SHIVAJI UNIVERSITY, KOLHAPUR

CENTRE FOR DISTANCE EDUCATION

# Money and Financial System

For

**B. Com. Part-II**

Copyright © Registrar,
Shivaji University,
Kolhapur. (Maharashtra)
First Edition 2008
Second Edition 2010

Prescribed for **B. Com. Part-II**

All rights reserved. No part of this work may be reproduced in any form by mimeography or any other means without permission in writing from the Shivaji University, Kolhapur (MS)

Copies : 500

*Published by:*
**Dr. D. V. Muley**
Registrar,
Shivaji University,
Kolhapur-416 004.

*Printed by :*

**Shri. J. B. Rajput**
Superintendent,
Shivaji University Press,
Kolhapur-416 004

ISBN-978-81-8486-086-3

★ Further information about the Centre for Distance Education & Shivaji University may be obtained from the University Office at Vidyanagar, Kolhapur-416 004, India.

★ This material has been produced with the developmental grant from DEC-IGNOU, New Delhi.

**Centre for Distance Education**
**Shivaji University, Kolhapur**


## EXPERT COMMITTEE

**Prof. (Dr.) N. J. Pawar**
Vice-Chancellor,
Shivaji University, Kolhapur

**Dr. D. V. Muley**
Registrar,
Shivaji University, Kolhapur.

## ADVISORY COMMITTEE

**Prof. (Dr.) N. J. Pawar**
Vice-Chancellor,
Shivaji University, Kolhapur.

**Dr. A. B. Rajge**
Director BCUD,
Shivaji University, Kolhapur.

**Dr. B. M. Hirdekar**
Controller of Examination
Shivaji University, Kolhapur.

**Dr. (Smt.) Vasanti Rasam**
Dean, Faculty of Social Sciences,
Shivaji University, Kolhapur.

**Prof. (Dr.) B. S. Sawant**
Dean, Faculty of Commerce,
Shivaji University, Kolhapur.

**Dr. T. B. Jagtap**
Dean, Faculty of Science,
Shivaji University, Kolhapur.

**Dr. K. N. Sangale**
Dean, Faculty of Education,
Shivaji University, Kolhapur.

**Dr. D. V. Muley**
Registrar,
Shivaji University, Kolhapur.

**Shri. B. S. Patil**
Finance and Accounts Officer,
Shivaji University, Kolhapur.

**Prof. (Dr.) U. B. Bhoite**
Lal Bahadur Shastri Marg,
Bharati Vidyapeeth, Pune.

**Prof. (Dr.) A. N. Joshi**
Director, School of Education,
Y. C. M. O. U. Nashik.

**Shri. J. R. Jadhav**
Dean, Faculty of Arts & Fine Arts,
Shivaji University, Kolhapur.

**Prof. (Dr.) S. A. Bari**
Director, Distance Education,
Kuvempu University, Karnataka.

**Prof. Dr. (Smt.) Cima Yeole**
(Member Secretary)
Director, Centre for Distance Education,
Shivaji University, Kolhapur.

## B. O. S. MEMBERS OF BUSINESS ECONOMICS

Chairman- **Shri. M. G. Bargule**
P. D. V. P. Mahavidyalaya, Tasgaon, Dist. Sangli.

- **Shri. N. B. Jadhav**
  Sagar Nivas, Behind Sadhana High-School,
  Gadhinglaj, Dist. Kolhapur.
- **Shri. B. R. Gundage**
  Arts, Science & Commerce College, Lonand,
  Dist. Satara.
- **Shri. B. K. Mane**
  Arts & Commerce College, Kasegaon,
  Tal. Walwa, Dist. Sangli.
- **Shri. P. N. Todkar**
  Dr. Babasaheb Ambedkar Mahavidyalaya,
  Peth-Vadgaon, Tal. Hatkanangle, Dist. Kolhapur.
- **Shri. M. B. Waghmode**
  Arts & Commerce College,
  51, Yadogopal Peth, Satara.
- **Shri. D. S. Tambolkar**
  P.D.V.P. Mahavidyalaya, Tasgaon,
  Dist. Sangli.
- **Dr. R. M. Tungare**
  Director Maharashtra Institute of Labour
  Studies, D. C. Road, Parel, Mumbai.
- **Shri. B. K. Mane**
  A.C.M.E. Tools, C/o. Mungi Electricals
  E-10/11 (2), M.I.D.C., Bhosari-Pune-411 026.

**Writers Team**


| Authors | Unit No. |
|---|---|
| **Prof. J. F. Patil**<br>Akshay B-6, Tara Terraces,<br>Samrat Nagar, S.S.C. Board Road, Kolhapur-8. | **1, 2** |
| **Shri. R. A. Waingade**<br>KIT Institute of Management Education and Research<br>Gokul Shirgaon, Kolhapur. | **4, 5, 7** |
| **Dr. Santosh Yadav**<br>Bharathi Vidyapeeth's<br>Institute of Management, Kolhapur | **3, 6, 8** |

■ **Editors** ■

**Shri. M. G. Bargule**
Head, Business Economics,
Vivekanand College, Kolhapur.

**Prof. (Dr.) J. F. Patil**
Akshay B-6, Tara Terraces,
Samrat Nagar, S.S.C. Board Road,
Kolhapur-416 008.

# Preface

We are happy to offer this Self-Instructional Material in the paper "Money and Financial System" for the B. Com. students of Centre for Distance Education, Shivaji University, Kolhapur.

Under commerce and management studies, study of money and financial system occupies a critically important position.

In this SIM book, we have covered topics like money, its evolution, types of money supply, functions of money and high power money, finances and its types, Commercial Banking, Credit Creation, Indian banking R.B.I. Development Banks, non-banking financial institutions, institutional credit and interest rates and practical banking.

Writers of various units have tried to give up-to-date data in critical but simplified manner. Self-Study questions, home exercises and list of books for additional reading are also given. In certain cases field work is also suggested. Important concepts and terms are identified and explained.

We believe that this SIM book will be of great help for the students. Readers and teachers are requested to write to Director, Centre for Distance Education, with suggestions for making the book more useful.

We are grateful to unit writers, and others form Centre for Distance Education and Shivaji University Press, for their kind cooperation in the production of this book.

Kolhapur.

**Prof. (Dr.) J. F. Patil**
Editor

## INDEX


| Unit No. | Topic | Page No. |
|---|---|---|
| 1. | Money and Financial System | 1 |
| 2. | Finance | 14 |
| 3. | Commercial Banking | 27 |
| 4. | Regional Rural Banks, NABARD & Lead Banks | 44 |
| 5. | Development Banks and Non-Banking Financial Institutions | 60 |
| 6. | Reserve Bank of India | 92 |
| 7. | Problems and Policies of Allocation of Institutional credit and Interest Rates | 103 |
| 8. | Practical Banking Operations | 121 |

Each Unit begins with the section Objectives -

Objectives are directive and indicative of :

1. What has been presented in the Unit and
2. What is expected from you
3. What you are expected to know pertaining to the specific Unit once you have completed working on the Unit.

The self check exercises with possible answers will help you to understand the Unit in the right perspective. Go through the possible answer only after you write your answers. These exercises are not to be submitted to us for evaluation. They have been provided to you as Study Tools to help keep you in the right track as you study the Unit.

## Unit -1
# Money and Financial System

---

**Contents :**

1.1 Objectives
1.2 Introduction
1.3 Subject description
    1.3.1 Semantics of the term Bank
    1.3.2 Evolution of Banking
    1.3.3 Evolution of Modern Banking in England
    1.3.4 Evolution of Banking in India
    1.3.5 Definition of Money
    1.3.6 Functions of Money
    1.3.7 Supply of Money
    1.3.8 High Power Money
1.4 Summary
1.5 Terminology
1.6 Self study questions
1.7 Exercises
1.8 Further Reading

## 1.1 Objectives :

The objectives of the study of this unit are -

1. To trace the evolution of the term Bank
2. To trace the evolution of banking
3. To understand the economic meaning of money
4. To study different definitions of money

5. To examine the functions of money
6. To examine components of supply of money
7. To study instruments of money supply
8. To understand the meaning of high power money
9. To understand the importance of high power money

## 1.2 Introduction :

Money is centrally vital in any economic system. In any economy, money assumes exceptionally great significance and importance. This is true in the case of both developed and developing economies. In a modern economy, we have a complex market mechanism which links and activates production, trade and distribution on a sustained basis. In fact, according to Joseph Schumpeter, it is through the innovator supported by the credit or financial system that dynamics of development takes place. Encouraging and mobilization of savings, motivating investment in various sectors and accelerating growth rate and making available a continuous flow of universally acceptable medium of exchange are some of the important functions carried out by money and banking or financial system.

## 1.3 Subject description :

**1.3.1 Semantics of the term Bank** : According to some economic historians, the term Bank is derived from Italian words 'Banc' or 'Banco'. Some times it is related to 'Banch' or 'Bank' which basically means a seating arrangement used by Jews in the Lombardy street from where they exchanged currency, advanced loans. When such bankers failed to honour their commitments such benches were broken from where we get the term Bankrupt. In Italian language Monte (mound in English) means a large quantity or heap of money and therefore Bank may be traced to Monte also. In German language Banck is a word, which Italians used as Banco, later on in French became Banke and in English language it became Bank. To sum up it may be said that there was banking business in Europe well since medieval period.

**1.3.2 Evolution of Banks** : Some experts maintain that institution of banks can be traced back to ancient period. However, it is certain that banks existed in Europe well from early beginnings of medieval period. It is seen that banks evolved differently in different countries. e.g.

**i) Babylon** : It is maintained that banks were there 2000 years B.C. in Babylon where priests in temples worked as bankers accepting deposits of money and valuables and used gold and silver for advances. The compound interest was

charged on such advances and loan. It is said that Igibi Bank of ancient Babylon was almost like a modern bank.

**ii) Greece** : In Greece also big temples worked as bank in ancient times. The temple priests worked as financial traders. They accepted deposits for safekeeping. It is not certain whether deposits were used for advances but temple wealth was used for lending on interest. After some period banking by temples gradually declined and traders started working as bankers on their own.

**iii) Rome** : According to some historians, modern banking business existed in Rome as an independent business without any involvement of religious places or persons. Banks accepting deposits and advancing loans on interest functioned in Rome since long back. There were certain regulations on these banks. After the decline of Roman empire, there was great social, political and economic chaos in Europe. There were frequent battles and wars. This adversely affected banking business. More importantly, money lending or usury was considered a sin and thus growth of banking was arrested.

According to Crowther, a monetary and banking expert, modern banking evolved from trader to money lender to goldsmith. Jews started developing banks since $12^{th}$ century. They started banks in Italy, France and Belgium.

**iv) Beginning of Modern Banking** : The modern history of Banking begins from $14^{th}$ century. Florence: The money lenders of Florence not only exchanged national currencies, but accepted deposits and advanced loans. There were great families like Bardi, Acciagnote, Peruzzi and Pitti who were traders but functioned as bankers. Banking was purely in private sector; mostly owned by big traders as against the ownership of shareholders in a modern bank. Although banking started in medieval European countries, most of the modern banking is based on English model.

**1.3.3 Evolution of Banking in England** : In England, banking evolved through some important phases.

**i) Commercial or Royal Bankers** : It was during $11^{th}$ century that King William the $1^{st}$, invited Jew traders/gold traders to come and settle in England and carry out banking business. Accordingly, many Jew traders and gold dealers migrated to England and developed banking business. They could do so because Jews were not under any religious binding in charging interest on loans advanced. The King appointed Jews as Govt. bankers. Jews carried out following banking activities.

**a) Advancing loans on land security,**

**b) Exchanging currencies.**

Jews as bankers were free to move anywhere in the country for business. For these concessions, they had to pay a certain share of their income to the King. However, during 12th century an anti-Jew environment developed and Jews were forbidden from entry into any business in England. Jews, therefore, left England. The vaccum thus created was filled in by Lombardi traders from Italy. Lombardi traders also exchanged currencies and advanced loans to industry. They worked as bankers to the Govt. King Edward third refuted their loans, which placed them under difficulties. Gradually the place of Lombardi bankers was taken by English bankers.

**ii) Goldsmith Bankers** : It is generally believed that foundations of English banking were laid by English traders and goldsmiths beginning from 14th century. Initially they started working as Govt. bankers through fierce competition with Lombardi bankers and traders. With increasing controls on their business, Lombardi traders started leaving England and naturally local English traders and goldsmiths became more operative. Englishmen could succeed as bankers because of huge profits made through international trade. Thus English bankers gradually replaced Lombardi and started regular functioning as accepting deposits, making advances, exchanging currencies, remittances abroad etc.

When King Charles was denied payment of a certain demanded amount, he confiscated precious metals from London tower where the same were deposited by traders and rich people for safety. This induced traders to move away from London Tower to private goldsmiths for safe keeping of precious metals. The goldsmiths used to construct strong rooms with continuous guards for this purpose. They issued receipts for the precious metals received. A small fee was charged. The receipts always carried a promise to pay back to the depositors their valuables and money at any time in future.

With increasing experience, the goldsmiths realized that mostly, most of the deposits lay unutilized and at any time, a very small portion of the deposits was demanded back. This gradually encouraged them to use the remaining portion for making advances to traders and industrialists on their own responsibility. To collect more deposits goldsmiths started paying some interest on such deposits. The receipts issued by goldsmiths gradually acquired the status of money because of wide confidence and acceptance. Traders started using these receipts for settling their payments. The goldsmiths encouraged traders to issue pay orders for settling mutual claims. In the course of time, goldsmiths started issuing more receipts than their deposits and such receipts acquired the status of money.

**iii) Beginnings of Modern Banking** : Goldsmith bankers had given large loans to the King. When King Charles refuted such loans, the goldsmith bankers found it very difficult to pay back deposits of their customers as easily as before. The peoples' faith in Goldsmith bankers was adversely affected. People wanted

some govt. control on such bankers. People wanted banking to be institutionalized rather than individualized. During the 16th century, Bank of Sweden (1556), Bank of Vornos (1584), and Bank of England (1694) were established almost as central banks. In 1751, Bank of England was entrusted with the management of govt. debt. Bank of England became a full-fledged central bank. Many private banks failed during the economic crisis of 1827.

This was followed by the permission given by the govt. to joint stock companies to start banks with unlimited liability. For some time they were given rights of note issues, but according to Banking Act of 1833, the private and joint stock banks were denied the right to issue money. In the later decades of 19th century, a gradually increasing process of merger of small banks took place. As a result, England has the five largest banks in the world with a wide-spread network of branches across the world. It is thus very evident that as Chrowther maintained, traders, money-lenders and goldsmiths are the predecessors of modern banks.

**1.3.4 Evolution of Banking in India** : Banking in some form existed in India since ancient times. The main purpose of banking was to facilitate trade. Even during Kautilya's period, interest was prevalent. During 12th century, bills of exchange or trade bills started being used. Moneylenders were a highly respected persons both in villages and big cities. They have had social and political status. Apart from financing trade and agriculture, big money lenders used to advance huge amounts to Kings. Moneylenders also carried out business of buying and selling precious metals like gold and silver. They were therefore, called as Goldsmith Firms. Some of the traditional names of these goldsmith bankers in India are Saraf, Shroff, Sheth, Sawakar, Mahajan, Khot, Gujar etc. These indigenous bankers carried out following functions :

i) Accepting deposits, (ii) Currency exchange, (iii) Accepting Bills of exchange, (iv) Advancing loans to locals, (v) Financing domestic and external trade, (vi) Buying and selling gold.

**i) Beginning of Modern Banking** : In the 18th century some banks were established. This became more common in 19th century. There were two kinds of banks- i.e. Banks started by Agency Houses and Commercial Banks.

With greater involvement of English in local trade, working of indigenous bankers was found inconvenient mainly because of multiplicity of local languages. Therefore in the late part of 18th century, certain British Agency Houses started banking business. Alexander & Co., an Agency House floated Hindustan Bank at Calcutta; the first of its kind in India. Generally such Agency House sponsored banks were based on unlimited liability and most of them failed because of close association

with trading, participation in capital market defective management and misuse of funds. In 1886, the General Bank of India was started.

**ii) Presidency Banks** : In the 19th century, three regional banks, commonly known as 'Presidency Banks' were established. These were -

a) Bank of Bengal – 1806

b) Bank of Bombay – 1840

c) Bank of Madras – 1843

During 1860's many commercial banks were established on limited liability principle. But many of them failed during civil war in U.S.A., mainly because of cotton market fluctuations due to forward marketing and gambling. During this period, presidency banks carried out most of the functions of commercial banks. They were given monopoly of govt.'s banking. With withdrawal of this monopoly, they were allowed to use govt. balances with them without interest. In 1902, these three presidency banks were merged to form Imperial Bank of India; which after nationalization in 1954-55, became State Bank of India.

**iii) The Rise of Indian Joint-Stock and Industrial Banks** : Due to civil war in U.S.A., cotton market was in upward swing which encouraged formation of some Indian banks on Joint Stock Company basis. e.g. Aundh Commercial Bank (1881), Punjab National Bank (1894), Peoples Bank (1901) etc. These banks financed not only trade but also big industries. Gradually, nationalist movement encouraged formation of predominantly Indian commercial banks like Bank of India, Bank of Baroda, Bank of Mysore etc. In 1918 Tata Industrial Bank was established with industrial (long term) finance as focus. Increasing war expenditure, rapidly growing money supply, increasing purchasing power in the hand of the people as also proper supervision by Reserve Bank of India (1935) as Central bank caused rapid expansion of banking activity in India. In 1969, 14 major commercial banks were nationalized. Again 6 more commercial banks were nationalized. Nationalization of banks led to tremendous growth in deposits and advances through a very large network of branches, more so in rural India.

**1.3.5 Money – Definitions** : Money is central to all activities in a modern economy. Money makes all things happen. Economic satisfaction or welfare is measured in terms of money. Wealth and property are measured in money. Money has been one of the most frequent causes of strife between individuals, groups, regions and nations. Money integrates all activities in a society. Naturally, it is proverbially said that "Money makes the mare go". Different experts have defined money in different words. Following are some definitions of money-

- According to Seligman, money is the thing that possesses general acceptability.
- In the opinion of Hartley Withers, 'money is what money does'.
- According to Crowther, money is any good, which is generally accepted as medium of exchange, as a measure of value and as a store of value.
- J.M. Keynes maintained that money is a thing, which is used to settle debt contract as also value contracts and which represents generalized purchasing power.
- D.H. Robertson defined money as a medium of debt settlement and as a means of buying goods.

A careful understanding of these definitions of money highlights following attributes of money :

- Generalized purchasing power
- Medium of exchange
- Measure of value
- Store of value
- Means of settlement of debt
- General acceptability

**1.3.6 Functions of Money** : As seen in the previous para, money performs some important functions in a modern economy. It needs to be noted that money as a universality accepted generalized purchasing power, removes all the difficulties of barter (need for double confidence of wants, divisibility, acceptability, storability, transportability, safety etc.)

