries, like Grameen Bank in Bangladesh, Bank Rakiat in Indonesia, Commercial & Industrial Bank in Philippines etc, gave further boost to the concept in India in the 1980s. India thus adopted the similar model of extending credit to the poorest sector and took a no. of steps to promote micro-financing in the country.

Types of Organizations and Composition of the Sector

Microfinance providers in India can be classified under three broad categories: formal, semiformal, and informal.

Formal Sector

The formal sector comprises of the banks such as NABARD, SIDBI and other regional rural banks (RRBs).

They primarily provide credit for assistance in agriculture and micro-enterprise development and primarily target the poor. Their deposits at around Rs. 350billion and of that, around Rs. 250billion has been given as advances. They charge an interest of 12-13.5% but if we include the transaction costs (number

of visits to banks, compulsory savings and costs incurred for payments to animators/staff/local leaders etc) they come out to be as high as 21-24%.

Semi - formal Sector

The majority of institutional microfinance providers in India are semi-formal organizations broadly referred to as MFIs. Registered under a variety of legal acts, these organizations greatly differ in philosophy, size, and capacity. There are over 500 non-government organizations (NGOs) registered as societies, public trusts, or non-profit companies.

Informal Sector

In addition to friends and family, moneylenders, landlords, and traders constitute the informal sector. While estimates of their importance vary significantly, it is undeniable that they continue to play a significant role in the financial lives of the poor.

Steps taken by India to promote micro-financing

It set up development banks, such as SIDBI, NABARD which focused on rural credit and micro-financing. NGOs and SHGs were encouraged to become the govt's arm in extending micro-credit to the poor. They were provided supplementary credit needed to fund the credit, paper work was reduced between them and the banks. Also, the govt assisted in mobilizing funds from formal financial institutions to meet the larger credit needs of these organizations.

Focus on Women for micro - credits

A lot of Micro-financing schemes are now increasingly focusing on women primarily as well. There are compelling reasons for this.

 Among the poor, the poor women are the most disadvantaged - they are characterized by lack of education and access to resources, both of which are required to help them work their way out of poverty and for upward economic and social mobility.

 The problem is more acute for women in countries like India, despite the fact that women's labor makes a critical contribution to the economy.

 Evidence shows that groups of women are better customers than men - they are better managers of resources - benefits of loans are spread wider among the household if loans are routed through women - mixed groups are often inappropriate in Indian society - record of all-male groups is worse than that of all-women groups, everywhere.

Current Scenario of Micro - financing in India

With 75 million poor households potentially requiring financial services, the microfinance market in India is among the largest in the world. Estimates of household credit demand vary from a minimum of Rs. 2,000 to Rs. 6,000 in rural areas and Rs. 9,000 in urban settings. Given that 80 percent of poor households are located in rural areas, total credit demand ranges between Rs. 255 billion and Rs. 500 billion. However, only Rs.18 billion of this amount has been generated so far. The reason for this is that major portion for rural crediting has been from the informal sector and this is at a very high interest rate, thus reducing the volumes of such credits, and by far has been for investment purposes (13%) and more for family emergencies (29%) and social expenditures (19%).

There are a number of factors why rural crediting by the formal sector has not taken pace so far.

 High fiscal deficits have meant that Government is appropriating a large share of financial savings for itself.

 Persisting interest rate restrictions reduce the attractiveness of lending, particularly to small, rural clients. On the other hand, informal credits have been attractive albeit high interest rates due to:

 Flexible repayment options

 Convenience and frequency with which such loans can be accessed

 Less reliance on collateral (only 16.5% of households report providing collateral against the loan)

Meeting the Demands

Inadequacies in rural access to formal finance and the seemingly extortionary terms of informal finance for the poor provide a strong need and ample space for innovative approaches to serve the financial needs of India's rural poor. A gap of as high as 85%-90% in supply and demand cannot be closed by only the existing MFIs because many, particularly the younger and smaller organizations, lack the institutional capacity to expand.

Key Concerns

All said and done however, there are certain key issues that need to be tackled before ensuring the benefits of micro-financing would reach their optimum levels.

Scaling-Up Microfinance: Microfinancing through formal and semi-formal can reach self-sustainability only when there is substantial volume which they can generate.

Effective policy, legal and regulatory framework - An enabling policy, legal and regulatory framework is critical to scaling-up. For this the govt. needs to take certain steps as:

 Reducing minimum start-up capital requirements to facilitate the transformation of MFIs into NBFCs

 Encouraging multiple sources of equity for MFIs

 Developing a set of prudential norms that are more appropriate to institutions serving the poor, and set up supervision mechanisms around those norms.

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