B.B.A (B & I): 112 Indian Banking System

Unit I

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Unit II

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UNIT-1

Concept and Purpose of Development Banking

Development banking means different to different people, in different places, and at different times. This only goes to show that development banking has evolved since it was first conceptualized as an 'instrument of development'. However, in its original form and in its broadest definition, it is a type of financial intermediation to help the country reach a higher and sustainable level of development. On the wider context, the desired level of development includes the whole spectrum of socio-economic progress. Development banking therefore can also be defined as a form of financial intermediation that provides financing to high priority investment projects in a developing economy. Both definitions imply that the purpose of development banking is to bring the country to a higher level of development.

A development bank is a 'bank' established for the purpose of 'financing development'. A traditional definition of a development bank is one which is a national or regional financial institution designed to provide medium-and long-term capital for productive investment, often accompanied by technical assistance, in less-developed areas. Development banks fill a gap left by undeveloped capital markets and the reluctance of commercial banks to offer long-term financing.

Difference between a Development Bank and a Commercial Bank

There are several differentiating factors between a development bank and a commercial bank. Some extreme observations below are made in order to emphasize "traditional" differences between the two in order to emphasize the point. Actual practice, of course, differs from commercial bank to commercial bank and from development bank to development bank. As the country's capital markets develop, there shall be less difference between these specialized institutions and the similarities shall become more apparent. With this as a premise, the traditional differences between development and commercial banks are in the following areas:

a) Impetus for the Creation of the Institution: A development bank is created as an instrument of economic development while a commercial bank is created by business opportunities.

b) Posture Relative to Business Opportunities: A development bank is supposed to be pro-active as it should take an active role to promote projects and to develop institutions (entrepreneurs). The projects chosen are those that are consistent with the economic development priorities. A commercial bank is known to be reactive to business opportunities. It requires bankability only after the entrepreneur's decision has been made; it waits for the idea to culminate into a funding requirement.

c) Types of Projects Supported: For a development bank, there is an explicit effort to support economic development projects. The following desired 'impact' projects form the basis for scanning for opportunities: import substitution (at competitive prices); exports; increased local demand; regional development (for example, tourism); and increased industrial efficiency through better technology. For a 5 commercial bank, the abovementioned goals are not the starting point for the identification of projects. Rather, they would most likely be side-benefits. A commercial bank has little concern for these objectives, except for the viability of the bank transaction. In short, a development bank's activities are project-based while that of the commercial bank are transaction-based.

d) Search Process for Projects Financed: A development bank goes into a planning cycle, identifying which are the likely areas to go into. For example, if it determines that exports is an area to be promoted, then it conducts a marketing study and seeks entrepreneurs to implement related projects. For the commercial bank, the search process is different. It asks, "Are you an exporter?", then looks at that entrepreneur's cash balance to determine if there is a marketing opportunity for the transaction.

e) Project Promotion Activities: A development bank offers counseling and advisory services for enterprise development and promotion as part of its development lending process. A commercial bank offers legal and business advice, appraisal services and credit investigation, usually for a fee. It undertakes very little project promotion and institutional development. Its emphasis is on client development and marketing.

f) Strategic Goals: A development bank has a more difficult strategic objective because it is involved with the concerns of the country, specifically economic development. Aside from this, after providing financing, it is also concerned with developing the enterprise. Developing them explicitly would mean additional costs to the bank. Enterprise development dramatically limits the number of accounts that a development can handle because this is time-consuming. A commercial bank's main concern is to generate profits. Other benefits are only incidental. With a commercial bank's cost-consciousness, economic development would be its last priority.

g) Criteria for Financing: A development bank assumes project risks and does not insist on too much collateral. It will provide financing as long as the other criteria are met. A commercial bank pays less attention to the project in relation to the collateral requirements. However, the more progressive banks are lending against project cash flow and without collateral.

h) Assessment of the Loan Proposal: A development bank employs project appraisal as a means to determine the viability of the project submitted for financing. Project appraisal looks at the technical, financial, marketing, management, environmental and economic aspects of the project. Loan repayment is based on the cash flow to be generated by the project. A commercial bank uses risk asset management as tool to assess the borrower. It looks at the so-called 5 C's of credit, i.e., character, capacity, capital, collateral and condition. It bases loan repayment on the capacity of the borrower to pay (even from other sources) than from the 'project' itself. Thus, it can be said that development bank financing is project-focused while that of a commercial bank is borrower-oriented.

i) Term of Loans Extended: A development bank provides mainly term loans (maturity of more than one year). On the other hand, a commercial bank provides mainly short-term loans (less than one year maturity).

j) Sources of Loan Funds: A development bank is dependent on concessionary, long-term funds, e.g. pension funds, funds from multilateral financial institutions like the World Bank, Asian Development Bank, etc. It has traditionally limited access to domestic or commercial funds. A commercial bank has a strong deposit base and its corporate borrowers are also depositors. They can match its commercial borrowing against its own short-term loans.

k) Lending Policies for Cyclical Industries: A development bank supports its clients in spite of short-term cycles while a commercial bank does not like cyclical industries.

l) Resource Mobilization: A development bank undertakes project promotion work to match concessionary long-term financing while a commercial bank mobilizes deposit funds from small depositors which are lent out to large companies.

m) Client Relationship: A development bank relates more to clients as borrowers. There is less day-to-day business relationship. Trade transactions of a commercial bank allow for frequent monitoring and close client relationship.

n) Scope of Institutional Mandate: A development bank is essentially a specialized institution. It has limited branching and range of products. The commercial bank has a generalized charter. It can offer a wide range of products (especially in the case of universal banks) and can open more branches.