Kinley has classified functions of money in through groups –

A) Primary or main functions

B) Complementary or secondary functions

C) Contingent functions

Among primary or main functions of money, we include following functions-

**i) Working as medium of exchange** : In every exchange, a good or service is bought / sold for which payment is made in terms of money. General acceptability of money as purchasing power makes this possible.

**ii) Measure of value** : Money measures value of a good or service. It is the standard of value. Length is measured in centimeters, cloth in yards, milk in

liters, gold in grams, steel in tonnes, grain in quintals and value is measured in money. Where for every economy there is a name for money e.g. in India rupee. It is believed that relative to goods and services, value of money is much more stable and therefore, it functions as a measure of value.

Among secondary functions of money, we include the following functions.

**i) Store of value** : It is always easier to store money rather than save cloth, grains, sugar, vegetables etc. This is so because value of money is relatively more stable. A large quantity of food grains will require a godown whereas equivalent money can be stored in a small briefcase.

**ii) Medium of settling future debts** : In many transactions, immediate payment of price is not possible. A contract is entered into whereby buyer promises to pay a certain amount of money for the goods purchased now. Money borrowed today is also repaid in the same money in future along with some interest, which is also paid in money.

**iii) Transfer of Wealth** : Geographic movement of purchasing power becomes easy in the form of money. It is easy to carry. In fact one can transfer wealth of any form anywhere by converting the same in money.

Among contingent functions, we include the following functions :

i) Distribution of national income among people, regions and generations. It helps payment of wages, interest, rent and profit.

ii) Basis for creation of credit.

iii) Helping proper allocation of ones income among various goods and services on the basis of constancy of marginal utility of income and law of equimarginal utility.

iv) Money makes all wealth and property commonly and uniformly measurable. In other words, money increases mobility of wealth.

**1.3.7 Supply of Money** : Supply of money is a very important concept. Money is demanded for routine daily transactions, for precautionary purposes and by some people for gambling purposes also. In a modern economy, money supply is a monopoly of the central bank, which is normally owned by the govt. There are certain differences of opinion regarding what constitutes money supply. At a point of time, money supply is stock concept but over a period of time, it is a flow concept. The velocity of circulation of money also influences money supply. Given the quantity of money, greater velocity of circulations increases money supply. In a general way money supply comprises of supply of legal tender in the form of coins and currency at a point of time. More technically, concept of money supply can be explained as under :-

i) Traditional or limited Approach

ii) Modern or Expanded Approach

Under traditional approach, money supply consists of the sum of -

- Coins – of various denominations
- Paper currency – currency notes of various denominations
- Credit money created by banking system.

Currency notes are pieces of paper carrying a promise by the Governor of the Central Bank to pay the bearer of the note the amount indicated on the note in legal tender. In India, money is supplied by Reserve Bank of India on the basis of Minimum reserve in terms of gold equal to Rs.115 Crores and Rs.85 Crores in terms of foreign exchange reserves. Central Govt. can make changes in foreign exchange component.

Under modern or expanded version or approach, money supply comprises money in the hands of people, demand deposits of banks, deposits with post offices and fixed deposits also. Normally, according to modern approach at any moment of time, money supply in the economy is given as –

M1 = Money i.e. currency notes and coins in the hands of the people + demand deposits + other deposits with Central bank.

M2 = Credit supply by the banking system.

M3 = M1 + M2 + time deposits with banks.

M4 = Comprises other assets like bonds, shares held by banks which have convertibility and some element of liquidity. This concept has been developed by Gurley and Shaw.

In India, at present money supply has following components –

| | | |
|---|---|---|
| Currency in circulation | - | A |
| Cash with banks | - | B |
| Currency with public | - | A – B |
| Other deposits with R.B.I. | - | C |
| Bankers' deposits with R.B.I. | - | D |
| Demand deposits | - | E |
| Time deposits | - | F |

RBI considers - A+C+D as Reserve Money

(A-B)+C+D    as Narrow Money

F+(A-B) +C+D as Broad Money

According to RBI,

M3 = Broad Money = currency with public
+ demand deposits
+ time deposits
+ other deposits with RBI

For Reserve Bank of India M3 is a more operative and practically important concept of broad money.

**1.3.8 High Powered Money** : High powered money is that money which effectively generates credit supply. Currency (notes and coins) with the people and various reserves of commercial banks constitute high-powered money. Changes in circulating money supply (including credit) depend on high-powered money. Banks have to keep certain reserves in accordance with directives of Central Bank like legal cash reserves to be kept with Central bank and a certain proportion of demand deposits as cash ratio. When such ratios increase, credit supply decreases and vice-a-versa. Basically these reserve ratios are determined by demand of people for holding cash. The concept of high-powered money was given by Milton Friedman.

Essentially high power money works as –

a) Basis for credit supply

b) Activator for the process of economic development generated by investment and innovation which depend on credit supply

c) Regulator of inflation by variations in the quantity of high power money. Higher reserve ratios control additional money supply. Regulation of currency notes also controls inflation.

It is to be noted that volume of high power money is normally determined by Central banks currency supply (directly) and various reserve ratios (inversely). Broadly monetary policy of Central bank influences volume of high power money. Monetary policy comprises variations in currency notes and coins, cash reserve ratio, other cash reserve ratios and bank rate also. All these forces influence volume of high power money.

## 1.4 Summary :

In this unit we have seen that –

i) Banking business evolved mainly in Babylon, Greece, Italy, Rome and England since medieval period.

ii) Banking evolution is attributed mainly to Govt. bankers, goldsmith bankers, traders, private / joint stock banks.

iii) In modern times, banking evolved particularly since 18$^{th}$ century.

In india, modern banking was developed by Agency Houses followed by emergence of commercial banks.

iv) We examined various definitions of money. Money is universally acceptable generalized purchasing power. Money is a matter of functions four, a medium, a measure, a store and a standard. Money facilitates savings, investment, growth and distribution.

v) Money supply comprises currency notes, coins, bank reserves, demand deposits, time deposits and even near money like bonds, shares etc.

vi) High-powered money is currency with people and reserves with banks. High-powered money is the basis of credit supply.

vii) High-powered money works as basis of credit supply, activator of growth / development and controller of inflation.

## 1.5 Terminology :

i) Money - Instruments of generalized purchasing power supplied by Central bank.

ii) Money lender firms or indigenous bankers –

- Individuals or institutions buying, selling and advancing money.

iii) Store of value - Money, in its purchasing power stores value.

iv) Credit money - Money created by commercial banks through loans out of deposits.

v) Velocity of circulation of money –

- The rate at which money changes hands per unit or time.

vi) Legal tender - Money created by Central bank on the authority of Govt.

vii) High powered money - The basis of credit supply.

viii) Bankruptcy - Absolute failure of a bank.

## 1.6 Self Study Questions :

**A) Fill in the blanks with right words.**

i) Credit money is created by … …

ii) Central Bank of India is known as … …

iii) 14 major Indian commercial banks were nationalized in … …

iv) Imperial Bank of India was the result of merger of previous … …

v) The concept of high powered money was developed by … …

**Answers** :

I) Commercial bnaks,

ii) Reserve Bank of India,

iii) 1969,

iv) Presidency banks

v) Milton Friedman

**B) State whether right or wrong.**

i) Money supply power rests with the govt.

ii) Ten-rupee currency note is signed by the Deputy Governor of RBI.

iii) Traders, moneylenders and goldsmiths are the forerunners of modern banks.

iv) In ancient times, temples were used as banks.

v) High-powered money is the basis of credit supply.

**Answers :**

i) Wrong, ii) Wrong, iii) Right, iv) Right, v) Right.

## 1.7 Exercises :

**A) Essay type questions.**

i) Explain the definitions and functions of money.

ii) Briefly narrate the evolution of banking.

iii) Explain components of money supply in India.

**B) Write notes on-**

i) Primary functions of money

ii) High powered money

iii) Broad money in India

iv) Reserve Bank of India

v) State Bank of India

## 1.8 Additional Reading :


i) Modern Banking – M.C. Vaish

ii) Money and Financial system – P.C. Jain and S.S. Varma.

iii) Modern Banking, Trade and Public Finance – M.V. Vaish.

iv) Shekhar K. C. – Banking Theory and Practice.

v) R.S Sayers – Modern Banking.


• • •

# Unit – 2

# Finance

**Contents :**


2.1 Objectives

2.2 Role of finance in an economy

2.3 Kinds of finance

2.4 Components of financial system

2.5 Financial intermediaries

2.6 Financial markets

2.7 Financial instruments and their functions

2.8 Summary

2.9 Terminology

2.10 Self-study questions

2.11 Exercises

2.12 Field work

2.13 Additional readings


## 2.1 Objectives :

Study of this unit will help the reader to understand –

i) the concept of finance and its role in a modern economy

ii) various kinds of finance

iii) various components of finance

iv) various financial intermediaries

v) various financial markets and

vi) various instruments of finance and their functions

## 2.2 Role of Finance in an Economy :

There was, long back, a time when all exchanges of goods and services to ok place through barter. There were some difficulties in barter, which restricted markets, division of labour was rudimentary and overall economic life was almost stationary. However, with the institution of money, difficulties of barter were removed; advanced division of labour took place with increasing extent of market. Agriculture, industry, trade, started growing. Modern banking under central banks emerged. Individual, proprietorship, partnership and finally joint stock companies became methods or forms of business organization, scale of operations increased due to wider markets and technology. Naturally, starting a business with limited own funds became increasingly difficult. Business enterprises started needing more and more borrowed funds, both for working capital and investment. Indeed Joseph Schumpeter maintained that process of economic development crucially depended on the supply of innovators on the one hand and credit (i.e.) finance on the other. Gradually, modern economics evolved a complex, well knit system which supplied finance capital (short term and long term) to business enterprises on interest and eventually finance itself became a great industry. Finance means provision of funds (a certain amount of purchasing power) to potential entrepreneurs for starting a business activity. Finance in a sense is blood circulation in body economic which keeps the entire system dynamic.

**A) What is finance? Some definitions of finance are given below-**

i) Britannica Encyclopedia defined finance as fund availability (money) for mobilization of resources for a business activity.

ii) R. Burns – According to Burns finance is a process whereby funds are raised to meet payment obligations emerging in a business trying to fulfill its objectives.

iii) According to Paul Hasin, finance means management of monetary affairs of a company. It includes (a) what has to be paid & when, (b) raising the money on the best possible terms available and, (c) devoting the available funds to the best uses.

iv) Broadly, finance is a concept larger than money. It is a process by which short term and long-term funds are made available for individuals and institutions. In common parlance finance is synonymous with loans, advances, borrowings etc. when a business unit is launched the unit may satisfy its financial needs by own savings, borrowings from relatives and friends, borrowing from banks, even money lenders and non-banking financial institutions. The finance taken as borrowings need to be repaid on certain conditions.

**B) The role of finance – Its importance** : All economic activities of individuals or institutions, sooner or later require more or less but certain amount of finance. Finance is crucially required in –

i) Agriculture – as crop loan, investment in machinery, irrigation, farmhouse etc.

ii) Industry (cottage, SSI and large) both public & private - as working capital (payment of wages and for raw material) as investment in plant & machinery, building and vehicles etc.

iii) Development planning – for construction of shipping, airports, railways, roads, dams, generation of electricity, schools, hospitals, communications etc.

iv) Development of public utilities like urban water supply, electricity supply and urban transport.

v) Housing

vi) Self-employment enterprises

vii) Govt. – Rural and Urban, local govt. as also state or central level governments also require finance.

viii) Balanced regional development requires greater flow of finance to backward or less developed regions.

In short, finance is a magic word in a modern monetary economy. Adequate, appropriate, reasonably priced and timely finance leads to development as also to growth.

## 2.3 Kinds of Finance :

Kinds of finance can be classified as under –

i) Finance by period

  a) Long term finance,

  b) Medium term finance,

  c) Short-term finance.

ii) Finance for foreign trade

  a) Pre-export finance

  b) Post-export finance

iii) International finance

iv) Other finance

Let us elaborate –

**i) Finance by period :**

Finance for more than 10 years period is described as long term finance. This is normally required by business enterprises for purchase of land, plant and machinery, building etc.

**a) Long Term Finance :** Long term finance is raised through –

**i) Share capital** – Business unit sells shares in own capital; equity and buyers become virtual owners of the unit. Shareholders get some profits when the unit makes profits. In case of losses, they do not get anything.

**ii) Preference shares** – Preference shares are shares for which profits are shared as a matter of first priority, may be returned after long period and may get a certain rate of interest every year even though losses are incurred.

**iii) Retained earnings** – Business enterprises, as a matter of routine, keep aside certain portion of profits as reserves. These reserves are retained earnings. Such finance does not attract any interest payment. Reserve fund, appreciation fund, charity fund are the various forms in which retained funds may be maintained.

**iv) Debentures** – Debentures are bonds issued by a business enterprise to the lenders for a certain period of time at a certain rate of interest. Debentures are used to mobilize finance on a regular basis. Some debentures are without security and some are with security. There are some debentures, which are redeemable, and some times these are irredeemable debentures also.

**v) Loans from financial institutions** – Institutions like Industrial Finance Corporations, IDBI, State Finance Corporation, ICICI, SIDBI, LIC and Unit Trust of India extend long-term loans to business enterprises for period beyond five years up to 25 years for investment purposes.

**vi) Commercial banks** – Commercial banks, co-operative banks and other banking agencies also provide long-term finance after careful examination of the projects. Long-term finance for agriculture is given by special agencies like NABARD, State Co-operative Banks and District Central Co-operative Banks.

**vii) Venture Capital Funds -** There are certain agencies, which provide long-term finance to innovative, bold and enterprising businessmen for their new business proposals when they do not get a long-term finance from the agencies mentioned above. Venture capital funds extend long-term finance through direct loans, purchase of debentures and underwriting the loans.

**viii) Higher purchase finance –** In some cases a financing agency provides plant and machinery through direct purchase and on higher to the business unit. The plant and machinery is owned by the financing agency and used by the business unit on certain conditions.

**ix) Term deposits –** A reputed business unit may invite long-term deposits at attractive interest from the public. This is also one of the ways to collect long-term finance.

**b) Medium Term Finance :** Finance for a period of more than one year and up to five years is normally described as medium term finance. Medium term finance is also raised by using various methods mentioned above in respect of long-term finance.

**c) Short Term Finance :** Short term finance is normally required by trading units and by industrial units for trade finance and / or working capital. Loans, cash credit, overdraft, hypothecation and bills of exchange are the routine ways of getting short-term finance from commercial banks. Cash credit is a certain arrangement by which businessmen can go withdrawing money from a bank up to a certain limit. He will be paying interest on actual borrowing. In certain cases of established business units, borrowing beyond a pre-decided amount i.e. overdraft is also used. When the business unit hypothecates finished products or raw material or equipments and gets a loan, it is hypothecation. At the time of repayment of loan, hypothecation is automatically released.

In certain cases, short-term finance is raised on the basis of commercial credit for a short period of time. Some times, advances from buyers also can be used as short-term credit.

**ii) Finance for Foreign Trade** : Foreign trade involves need for regular finance through various agencies. When an exporter has a definite demand letter from a foreign trader, the domestic commercial banks and other financing agencies provide finance, which is known as pre-export finance, where the term is normally up to 6 months. Stock in godown ready for exports, other hypothecation as also guarantee from export credit guarantee institutions can be used as security for extending export finance. Similarly, finance is made available post export also on the basis of receipts, contracts, registers and government guarantee. Export finance is normally short-term finance.

**iii) International Finance** : International finance is made available through a number of international financing agencies, which include agencies like International Monetary Fund (which extends short term finance to bridge balance of payments problem), International Bank for Reconstruction and Development Bank (which provides long term finance), Asian Development Bank, International Finance

Corporation, etc. Generally, the finance made available by agencies other than IMF is for more than 10 years and mainly aims at developmental projects like dams, canals, electricity generation, refineries, railway, shipping and eradication of slums. Commercial banks also make available international finance to well-established business firms both in domestic currency and foreign currencies.

**iv) Other type of Finance** : Agencies like Industrial Development Bank of India, Small Industries Development Bank of India, State Finance Corporations and NABARD provide seed capital in the initial stages of business enterprises. Such finance is without interest but at a certain rate of service charge. Conditions of finance and repayment are determined on the basis of nature of enterprise through negotiations. In certain cases, different financing agencies extend finance without any security to establish business. In fact, subsidies, concessions in excise duty, sales tax, income tax, transport, storage and export by the government can also be considered as a type of finance.

## 2.4 Components of Financial system :

In any modern economy we observe a certain well organized financial system. In any financial system the concepts of saving and investment are central. In fact, a financial system is supposed to establish a dynamic equilibrium between funds made available by saving and funds demanded by investment. It is therefore; clear that financial system is a process, which brings together savings and investment, financial papers and financial institutions for financing trade and business. It is, therefore, necessary to examine various components of financial system.

Flow chart No.1 depicts in one glance a financial system.

(Please see page No.7 for Flow Chart No.1.)

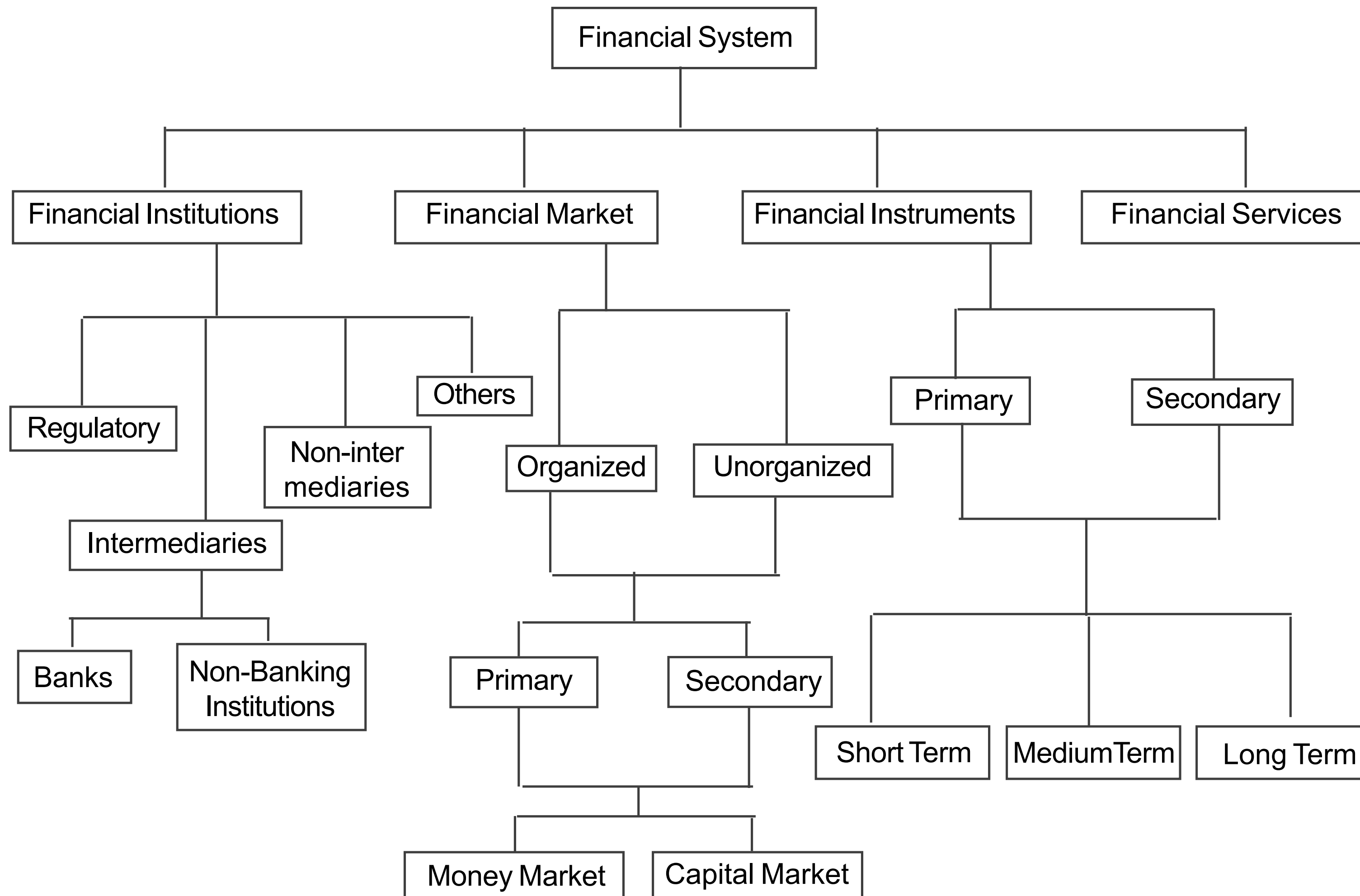
We will now examine various components of the financial system.

## 2.5 Financial Intermediaries :

Under this group we include following components. It is the combined working of these institutions, which enables the financial system to function efficiently. In any economy, there are organized systems of borrowers and lenders which are brought together by financial institutions and therefore, they are known as financial intermediaries. In India, these financial institutions are :

**1. Reserve Bank of India** : This is the apex of the financial system, established in 1934 and nationalized in 1949. It functions as banker to the government, supplier and controller of money and credit, maker of monetary policy and collector of financial information and data as also other data. It controls the working of rest

# Flow Chart No.1



of the financial systems directly or indirectly through money supply, credit supply by using instruments of bank rate, open market operations, margins, rationing, directives etc.

**2. Commercial Bank** : Commercial banks are a very important component of financial institutions. They constitute the main supply of short-term and medium-term credit for domestic as well as foreign trade. Commercial banks include nationalized banks, private commercial banks, co-operative banks as also foreign banks, which through a network of branches make short term and medium term finance available to cottage, small and large industry, trade and business as also agriculture and infrastructural projects by mobilization of savings.

**3. Financial Corporations** : After independence, financial system of India went on expanding. In 1948, Industrial Finance Corporation of India was established. In 1956, Industrial Credit and Investment Corporation of India was established in 1964, Industrial Development Bank of India was established, Industrial Reconstruction Bank of India was established in 1971, whereas state governments established State Finance Corporations. At a late stage, Small Industries Development Bank of India was established. ICICI and IDBI got converted in to banks recently.

**4. Insurance Companies** : Before independence, we had private sector insurance companies, but then we had Life Insurance Corporation of India in the public sector along with four subsidiaries of General Insurance Corporation. After 1998, again private sector insurance companies like Bajaj-Allianz, New York Max Life Insurance, ICICI Prudential etc. came into being.

**5. Mutual Funds** : For people of small means, it is not possible to invest in corporate equity because of their small savings. Mutual Funds are established by different major banks to mobilize small savings and channelise the same in industrial investment through efficient management and to minimize risk for small investors. Unit Trust of India pioneered in this sector.

**6. NABARD** : National Bank for Agricultural and Rural Development was established in 1982 for short term as well as long term finance for agriculture through co-operative credit system.

**7. Post Office** : Post Offices in India run a banking unit to collect small savings of the people and make them available for public sector investment.

State Bank of India runs a scheme for Public Provident Funds and we have National Housing Bank also, which provides finance for construction sector.

· **Functions of Financial Institutions** : Most of these financial institutions carry out following functions of great developmental significance-

i) Mobilization of savings from various sections of the society.

ii) Raising of capital- Financial institution collect large finance through equity and bonds for various projects of development in private and public sector.

iii) Financial institutions provide not only finance but also direction, advise in respect of market conditions, technology, demand projection, input supplies and many other aspects.

iv) Financial institutions provide loans to agriculture, industry and trade.

v) Financial institutions create an atmosphere of faith and confidence in the minds of savers and investors in all sectors of the society.

vi) Financial institutions participate in the management of industry through participation of equity.

vii) Financial institutions provide security to the depositors and allocate available funds to various industrial and trading activities taking care of full recovery plus some profits within the limits of law.

## 2.6 Financial Markets :

Financial markets are of two types –

a) Money market, &

b) Capital market.

**a) Money market** : Money market is that market where short-term credit is supplied and demanded. The major components of money market are organized money market and unorganized money market. The unorganized money market consists of money- lenders and indigenous bankers. The organized money market consists of all banks under the control of Reserve Bank of India, which carry out business of short-term credit (up to one year). Individuals, industrial firms, trading firms, service agencies and other similar business enterprises borrow short-term credit in this market. Indian money market is not homogeneous because of the existence of unorganized money market, where there are differences between interest rates, margins and securities.

**b) Capital market** : This is the other part of financial market where long term credit is bought and sold, in other words, where capital is bought and sold. In this capital market large industrial houses, corporations, central and state governments, non-banking financial institutions as also commercial and developmental banks participate. Capital market makes available long-term loans for

major projects in industry, infrastructure, agriculture etc. It is because of the capital market that investment finance is made available to innovators who instigate and sustain the process of growth and development. Stock market or share market is a major sub-component of capital market. Securities and Exchange Board of India (SEBI) regulates the working of capital market in the public interest.

Financial markets carry out following functions :

i) Creating capital for long-term investment and short-term business for various sectors of the economy.

ii) Making finance available for the process of development.

iii) Contribute to the disciplined development of the financial system and makes it transparent and conducive for the development of trade, industry and services.

iv) Mobilization of savings

v) Ensure economic discipline

In India, particularly after independence, financial system has undergone great changes, has acquired richness of components, depth of experience and increasing discipline through controls by Reserve Bank of India and SEBI.

## 2.7 Financial Instruments and their functions :

Financial instruments constitute an important aspect of financial market. Financial instruments are methods through which financial transactions are effected efficiently. Financial instruments have approval of the Reserve Bank as instruments for mobilizing finance and disbursing the same. These financial instruments are-

**1) Call Money** : Call money is finance for one single day, i.e. 24 hours. Normally banking institutions and non-banking financial corporations deal in call money market through the supervision and agency of Reserve Bank of India.

**2) Treasury bills or Government Securities** : Treasury bills or government securities are written commitment of government of India to repay certain amount at a certain time in future for which the period varies from 15 days to one year. Treasury bills can be placed as securities against which loans can be obtained.

**3) Trade bills** : Trade bills or bills of exchange are commitment given by one trader to another trader for payment of a certain amount on a certain date. Normally, bills of exchange are discounted by commercial banks by charging margin. In case of need commercial banks can get these bills of exchange rediscounted at the central bank.

**4) Commercial papers** : These include bills of exchange, registration documents, ownership papers, claim documents, godown receipts and future contracts. Such commercial papers between reputed and established firms are used by banking system to provide finance.

**5) Deposit papers** : Commercial banks use deposit receipts for providing finance to individuals and institutions for a period of 3 months to a year. Banks charge a discount of these deposit papers as per supervision of central bank.

**6) Partnership Document** : In case of partnership firms a partner who requires additional finance can pledge his partnership right to a financial institution and get finance. For the period of which finance is taken, the financer becomes the partner in a firm. Sometimes, such partnership documents are sold by one bank to another bank also. The partner can regain his rights by paying interest and commission to the financer even before the agreed term.

**7) Intra-Institution deposit receipts** : In a big organization which owns a number of subsidiaries sometimes deposit receipts are used as financial documents for short period financial accommodation.

## 2.8 Summary :

In this unit, we have examined the concept of finance, its importance for industry, agriculture and infrastructure, employment generation and balanced development. We also studied kinds of finance particularly long term finance, medium term finance and short term finance, their various methods, finance for foreign trade and international finance. We examined the meaning of financial system and various components of the same. We also analyzed the functions of financial institutions. We examined financial market like money market and capital market and their functions. Finally, we briefly explained various financial instruments.

## 2.9 Terminology :

1. **Finance** - Provision of capital for short term and long term for business purpose.
2. **Share capital (Equity**) – This is a certain share in the own capital of a business unit controlled and owned by a share holder.
3. **Financial system** - Financial system is a process where savings and investment are mobilized through various financial systems for the development of trade and industry both private and public.

4. **Financial intermediaries** – These are various financial institutions and corporations which work as agents for the buying and selling of short term and long term finance for trade and industrial firms.

5. **Money market** - Market for short term credit.

6. **Capital market** - Market for long term credit.

7. **Financial papers** - These are papers and documents which are used for financial transactions and security.

## 2.10 Self study questions :

**A) State whether right or wrong.**

1) Economic growth and development are possible without finance.
2) Finance can be classified mainly by time period.
3) Central bank (in case of India Reserve Bank of India) is the apex of financial system.
4) NABARD provides industrial finance
5) Capital market deals in short term credit

**Answers** :

1) Wrong, (2) Right, (3) Right, (4) Wrong, (5) Wrong.

**B) Fill in the blanks.**

1) Financial corporations provide … … finance.
2) … … is one of the simple ways of raising finance.
3) NABARD is … … bank for agriculture.
4) Stock market is regulated by … …
5) … … are components of both short term and long term finance for both agriculture and industry.

**Answers :**

(1) Long term, (2) Public deposits, (3) Apex,

(4) SEBI, (5) Commercial banks

## 2.11 Exercises :

**A. Essay type questions :**

1) Explain the importance of financial system in economy.
2) Discuss main types of finance.
3) Explain the components of financial system
4) Explain the functions of financial market.

**B. Write notes on-**

1) Money market
2) Capital market
3) Financial intermediaries
4) Financial corporations
5) Reserve Bank of India

## 2.12 Field work :

Visit local District Industries Center and enumerate various financial institutions which finance industry.

## 2.13 Additional Readings :


1) Money and Financial system by P.C. Jain and S.S. Verma
2) Financial Management by Kuchal
3) Fundamentals of Financial Management by Prassann Chandra
4) Indian Economy by Datta & Sundaram
5) Financial Institutions and Markets by Bhole L.M.
6) Money and Financial system by P.K. Deshmukh.
7) Money, Banking and International Trade by K.P.M. Sundaram.


. . .

# Unit – 3
# Commercial Banking

## Contents :

3.1 Objectives
3.2 Introduction
3.3 Definition of commercial bank
3.4 Functions of commercial banks
3.5 Importance of commercial banking
3.6 Balance sheet of commercial banks
3.7 Non-performing Assets of Banks – Causes and remedial measures
3.8 Credit creation by commercial banks Limitations on credit creation
3.9 Summary
3.10 Terminology
3.11 Self study questions
3.12 Exercises
3.13 Field work
3.14 Further reading

## 3.1 Objectives :

The study of this unit will help the readers to understand –

i) Meaning of a Commercial Bank and its definition

ii) Functions of a commercial banks

iii) Balance sheet of a commercial bank

iv) Importance of commercial banks

v) Non-performing assets of banks, their causes and remedial measures

vi) Credit creation by commercial banks and its limitations

## 3.2 Introduction :

We have seen earlier the evolution of money and banking in details. Let us recapitulate. The term Bank has links with Banque, a Greek word, which is synonymous with Bench. In ancient times Jews of Lombardi, used such benches, locally known as Banco to carry out business of exchanging currencies. In German language, 'Banc' means a joint stock company. These earlier Banks meant an entity dealing in money. A money trader who could not honor his obligations was described as Bankrupt, because people destroyed his Banco or bench.

The origins of modern banking can be traced to ancient temples, where priests worked as trustees and traders of deposits. Later on during medieval period, Jews started lending money at interest. They also financed Kings on large scale in return for which they were given rights to buy and sell debts. According to Adam Smith, banks started in Italy as finance companies to assist the govt. In 1157 was established 'The Bank of Venice' which could be considered as the earliest predecessor of modern bank. This was followed by the establishment of Bank of Barcelona and Bank of Geneva. In 17th century, Bank of Amsterdam was started and in 1664 Bank of England was started which may rightly be considered as the beginning of modern banking. Commercial banks at present constitute the main element of money and capital market. They function for profits. They accept deposits, advance loans, invest and extend related services to the customers. They pay back deposits as and when demanded. They charge a rate of interest on loans greater than the rate of interest paid to the depositors. They issue cheques and accept cheques. Commercial banks create credit in the process of their functioning.

## 3.3 Definitions of Commercial Banks :

Commercial banks have been defined in various ways. Following are some of the definitions-

i) According to Crowther, a bank is an institution, which collects money from those who have it spare or who are saving it out of their income, and lends this money out to those who require it.

ii) Walter Leaf defines banker as a person or corporation, which holds itself out to receive from the public deposits payable on demand or cheques.

iii) Oxford Dictionary defines a bank as an establishment for the custody of money, which it pays out on a customer's order.

iv) R.S. Sayers defines a bank as an institution whose debts are widely accepted in the settlement of other people's debts to each other.

v) The Banking Companies Act 1949 defines a bank as one which transacts the business of banking which means accepting, for the purpose of lending or investment of deposits, of money from the public, repayable on demand or otherwise and withdrawable by cheques, draft or otherwise.

## 3.4 Functions of Commercial Banks :

Banks are purveyors of credit. They carry out a number of functions. The important functions of commercial bank are –

**1) Accepting Deposits :** The main or primary function of banks is to accept, collect or mobilize deposits from the public. These deposits are of three types, viz. (a) Time or Fixed Deposits, (b) Savings Deposits, (c) Current deposits.

Fixed deposits are generally for one or more than one-year period (3,5, 10 or even more). Depositors cannot withdraw these deposits before the expiry of the period for which the same is kept. Normally time deposits attract higher rates of interest.

Saving deposits attract lower interest rates and may be withdrawn once or twice a week. The main purpose of savings deposits is to encourage and mobilize savings. In practice, savings deposits are treated as accounts, which can be operated virtually as current accounts.

Current account deposits are normally operated by traders, professionals, businessmen, industrialists etc. Current account deposits do not get any interest.

**2) Advancing Loans** : Deposits collected by banks are not kept idle. Keeping aside a certain % of these deposits for liquidity purposes (for meeting demand for cash by depositors) banks advance loans to businessmen on higher rates of interest to earn income. Banks give loans through (i) cash credit, (ii) overdrafts and (iii) loans against some securities for short term, medium term and sometimes even for long term. Banks also make loans available through discounting of bills of exchange. More importantly, banks make large amounts of loans for very short period (call money or short notice loans) at higher rates of interest and earn a major portion of their income.

Cash credit is a facility under which a borrower can withdraw up to a certain limit by prior arrangement, and interest is charged on the actual withdrawals.

Overdraft is a facility by which a customer can withdraw from his account even beyond his balances, but up to a limit where excess withdrawals will be charged interest.

Discounting bills of exchange (trade bill) is a method whereby a trader can discount a trade bill (a promise by other trader to pay a certain amount on a certain future date) with a bank for a commission and in the case of need for liquidity; bank can easily rediscount the same with central bank or some other bank also.

**3) Investment of Funds** : Commercial banks, in the interest of security as also some minimum income, invest some portion of funds in Govt. securities and reliable bonds in the market. Investment in Govt. securities is the important thing because they are secure as also fetch a certain income.

**4) Promoting Use of Cheques** : Cheques are for all practical purposes a safe and easy method of advancing loans because cheques can be used as a security.

**5) Agency Services** : Commercial banks give following agency services for a certain commission-

i) Transfer of funds through draft, telegraphic transfer etc. in respect of interest payment, dividend, rent, subscription, insurance premium etc.

ii) Collection of funds for the customers

iii) Working as trustee, attorney or executor

Iv) Working as tax consultant

v) Working as agent or representative for passport, travel booking etc.

**6) Dealing in Foreign Exchange**

**7) Financing International trade** (export, import and storage and transport).

**8) Creation of Credit** : We have already seen that commercial banks create credit by using deposits to give loans, which again become deposits and constitute a basis for further advances within the limits set by Central Bank's cash reserve requirements and structure of deposits.

**9) Other services** : These include –

i) Safe Deposit vaults or lockers

ii) Issue of travelers' cheques

iii) Electronic banking services like ATM, Credit Card, Debit Card

iv) Collection of data

v) Financial advise

vi) Underwriting issue of capital by firms, when banks guarantee purchase of issued capital (shares) peoples' confidence increases.

10) Assisting social and economic projects like educational finance, health finance, subsidized finance for agriculture and SSI etc., financing below poverty line people with low rate of interests.

## 3.5 Importance of Commercial Banks :

Importance of banks in a modern economy is beyond description. They constitute an important part of money and capital market. Banks encourage and assist monetization of the system. Banks encourages savings, mobilize them as deposits and invest them in trade, industry and agriculture productively. They thus help in the development of economy. Schumpeter has highlighted role of credit in development. We know that credit is the main product of banking business. To be precise, commercial banks acquire critical and strategic importance in a modern economy because –

i) they mobilize savings

ii) they allocate funds in different sectors for capital formation and working capital and assist development and growth.

iii) they accelerate monetization of the economy

iv) they translate monetary policy of govt. in actual business.

v) they finance agriculture, trade, and industry and external trade also

vi) they finance education, training and research

vii) they help cottage and SSI with lower interest rate loans

viii) They develop banking habits among people. In short, commercial banks, by proper husbanding of funds, generate, maintain and accelerate economic activity in a sustained way. Commercial banks are the powerhouses in a modern economy.

## 3.6 Balance Sheet of A Bank :

Being a business unit, an economic enterprise, registered under legal provisions, a bank has to maintain and publish periodically (normally annually) a detail statement of its financial transactions, which is known as Balance Sheet. A careful examination of the balance sheet of a bank shows health or ill health, financial

strength and / or weakness of the bank. Balance sheet of a bank is essentially a statement of assets and liabilities.

The left side of the balance sheet shows liabilities (amounts due to others) of a bank. The right side of the balance sheet shows assets (amounts due from others) of a bank. Bank balance sheet is prepared in double entry accounting method). Liabilities and assets always balance.