IDBI

The Industrial Development Bank of India (IDBI) was established on 1 July 1964 under an Act of Parliament as a wholly owned subsidiary of the Reserve Bank of India. In 16 February 1976, the ownership of IDBI was transferred to the Government of India and it was made the principal financial institution for coordinating the activities of institutions engaged in financing, promoting and developing industry in the country. Although Government shareholding in the Bank came down below 100% following IDBI's public issue in July 1995, the former continues to be the major shareholder (current shareholding: 75%). IDBI provides financial assistance, both in rupee and foreign currencies, for green-field projects as also for expansion, modernisation and diversification purposes. In the wake of financial sector reforms unveiled by the government since 1992, IDBI also provides indirect financial assistance by way of refinancing of loans extended by State-level financial institutions and banks and by way of rediscounting of bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

IDBI has played a pioneering role, particularly in the pre-reform era (1964–91),in catalyzing broad based industrial development in the country in keeping with its Government-ordained 'development banking' charter.

Narasimam committee recommends that IDBI should give up its direct financing functions and concentrate only in promotional and refinancing role. But this recommendation was rejected by the government. Later RBI constituted a committee under the chairmanship of S.H.Khan to examine the concept of development financing in the changed global challenges. This committee is the first to recommend the concept of universal banking. The committee wanted the development financial institution to diversify its activity. It recommended to harmonise the role of development financing and banking activities by getting away from the conventional distinction between commercial banking and developmental banking In of IDBI Act.

NABARD

NABARD is the apex institution in the country which looks after the development of the cottage industry, small industry and village industry, and other rural industries. NABARD also reaches out to allied economies and supports and promotes integrated development. And to help NABARD discharge its duty, it has been given certain roles as follows:

1. Serves as an apex financing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas.
2. Takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.
3. Co-ordinates the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with Government of India, State Governments, Reserve Bank of India (RBI) and other national level institutions concerned with policy formulation
4. Undertakes monitoring and evaluation of projects refinanced by it.
5. NABARD refinances the financial institutions which finances the rural sector.
6. The institutions which help the rural economy, NABARD helps develop.
7. NABARD also keeps a check on its client institutes.

8. It regulates the institution which provides financial help to the rural economy.
9. It provides training facilities to the institutions working the field of rural upliftment.
10. It regulates the cooperative banks and the RRB's, and manages talent acquisition through IBPS CWE.

NABARD's refinance is available to State Co-operative Agriculture and Rural Development Banks (SCARDBs), State Co-operative Banks (SCBs), Regional Rural Banks (RRBs), Commercial Banks (CBs) and other financial institutions approved by RBI. While the ultimate beneficiaries of investment credit can be individuals, partnership concerns, companies, State-owned corporations or co-operative societies, production credit is generally given to individuals. NABARD has its head office at Mumbai, India.

NABARD operates throughout the country through its 28 Regional Offices and one Sub-office, located in the capitals of all the states/union territories. Each Regional Office[RO] has a Chief General Manager [CGMs] as its head, and the Head office has several Top executives like the Executive Directors[ED], Managing Directors[MD], and the Chairperson. It has 336 District Offices across the country, one Sub-office at Port Blair and one special cell at Srinagar. It also has 6 training establishments.

NABARD is also known for its 'SHG Bank Linkage Programme' which encourages India's banks to lend to self-help groups (SHGs). Because SHGs are composed mainly of poor women, this has evolved into an important Indian tool for microfinance. As of March 2006 2.2 million SHGs representing 33 million members had to been linked to credit through this programme.

NABARD also has a portfolio of Natural Resource Management Programmes involving diverse fields like Watershed Development, Tribal Development and Farm Innovation through dedicated funds set up for the purpose.

SIDBI

Small Industries Development Bank of India is an independent financial institution aimed to aid the growth and development of micro, small and medium-scale enterprises (MSME) in India. Set up on April 2, 1990 through an act of parliament, it was incorporated initially as a wholly owned subsidiary of Industrial Development Bank of India. Current shareholding is widely spread among various state-owned banks, insurance companies and financial institutions. Beginning as a refinancing agency to banks and state level financial institutions for their credit to small industries, it has expanded its activities, including direct credit to the SME through 100 branches in all major industrial clusters in India. Besides, it has been playing the development role in several ways such as support to micro-finance institutions for capacity building and on lending. Recently it has opened seven branches christened as Micro Finance branches, aimed especially at dispensing loans up to ₹5 lakh.

It is the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for Co-ordination of the functions of the institutions engaged in similar activities.

IFCI

At the time of independence in 1947, India's capital market was relatively under-developed. Although there was significant demand for new capital, there was a dearth of providers. Merchant bankers and underwriting firms were almost non-existent and commercial banks were not equipped to provide long-term industrial finance in any significant manner.

It is against this backdrop that the government established The Industrial Finance Corporation of India (IFCI) on July 1, 1948, as the first Development Financial Institution in the country to cater to the long-term finance needs of the industrial sector. The newly-established DFI was provided access to low-cost funds through the central bank's Statutory Liquidity Ratio or SLR which in turn enabled it to provide loans and advances to corporate borrowers at concessional rates.