The balance sheet of a commercial bank shows, in greater details following entries:

**Chart : 3.1**

**Bank's Balance Sheet**

| Liabilities | Assets |
|---|---|
| 1. Share Capital<br>a) Authorised capital<br>b) Issued capital<br>c) Subscribed capital<br>d) Called up capital<br>e) Paid up capital | 1. Cash / Funds<br>a) Cash in hand<br>b) Cash with other banks |
| 2. Reserve Funds<br>a) General Reserve fund<br>b) Dividend Equalization<br>c) Investment reserve fund<br>d) Unexpected Expenditure Reserve fund<br>e) Reserve for Bad and doubtful debts. | 2. Money at call & short notice |
| 3. Deposits<br>a) Current deposits<br>b) Savings deposits<br>c) Fixed deposits<br>d) Recurring deposits<br>e) Other deposits | 3. Bills discounted and Treasury bills |
| 4. Loans and Advances from other banks. | 4. Investment |
| 5. Bills payable | 5. Loans and Advances given to customers. |
| 6. Bills for collection | 6. Bills for collections |

| | |
|---|---|
| 7. Acceptance and Endorsement on account of customers | 7. Acceptance on account of customers |
| 8. Other liabilities | 8. Fixed assets, building, furniture, vehicles, land etc. |
| 9. Liabilities of other branches. | 9. Assets from other branches. |
| 10. Profit or Loss | |

Let us now briefly explain various items of Liabilities first –

**A) i) Capital :**

- Authorized capital is the maximum amount of equity or share capital, which the bank can collect by selling shares. As and when required this can be increased or decreased with the prior permission of the regulatory authority.
- Issued capital is the number of shares issued for immediate sale.
- Subscribed capital is the value of number of shares actually bought by the people.
- Called up capital is the amount of sold shares immediately called up for payment.
- Paid up capital is the portion of called up capital actually paid by the shareholders.

**ii) Reserves** : Reserves are to be accumulated every year through diversion of some income for the specified purposes, i.e. general purpose, dividend equalization, investment, unexpected expenses etc. Reserves strengthen the sustaining capacity of the bank.

**iii) Deposits** : Deposits are funds kept by people with banks on the faith that the same can be obtained in cash as and when needed. Current account deposits do not get interest; whereas savings account deposits get some interest and fixed account deposits attract higher interest rates depending on period of deposit. Other deposits like recurring deposits are method of collecting small savings for which some interest is paid. Recurring deposits are normally collected every month.

**iv)** **Loan from other banks** are borrowings by a bank from others banks to meet liquidity needs.

**v)** **Bills payable** are dues for certain services and facilities received from others.

**vi)** **Bills for collection** are payments due from certain parties to the customers of the bank.

**vii)** **Acceptance or Endorsement of Bills** for customers is payment on behalf of customers for trade bills received.

**viii)** **Other liabilities** – not classified in any of the liabilities explained above.

**ix)** **Profits or losses** are also liabilities because are receivables by shareholders in terms of dividends or lack of dividends.

**B)** **Assets** :

i) Cash-Banks, by experience known that they have to keep a certain % of their deposits in cash to honor the obligation to pay on demand cash to the depositors or immediately. Some cash is kept with other banks also.

ii) Call money and short notice - Those are very short-term loans (24 hours call money) and short notice (15 days), mainly for liquidity purposes. They can be realized as cash within short periods.

iii) Bills discounted – These are trade bills or bills of exchange discounted by the bank for businessmen. When required banks can rediscount them with central bank (RBI) to get cash required. At maturity (normally three months) they are paid by those in whose name bill is drawn. Bills for collection also fall in the category.

iv) Investments – Banks generally invest their excess funds in govt. securities and in certain cases, private securities also, which give them good returns and which are relatively more easily convertible in cash without actual loss.

v) Loans and advances – are loans given to trade and industry for short terms. These are the main source of income for the banks.

vi) Building, furniture, stationary, vehicles etc – These are tangible assets of the banks. They amount to non-liquid assets, difficult to convert into cash without loss.

Balance sheet of a bank, at any point of time, is the exact indicator of its financial health and thus becomes a guide for the Board of Directors to introduce changes in its business and management if necessary.

## 3.7 Non-Performing Assets (NPA) of the Banks :

**A) What is an NPA?**

In 1991, Govt. of India, through the influence of IMF + World Bank nexus, adopted new economic policy. One of the major components of economic reforms was financial sector reforms, which were recommended by M. Narsinham in his 2 reports during 1990's. In these reports, M. Narsinham mainly recommended adoption of international accounting standards, gradual privatization of banks, consolidation, and banking sector restructuring.

One of the main recommendations of Narsinham committee was regarding identification of non-performing assets (NPAs) of banks, and measures to minimize them. Broadly NPA is the loan amount which is not recovered from the borrower or payment of principal or interest amount or both are overdue to bank. Narsinham, committee suggested that NPAs should not be more than 5% of their assets.

**B) NPAs are classified as under –**

i) **Standard Assets** : Those loans or assets whose repayments and interest payments are not overdue for such standard assets a provisioning of only 0.25% of income was suggested.

**ii) Sub-Standard Assets** : These are loans or assets in which case repayment of principal amount and interest are due for a period less than 12 months. For such assets, the committee suggested a provisioning of 10% of profits.

**iii) Doubtful Assets** : These are loans which after being classified as substandard remain unproductive for further 12 months or remain unproductive for more than 2 years, are classified as doubtful assets. Such NP assets need for second year – 20%, for 3$^{rd}$ year- 30% and for more than 3 years 50% provisioning from profits. In case of such assets sale value is generally less than 50% of asset value.

**iv) Loss Assets** : These are loans, which remain NPAs for more than three years and in whose case sale value is negligible, and which are not written off, by the bank. In case of such NPAs, the committee recommended 100% provisioning from profits.

**C) NPAs in Public Sector Banks in India** : Table No.3.1 gives information regarding NPAs of nationalized (public sector) banks in India for recent years-

**Table : 3.1**

**NPAs in Public Sector Banks**

| Year | Gross NPAs % |
|---|---|
| 1993 | 11.80 |
| 1994 | 23.60 |
| 1995 | 19.50 |
| 1996 | 17.30 |
| 1997 | 17.40 |
| 1998 | 14.90 |
| 1999 | 13.80 |
| 2000 | 13.91 |
| 2001 | 12.61 |
| 2002 | 11.01 |
| 2003 | 9.72 |
| 2004 | 8.21 |
| 2005 | 5.84 |
| 2006 | 3.96 |

Source : Various reports of Reserve Bank of India.

Table 3.1 clearly shows that NPAs of public sector banks in India were vary high to 2002, after which they came down rapidly.

**D) Category wise NPAs** : In table No.3.2 we show gross NPAs by different categories of banks for 1996-97 and 2003-04.

**Table : 3.2**

**Gross NPAs of Banks**

| Banks | Gross NPAs % | |
|---|---|---|
| | 1996-97 | 2003-04 |
| 1. Public Sector Banks | 19.05 | 13.99 |
| 2. State Bank of India | 15.81 | 14.08 |
| 3. New Private Banks | 2.63 | 4.15 |
| 4. Old Private Banks | 10.71 | 11.25 |
| 5. Foreign Banks | 4.29 | 6.99 |

Source : Various publications of CMIE.

It is seen that relatively speaking, in both years NPAs of public sector banks (including State Bank of India) were more than 10%. In case of old private sector banks also incidence of NPAs is more than 10% in both years, but it is less than in public sector banks. New private sector banks and foreign banks show a significantly less incidence of NPAs.

**E) Causes of NPAs** : According to studies conducted / sponsored by R.B.I., Narsinham committee findings and other studies, there are a variety of causes for the growth of NPAs of banks-

**a) Internal Factors** – Following are the main components of internal factors responsible for NPAs.

i) Loans sanctioned carelessly without proper loan appraisal, project analysis and credit worthiness of borrowers.

ii) Political influence in sanctioning loans to unworthy persons and subsequent concessions and facilities cause NPAs.

iii) Wrong appraisal of loan proposal by the bank

iv) Inordinate delay in sanctioning and disbursing loan amounts

v) Rising operational costs of banks

vi) Wrong, costly and time consuming methods of debt recovery

vii) Inadequate information about borrowers

viii) Debt wavers by govt.

ix) Gaps and inadequacies in legal procedure

x) Willful defaulters

**b) External Factors for NPAs** : Following are the external factors which caused increase in NPAs of commercial banks-

i) Economic recession and depression

ii) Natural disasters like quake, cyclones, floods and fires

iii) Industrial sickness due to power shortage, raw material scarcity, lack of working capital, outdated technology

iv) Diversion of loans- Use of loans for purposes other than business

**c) Management of NPAs** : Various methods of debt recovery and avoidance of NPAs have been suggested by R.B.I. and Govt. of India. These are –

i) Debt Recovery Tribunals – For this purpose, legislation was passed for

fast recovery of debt (1993). The act was again amended in 2000, which empowered tribunal with added legal powers.

ii) Asset Reconstruction Companies – RBI has powers to establish debt scrutiny and restructuring companies. State Bank of India, in collaboration with other banks has already established an ARC. Such ARCs can reduce incidence of NPAs.

iii) Securitization, Reconstruction and Implementation Law – In 2002, Govt. of India has passed an act enabling banks to take over securities and collaterals and sell the same for recovery of the debt.

iv) Restructuring of Industrial Loans – Since 2001, a process of restructuring of industrial loans has been initiated. Re-fixing rates of interest (decrease), increasing repayment period or giving it a fresh status and treating it as standard. During 2003, loans of 71 companies were examined and debts of Rs.53,776 Crores were standardized.

v) Fast Recovery Action Mechanism - has been established by RBI. This is divided in two parts –

   1) Mandatory Actions : This includes special action plan for reducing NPAs by considering new NPAs. Loan policy is reviewed. Loan recovery plan is also reviewed frequently. Legal proceedings are regularly reviewed. There is supervision of risky loans and some restrictions are placed on loans.

   2) Conscientious Action : This includes prohibiting opening of new branches, stopping of dividend payment and reducing capital in sub-branches.

vi) Indian Credit Information Bureau – In 2001, State Bank of India in collaboration with other banks, established this information bureau. Banks, if they want to get information regarding credit status of any business unit they get it because, banks and financial institutions supply all their credit information to this bureau. With such information, both banks and borrowers are restricted in reckless loan behaviors.

## 3.8 Credit Creation By Commercial Banks –

**a) Introduction** : In the process of their functioning as banks, commercial banks create credit money. Credit money activates economic system. Deposits and capital collected by banks work as loanable funds for individuals, traders and industrialists. In the process of collection of deposits and advancing of loans, credit is created. In fact, credit supply created by banks is much larger than the volume

of deposits. Fundamentally, banks can create credit because depositors believe in their long-term continuity and their ability to pay cash on demand by the depositor. Secondly, it is to be noted that all the depositors never demand all their deposits at the same time. In fact at any given point of time, a certain proportion of depositors withdraw a certain portion of deposits. Naturally all balance amounts of deposits can be used by banks for loans and advances to borrowers at higher rate of interest, which gives them profits, which are given as dividend to shareholders. Moreover, most of the depositors use cheques for payments. According to R.S. Sayers, banks are not only the suppliers of money but they function as factories of credit.

It is, thus, clear that every deposit creates credit. But it is equally true that every loan creates a deposit. According to Keynes, deposits are the children of loans.

**b) Base of Credit Creation** : The confidence and faith of people in banks attracts an ever increasing flow of funds in the form of deposits to the banks. Banks assure depositors of total safety and liquidity (ability to pay cash on demand). It is through these deposits that loans are advanced. Loans are also given on the basis of some security. According to Hartley Withers, every deposit in a bank creates a loan and every loan creates a deposit.

A deposit from a customer out of his savings is a primary deposit, which through a loan creates a derived deposit. Loans, advances, cash-credits, overdraft are examples of derived deposit.

**c) Process of Credit Creation** : All legal tender has govt. or legal authority, credit money has no such authority. However, credit money has public acceptability because of confidence of people in bank's continuity, safety, and liquidity. When a bank makes a loan from its deposits to say Mr. X, he keeps the same amount of loan as a deposit in the same bank or some other bank, from which he can withdraw up to a limit, as and when he requires money.

Let us remember that all banks have to maintain a certain proportion of their deposits (fixed and savings) in the form of cash. This cash reserve ratio is generally legally decided by the Central Bank (RBI).

Suppose, this cash reserve ratio is 10% of all deposits. Now we can illustrate credit creation by a hypothetical example. This is given in following table-

**Table : 3.3**

**Process of Credit Creation**

| Bank | Deposit | Cash Reserve | New Loan |
|---|---|---|---|
| IDBI Bank | 5,000/- | 500/- | 4,500/- |
| Bank of India | 4,500/- | 450/- | 4,050/- |
| Bank of Baroda | 4,050/- | 405/- | 3.645/- |
| Bank of Maharashtra | 3,645/- | 364.5 | 3,280.5 |
| All Banks | 50,000/- | 5,000/- | 45,000/- |

This process clearly shows that a loan sanctioned becomes a new deposit, which forms further basis for advancing a new loan. The loan may be kept in the sanctioning bank or some other bank also. Inter bank relations therefore, are crucially important.

It is to be noted that larger the cash reserve ratio, smaller is the creation of credit. We can use the following formula for credit creation –

C = Credit creation (total)

D = Primary deposit

R = Cash reserve ratio = 1/10

$$\therefore C = D \left( \frac{1}{\frac{1}{R}} \right)$$

Suppose, primary deposits of banks are Rs.20,000/- and cash reserve ratio $= \frac{1}{10}$

Then –

$$C = 20{,}000 \left( \frac{1}{\frac{1}{10}} \right)$$

$$= 20{,}000 \ (10)$$

$$= 2{,}00{,}000/-$$

In simple, inverse of cash reserve ratio gives us the credit-multiplier.

**d) Limitations of Credit Creation** : Following are the limits on credit creation -

i) Total size of legal money supply - Larger the money supply, given the CRR, larger is the credit creation.

ii) CRR – Higher CRR reduces and lower CRR increases credit creation, CRR depends on people's monetary and banking habits.

iii) Availability of acceptable securities - Larger availability of such securities increases credit supply and vice-versa.

iv) Economic conditions – Optimistic economic conditions increase credit creation whereas pessimistic economic conditions reduce credit creation.

v) Clearing system – A well-organized clearing house system increases credit creation.

vi) Demand for loans – In an optimistic investment climate, demand for loans increases and naturally credit creation also increases.

In short, credit creation process is basically dependent on supply of savings, demand for loans, monetary & banking habits, people's faith in banks and an efficient regulatory authority.

## 3.9 Summary :

In this unit we have traced evolution of banking, definitions of banks and their main functions and their importance.

We have explained the balance sheet of a bank in detail.

We also examined non-performing assets, their causes and their management.

Finally we examined the process of credit creation by commercial banks and limitations thereon.

## 3.10 Terminology :

i) Commercial Bank- An institution dealing in deposits and loans

ii) Asset- Wealth or property, payments due from others

iii) Liability- Payments due to others

iv) Authorised capital- Maximum of capital to be raised by sale of equity

v) Issued capital- Shares brought to market for sale

vi) Subscribed capital - Shares to be bought by people

vii) Paid up capital- Actual amount of share value paid

viii) NPA - Loans and advances not recovered along with interest beyond a certain period

## 3.11 Self-Study Questions :

**A) Fill in the blanks.**

1) Modern banks originated in … …
2) Commercial banks create … …
3) Balance sheet of a bank shows … …
4) Standard asset is … …
5) Loss asset is … …

**Answers** :

1) Italy,
2) Credit,
3) Liabilities and assets
4) A loan on which interest and installments are regularly paid
5) A loan on which interest and installment are due for more than three years.

**B) State whether right or wrong.**

1) Mobilising deposits is the main function of banks.
2) Banks do not discount trade bills
3) During last 15 years NPAs in India increased
4) Debt Recovery Tribunals decrease NPAs.
5) Commercial banks help development.

**Answers :**

1) Right, (2) Wrong, (3) Wrong, (4) Right, (5) Right.

## 3.12 Exercise :

**A) Essay type questions.**

1) Define and discuss a commercial bank in terms of its functions and importance.

2) Explain balance sheet of a bank

3) Elaborate process of credit creation by banks

**B) Write notes -**

1) Cash reserve ratio

2) Limitations on credit creation

3) Causes of NPAs.

## 3.13 Field Work :

Prepare a note on the balance sheet of your bank for 2006-07.

## 3.14 Additional Reading :


1) M.C. Vaish - Money, Banking, Trade and Public Finance, Wiley Eastern Ltd., New Delhi.

2) M.L. Seth - Monetary Economics – L.N. Agarwal Educational publishers.

3) B.N. Ghosh - Modern Macro Economics, Himalaya Publishing House, New Delhi.

4) S.M. Methane - Money Banking, International Trade and Public Finance – Himalaya Publishing House, New Delhi.

5) Ravishankar Kumar Singh – Indian Banking and Financial Sector Reforms Vol.I & Vol.II – Abhijeet Publications, New Delhi.

6) J.F. Patil, P.J. Tamhankar, S.S. Sahasrabudhe - Macro Economics – Phadke Prakashan, Kolhapur.


• • •

# Unit – 4

# Regional Rural Banks, NABARD & Lead Banks.

## A) Regional Rural Banks (RRBs)

**Index :**


4.1 Objectives
4.2 Introduction
4.3 Establishment and Nature of RRBs
4.4 Responsibility of RRBs
4.5 Capital of RRBs
4.6 Management of RRBs
4.7 Objectives of RRBs
4.8 Functions of RRBs
4.9 Progress of RRBs
4.10 Problems of RRBs
4.11 Measures
4.12 Check your Progress
4.13 University Questions
4.14 References
4.15 NABARD - Objectives
4.16 Introduction
4.17 Establishment of NABARD
4.18 NABARD's Capital
4.19 NABARD's Management
4.20 NABARD's Functions
4.21 NABARD's Performance

4.22 Evaluation of NABARD
4.23 Check your Progress
4.24 University Questions
4.25 References
4.26 Lead Bank Scheme - Objectives
4.27 Introduction
4.28 Background
4.29 Meaning
4.30 Objectives
4.31 Functions
4.32 Working
4.33 Shortcomings
4.34 Check your Progress
4.35 University Questions
4.36 References

## 4.1 Objectives :

1) Studying the establishment & nature of RRBs
2) Understanding the responsibility of sponsor bank
3) Understanding capital structure and management of RRBs
4) Studying objectives & functions of RRBs
5) Studying progress and problems of RRBs
6) Studying the measures adopted to solve the problems of RRBs

## 4.2 Introduction :

Nearly 70% of India's population lives in rural sector. So, economic development of India in true sense is possible only if rural sector develops, and that is possible only if the institutional credit reaches the countryside. The 'Banking Commission' of 1972 floated the concept of rural banks. A study group on rural banks, chaired by M. Narasimham, upheld the concept and recommended establishment of rural banks. In 1976, 'Regional Rural Banks Act' was passed.

## 4.3 Establishment & Nature of RRBs :

5 RRBs were set up on the occasion of Mahatma Gandhi's birthday 2nd October. These were established at Moradabad and Gorakhpur in U.P., at Bhivani in Hariyana, at Jaipur in Rajasthan, and at Malada in West Bengal; and were sponsored by Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank respectively.

Regional Rural Banks are set up on the initiative of State and Central Govt., sponsored by a bank and work in the rural areas. Their operation area is limited to either one or two districts. These banks lend to small and marginal farmers, rural artisans, agricultural labourers etc. and charge interest rate, which should not be more than the one charged by primary agricultural credit societies (PACS) in the State.

## 4.4 Responsibility of RRB :

As per the amendment of 1987, the sponsoring bank should guide in the area of capital raising, employee recruitment, training, managerial advice, etc.

Sponsoring banks provide help to RRBs in the following areas :

i) Contributing in the capital of RRB.

ii) Providing managerial help

iii) Making required staff available

iv) Financing training expenses

v) Providing financial help under refinance

vi) Providing guidance for the investment

Though the above types of help is to be provided during first 5 years, sponsoring banks are found to be continuing the same even after 5 years.

## 4.5 Capital :

Every regional bank has an authorized capital of Rs.1 crore, with 1 lakh shares of Rs.100 each. The issued and paid up capital is of Rs.25 lakhs; of which 50% is contributed by sponsoring bank, 35% by central Govt. and 15% by state Govt. An amendment of 1987 raised authorized capital to Rs.5 Crores and paid-up capital to Rs.1 Crore.

## 4.6 Management :

Board of Directors, which consists of 9 members, is responsible for day-to-day

working of RRBs. Of the 9 directors, 4 are appointed by the central govt., of which 1 is elected as Chairman. Two directors are appointed by State Govt. and remaining 3 by sponsoring bank. The total number of directors should not cross 15. RBI and NABARD are allowed to appoint one director each. The tenure of the board of directors is 5 years. After the establishment of NABARD, all the powers regarding RRBs have been transferred to it.

## 4.7 Objectives of RRBs :

Following are the objectives of RRBs :

i) Extending loan assistance to small & marginal farmers, artisans, small entrepreneurs, traders and agricultural labourers.

ii) Helping in accelerating the growth of rural sector.

iii) Developing saving habits among rural people.

iv) Freeing the rural people from the clutches of moneylenders.

v) Removing regional imbalances.

## 4.8 Functions of RRBs :

RRBs perform following functions :

i) Providing individual or group loans to rural people.

ii) Ensuring that financial activities are productive and viable.

iii) Devising new schemes of credit allocation to people from backward castes (i.e. S.C.s & S.T.s ) and generating self-employment opportunities to them.

iv) Making efforts for the upliftment of the economically weak people by introducing special credit allocation schemes for them.

v) Accepting deposits and other banking functions are also performed by RRBs.

## 4.9 Progress of RRBs :

RRBs have played an important role in increasing the flow of institutional credit to the rural sector since inception. At present, 196 RRBs are working in 23 States with a network of 14,500 branches. 95% of their loan assistance is given to weak units and 90% branches have been opened in those areas, which were not served by banks earlier. The progress card of RRBs is described below :

### Progress of RRBs :

| Particulars | March 1999 | March 2003 |
|---|---|---|
| 1) No. of RRBs | 196 | 196 |
| 2) No. of Branches | 14,499 | 14,500 |
| 3) Deposits (Rs. in Crores) | 27,065 | 48,500 |
| 4) Loans (Rs. In Crores) | 11,355 | 21,773 |

## 4.10 Problems of RRBs :

RRBs face following problems :

**i) Organizational problems** : The performance of the RRBs is adversely affected by the lack of co-ordination between those, which control it (i.e. sponsoring bank, NABARD, Central and State Govt.). Further, their area is limited to one or two districts. Shortage of expert staff is also a problem.

**ii) Problem of recovery** : These banks have not been successful in recovery of loans. In case of some banks, the recovery percentage is 55. Faulty allocation, absence of monitoring, misuse of funds, political interference, and natural calamities are responsible for poor recovery percentage.

**iii) Huge losses** : Finance minister, in his 1994-95 budget, stated that 150 RRBs out of 196 were in loss at least once during first 5 years. The reasons responsible include poor recovery percentage, increase in expenditure due to continued branch expansion, less than proportionate increase in income and lack of skilled manpower.

**iv) Management problems** : RRBs are small institutions working at district level. The sponsoring bank appoints the managerial staff, which can't take decisions on its own. Board of Directors, do not meet regularly and control from multiple entities creates delays in decision-making.

## 4.11 Measures :

Narsimham Committee, and the Agricultural Credit Review Committee, chaired by Khusro have recommended that RRBs be merged with either sponsoring banks or other commercial banks. However, M.L.Dantwala has opined that this is not the solution to the problems of RRBs.

Following measures have been recommended for solving the problems and making RRBs strong.

i) RRBs be allowed to function beyond their jurisdiction

ii) Separate machinery be formed to monitor their functioning

iii) New capital be injected in them

iv) These banks should attempt to develop saving habits among rural people and link their loans to the savings

Govt. should pay more attention to the problems of RRBs as these can play very important role in rural development.

## 4.12 Check your progress :

### Q.1 Answer the following in one sentence.

1) When was the RRBs Act passed?

2) How many RRBs were set up in the beginning and where?

3) Whom can the RRBs tend to?

4) How are the RRBs managed?

5) How many RRBs are there in India at present?

### Q.2 State whether true or false.

1) Every RRB has its sponsoring bank.

2) The area of RRBs is very wide.

3) The sponsoring bank does the functions like capital raising, recruitment of employees, training, managerial advice etc. during initial 10 years.

4) RBI contributes 50% of the capital of RRBs.

5) Authorized capital and paid-up capital of RRBs was raised to Rs.5 Cr. & Rs.1 Cr. respectively since 1987.

## 4.13 University Questions :

### A) Long answer type questions.

i) Explain in detail the objectives and functions of RRBs.

ii) Evaluate the working of RRBs

iii) What are RRBs? Explain their problems and measures.

**B) Write short notes.**

i) Regional Rural Banks.

ii) Functions and progress of RRBs.

## 4.14 References :

1) RBI, 'Report on Trade and Progress of Banking in India', 1989-90.

2) Rudar Dutt and K.P.M. Sundaram – 'Indian Economy' 54th Edition – 2006, S.Chand & Company Ltd., New Delhi.

3) S.K.Misra & V.K.Puri – 'Indian Economy' 23rd Edition, Himalaya Publishing House, New Delhi.

# B) National Bank for Agriculture and Rural Development (NABARD)

## 4.15 Objectives :

i) Know the background of establishment of NABARD.

ii) Understanding capital structure of NABARD.

iii) Understanding the management of NABARD.

iv) Studying the functions and progress of NABARD.

## 4.16 Introduction :

Indian agriculture received loan assistance indirectly from the RBI. An independent department was set up for providing agricultural credit. In 1963, Agriculture Refinance and Development Corporation was constituted to make refinance facility available. Yet, there were many problems in the allocation of agricultural credit. As a solution, a recommendation to set up a bank at national level was made by a committee set up by RBI.

## 4.17 Establishment of NABARD :

The existing institutional credit flow from commercial banks (public & private), co-operative banks to the agriculture and rural sector was inadequate. A need was felt to have an apex bank for agricultural and rural development in an agrarian country like India. Expert Committee had also recommended for the same. As a result, NABARD was established through a separate bill presented in the Parliament on 12th

July 1982. It was expected to provide loan assistance to small, handicraft and village industries and to take over the agricultural credit function of RBI. NABARD functions as an apex body in the co-operative credit structure in India.

### 4.18 NABARD's Capital :

NABARD had an authorized share capital of Rs.100 Crores and paid-up capital of Rs.100 Crores. It was raised to Rs.2,000 Crores in 1999. NABARD's capital is subscribed by RBI and Central Govt., 50% each. It receives finance from Central Govt. and World Bank. It can also raise capital from the open market. NABARD also receives funds from National Agriculture Credit Fund (Stabilization fund). It is dependent on RBI for short term and working capital requirement. During last few years, NABARD's capital & funds have increased enormously.

### 4.19 Management of NABARD :

NABARD's management consists of 16 directors. They are appointed in the following manner :

- RBI's deputy governor is the Chairman of the bank,
- RBI appoints 3 directors,
- Central Govt. appoints 3 directors,
- 2 experts from co-operative banks and 1 from commercial bank are appointed as directors.
- State Govts. appoint 2 directors.
- 2 Experts from the area of rural economy and rural development.
- 1 Managing Director.
- 1 Full time Director.

### 4.20 Functions of NABARD :

Following are the main functions of NABARD :

1) It provides refinance to agriculture, small and village industries, handicrafts etc.
2) It provides short, medium and long term loan assistance to RBI approved State Co-operative banks, rural development banks, land development banks and other institutions.
3) BANARD provides long term loans (20 years maturity) to state govts., so that they can subscribe to the share capital of co-operative credit societies.

4) It provides long term loans and helps in raising capital to those institutions, which are working for agricultural and rural development and are approved by Central Govt.

5) NABARD plays the role of a coordinator among the activities of Central Govt., State Govts., and planning commission so as to develop the rural economy.

6) NABARD is entrusted with the responsibility of inspecting the working of RRBs, co-operative banks and primary co-operative institutions.

7) It has instituted 'research and development fund' for financing the agricultural and rural development related research.

8) It also provides financial assistance on a large scale for mechanization in agriculture, minor irrigation, forest conservation and horticulture.

## 4.21 NABARD's Performance :

NABARD functions as an apex bank among the institutions providing credit for the development of agriculture, small and village industries, handicrafts etc. NABARD's performance is described below :

**i) Short term loans** - NABARD's short term loan assistance to agricultural sector was Rs.8,160 Crores in 1999-2000, which increased to Rs.8,820 Crores in 2003-04. the rate of interest charged on these loans is 3% less than the regular one.

**ii) 20 point programme** - Under the new 20 point programme, banks are provided loan assistance so that they can lend to small and marginal farmers and economically weak units. Such a lending is to be done at a specific rate of interest.

**iii) Medium-term loans** - Medium term loans are provided for the development of agriculture.

**iv) Long-term loans** - NABARD extends long-term loans to state govts., so that they can subscribe to the share capital of co-operative institutions.

**v) Increase in refinance** - NABARD provides refinance to state co-operative banks and regional rural banks for the short and medium-term. By the end of 2002, it had provided refinance assistance to the tune of Rs.6,590 Crores to state co-operative banks and RRBs. State Govts.,also receive special assistance from NABARD for purchasing shares of weak co-operative institutions and banks.

During 2001-02, NABARD had provided refinance of Rs.12,000 Crores to

weaving institutions and industrial co-operative institutions for purchasing fertilizers and other inputs, stocking and distribution as also for production and sale.

vi) **Assistance under Integrated Rural Development Programme** : It provides refinance to weak units for minor irrigation, animal husbandry, fishing business, small business etc. under IRDP.

vii) **Priority to agricultural mechanization** : NABARD has given priority to mechanization of agriculture. Nearly 28% of its loans have been given for this reason.

viii) **Development of backward regions** : NABARD has provided special attention for increasing agricultural investment in those states, which have less developed agricultural sector. Backward states have received 50% of loan assistance provided by NABARD. U.P., Bihar, Rajasthan, Madhya Pradesh, Orissa are the main beneficiaries.

ix) **Establishment of Rural Infrastructure Development Fund** : Rural Infrastructure Development Fund was established by NABARD with the help of Central Govt., in 1995-96. This fund is meant for financing development of rural infrastructural projects like major irrigation, roads, water management, flood control etc.

During 1995 and 31st March 2004, this fund had provided Rs.16,300 Crores for the construction of roads and bridges, Rs.12,140 Crores for irrigation and Rs.6,240 Crores for other reasons, that is, a total of Rs.34,680 Crores. During 2003-04, Rs.7,605 Crores were spent on 7,827 schemes.

x) **Efforts for re-structuring of co-operation** : NABARD has made efforts for restructuring co-operation in the country. Primary Agricultural Credit Societies were restructured. It also provided help for rehabilitation of district central co-operative banks.

## 4.22 Evaluation of NABARD :

The Khusro Committee set-up for the evaluation of NABARD has stated that it has done a commendable job in the sphere of refinance. The loan assistance provided by NABARD has helped in the development of agriculture, small and village industries and the rural sector as a whole. However, NABARD has failed in preventing the laggardness of co-operative banks. It has done an appreciable task in some states, while in other states; its performance has been very poor. In sum, NABARD has been playing an important role in the development of agriculture and rural sector.

## 4.23 Check your progress :

**Q.1 Answer in one sentence.**

i) When was NABARD established?

ii) Who provides capital to NABARD?

iii) How many members does NABARD's board consist of?

iv) Which fund was set-up by NABARD for rural infrastructure development?

**Q.2 State whether true or false.**

i) NABARD functions as an apex institution in the co-operative credit structure.

ii) Govt. of India and RBI contribute 50% each in NABARD's capital.

iii) NABARD depends on state govts., for short-term and working capital.

iv) RBI's deputy governor is the Chairman of NABARD.

v) NABARD provides only long-term loan assistance.

## 4.24 University questions :

**A. Long answer questions.**

i) Describe in detail functioning of NABARD.

ii) Explain NABARD's contribution in agriculture and rural development.

**B. Write short notes.**

i) NABARD,

ii) NABARD's performance,

iii) NABARD's capital structure and management.

## 4.25 References :


1) RBI Bulletin, May 1999, P.688.

2) S.K.Misra & V.K. Puri – "Indian Economy",23rd Edition; Himalaya Publishing House, New Delhi.

3) Rudar Dutt & K.P.M. Sundaram, "Indian Economy" 54th Edition 2006, S.Chand & Company Ltd.,New Delhi.

## C) Lead Bank Scheme.

### 4.26 Objectives :

i) Understanding the background of Lead Bank Scheme.

ii) Understanding the meaning and objectives of Lead Bank Scheme.

iii) Studying functions and working of Lead Bank Scheme.

iv) Studying the problems/drawbacks of Lead Bank Scheme.

### 4.27 Introduction :

In the previous unit, we saw the different functions performed by commercial banks for industry, trade etc. Recognizing the role that these banks can play, Govt. of India imposed social control over them in 1967. The main intention was to accelerate rate of growth, providing banking facilities to the rural areas and extending loan assistance to the important sectors. However, as govt. realized that social control will not be enough to fulfill the objectives, a decision of nationalizing 14 main commercial banks was taken on 19th July 1969. Setting up of Lead banks is also an important decision taken for the development of the country.

### 4.28 Background of Lead Bank Scheme :

A study group under the Chairmanship of Dr. Dhananjayrao Gadgil was formed by the National Credit Corporation for making suggestions to remove regional inequality and imbalance. The group submitted its report in 1969. At that time, commercial banks accounted for 83% of total loan allocation, but 5000 villages had not received banking facilities. As a result, the study group recommended that commercial banks should adopt regional approach. It implies that commercial banks should pay attention to the social justice and consider district as the focus area for their activities. Overall economic and social development of the district should be their top most objective. After the report of the study group was submitted to RBI, RBI set up a committee under the Chairmanship of F.K.F.Nariman. This committee also upheld the recommendations of Gadgil group and floated the concept of Lead Bank. Finally, RBI announced the Lead Bank Scheme at the end of 1969.

### 4.29 Meaning :

The basic idea behind the lead bank scheme is that a bank should lead and take initiative for the development of a district. Lead banks are supposed to function in co-ordination with other banks and financial institutions in the district in designing and implementing schemes of economic development.

This scheme was introduced at end of 1969 in 336 districts, excluding metropolitan cities like Mumbai, Kolkata, Chennai and Union Territories like Delhi, Pondecherri and Goa. They were allotted to 14 Nationalised Banks, State Bank and its seven associate banks and 3 private banks. The field of the bank was decided on the basis of the size of the bank, availability of the resources with the bank and affiliation to the district etc. Lead bank is supposed to conduct a survey of the district, check the possibility of developing agriculture, industry (small or large) and other businesses and take a lead in meeting total credit needs of the district.

## 4.30 Objectives of Lead Bank Scheme :

1) Bringing co-ordination in the functioning of commercial banks, co-operative banks and other financial institutions operating in the district.
2) Bringing effectiveness in branch expansion, guidance and monitoring.
3) Establishing close relationship between loan business and banking business.
4) Encouraging saving by conducting survey of district's resources.
5) Assisting in the development of agriculture and agro-based and small industries of the district.
6) Removing hurdles in the development of district.
7) Accelerating the pace of economic activities at district level.
8) Establishing close relations and co-ordination between district level govt. officials and banking institutions.

## 4.31 Functions of the Lead Bank :

Lead bank, as a consortium leader, performs following functions :

**1) Preparing economic report of the district** : This is an important function of the lead bank and helps in taking important decisions like where to open new branches in the district, how much deposits could be collected from a region, which parts will see industries flourishing, and how much credit is needed in a region etc.

**2) Continuity in economic survey** : The lead bank should take the responsibility of conducting economic survey of the district every year. Continuity will help in knowing the extent of progress and also the shortcomings in it.

**3) Preparing District Credit Plan** : Lead bank initiates preparing the district credit plan in association with the commercial banks and govt. banks. District credit plan is a prediction about how much credit will be required for agriculture, industry and commerce in the district next year. Lead bank must ensure that every bank from

the district will share the responsibility of meeting the credit requirements.

**4) Appointing an Advisory Committee at district level** : A committee consisting representatives of credit societies, banks and govt. officials (representatives from Panchayat Samiti and Zilla Parishad) is formed. District Collector is the ex-officio Chairman of this committee. The committee has following two responsibilities:

**a)** Coordinating the activities of commercial banks, co-operative banks and other financial institutions from the district.

**b)** Coordinating the development accounts of commercial banks, co-operative banks and other financial institutions from the district.

## 4.32 Working of Lead Bank Scheme :

The scheme has been implemented since 1970. In the beginning, due to ambiguous nature of the scheme, banking sector went through chaos. However, as the details were made available, the scheme started functioning. By March 1978, every lead bank had prepared the district credit plan. However, it was criticized on several grounds.

i) Agriculture did not receive proper place in credit schemes.

ii) Co-operative institutions were not given proper place and importance in the credit plan.

iii) Credit plan was not consistent with the district development scheme.

In 1981-82, RBI published guiding principles for preparing district credit plan. Banks were asked to consider following things :

i) Making efforts to reduce unemployment and under employment in the district.

ii) Raising income levels of people living below poverty line.

iii) Initiating labour intensive projects in the district.

iv) Making efforts for raising agricultural productivity.

v) Preparing a scheme for the progress of small & marginal farmers.

vi) Preparing development plans for landless labourers, backward caste people.

vii) Credit plan should be based on strong economic and technical foundation.

viii) Of the total agricultural credit in the district, 50% should flow to small and marginal farmers. In the rural areas, credit deposit ratio should be maintained at 60%.

Until 2001, 576 districts were brought under the purview of lead bank scheme. Lead banks have done far better than the objectives of lead bank scheme. Public sector banks have been instrumental in implementing the scheme.

## 4.33 Shortcomings of the Lead Bank Scheme :

Following are main shortcomings:

1) **Impractical Credit Plan** : The credit plans prepared by lead banks are said to be impractical, as these are not based on scientific foundation. The credit plan should be prepared taking into consideration total number of banks and financial institutions, their credit creation capacity, possibility of economic expansion etc.