LIBERALIZATION - CONVERSION INTO COMPANY IN 1993

By the early 1990s, it was recognized that there was need for greater flexibility to respond to the changing financial system. It was also felt that IFCI should directly access the capital markets for its funds needs. It is with this objective that the constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Indian Companies Act, 1956. Subsequently, the name of the company was also changed to "IFCI Limited" with effect from October 1999.

UNIT-2

Role of Central Bank

Most countries have some form of Central Bank serving as the principle authority for the nation's financial matters.

Primary duties for a Central Bank include:

1. Implement a monetary policy that provides consistent growth and employment
2. Promote the stability of the country's financial system
3. Manage the production and distribution of the nation's currency
4. Inform the public of the overall state of the economy by publishing economic statistics

Fiscal and Monetary Policy

- Fiscal policy refers to the economic direction a government wishes to pursue regarding taxation, spending, and borrowing.
- Monetary policy is the set of actions a government or Central Bank takes to influence the economy in an attempt to achieve its fiscal policy.
- Central Banks have several options they can use to affect monetary policy, but the most powerful tool is their ability to set interest rates.

How Central Banks Use Interest Rates to Implement Fiscal Policy

- A primary role for most Central Banks is to supply operational capital to the country's commercial banks. This is done by offering loans to these banks for short time periods – usually on an overnight basis.
- This ensures the banking system has sufficient liquidity for businesses and individual consumers to borrow money, and the availability of credit has a direct impact on business and consumer spending.
- The Central Bank charges interest on the short-term loans it provides. The rate charged by the Central Bank affects the interest rate that the banks charge their customers as the banks must recover their cost (the interest they paid) plus earn a profit.
- Central Banks use the relationship between the short-term rates at which it offers loans, and the interest rate the banks charge, as a way to influence the cost for the public to borrow money.
- If the Central Bank feels that an increase in consumer spending is needed to stimulate the economy, it can lower short-term rates when providing loans to the commercial banks. This usually results in the banks lowering the interest they charge, making borrowing less costly for consumers which the Central Bank hopes will lead to an increase in overall spending.

- If a tightening of the economy is needed to slow inflation, the Central Bank can increase interest rates making loans more expensive to acquire, which could lead to an overall reduction in spending.

Supply and Demand of Currency

- Just like any commodity, the value of a free-floating currency is based on supply and demand.
- To increase a currency's value, the Central Bank can buy currency and hold it in its reserves. This reduces the supply of the currency available and could lead to an increase in valuation.
- To decrease a currency's value, the Central Bank can sell its reserves back to the market. This increases the supply of the currency and could lead to a decrease in valuation.
- International trade flows can also influence supply and demand for a currency. When a country exports more than it imports (a *positive* trade balance), foreign buyers must exchange more of their currency for the currency of the exporting country. This increases the demand for the currency.

RBI and Monetary Policy

Monetary policy is the process by which monetary authority of a country, generally a central bank controls the supply of money in the economy by exercising its control over interest rates in order to maintain price stability and achieve high economic growth.[1] In India, the central monetary authority is the Reserve Bank of India (RBI) Is so designed as to maintain the price stability in the economy. Other objectives of the monetary policy of India, as stated by RBI, are:

Price Stability

Price Stability implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favourable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability.

Controlled Expansion Of Bank Credit

One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

Promotion of Fixed Investment

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

Restriction of Inventories

Overfilling of stocks and products becoming outdated due to excess of stock often results is sickness of the unit. To avoid this problem the central monetary authority carries out this essential function of restricting the inventories. The main objective of this policy is to avoid over-stocking and idle money in the organization

Promotion of Exports and Food Procurement Operations

Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.

Desired Distribution of Credit

Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.

Equitable Distribution of Credit

The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people

To Promote Efficiency

It is another essential aspect where the central banks pay a lot of attention. It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.

Reducing the Rigidity

RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

Regulation and Supervision of banking system,

Bank regulations are a form of government regulation which subject banks to certain requirements, restrictions and guidelines. This regulatory structure creates transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things.

Given the interconnectedness of the banking industry and the reliance that the national (and global) economy hold on banks, it is important for regulatory agencies to maintain control over the standardized practices of these institutions. Supporters of such regulation often hinge their arguments on the "too big to fail" notion. This holds that many financial institutions (particularly investment banks with a commercial arm) hold too much control over the economy to fail without enormous consequences. This is the premise for government bailouts, in which government financial assistance is provided to banks or other financial institutions who appear to be on the brink of collapse. The belief is that without this aid, the crippled banks would not only become bankrupt, but would create rippling effects throughout the economy leading to systemic failure.

Objectives of bank regulation

The objectives of bank regulation, and the emphasis, vary between jurisdictions. The most common objectives are:

1. Prudential—to reduce the level of risk to which bank creditors are exposed (i.e. to protect depositors)
2. Systemic risk reduction—to reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures
3. Avoid misuse of banks—to reduce the risk of banks being used for criminal purposes, e.g. laundering the proceeds of crime
4. To protect banking confidentiality
5. Credit allocation—to direct credit to favoured sectors
6. It may also include rules about treating customers fairly and having corporate social responsibility (CSR)

General principles of bank regulation

Banking regulations can vary widely across nations and jurisdictions. This section of the article describes general principles of bank regulation throughout the world.

Minimum requirements

Requirements are imposed on banks in order to promote the objectives of the regulator. Often, these requirements are closely tied to the level of risk exposure for a certain sector of the bank. The most important minimum requirement in banking regulation is maintaining minimum. To some extent, U.S. banks have some leeway in determining who will supervise and regulate them.

Supervisory review

Banks are required to be issued with a bank license by the regulator in order to carry on business as a bank, and the regulator supervises licensed banks for compliance with the requirements and responds to breaches of the requirements through obtaining undertakings, giving directions, imposing penalties or revoking the bank's license.

Market discipline

The regulator requires banks to publicly disclose financial and other information, and depositors and other creditors are able to use this information to assess the level of risk and to make investment decisions. As a result of this, the bank is subject to market discipline and the regulator can also use market pricing information as an indicator of the bank's financial health.

Instruments and requirements of bank regulation

Capital requirement

The capital requirement sets a framework on how banks must handle their capital in relation to their assets. Internationally, the Bank for International Settlements' Basel Committee on Banking Supervision influences each country's capital requirements. In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accords. The latest capital adequacy framework is commonly known as Basel III.This updated framework is intended to be more risk sensitive than the original one, but is also a lot more complex.

Reserve requirement

The reserve requirement sets the minimum reserves each bank must hold to demand deposits and banknotes. This type of regulation has lost the role it once had, as the emphasis has moved toward capital adequacy, and in many countries there is no minimum reserve ratio. The purpose of minimum reserve ratios is liquidity rather than safety. An example of a country with a contemporary minimum reserve ratio is Hong Kong, where banks are required to maintain 25% of their liabilities that are due on demand or within 1 month as qualifying liquefiable assets.

Reserve requirements have also been used in the past to control the stock of banknotes and/or bank deposits. Required reserves have at times been gold coin, central bank banknotes or deposits, and foreign currency.

Corporate governance

Corporate governance requirements are intended to encourage the bank to be well managed, and is an indirect way of achieving other objectives. As many banks are relatively large, with many divisions, it is important for management to maintain a close watch on all operations. Investors and clients will often hold higher management accountable for missteps, as these individuals are expected to be aware of all activities of the institution. Some of these requirements may include:

1. To be a body corporate (i.e. not an individual, a partnership, trust or other unincorporated entity)
2. To be incorporated locally, and/or to be incorporated under as a particular type of body corporate, rather than being incorporated in a foreign jurisdiction.
3. To have a minimum number of directors
4. To have an organisational structure that includes various offices and officers, e.g. corporate secretary, treasurer/CFO, auditor, Asset Liability Management Committee, Privacy Officer, Compliance Officer etc. Also the officers for those offices may need to be approved persons, or from an approved class of persons.
5. To have a constitution or articles of association that is approved, or contains or does not contain particular clauses, e.g. clauses that

enable directors to act other than in the best interests of the company (e.g. in the interests of a parent company) may not be allowed.

Financial reporting and disclosure requirements

Among the most important regulations that are placed on banking institutions is the requirement for disclosure of the bank's finances. Particularly for banks that trade on the public market, in the US for example the Securities and Exchange Commission (SEC) requires management to prepare annual financial statements according to a financial reporting standard, have them audited, and to register or publish them. Often, these banks are even required to prepare more frequent financial disclosures, such as Quarterly Disclosure Statements. The Sarbanes-Oxley Act of 2002 outlines in detail the exact structure of the reports that the SEC requires.

In addition to preparing these statements, the SEC also stipulates that directors of the bank must attest to the accuracy of such financial disclosures. Thus, included in their annual reports must be a report of management on the company's internal control over financial reporting. The internal control report must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting. Under the new rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report. Furthermore, the SEC added a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Credit rating requirement

Banks may be required to obtain and maintain a current credit rating from an approved credit rating agency, and to disclose it to investors and prospective investors. Also, banks may be required to maintain a minimum credit rating. These ratings are designed to provide color for prospective clients or investors regarding the relative risk that one assumes when engaging in business with the bank. The ratings reflect the tendencies of the bank to take on high risk endeavours, in addition to the likelihood of succeeding in such deals or initiatives. The rating agencies that banks are most strictly governed by, referred to as the "Big Three" are the Fitch Group, Standard and Poor's and Moody's. These agencies hold the most influence over how banks (and all public companies) are viewed by those engaged in the public market. In recent years, following the Great Recession, many economists have argued that these agencies face a serious conflict of interest in their core business model. Clients pay these agencies to rate their company based on their relative riskiness in the market. The question then is, to whom is the agency providing its service: the company or the market?

Large exposures restrictions

Banks may be restricted from having imprudently large exposures to individual counterparties or groups of connected counterparties. Such limitation may be expressed as a proportion of the bank's assets or equity, and different limits may apply based on the security held and/or the credit rating of the counterparty. Restricting disproportionate exposure to high-risk investment prevents financial institutions from placing equity holders' (as well as the firm's) capital at an unnecessary risk.