2) **Lack of Coordination** : Lead banks have been criticized on the ground that they have failed in coordinating the activities of commercial banks, co-operative banks and other financial institutions from the district.

3) **Lack of Basic Facilities** : Many districts lack the basic facilities required for carrying out developmental work. Lead banks have attained limited success due to lack of facilities like transport, communication, storage faciltity, insurance companies markets etc.

4) **Lack of Enterprise** : For the successful implementation of credit plan, creative leadership and enterprise is required. However, many districts lack such leadership and enterprise.

5) **Lack of Trained Experts and Experienced Staff** : Many commercial banks find it difficult to get trained experts and experienced staff required for implementing new schemes.

6) **Flawful Technical and Economic Survey** : Lack of trained staff creates difficulties in conducting technical and economic survey.

7) **Non-cooperation from other banks :** Under the scheme, lead bank takes lead, but if other banks do not cooperate implementation of the credit plan will suffer.

8) **Unfair Distribution of the Districts :** If the allotted district is unknown to the bank, it becomes difficult for the lead bank to work in such district.

Despite these short-comings, lead bank scheme can be highly successful if survey of the district is done properly and if other banks cooperate with the lead bank.

## 4.34 Check your progress :

### Q.1 Answer in one sentence.

1) From which year the implementation of the lead bank scheme started?
2) What is at the centre in lead bank scheme?
3) Which cities were excluded from the lead bank scheme?
4) Who is the Chairman of the district level advisory council?
5) Who prepared the district credit plan?

## 4.35 University level Questions.

### Q.1 Long answer questions.

1) Review the working of lead bank scheme.
2) Explain in detail objectives and working of lead bank scheme.
3) Evaluate the lead bank scheme.

### Q.2 Write short notes.

1) Lead bank scheme.
2) Functions of lead bank.
3) Shortcomings of lead bank scheme.

## 4.36 References :


1) "The Lead Bank Scheme" : Progress & Prospective", R.B.I. Bulletin, Nov. 1970.
2) Rudar Dutt & K.P.M. Sundaram – 'Indian Economy' 54th Edition- 2006, S.Chand & Company Ltd; New Delhi.


• • •

## Unit – 5

# Development Banks and Non-Banking Financial Institutions

**Contents :**


5.0 Introduction

5.1 Objectives

5.2 Development Banks and Financial Institutions

- 5.2.1 Introduction
- 5.2.2 Definition
- 5.2.3 Features of Development Banks
- 5.2.4 Functions of Development Banks
- 5.2.5 Structure of Development Banks
- 5.2.6 Main Development Banks in India
  1. Industrial Finance Corporation of India
  2. Industrial Credit & Investment Corporation of India
  3. Industrial Development Bank of India
  4. Industrial Investment Bank of India
  5. Small Industries Development Bank of India
  6. State Financial Corporations
  7. State Industrial Development Corporations
  8. Export-Import Bank of India
  9. Check your progress

5.3 Non-Banking Financial Institutions :

- i) Distinction between banks and NBFIs
- ii) Classification of NBFIs

a) Unorganized,

b) Organized

iii) Features of NBFIs

iv) Role of NBFIs

v) NBFIs in India

a) UTI (Unit Trust of India)

b) LIC (Life Insurance Corporation)

c) GIC (General Insurance Corporation)

d) Mutual Funds

vi) Check your progress

5.4 Unregulated Credit Market

i) Money lenders

ii) Indigenous Bankers

iii) Check your progress

iv) Answers- 1,2,3.

5.5 Summary

5.6 Terms to remember

5.7 Some important questions

5.8 Answer in brief

5.9 Write notes

5.10 Field work

5.11 Reference books

## 5.0 Introduction :

In the previous unit, we discussed about Regional Rural Banks (RRBs), Lead Bank Scheme and National Bank for Agriculture and Rural Development (NABARD). This unit will provide information about Development Banks and Non-Banking Financial Institutions. It also deals with unorganized money market consisting of indigenous bankers and money lenders.

## 5.1 Objectives :

This unit will help students understand –

i) Meaning, features, functions of development banks and their structure in India.

ii) Functioning of main development banks in India

iii) Non-bank financial institutions of India

iv) Distinction between banks and non-bank financial institutions

v) Types of non-bank financial institutions

vi) Features of non-bank financial institutions

vii) Importance of non-bank financial institutions in the economy

viii) Reasons behind the classification of money market into a) organized and b) unorganized

ix) Meaning of indigenous bankers and money lenders

x) Features and functions of indigenous bankers and drawbacks in their working.

## 5.2 Development Banks and Non-banking Financial Institutions :

**5.2.1 Introduction** : A financial institution which performs the functions of accepting deposits and giving loans is called as 'Bank'. Banks are classified on the basis of their functions and nature. For example, Commercial Bank, Investment Bank, Saving Bank, Foreign Exchange Bank, Development Bank etc. Development bank is thus a type of bank.

Industrial Revolution in Europe coincided with the establishment of development banks. Such a bank was established in Belgium in 1822. In France it was established in 1852, in Japan in 1920, in Canada in 1944, in England in 1945 and it was set up in India in 1948.

### 5.2.2 Definition :

i) According to Prof. Shirley Bosky, a financial institution providing loans to developmental projects and other banking services in accordance with the banking rules is called as Development Bank. In other words, a financial institution which functions in accordance with the banking rules and distributes loans to economically viable developmental projects after careful study and also provides other banking services is termed as a development bank.

ii) In view of Prof. William Diamond, development bank is one which encourages new enterprises, provides them capital and thus helps in industrial development.

iii) Dr. K.V. Prabhakar opines that development bank is a multipurpose institution, which shares the organizational risk, changes its policy as per the industrial environment and encourages new industrial projects.

iv) According to Shri B.K. Madan, development bank is an institution which not only supplies capital to industries but also provides them technical and managerial advice and helps in sale and management.

From the above definitions, it can be argued that development bank is one which encourages industrial progress by supplying long term capital and by guiding industrial units about technology, management and other relevant aspects and thus speeds up the economic development of a country.

Development bank is established with the intention of providing long term loans to industrial units, and units engaged in trade and agriculture. It provides medium or long term loans for setting up production unit, expansion of the existing unit or for increase in production. It buys shares or debentures of companies, helps in the sale of share and debentures and provides other banking services. Some countries have seen establishment of the development banks in the private sector, while some in public sector. These banks provide loan assistance to economically viable units, provide them advice and guidance, solve their problems and therefore, help in their development and the development of the economy. It is because of this that they ar termed as partners in development.

**5.2.3 Features of Development Banks :**

**1. It is a financial institution** : It distributes its share capital, debentures to people and collects funds, which are used for giving loans. It is an institution functioning in accordance with the banking rules.

**2. Multipurpose financial institute** : These banks help in starting new projects, in raising capital, guide in the purchase of machines, vehicles etc., provide advice for running an enterprise, guide in the purchase of raw material and sale of finished products and help in other respects also.

**3. Medium & Long-term loans to business firms :** These banks provide medium and long term loan assistance to economically viable business units.

**4. Don’t accept deposits :** These banks don’t accept deposits from the people like commercial banks. General public cannot open current, savings or recurring accounts with these banks.

5. **Expert institution :** These banks appoint experts from various fields like industry, commerce, agriculture and take their help. These banks function in consultation with these experts. Borrowers therefore, can avail their advice at concessional rate fee.

6. **Developmental finance :** These banks help in the process of economic development by making finance available to the productive units. These units, which have the potential of survival, which can withstand competition, are assisted by the development banks.

7. **Encouragement to the investment and entrepreneurship :** These banks not only assist existing units but also motivate setting up of new units, and help them in their further development.

8. **More stress on implementation :** These banks do not merely provide finance, but guide industrial units in deciding location of plant, in the purchase and installation of machinery, in the production and management of the unit and also in the sale of final produce. Development banks assist industrial & other units so that they will succeed and others will draw lessons from them.

9. **Inspiration to new and small units :** Experts of these development banks motivate new and small business units for their development.

10. **Social & economic objectives :** These banks work for the achievement of those objectives which will promote overall development of the country.

11. **Encouragement to saving and investment** : As these banks promote the development of new and existing business units, they indirectly help in improving savings and investment levels in the economy.

12. **Objective of social well-being** : The development banks function for the social well-being by assisting in the development of both public and private business units from industry, commerce and trade, agriculture, services. They provide advice and guidance for the success of these business units. Thus, these banks work for the improvement of social well-being.

### 5.2.4 Functions of the Development Bank :

**1)** Selecting economically viable business units after careful study and providing them loan assistance.

**2)** Providing risk capital to the business units

**3)** Providing medium and long tem loans to projects

**4)** Investing in the share capital or debentures of business firms

5) Helping business firms in the sale of shares and debentures

6) Providing guarantee to the loans raised by business units

7) Providing guidance to the management regarding technology, market, labour etc.

8) Finding developmental projects and encouraging their initiation and implementation by making loan assistance available

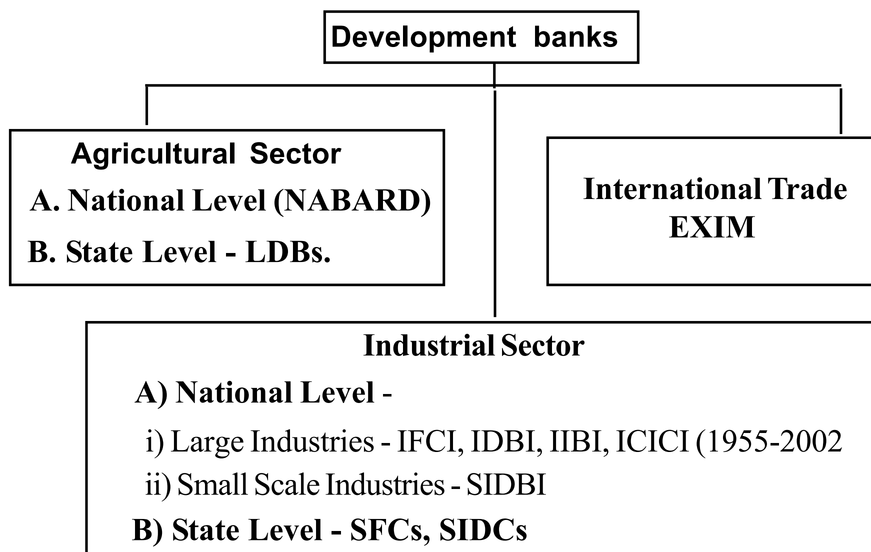
9) Designing developmental projects and evaluating them after they start functioning

10) Appointing experts from different fields for providing guidance to the entrepreneurs

11) Conduct of surveys and research

12) Coordinating among the financial institutions working in the field of agriculture, industry and trade and other development institutions

**5.2.5 Nature / Structure of Development Banks in India** :




The above-mentioned development banks have been established in the post-independence period by the Central and State Governments.

**1) Development Banks in Agricultural Sector** : To assist the projects in agricultural sector, NABARD was constituted (1982) at the national level. Land Development Banks have been functioning at the State level for the same reason.

**2) Development Banks in Industrial Sector** : Owing to the efforts done by the Central Govt. several development banks have been established for assisting big developmental projects in the country. Industrial Finance Corporation of India (1948), Industrial Development Bank of India (1964), Industrial Investment Bank of India (19971) and Industrial Credit and Investment Corporation of India (1955) are the leading development banks established in India. To meet the credit needs of small scale industries, Small Industrial Development Bank of India was set up in 1990. State Govts. Have also set up State Industrial Development Corporations (SIDC) State Industrial Investment Corporations (SIIC) for assisting business units in their states.

**3) Development Bank for International Trade** : Export-Import Bank of India (EXIM) was set up in 1982 to boost India's foreign trade.

As mentioned above some development banks operate at national level, while some at State level. Apart from them, some banks work as saving banks, but they also provide financial assistance to business units. Therefore, they are also termed as development banks. For example, Unit Trust of India (UTI), Life Insurance Corporation (LIC), General Insurance Corporation (GIC).

**5.2.6 Main Development Banks in India** : We shall now discus the main development banks in India.

**5.2.6.1 The Industrial Finance Corporation of India Ltd. (IFCI) :** IFIC was established in 1948 by the Indian Govt. The share capital of IFCI is subscribed by IDBI, scheduled commercial banks, insurance companies and other financial institutions. This corporation was converted into public limited company since 1993. This corporation complements the efforts of other development banks. It provides loan assistance out of its resources, which are built through the sale of its debentures, foreign exchange loan from the World Bank, acceptance of deposits with maturity of more than 5 years and loans from the Reserve Bank of India.

- **Functions :**

i) Providing long-term loans (up to 25 years maturity) to the production units or purchasing debenture / bonds of same maturity.

ii) Providing guarantee to the loans up to 25 years of maturity raised by production units.

iii) Underwriting the share capital or debentures of production units and making arrangement for their sale.

iv) Guaranteeing the sale of share capital or debentures and at time purchasing them.

v) Guaranteeing the pending payments from importers

vi) Providing financial assistance to the large and medium enterprises

vii) Providing loans either in rupees or foreign currency.

Following factors are considered while issuing loan :

1) The importance of the project to the economy.

2) Installation cost and potential of survival.

3) Nature of the security mortgaged.

4) Availability of production technology and raw material

5) The quality of output and its importance to the country

6) Ability of the management etc.

- **Working of IFCI** : IFCI was the first to enter into the area of development banking. It has worked since its inception in an efficient manner-

1) Loans : It has approved loans of Rs.10,300 Cr. During 1948 and 1996. Rs.2,120 Cr. Were distributed in the year 2000-2001.

2) Industrial Development : This Corporation has assisted in the development of industrial units from textiles, paper, chemicals, fertilizers, cement, food products, automobiles, machines, lead, rubber etc.

3) Capital raising : This corporation has helped in raising capital for large industries.

4) Training : Training facility is provided to the staff of financial institutions.

5) Risk capital : It has started providing risk capital since 1975 to the upcoming units at concessional rates of interest.

6) Guidance to organizers : At Delhi, a department of merchant banking and allied services has been set-up to guide entrepreneurs in designing the project and raising required resources for the same.

**5.2.6.2 : The Industrial Credit & Investment Corporation of India Ltd. (ICICI)** : Govt. of India set up ICICI in 1955 as a private sector development bank. It came into existence with the help from capitalists from developed countries. its authorized share capital has increased from Rs.25 to Rs.100 Cr. Share capital of Rs.1 Cr. is subscribed by the individuals and institutions from England and America. World Bank has issued a loan of $10 million to it. Until 1963, this loan was $ 50 million. Other subscribers of ICICI share capital include Central Govt. of India, Institutions, Industrialists and foreign institutions etc.

- **Functions** :
  1. Providing medium and long term loans for starting private production units, for their expansion, modernization etc.
  2. Helping in raising the investments by Indians and foreigners in the private sector production units.
  3. Providing technical and managerial assistance in order to increase production and employment opportunities in private sector.
  4. Guaranteeing the loans of private sector units.
  5. Providing capital to developmental projects in the private sector, committing to buy their minimum share capital, and providing foreign currency loan to such units.
  6. Establishing strong relations with the foreign financial institutions.
- **Working of ICICI** :
  1. Loans : During 1955 to 1998, the corporation had sanctioned loans of Rs.1,07, 000 Cr. and distributed Rs.63,900 Cr. In 2000-01 and 2001-02, Rs.31,360 Cr. and Rs.25,830 Cr. respectively were distributed as loans.
  2. Financial assistance both in rupee and foreign currency : It has issued foreign currency and rupee loans to several production units.
  3. Leasing finance : It has also provided finance for taking machines and other instruments required for a project on lease.
  4. Industrial units in backward area : ICICI has encouraged setting up industrial units in backward areas.
  5. Other operations : It has started merchant banking division, a mutual fund, a credit rating institution – CRISIL. It has also provided help for technological up gradation.

ICICI merged with ICICI bank in March 2002 and became first Universal bank in India providing all financial services under one roof.

**5.2.6.3 : The Industrial Development Bank of India (IDBI)** : IDBI was established in July 1964 by the Govt. of India with a view to provide long term financial assistance to industrial units in India. Earlier, IDBI functioned as a wholly owned subsidiary of RBI, however, it was made autonomous in the year 1976. IDBI has been primarily working with aim of removing lacunae from the pattern of industrialization. It functions as an apex bank for the development banks engaged in industrial financing. Therefore, it enjoys wider powers.

- **Functions** :

  **1.** Being an apex bank, it regulates industrial development in India, formulates schemes for new projects, implements them and also tries to remove lacunae in the industrial pattern.

  **2.** Provides technological and administrative help for the expansion and management of the industrial sector.

  **3.** Provides refinance facility to IFCI and SFCs with the permission of Govt. of India.

  **4.** It co-ordinates the activities of development financial institutions.

  **5.** It helps in sale or purchase of industrial bonds / debentures.

  **6.** It carries out research work by collecting information about market conditions, investment, technological progress etc., and the same is made available to the industrial sector.

IDBI can build its financial resources through shares, debentures, deposits from companies, borrowings from RBI and the Govt. of India. The total resources of IDBI amounted to Rs.71,783 Cr. in 2000-2001. It had provided total financial assistance to the tune of Rs.2,23,134 Cr. until March 2001. During 2003-04, IDBI had provided direct loan assistance of Rs.37,875 Cr.

**IDBI's contribution to industrial development in India** : IDBI enjoys an important place in the sphere of industrial finance. The financial assistance provided by IDBI is classified into following three categories :

**A) Direct financial assistance to industrial units** : IDBI extends help to industrial units in the form of loans, subscribing to shares, debentures and underwriting. It functions as the lender of last resort. Its functioning never comes in competition with other industrial financial institutions. Direct financial assistance from IDBI has helped many industrial enterprises survive in difficult times.

**B) Indirect financial assistance to industrial enterprises :** IDBI provides refinance to State Finance Corporations, State Industrial Development Corporations and Commercial Banks. Thus, it indirectly helps in the development of industries. The indirect financial assistance also takes the form of rediscounting of bills, subscription to shares and bonds of financial institutions and seed capital assistance.

**C) Assistance to Backward areas :** IDBI has helped industrial units located in backward region or states in several ways. For example, it has provided long-term concessional loan assistance to industrial project located in backward regions. It also provides concessional refinance assistance to projects in backward regions

and special concessions under bill rediscounting scheme. It has helped entrepreneurs in identifying economically viable project and has also provided technical assistance.

**5.2.6.4 The Industrial Investment Bank of India (IIBI)** : Govt. of India set up Industrial Reconstruction Corporation of India (IRCI) in 1971 with the objective of helping sick industrial units. The IRCI was converted into Industrial Reconstruction Bank of India (IRBI) in 1985. Again in 1997, IRBI was renamed as Industrial Investment Bank of India (IIBI).

This bank not only provides loan assistance but it thoroughly reviews the position of sick industrial units and helps in their restructuring and rehabilitation. It focuses on making sick industrial units economically viable. It extends help in the form of financial assistance, technical and managerial assistance, transportation and marketing facilities, solving labour problems etc. IIBI has given a new life to several sick industrial units. As a result, unemployment has been avoided, wastage of investment has been prevented and all this has helped India's industrial economy.