Too Big To Fail and Moral Hazard

Among the reasons for maintaining close regulation of banking institutions is the aforementioned concern over the global repercussions that could result from a bank's failure; the idea that these bulge bracket banks are "too big to fail". The objective of federal agencies is to avoid situations in which the government must decide whether to support a struggling bank or to let it fail. The issue, as many argue, is that providing aid to crippled banks creates a situation of moral hazard. The general premise is that while the government may have prevented a financial catastrophe for the time being, they have reinforced confidence for high risk taking and provided an invisible safety net. This can lead to a vicious cycle, wherein banks take risks, fail, receive a bailout and then continue to take risks once again.

Current Developments and Reports of RBI

RBI announces new development and regulatory policies

As part of its Annual Monetary Policy Statement , the RBI also introduced new development and regulation policies for the financial sector. Some of the key initiatives include:-

1. **Financial inclusion and Direc Benefit Transfer (DBT):-** The RBI proposes to open accounts for all eligible individuals with the support of local government authorities, seeding new accounts with Aadhaar numbers and implementing a mechanism to monitor and review the progress of DBT.
2. **Priority sector guidelines:-** the loan limit for Micro and Small Enterprises is to be increased to Rs 50 million per borrower(from Rs 20 Million). In addition, there will be an increase in the loan limit to Rs 50 million per borrower (from 10 million) under the head of indirect finance to

agriculture(this includes bank loans to dealers/ sellers of fertilizers, pesticides, seeds, cattle feed, poultry feed and agricultural implements.)

3. **Prudential guidelines on restructuring of advances by banks/ financial institutions:-** the Mahapatra Committee had issued recommendations on prudential guidelines for restructuring advances provided by banks and financial institutions.
4. **Banking structure in India:**- the RBI is planning to launch a policy discussion paper on the banking structure in India based on the recommendations of the Committeee on Banking Sector Reforms, 1998 and the Committee on Financial Sector Reforms, 2008.
5. **Lead bank scheme(LBS):-** The RBI is to bring all districts in metropolitan areas under the purview of the LBS. The LBS is a mechanism for coordinating between government authorities and banks to provide doorsteps banking to the financially excluded segment of the population.

Maintenance of CRR & SLR

Cash Reserve Ratio (CRR) is the amount of funds that all Scheduled Commercial Banks (SCB) excluding Regional Rural Banks (RRB) are required to maintain without any floor or ceiling rate with RBI with reference to their total net Demand and Time Liabilities (DTL) to ensure the liquidity and solvency of Banks (Section 42 (1) of RBI Act 1934). The current CRR is 4.75% and at present no incremental CRR is required to be maintained by the banks.

SLR stands for Statutory Liquidity Ratio. Apart from CRR, every bank is required to maintain in India at the close of business every day, a minimum proportion of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold and un-encumbered approved securities. The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio (SLR). Present SLR is 23%. (Reduced w.e.f. 11/08/2012 from earlier 24%).

RBI is empowered to increase this ratio up to 40%. An increase in SLR also restricts the bank's leverage position to pump more money into the economy. In the event of SCBs SLR holdings fall below the statutory requirement upto 2% of their DTL, they can avail the Marginal Standing Facility (MSF) upto 2% of their net DTL outstanding at the end of the second proceeding fortnight and they will not have the obligation to seek specific waiver of the default in SLR compliance arising out of use of this facility

Interest Rate Policy

An **interest rate** is the rate at which interest is paid by borrowers for the use of money that they borrow from a lender. Specifically, the interest rate (I/m) is a percent of principal (P) paid a certain amount of times (m) per period (usually quoted per annum). Interest-rate targets are a vital tool of monetary policy and are taken into account when dealing with variables like investment, inflation, and unemployment. The central banks or reserve banks of countries generally tend to reduce interest rates when they wish to increase investment and consumption in the country's economy. However, a low interest rate as a macro-economic policy can be risky and may lead to the creation of an economic bubble, in which large amounts of investments are poured into the real-estate market and stock market.

RBI's balance sheet

To ensure that temptations of the government emanating from external compulsions do not to dilute the strength of RBI's balance sheet, the government should take measures to augment the share capital of the RBI after amending the RBI Act

The Reserve Bank of India (RBI) has published its Annual Report 2011-12 on 23 August 2012. The accounts presented in the report shows that RBI's income increased during 2011-12 by about 43% as compared to the previous year (from Rs37,070 crore to Rs53,176 crore). Transfer of surplus profit to the Government of India (GOI) was Rs16,010 crore which as percentage to gross income is lower by around 10.4% as compared to 2010-11. Obviously, the transfer of "surplus income" to the government in a routine manner when the reserves position of the central bank shows a declining trend needs a review. Considering the size of RBI's balance sheet, recouping the reserves position to healthier levels will be a Herculean task.

Considering the size of its balance sheet and the internal and external pressures on its income generating capabilities, as also the nature of shocks RBI has to absorb from time to time, GOI should support the central bank's efforts to augment its reserves at least on par with the 12% norm of capital adequacy RBI expects from banks it supervises.

RBI, on its part, should think in terms of generating reasonable income from deployment of captive funds it is mandated to manage, without any compromise on safety of investments. In this context, the addition of about 200 tonnes to holdings in gold three years back was a welcome move. The central bank should further augment the gold component in reserves by tapping domestic gold stock with policy and legislative support from GOI.

Earnings from Foreign Sources

The RBI's rate of earnings on Foreign Currency Assets and gold was lower at 1.47% in 2011- 12 compared with 1.74% in 2010-11. The report attributes this to the low interest rates prevalent in international markets. The following table gives the details.

Earnings from Foreign Sources (crores of rupees)				
Item	Year ended		Variation	
	June 30, 2011	June 30, 2012	Absolute	Per cent
1	2	3	4	5
Foreign Currency Assets (FCA)	12,68,744	14,49,281	1,80,537	14.2
Average FCA	12,17,751	13,47,755	1,30,004	10.7
Earnings from FCA (and gold) (interest, discount, exchange gain/loss, capital gain/loss on securities)	21,150	19,810	-13.40	-6.3
Earnings from FCA (and gold) as percentage of average FCA	1.74	1.47		

(Source: RBI Annual Report 2011-12, Table XI.2)

It is a fact that our Forex Reserves Management has not been getting the attention it deserved, as RBI's own priorities hovered more around internal debt management and monetary policy concerns. It is comforting to see that RBI governor Dr D Subbarao is focusing on the components of forex reserves and their vulnerabilities. The return on forex investments has not been encouraging and one gets an impression that there has been some complacency in augmenting the reserves position, resulting in the reserves stagnating around $300 billion for quite some time now. On the part of GOI/RBI, it was a late decision in the last quarter of 2009 to increase the gold component in the country's forex reserves by about 200 tonnes, by a purchase from the International Monetary Fund. In the context of improving the country's image as one with a decent net-worth, it is important to manage the domestic gold holdings outside the forex portfolio also and make them visible and available as part of the nation's resources. Let us not forget the 1991 episode when solid gold had to be carried abroad for pledging and borrowing. Such shameful experiences can be avoided in future, if a part of domestic stock of the estimated 18,000 tonnes of gold is made tradable and a decent domestic stock of standard gold acceptable in international market is built up.

RBI's internal reserves Contingency Reserve (CR) represents the amount set aside on a year-to-year basis for meeting unexpected and unforeseen contingencies, including depreciation in the value of securities, exchange guarantees and risks arising out of monetary/exchange rate policy operations. In order to meet the needs of internal capital expenditure and make investments in subsidiaries and associate institutions, a further sum is provided and credited to the Asset Development Reserve (ADR). The amount of transfer to the CR and the ADR and the surplus transferred to the government as a percentage of the total income in the last five years is set out in the table below:

Contingency and Asset Development Reserves and Surplus Transferred to the Government

(crores of rupees)

Item	2007-08	2008-09	2009-10	2010-11	2011-12
1	2	3	4	5	6
Total Income (Gross)	57751	60732	32884	37070	53176
i) Transfer to Contingency Reserve	33430	26191	5168	12167	24677
	(57.9)	(43.1)	(15.7)	(32.8)	(46.4)
ii) Transfer to Asset Development Reserve	3208	1310	550	1235	2348
	(5.6)	(2.2)	(1.7)	(3.3)	(4.4)
iii) Transfer of Surplus to the Government	15011	25009	18759	15009	16010
	(26.0)	(41.2)	(57.0)	(40.5)	(30.1)
Transfer of Surplus to the Government as Percentage of Total Income (Gross) less Expenditure	29.1	47.6	76.6	52.8	37.2

Note: Figures in parentheses indicate proportion to the total income (gross).

(Source: RBI Annual Report 2011-12, Table XI.6)

The report recalls that "to meet the internal capital expenditure and make investments in its subsidiaries and associate institutions, the RBI had created a separate ADR in 1997-98 with the aim of reaching 1% of the central bank's total assets within the overall indicative target of 12% of the total assets set for CR and ADR taken together". But despite a transfer of Rs2,348 crore in 2011-12, from income to ADR raising its level to Rs18,214 crore as on 30 June 2012, the CR and the ADR together constituted only 9.7% of the total assets of the RBI as on 30 June 2012 showing a fall of 0.6% from the level of 10.3% during the previous year, taking the original target of 12% further away. It may be recalled that in 2009 the target was almost in sight when the level reached 11.9%. The ADR now accounts for 0.8% of the total assets of the RBI as against the target of 1%.The position of CR and ADR during the last five years was asunder:

Balances in Contingency Reserve and Asset Development Reserve				
(crores of rupees)				
As on 30 June	CR	ADR	Total	Percentage to Total Assets
1	2	3	4=(2+3)	5
2008	1,27,201	12,772	1,39,973	9.6
2009	1,53,392	14,082	1,67,474	11.9
2010	1,58,561	14,632	1,73,192	11.3
2011	1,70,728	15,866	1,86,594	10.3
2012	1,95,405	18,214	2,13,619	9.7

(Source: RBI Annual Report, Table XI.8)

To ensure that temptations of the government emanating from external compulsions do not to dilute the strength of RBI's balance sheet, the GOI should take measures to augment the share capital of RBI after carrying out appropriate amendments to the RBI Act. Till such time RBI should be allowed to retain surplus income by transfer to reserves. Considering the size of its balance sheet and the internal and external pressures on its income-generating capabilities, as also the nature of shocks the apex bank has to absorb from time to time, the central bank's reserves need to be augmented on an ongoing basis.

UNIT-3

Commercial Banking:

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).