**5.2.6.5 Small Industries Development Bank of India (SIDBI)** : SIDBI is the wholly owned subsidiary of IDBI and is engaged in meeting financial needs of small scale industrial units. The decision to set up SIDBI was announced in the budget of 1988-89 and it actually started working form 2nd April 1990. It functions as an apex institution in the area of SSI finance. It plays the role of a coordinator among the activities of Commercial Banks, Co-operative Banks, Regional Rural Banks, State Finance Corporations and State Industrial Development Corporation.

- **Functions :**
  1. Providing refinance to primary institutions engaged in SSI financing.
  2. Providing short and medium term loan assistance to SSIs.
  3. Discounting and rediscounting bills of exchange.
  4. Extending seed capital / soft loans to entrepreneurs.
  5. Providing export credit to the SSIs, small entrepreneurs in the purchase of assets, raw material / finished products etc.

**Financial Assistance of SIDBI**

(Rs. In Crores)

| Particulars | 1990-91 | 1994-95 | 2000-01 |
|---|---|---|---|
| Sanctioned loans | 2410 | 4000 | 10820 |
| Actual loans distributed | 1840 | 3390 | 6440 |

SIDBI has played an important role in the sphere of SSI finance since 1990. It has supported the development of SSI units through the provision of loans, coordination among financial institutions, discounting and rediscounting of bills etc.

**5.2.6.6 State Financial Corporations (SFCs)** : Govt. of India passed State Financial Corporations Act in 1957 and accordingly every state (except Jammu Kashmir) established State Financial Corporation with a view to provide financial assistance to production units of their states. These SFCs help small & medium enterprises from their respective states. At present, 18 states have set up SFCs and their share capital is being subscribed to by respective state Govts, RBI, Public Sector Banks, Companies, Co-operative banks and private people.

Nature of these SFCs is similar to IFCI. Their functions include extending loans with the maturity up to 25 years, guaranteeing the loans, maximum loan of Rs.10 lakhs to a single institution. (at present this limit is Rs.60 lakhs to co-operative institutions and Rs.15 lakhs to private institutions.)

**Performance of SFCs.**

(Rs. In Crores)

| Particulars | 1980-81 | 1990-91 | 2000-01 | 2001-02 |
|---|---|---|---|---|
| Sanctioned loans | 370 | 1860 | 2800 | 2080 |
| Loans distributed | 250 | 1270 | 2000 | 1760 |

**5.2.6.7 State Industrial Development Corporations (SIDCs)** : Indian state govts started setting up State Industrial Development Corporations after 1960. It was first in Bihar and later in other states that the SIDCs were established. Until 2002, 28 states and Union territories have constituted SIDCs.

Providing loan assistance to small & medium enterprises in the state, important and essential information, different facilities, setting up industrial units in backward regions of the state and promoting balanced development of the State, are the important functions of the SIDCs.

**Performance of SIDCs.**

(Rs.in Crores)

| Particulars | 1980-81 | 1990-91 | 2000-01 | 2001-02 |
|---|---|---|---|---|
| Sanctioned loans | 19 | 216 | 2080 | 2100 |
| Loans distributed | 11 | 125 | 1660 | 1720 |

**5.2.6.8 The Export-Import Bank of India (Exim Bank)** : Exim Bank came into existence on 1st January 1982 as a subsidiary of IDBI, with a view to facilitate India's foreign trade. The main function of the Exim Bank is to co-ordinate the activities of those institutions, which are engaged in financing exports and imports and providing them the refinance facility.

Exim bank has a paid-up capital of Rs.440 Cr., of which Rs.100 Cr. have been paid by Govt. of India. The sources of funds for Exim bank include : a) loans or grants from Govt. of India and RBI, b) loans from foreign financial institutions, c) funds raised through Euro-Dollar market, d) sale of debentures in India.

- **Functions :**

  1) Loans assistance to export-import between India and other countries.
  2) Solving the problems faced by Indian exporters.
  3) Promoting exports of capital goods from India.
  4) Promoting growth in exports and making adequate finance available for the same.
  5) Providing guarantee to the shares, debentures of companies engaged in foreign trade.
  6) Extending refinance and technical and managerial help to the institutions engaged in financing foreign trade.

- **Performance of Exim Bank** :

  **1) Financial assistance for the growth in foreign trade** : The financial help provided by the Exim bank under financial assistance facility amounted to Rs.2470 Cr. until 1996, as a result of which, exports of chemical, textile machinery, transport equipment, power generation have grown faster.

  **2) Non-fund help** : Exim bank provides guarantee to the deferred payment due in foreign trade. Such a guarantee amounted to Rs.102 Crores in 1982. The guarantee contributed started declining due to some difficulties.

  **3) Assistance from foreign financial institutions** : Exim bank has been successful in raising financial assistance to the exporter and importers through the help from World Bank, Asian Development Bank, African Development Bank etc.

  **4) Financial schemes** : Exporters have been provided rupee loans for increasing production; they have also been guided for capturing foreign

markets, export commercial houses have been helped in developing strategies of sellers development schemes etc.

- **Check Your Progress – 1.**

**Q. State whether following statements are true or false.**

1) Development banks provide loan assistance to every person-demanding loan.
2) Development banks extend loans to production units for purchasing raw materials and payment of wages.
3) A borrower from development bank receives other facilities free of cost.
4) Development banks are termed as partners in economic development of the country.
5) Development banks help in industrial growth.
6) Development banks offer medium or long-term loans to production units.
7) Commercial banks and development bank have similar functions.
8) Projects which do not undertake production in accordance with needs of the economy are not financed by development banks.
9) Exim. bank is the only bank established to fund India's exports and imports.
10) At present ICICI is working as a development bank.
11) IFCI is working for the rehabilitation of sick industrial units.
12) State Industrial Development Corporations extend financial help to large industrial units.
13) The Industrial Credit and Investment Corporation of India (ICICI) is a commercial bamk.

## 5.3 Non-Banking Financial Institutions (NBFI) :

Those institutions, which collect funds from people in different forms and make the same available as loans to needy people or institution and are registered under Company Act (not under Banking Act) are called as Non-Banking Financial Institutions. Their main function is to bring together suppliers and demand of loanable funds.

According to the RBI (Amendment) Act of 1997, NBFI means –

A) A financial institution, which is a company.

B) Its main business is to collect money in various forms from people and lending the same to needy people or institutions.

C) A Non-Bank Institution declared so by RBI with the permission of Govt. of India.

NBFI are all those institutions, which are engaged in the business of hire-purchase finance, housing finance, investment, loans, leasing, mutual funds etc.

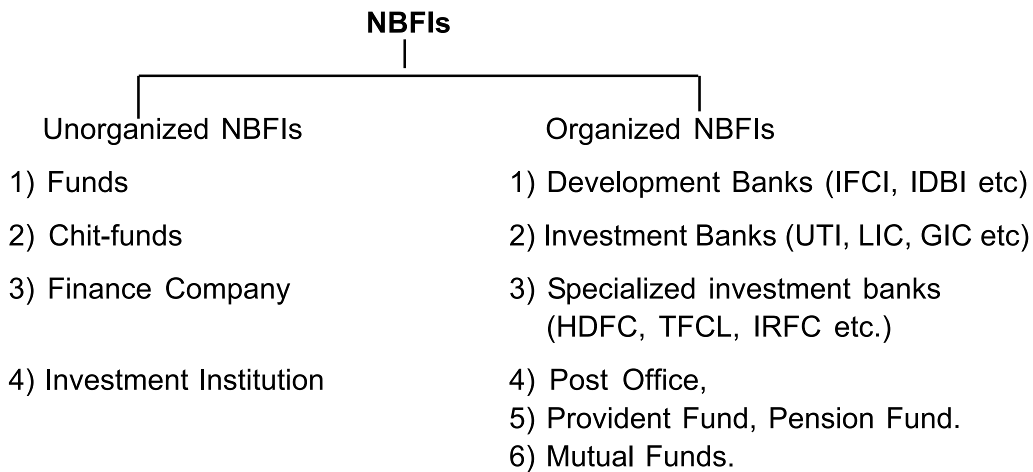
**5.3.1 Distinction between banks and NBFIs** : Commercial banks are registered under the banking Act, work in accordance with the banking regulation and are regulated by the RBI. NBFIs on the other hand, are registered under the Company Act, and therefore, do not fall under the purview of RBI regulations. They collect savings of the people in several forms and lend the same to the needy people & institutions.

The distinction between the commercial banks and NBFIs is described below–

| Commercial Banks | NBFIs |
|---|---|
| 1. Banking functions are primary. | 1. Preference is given to specific functions. |
| 2. Focus on acepting deposits and giving loans | 2. Accept medium and long-term deposits and lend only to specific purpose. |
| 3. Homogeneous institutions. | 3. Heterogeneous institutions. |
| 4. Types - Comm. Banks, Co-op. banks, Exchange banks, rural banks etc. | 4. Types- Development banks, Investment banks, Post-office, Life Insurance funds etc. |
| 5. Credit creation is possible. | 5. Credit creation not possible. |
| 6. Importance is given to security of deposits. | 6. More focus on offering high return. |
| 7. Offer short-term loans, and therefore, fall into money market. | 7. Offer all term-loans & therefore, are related with both money and capital market. |
| 8. Deposits can be withdrawn using cheques or slips. | 8. Deposits cannot be withdrawn with cheques. |

## 5.3.2 Classification of NBFIs :

The operation of NBFIs have increased tremendously in the recent past and across India. These NBFIs are classified in the following manner :




**A) Unorganized NBFIs** : These are unorganized, work independently, and without any co-ordination. These are as follows :

**i) Fund** : Such funds are more active in south India. They register under Company act, collect deposits from members and lend money for buying or against house property, gold and jwellery. They also lend for marriages and for paying off old debts.

**ii) Chit funds** : Some people come together and form groups. The group members contribute to the fund, out of which loan is issued to a person whose name comes on to the chit which gets selected. Only group members are entitled to get loans. Such chit funds were prominent in Tamilnadu and Kerala in the beginning, but have now spread to other states as well.

**iii) Finance company** : These are the companies which have their own capital of Rs. 1 lakh and also raise funds through sale of shares. They collect deposits by offering attractive rate of interest and provide loans to traders, businessmen, and small entrepreneurs. Those who cannot obtain loans from commercial banks, turn to such finance companies for high interest loans. These companies are not registered with RBI. They also finance speculative activities.

**iv) Investment institutions** : These institutions collect money from the people and invest in debt market or in debentures of companies. First these investment institutions came into existence in 1933 by the name of Industrial Investment Trust. Their number increased in the later period and now their number is at around 600. These institutions are private limited companies. These have been promoted by leading industrialists like Birla, Dalmiya, Goenka, J. K. Group etc.

**B) Organized NBFIs :** These NBFIs work in coordination with each other. Following are the NBFIs which fall in to organized category.

i) **Development Banks** : These banks have been dealt with in the beginning of this unit.

ii) **Investment Banks** : Investment banks are those financial entities which collect money from public in one form or another and invest as per their policy. For example, Unit Trust of India (UTI) collects money by selling its units and lends the same money to production units, invests in debt market. Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) collect money as insurance premium and invest the same in debt market.

iii) **Specialized Investment Banks** : Some financial institutions work as specialized investment banks. They concentrate only in one area, for example, house construction, tourism development etc. Housing Development Finance Corporation (HDFC) specialized in home loan finance. Similarly, Tourism Finance Corporation works on tourism development. Indian Rail Finance Corporation lends money for the development of railway.

iv) **Post Office** : Post and Telegraph Department of Govt. of India has a countrywide network. Post offices accept deposits since 1982 and they amounted to Rs.311782 Crores until 2003. This money is invested in accordance with the rules of Post and Telegraph Department.

v) **Provident Fund** : A certain percent amount is collected from the monthly salary of an employee for the provident fund. Employees of Govt. and Semi-Govt. enterprises, also of private enterprises can avail the facility of provident fund. Provident fund had a total collection of Rs.25,438 Crores up to 1995-96. This money is made available to the Govt. for investment in public sector.

vi) **Mutual Funds** : It plays the role of an intermediator between people and business units. Those people who lack the knowledge of investing, hand over their money to mutual funds and these in turn, invest the fund in a manner to secure maximum return to the people.

### 5.3.3 Features of NBFIs :

**1) Small size** : NBFIs are small entities in terms of their size and scope. Some NBFIs are larger in size like Provident Fund, Pension Fund etc., but mostly these are small size institutions. Their structure is easy and simple and management cost is low.

**2) Less Capital intensive** : These entities have very low amount of owned capital. The attractive returns offered help them to collect larger sum of money from the people. If they do not offer attractive returns to the people, their existence will be in danger, as they will find it difficult to collect deposits.

**3) Easy availability of loans** : Borrowers turned down by the commercial banks and development banks, go to these NBFIs. Loans from NBFIs are easily available as very few documentation is required. Handicraft and small industries, small businessmen, sundry traders, often turn to NBFIs for loans.

**4) Unsafe loans** : The loans offered by NBFIs involve more risk as these are offered without or with inadequate mortgage. The recovery of loans, therefore, becomes difficult.

**5) Rescheduling of loans** : Many a times, the loans offered for short and medium term are not recovered and, therefore, converted into long term loans. As a result, amount of loan, term and rate of interest increase.

**6) Lack of co-ordination** : The number of NBFIs has increased rapidly. Up to 1996, there were 39,450 NBFIs working in India. Most of the NBFIs were small size entities with very few large ones. These smaller size NBFIs do not have any co-ordination among them. They act independently and focus on short-term profit and therefore, do not survive in the long run.

**7) Annual report and balance sheet** : Except few, most NBFIs ignore auditing of their accounts, publication of balance sheet and other relevant information. This is not good from the point of view of depositors.

**8) Fulfillment of several needs of the economy** : People need loan assistance in several activities like agriculture, industry, trade, service sector, and also for consumption, education, home construction, purchase of vehicle, health etc. NBFIs come forward to provide loan assistance in all the areas where it is possible to earn maximum rate of interest.

**9) Independent Policy** : NBFIs are required to follow the rules and orders of RBI. They are registered under Company Act, but capital limitation, profit provisioning maintaining reserves, auditing of accounts and publication of balance sheet etc., are not binding on them. As a result, many NBFIs emerge and conduct their business independently.

**10) Perfection in work** : Some NBFIs conduct their business very efficiently. They always strive for perfection in their work, which in turn benefits both the depositors and borrowers. Other NBFIs either get into the problems or don't survive.

### 5.3.4 Role of NBFIs in the economy :

**1) Beneficial to savors :**

a) These NBFIs safely invest the savings of the people,

b) They also provide liquidity to the savers; (unit holders of UTI and policyholder of LIC can borrow against their investments,

c) Other benefit : Life insurance and insurance against fire, theft, accident, the stock, debentures, units of the NBFIs are tradable.

**2) Benefits to Investors :**

a) Easy availability of loans at fair rate of interest,

b) As the NBFIs are heterogeneous, it is possible to draw benefits from different fields,

c) Small and weak, new business or individual entities can access loan assistance,

d) NBFIs provide loans against immovable property like house, vehicles, durable goods etc.

**3) Benefits to the economy :**

a) Acceleration of economic growth.

b) Attaining saving investment balance at high level becomes possible.

c) Several avenues of savings, deposits, insurance policy, purchase units, share and debentures, provident fund, pension etc.

d) Indicator of economic development : NBFIs working efficiently throughout the country is an indication of financial reforms and strength.

**4) Stability in capital market** : Different financial instruments are made available by the NBFIs. The credit needs of different entities are fulfilled. As a result, the mismatch between demand and supply for funds is avoided and stability is maintained in capital market.

**5) Benefits from specialized institution** : NBFIs work for specific reason or in an area. For example, LIC in Life insurance, GIC in General insurance, UTI mutual fund for investment in stock market, HDFC in housing finance. Consequently, people receive specialized services.

NBFIs can play a more important role in country's economic development if they are regulated by RBI or a separate regulatory body.

**5.3.5 Non-Banking Finance Institutions in India** : Non-banking financial institutions or intermediaries is a wider concept. It includes financial institution form unorganized as well as organized sector. It is however, said by some people that large institution from debt market and insurance companies are included in to the NBFIs. (Financial Institutions & Financial Market – by Shreedhar Desphande & Vinayak Deshpande – Himalaya Publishing house) Small institutions, investment institutions, housing finance institution all fall in to the category of NBFIs. Development banks, investment banks, and mutual funds are included in to NBFIs. We have already discussed development banks in this unit. So, we shall focus on some investment bank, mutual funds in India.

**5.3.5.1 The Unit Trust of India (UTI)** : The Unit Trust of India (UTI) came into existence on 26th November 1963 with the objective of collecting savings of small investors and investing the same in the share capital and debentures of production units. It is an important public sector investment bank. It is run by the 9 appointed trustees. The President / Chairman is appointed by the RBI. Executive Chairman is also appointed. 4 Trustees are also appointed, of them LIC & RBI appoint one each, while other two are appointed by the shareholders. In the beginning, UTI had an authorized capital of Rs.5 Crores, (of which 80% was subscribed by RBI, SBI and LIC). Sale of units is the major source of building resources to UTI. The worth of total assets under the management of UTI is Rs.53,629 Crores in July 2002.

- **Objectives of UTI** :

1) Developing saving habits among people & collecting their savings through the sale of units.
2) Converting savings into investment – investing in shares and debentures of companies.
3) Ensuring maximum use of natural resources – by lending funds to such projects which can ensure efficient & maximum use of natural resources.
4) Generating employment – by encouraging investment in the economy.
5) Bringing benefits of debt market transactions to the general public – by ensuring maximum returns on their savings.

- **Performance of UTI** : UTI has collected a huge sum of money through several schemes (approximately 72) from the people. By end of June 2000, UTI had nearly 25 lakh investors and total resources of Rs.74,291 Crores. The huge resource base of UTI was the result of backing from Govt. of India. However, UTI lost people's

confidence as it could not withstand competition which new economic policy brought with it and the recession in the stock market in 2001. Govt. of India also refused to help out UTI and as a result, it was decided to stop the sale of units. People earlier believed investment in units of UTI to be safest, most liquid, offering attractive returns and ensuring growth in their wealth. This belief was slackened after 2001. After 2005, UTI has restructured itself, adopted new investment strategy, but it no longer receives the response, which it received in the past.

In sum, UTI has been engaged in collecting small saving of the people and directing them into productive investments in the economy. The following table shows the investment profile of UTI-

**Investment of UTI.**

(Rs. In Crores)

| Particulars | June 1999 | June 2000 | June 2002 |
|---|---|---|---|
| Investment in companies | 56,841<br>(89.4%) | 66.967<br>(90.2%) | 50,202<br>87.1%) |
| Other investment | 6,707<br>(10.6%) | 7,324<br>(9.8%) | 7,428<br>(12.9%) |

Source : Money & Financial Systems, by Dr. P.K. Deshmukh. p.p. 275.