Banker Customer Relationship,

- A banker is the one who gets into debts and creates debts. H.L. HART – the banker is one who receives money, collects cheques and drafts, for customers, with an obligation to honour the cheques drawn by customers from time to time subject to availability of amounts in the account. Section 3 of NI ACT 1881, and Section 2 of BILL OF EXCHANGE ACT 1882. State that the term banker includes person or corporation or a company acting as banker. Under Section 5 (1) of Banking Regulations of 1949, a banking company is defined as any company which transacts banking business. Under Section 5 (1) B , banking business means accepting for the purpose of landing or investment, deposits of money from the public, repayable on demand or otherwise withdraw able by cheque , draft or otherwise..
- CUSTOMER A person who buys goods or services from a shop or a business entity. A person you deal with as a business entity. There is no statutory definition. A person/ company/entity who has an account with a bank is a customer. There is no unanimity as regards to the time period of the dealings. A casual transaction like encashment of a cheque does not entail a person to be customer. The duration of association of the customer with the bank is of no essence. A

customer is one who has an account with the bank and to whom the banks undertakes to extend business of banking.

Management of Deposit Business & Credit Business

Deposit Business

1. . Funds placed into an account at a depository institution to increase the credit balance of the account.
2. Down payment given in advance to support the intention to complete a commercial transaction.

Credit Business

and partners don't know whether or not you're likely to pay them. Looking at your business credit helps them decide if they should take a risk on you. With strong business credit, we borrow at lower costs, and we get more favourable terms from suppliers. You may also be able to get loans without a personal guarantee.

Fee Based services of Banks

Banks offer the following services to account holders at their specified branches — multi-city / Payable at Par (PAP) cheque facility, anywhere banking facility, trade services, phone banking facility, internet banking facility, credit card, debit/ATM card, mobile banking and Real Time Gross Settlement (RTGS).

Foreign banks are expanding the number of products on offer, their complexity such as derivatives, leverage financing. Doorstep banking facilities are being offered by some of these banks to cater to convenience lifestyle of its customers. Private banks are extending services including wealth management and equity trading apart from credit cards.

Liquidity Vs. Profitability

Liquidity: Having enough money in the form of cash, or near-cash assets, to meet your financial obligations. Alternatively, the ease with which assets can be converted into cash.

Profitability: A measure of the amount by which a company's revenues exceed its relevant expenses.

Profitability refers to the amount of revenue gained when a business entity exceeds in revenue the amount needed to sustain it in terms of expenses, costs, and taxes. Liquidity refers to the availability of liquid, or cash, assets of a given business entity. The difference can be phrased in terms of profit versus assets.

Credit Assessment

An assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities.

A **credit rating** evaluates the credit worthiness of a debtor, especially a business (company) or a government. It is an evaluation made by a credit rating agency of the debtor's ability to pay back the debt and the likelihood of default.

PRINCIPLES OF BANK LENDING POLICIES---------------

The main business of banking company is to grant loans and advances to traders as well as commercial and industrial institutes.

The most important use of banks money is lending. Yet, there are risks in lending.

So the banks follow certain principles to minimize the risk:

1. Safety

2. Liquidity

3. Profitability

4. Purpose of loan

5. Principle of diversification of risks

• **SAFETY:-**

Normally the banker uses the money of depositors in granting loans and advances.

So first of all initially the banker while granting loans should think first of the safety of depositor's money.

The purpose behind the safety is to see the financial position of the borrower whether he can pay the debt as well as interest easily.

• **LIQUIDITY:-**

It is a legal duty of a banker to pay on demand the total deposited money to the depositor.

So the banker has to keep certain percent cash of the total deposits on hand.

Moreover the bank grants loan. It is also for the addition of short term or productive capital. Such type of lending is recovered on demand.

• **PROFITABILITY:-**

Commercial banking is profit earning institutes. Nationalized banks are also not an exception.

They should have planning of deposits in a profitability way pay more interest to the depositors and more salary to the employees.

Moreover the banker can also incur business cost and can give more benefits to customer.

• **PURPOSE OF LOAN:-**

Banks never lend or advance for any type of purpose.

The banks grant loans and advances for the safety of its wealth, and certainty of recovery of loan and the bank lends only for productive purposes.

For example, the bank gives such loan for the requirement for unproductive purposes.

• **PRINCIPLE OF DIVERSIFICATION OF RISKS:-**

While lending loans or advances the banks normally keep such securities and assets as a supports so that lending may be safe and secured.

Suppose, any particular state is hit by disasters but the bank shall get benefits from the lending to another states units.

Thus, he effect on the entire business of banking is reduced.

Secured & Unsecured Advances.

Often in our search for finance options, we are led into a crossroad where we have to make a choice between secured and unsecured loans. Both are equally alluring and put the borrower in a difficult spot. It is difficult to make up the mind regarding one particular finance option because each has their share of advantages and disadvantages. Depending on our financial situation, we will have to choose which loan is best for ourselves. Lets understand the basic crux of secured and unsecured loans.

Secured Loan: A loan backed by assets (e.g. a car or property) belonging to the borrower in order to decrease the risk assumed by the lender. The assets may be forfeited to the lender if the borrower fails to make the necessary payments. From the creditor's perspective this is a category of debt in which a lender has been granted a portion of the bundle of rights to specified property. Usually in secured loans the end use of loan amount drawn is given.

Following are the examples of the secured loans:
- **Car Loan** is taken to buy a new/used car.
- **Home Loan** is taken to buy or construct or renovate a home.

• **Car Overdraft** is taken as a loan against mortgaging your car, but you can use the amount taken for your any personal use.
• **Loan against Property** is also a form of secured loan where your pledge your asset and use the amount needed for consolidating your debt or foe any other end use.
• **Secured Business Loan** can also be secured if any asset (machinery, stock, raw material, building etc) are pledged against the loan amount required.

Unsecured Loan: With this type of loan, you do not need to put your collateral against the loan. The loan is given on the basis of your income and expense behaviour.
Following are the examples of the unsecured loans:
• **Personal Loans** is the most common form of unsecured loans, which is referred to as all-purpose loans; they are ideal to buy a product for which you do not have ready liquidity.
• **Unsecured Business Loan,** as the name explains is a type of loan that doesn't require collateral. It is typically at a higher rate of interest and is taken for a comparatively smaller tenor.
• **Credit Card loans** Credit card is the most flexible form of short-term borrowings with easy repayment options.
• **Bank Overdraft** is also a form by which you can avail unsecured finance from your bank for your business.

Unit-4

Overview and regulation fir Indian Banks

Currently in most jurisdictions commercial banks are regulated by government entities and require a special bank license to operate. Usually the definition of the business of banking for the purposes of regulation is extended to include acceptance of deposits, even if they are not repayable to the customer's order—although money lending, by itself, is generally not included in the definition.

Unlike most other regulated industries, the regulator is typically also a participant in the market, i.e. a government-owned (central) bank. Central banks also typically have a monopoly on the business of issuing banknotes. However, in some countries this is not the case. In UK, for example, the Financial Services Authority licenses banks, and some commercial banks (such as the Bank of Scotland) issue their own banknotes in addition to those issued by the Bank of England, the UK government's central bank.

Some types of financial institutions, such as building societies and credit unions, may be partly or wholly exempted from bank license requirements, and therefore regulated under separate rules. The requirements for the issue of a bank license vary between jurisdictions but typically include:

• Minimum capital

• Minimum capital ratio

• 'Fit and Proper' requirements for the bank's controllers, owners, directors, and/or
senior officers

• Approval of the bank's business plan as being sufficiently prudent and plausible.

Indian Scheduled Commercial Banks

The commercial banking structure in India consists of scheduled commercial banks, and unscheduled banks.

Scheduled Banks: Scheduled Banks in India constitute those banks which have been

included in the second schedule of RBI act 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42(6a) of the Act.

"Scheduled banks in India" means the State Bank of India constituted under the State

Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined in the s State Bank of India (subsidiary banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking companies (Acquisition and Transfer of Undertakings)

Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve bank of India Act, 1934 (2 of 1934), but does not include a co-operative bank". For the purpose of assessment of performance of banks, the Reserve Bank of India categories those banks as public sector banks, old private sector banks, new private sector banks and foreign banks, i.e. private sector, public sector, and foreign banks come under the umbrella of scheduled commercial banks.

There are several types of banks, which differ in the number of services they provide and the clientele (Customers) they serve. Although some of the differences between these types of banks have lessened as they have begun to expand the range of products and services they offer, there are still key distinguishing traits. These banks are as follows:

1. **Commercial banks**, which dominate this industry, offer a full range of services for individuals, businesses, and governments. These banks

come in a wide range of sizes, from large global banks to regional and community banks.

2. **Global banks** are involved in international lending and foreign currency trading, in addition to the more typical banking services.

3. **Regional banks** have numerous branches and automated teller machine (ATM) locations throughout a multi-state area that provide banking services to individuals. Banks have become more oriented toward marketing and sales. As a result, employees need to know about all types of products and services offered by banks.

4. **Community banks** are based locally and offer more personal attention, which many individuals and small businesses prefer. In recent years, online banks—which provide all services entirely over the Internet—have entered the market, with some success. However, many traditional banks have also expanded to offer online banking, and some formerly Internet-only banks are opting to open branches.

5. **Savings banks** and savings and loan associations, sometimes called thrift institutions, are the second largest group of depository institutions. They were first established as community-based institutions to finance mortgages for people to buy homes and still cater mostly to the savings and lending needs of individuals.

6. **Credit unions** are another kind of depository institution. Most credit unions are formed by people with a common bond, such as those who work for the same company or belong to the same labour union or church. Members pool their savings and, when they need money, they may borrow from the credit union, often at a lower interest rate than that demanded by other financial institutions.

7. **Federal Reserve banks** are Government agencies that perform many financial services for the Government. Their chief responsibilities are to regulate the banking industry and to help implement our Nation's monetary policy so our economy can run more efficiently 35by controlling the Nation's money supply—the total quantity of money in the country, including cash and bank deposits. For example, during slower periods of economic activity, the Federal Reserve may purchase government securities from commercial banks, giving them more money to lend, thus expanding the economy. Federal Reserve banks also perform a variety of services for other banks. For example, they may make emergency loans to banks that are short of cash, and clear checks that are drawn and paid out by different banks.

8. **The money banks lend**, comes primarily from deposits in checking and savings accounts, certificates of deposit, money market accounts, and other deposit accounts that consumers and businesses set up with the bank. These deposits often earn interest for their owners, and accounts that offer checking, provide owners with an easy method for making payments safely without using cash. Deposits in many banks are insured by the Federal Deposit Insurance Corporation, which guarantees that depositors will get their money back, up to a stated limit, if a bank should fail.

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