**5.3.5.2 Life Insurance Corporation of India (LIC)** : A beginning of Life Insurance in India was made in 1818. In the post-independence period, all private life insurance companies were nationalized to form Life Insurance Corporation in 1956. LIC enjoyed the position of monopoly in the area of life insurance until the introduction of new economic policy. The Post department is also engaged in the insurance business, but the share is very small. Several private and foreign insurance companies have started operation in India. However, LIC continues to be the market leader.

- **Functions** :

  1) Insuring life of people – This is the prime function of the LIC. It receives funds in the form of insurance premium and the collected fund is invested elsewhere.

  2) Developing saving habits among people.

  3) Pooling the savings of the people.

  4) Providing loans to the Govt., out of its funds.

5) Investing in public sector enterprise.

6) Providing loans to the policyholders for home construction.

7) Providing loans to co-operative and private projects. Investing in their share capital, debentures etc.

LIC has its headquarters at Mumbai and 7 regional offices. It also has divisional offices at 100 cities and 2048 branch offices. It's branches are also found in countries like Fiji, Mauritius, England. Apart from collecting insurance premium, settling insurance claims, it also maintains a portfolio, which consists mainly debt instruments. LIC has earned the status of a reliable institution in area of life insurance. It has maintained its position even after the entry of private and foreign players. Approximately 14.11 Crore customers enjoy the services of LIC and its total premium collection was of the order of Rs.281,000 Crores in 2002-03. During the same year, it had total investment of Rs.182694 of which Rs.180565 were invested in public sector and Rs.2129 Crores in private sector. This clearly shows the importance of insurance companies in enhancing investment in the economy. LICs work in terms of resettlement of claims is also commendable. It had paid Rs.8,955 Crores in 1995-96 as claim resettlement.

**5.3.5.3 General Insurance Corporation of India (GIC)** : General Insurance Corporation of India came into existence after the nationalization of 68 Indian and 45 foreign general insurance companies in 1971. GIC started its working from 1st January 1973.

GIC provides insurance against goods transport, transport equipments, machinery, durable goods, assets, fire, theft, sea transport, accidents, third party insurance etc. Due to wide nature of its operations, GIC conducts its business through 4 subsidiaries. These are: 1) National Insurance Company Ltd., 2) New India Assurance Company Ltd., 3) Oriental Fire and General Insurance Company Ltd., and 4) United India Insurance Company Ltd.

In 2002, GIC was de-linked from its 4 subsidiaries by amending the General Insurance (nationalization) Act, GIC is continuously doing refinance business. During 2001-02, GIC sanctioned financial assistance of Rs.418 Crores to Companies, and distributed Rs.308 Crores.

**5.3.5.4 Mutual Fund** : Mutual fund is an intermediary engaged in pooling together savings of people through various schemes and using the same for investing in shares, debentures etc. so as to generate reasonable return to the people (i.e. investors). Common people do not possess the expertise required for investing in stock market or debt instruments. So, mutual funds assume the responsibility of

investing people's money in a rightful way so as to minimize risk and generate fair return to them. Mutual funds are therefore, mediators between common people who want to invest and business units, which approach stock or debt market for the funds.

Mutual fund is established jointly by several investors. Such fund is known as 'unit trust' in England. In India, UTI introduced first mutual fund in 1986, and this followed by other banks and financial institutions. For example, State Bank of India, Canara Bank, Indian Bank, Bank of India, Punjab National Bank, Bank of Baroda and private sector players like Pioneer, Kothari Mutual Fund, Prudence, Morgan Stanley etc.

To derive maximum return from their investment in stock market or debt market, mutual funds appoint capital market experts. It is in consultation with these experts that mutual funds make their decisions regarding sale and purchase of securities. Securities (i.e. shares, bonds etc) are bought at a low price and sold at high price, so as to make maximum gain. This requires the mutual funds to keep constant watch on movements in stock and debt and the factors, which influence these markets. This task is well performed by the experts under the mutual fund. Mutual funds do not concentrate only on maximum profits but they also diversify their investment portfolio so as to minimize risk.

- **Functions** :
    1) Collecting the savings of people for investment.
    2) Making investments in stock market.
    3) Maximising returns and minimizing risk in stock market investment with the help of experts.
    4) Dealing in sale and purchase of shares and debentures of companies.
    5) Distributing the profit in proportion with the savings made available.

Following are two types of mutual funds :

**a) Close Ended Funds** : Under this types, savings of the people are collected for a fixed period. So, the investments in such funds remain locked for a fixed period and it is not possible to withdraw the money. After the maturity, profits are distributed as dividend.

**b) Open Ended Funds** : As the name indicates, investors can walk in or out of such funds any time they want. People, who invest in such funds, retain the flexibility of entering or quitting.

The amount raised through both the types is used by the mutual fund for making investments in shares, bonds, debentures or any other instrument.

- **Progress of Mutual Funds in India** : Mutual funds business in India started from 1986. In the beginning, the mutual funds in India registered slow growth; as most savers turned to bank deposits and Govt. securities due to high interest rates. Bank deposits with attractive interest rates were preferred against the investment in shares.

**Mutual fund industry started doing well after 1998**-99 with the good performance of the stock market. High dividends offered attracted large number of savers. The total corpus of mutual funds was Rs.480 Crores in 1995-96, which increased to Rs.15,400 Crores in 1999-2000. This growth was followed by sluggishness owing to increase in dividend distribution tax and stock market turmoil perpetuated by people like Ketan Parekh. All these developments adversely affected mutual fund business in India. Post 2005-06, however, mutual funds have registered impressive growth.

### 5.3.6 Check Your Progress – 2.

**Q. State whether following statements are true or false.**

1. Commercial banks in India follow the orders of RBI.
2. NBFIs are controlled by the RBI.
3. Financial institutions specializing and achieving perfection in one area are called NBFIs.
4. Funds, Chit Funds are organized sector NBFIs.
5. India has seen the development of organized sector HBFIs in recent times.
6. Development of NBFIs helps in accelerating the growth of the economy.
7. NBFis charge low rate of interest than the banks.
8. Most NBFIs are strong and have a potential to survive in the long run.
9. Development of NBFIs have enlarged the choice of borrowers.
10. LIC earlier was categorized as NBFI, but now it has been termed as an investment institution.
11. GIC performs the only function of providing refinance.
12. Mutual fund is an institution, which functions to minimize risk and maximize returns from stock market investment.

## 5.4 Unregulated Credit Market :

Credit market is formed by those who demand and supply funds. Constituents of credit market are classified into two categories : a) Regulated credit market and b) Unregulated credit market.

**A) Regulated Credit Market** : Central Bank is an apex institution in credit market of any country. So, it should have control over money supply and demand. Regulated credit market is one where central bank has control over the supplier of loanable funds. These include commercial banks, co-operative banks, exchange banks, development banks, rural banks etc.

**B) Unregulated Credit Market** : Unregulated credit market comprises all those financial institutions which are not controlled by central bank and function in accordance with their own policy. The main constituents of unregulated money market are moneylenders, indigenous bankers, funds, chit funds etc.

In the following analysis, we shall deal with moneylenders, indigenous bankers in detail.

### 5.4.1 Money Lenders :

A person who lends his own money is called as moneylender. Moneylenders either use their own funds or collect deposits for giving loans. They themselves assume the responsibility of lending money and recovering the same along with the rate of interest.

According to Indian Central Banking Enquiry Committee, moneylender is an entity whose primary business is not banking, but lending money to the people.

In the opinion of Dr. L.C. Jain, moneylender is an individual or private institution, which lends money but doesn't accept deposit or discount bills.

The business of moneylender is as old as human history. This business has some advantages as also disadvantages, with the latter exceeding the former. As a result, central banks in all the countries are trying to close it down. Moneylenders lend money to anybody as per their wish, charge exorbitant rates of interest and use all ways to recover the loans. They don't keep accounts of their activities and are not controlled by anyone. They exploit the borrowers with fake or wrong accounts. They can play an important role in the economy if their activities are regulated.

### 5.4.2 Indigenous Bankers :

Indigenous bankers are doing loan business along with moneylenders, since the time when even commercial banks were not in existence. These are called as indigenous bankers as these are inhabitants of this country and doing this business

for generations. In 1930, indigenous bankers and moneylenders accounted for nearly 90% of total loans, which declined to 50% and further to 15% at present. Though their share in total loans has declined, they continue to be major source of funds in the rural sector.

### 5.4.2.1 Definitions :

According to Dr. L.C.Jain, indigenous bankers are those entities, which are engaged in collecting deposits or trading bills or both along with giving loans. This definition was also accepted by the Central Banking Inquiry Committee (1929).

B.C. Ghosh opined that indigenous banks trade in bills of exchange doesn't matter whether they accept deposits or not.

In the Opinion of G.L. Karkal, those entities, which trade in bills of exchange, even if they don't accept deposits or give loans, are called indigenous bankers.

In short, indigenous bankers primarily deal in bills of exchange and not necessarily accept deposits or extend loans.

### 5.4.2.2 Features of Indigenous Bankers :

1) These have a long history and tradition.
2) This business has been a monopoly of particular class of people. They include Marwadi, Shetti, Multani, Khatri, Bohra, Jain, Gujarati, Shroff etc.
3) The above-mentioned classes do their business in their respective areas. For example, Marwadi people are found in Mumbai, Kolkatta.
4) This business is mostly carried out in cities where trade takes place on large scale.
5) Indigenous bankers increase the scale of their business by opening branches.
6) Indigenous bankers are found in two types, viz. i) those who concentrate only in banking business and ii) those who do banking business along with their other business.
7) Indigenous bankers work in unions called as 'Mahajan'. They discuss their problems and also carry out social activities.
8) They are heterogeneous as they are divided caste-wise, have different rules.

### 5.4.2.3 Functions :

Indigenous bankers conduct their business in an informal way. An appointed assistant handles their business. Most of their customers are known to them. Therefore, many times loans are offered without any mortgage. No accounts are maintained and everything is based on trust.

The main function of indigenous bankers are as follows :

**1) Accepting deposits** : Indigenous bankers mostly use their own funds or accept deposits from their relatives of friends. People keep deposits with them for safety purpose or for loan purpose.

All India Rural Credit Survey (1951) stated that nearly 67% indigenous bankers accept deposits and 40% of depositors were traders. The interest rate offered varies with the maturity and amount of deposit. At times, high interest rates are offered to attract deposits. These also borrow funds from commercial banks.

**2) Giving loans** : Loans are offered by indigenous bankers to needy people and of short and medium maturity. Loans are given for internal trade, purchase of material, machinery etc. and to known industrialists, traders, artisans and farmers. A promissory note is used in small loans, while Govt. bond paper is used for large loans. Loans are also offered using bills of exchange. Sometimes, loans are offered on the mortgage of agricultural land, building, machinery, vehicles, jwellery etc. Rate of interest charged various with the amount of loan, mortgage, and the reason for loan and is usually higher than the interest rate charged by commercial banks.

**3) Bills business** : This is the prime business of indigenous bankers. Loans are offered either by writing or discounting a bill of exchange. Bill of exchange is an order issued by drawer/creditor to the drawee/debtor for the payment of specific amount at a future date. The debtor accepts this order.

**Specimen / Format of Bill of Exchange :**

Kolhapur

Date :

On demand, Mr. … … … … … … … … … …. … … … … … … … … … … or bearer will be paid Rs. … … … … … … … … … … (Rs. In Words … … … … ……………………………………………………..) the full value at 10% interest rate.

Signature of Drawee Signature of Drawer.

Every indigenous banker tries to differentiate his bill of exchange from that of others, however, it has some common things like the amount, rate of interest, the period, and the signatures of drawer and drawee. Bills of exchange usually have maturity periods of 31 days, 91 days and 361 days.

The rate at which the bill of exchange is discounted is called market rate, which is usually higher than the rate of interest mentioned on it. There are several types of bills of exchange.

Indigenous bankers at time, rediscount the already discounted bills of exchange with the commercial banks if they need money.

#### 5.4.2.3 Drawback of Indigenous Bankers :

1) These are not regulated by Central bank.
2) The way they conduct their business is traditional and lacks creativity and innovativeness.
3) Many indigenous bankers mix their own trading or any other business with the banking business. As a result, depositor with them may face problems.
4) They charge exorbitant rates of interest.
5) They don't have any contact with the organized credit market. As a result, reforms in the banking and financial sector have not touched them.
6) They conduct their business on their own funds only. They do not think about expansion in their business.
7) They have not contributed in any way in the development of bills market, despite the fact that their main business is one of dealing in bills.
8) There is no unity among indigenous bankers. Small unions based on caste are there, but large unions encompassing all indigenous bankers are not found.

- **Future Prospects for Indigenous Bankers** : Indigenous bankers have been in the business of banking for generations. Their role and importance has however, diminished in recent times. Few popular indigenous bankers conduct their business in cities and they will continue doing so as they have same captive customers. Indigenous bankers know these customers very well, can fulfill their credit needs and can also offer loans with any mortgage.

### 5.4.3 Check your progress :

**Q. State whether the following statements are true or false.**

1) Debt / Credit market means all those who demand and supply loanable funds.

2) Financial institutions not controlled by Central bank are called unregulated credit market.

3) Existence of unregulated credit market reduces the effectiveness of monetary & credit policy of Central bank.

4) An individual, who's primary business is not banking, but who is engaged in giving loans, is called money lender.

5) The business of moneylenders can become beneficial if drawbacks in it are removed.

6) Indigenous bankers have long history and tradition.

7) Banking is the main business of indigenous bankers.

8) Indigenous bankers need permission of the RBI to start their business.

9) Reserve Bank of India has full control over indigenous bankers.

10) Bill of exchange is an order issued by the debtor to the creditor for paying a certain sum of money.

11) The rate of discount is decided in accordance with the rate mentioned in the bill of exchange.

12) Indigenous bankers have started introducing modern practices in their business.

### 5.4.4 Answers to check your progress –1.

1) False, 2) False, 3) False, 4) True, 5) True,

6) True, 7) False, 8) True, 9) False, 10) False.

11) False, 12) False, 13) True.

### 5.4.5 Answers to check your progress – 2.

1) True, 2) False, 3) True, 4) False, 5) True,

6) True, 7) False, 8) False, 9) True, 10) True,

11) False, 12) True.

### 5.4.6 Answers to check your progress – 3.

1) True, 2) True, 3) True, 4) True, 5) True,

6) True, 7) True, 8) False, 9) False, 10) False,

11) False, 12) False.

## 5.5 Summary :

Commercial banks in the country functions in accordance with the banking regulation and are controlled by the Central bank. Other financial institutions, which are similar to commercial banks, but are not controlled by the Central bank, fall into the category of development banks. Development banks first emerged in Europe, while in India, it was Govt. of India's deliberate efforts, which led to their emergence. Functions and feature of development banks are different from that of commercial banks. In India, some development banks are at national and some at state level. Except ICICI, all development banks are in the public sector.

Financial entities engaged in lending and borrowing, but not controlled by the Central bank, are termed as non-banking financial institutions as intermediates (NBFIs). NBFIs have several types, for example, funds, chit-funds, finance company etc. in the unorganized sector and development banks, investments banks, specialized investment banks etc. in the organized sector. NBFIs help in speeding up the growth of the economy.

Debt / Credit market refers to the market where demanders and suppliers of funds interact with each other. The constituents of debt market, which are not controlled by the Central bank, fall into the category of unregulated debt market. Many lenders and indigenous bankers constitute unregulated debt market. They conduct their business privately and independently. These have some advantages and disadvantages. However, disadvantages have not yet been removed. Their influence in the economy is diminishing consequent upon the increasing importance of organized debt market.

## 5.6 Terms to Remember :

1) An institution primarily engaged in accepting deposits and giving loans is called a bank.

2) A bank, which finances economically viable projects after careful study is known as development bank.

3) Financial entities, dealing with funds, registered under Companies Act, not controlled by Central bank and specializing in one functional area, are called Non-banking Financial institutions.

4) Unregulated debt market refers to the suppliers of loanable funds, which are not controlled by the Central Bank.

5) An Individual engaged in extending loans out of his own funds and on his own terms, is known as money lender.

6) Those entities, which offer loans on the basis of bills of exchange are called indigenous bankers.

## 5.7 Some Important Questions.

1) Define development banks and describe their features.

2) Describe the meaning and functions of development banks.

3) Give a brief account of national level development banks.

4) Explain the working of main banks providing assistance to small and medium enterprises.

5) What do you mean by NBFIs? Classify them and provide a brief information.

6) What are the NBFIs? Explain their features.

7) Explain the types of NBFIs and provide brief information.

8) What is unregulated debt market? Explain money lenders and indigenous bankers.

9) What are indigenous bankers? What are their functions? Explain their drawbacks.

10) What do you mean by unregulated debt market? Explain its drawbacks.

## 5.8 Answer in brief.

1) Explain the features of development banks.

2) Describe the functions of development banks.

3) What are the development banks assisting small & medium enterprises.

4) Explain the development bank engaged in financing foreign trade.

5) Distinguish between common bank and NBFI.

6) Explain the features of NBFIs.

7) Explain the advantages and disadvantages of money lenders.

8) What are indigenous bankers? Explain their functions.

## 5.9 Write short notes.

1) Structure of development banks.
2) Industrial Finance Corporation of India Ltd. (IFCI).
3) Industrial Development Bank of India Ltd. (IDBI).
4) Industrial Investment Bank of India (IIBI).
5) State level development banks.
6) Industrial Credit & Investment Corporation of India Ltd. (ICICI).
7) Unit Trust of India (UTI).
8) Life Insurance Corporation of India (LIC).
9) General Insurance Corporation of India (GIC).
10) Mutual Fund.
11) Importance of NBFIs.
12) Moneylenders.

## 5.10 Field Work –

**Visit the local branch of UTI and prepare a note on it.**

## 5.11 Reference Books :


1) Money & Financial Systems – Dr.P.K. Deshmukh – Phadake Prakashan.
2) Industrial Management – Nandkumar K. Hukeri – E.P. Engineering Services.
3) Banking and Finance – Dr. P.K. Deshmukh.
4) Indian Banking System – Bhole L.M.


• • •

## Unit – 6

# RESERVE BANK OF INDIA

**Structure :**


6.1 Introduction

6.2 Unit objectives

6.3 History of Reserve Bank of India

6.4 Functions of Reserve Bank of India

- 6.4.1 Monopoly of note issue
- 6.4.2 Banker to the government
- 6.4.3 Banker's bank and supervision of banks
- 6.4.4 Controller of credit
- 6.4.5 Custodian of foreign exchange reserves

6.5 Instrument of Credit Control

- 6.5.1 Quantitative methods
  - 6.5.1.1 Bank rate
  - 6.5.1.2 Open market operations
  - 6.5.1.3 Variable reserve requirement
- 6.5.2 Qualitative method

6.6 Monetary policy of Reserve Bank of India

- 6.6.1 Objectives of monetary policy
- 6.6.2 Main features of monetary policy since independence

6.7 Summary

6.8 Self Assessment Questions

6.9 Further readings

## 6.1 Introduction :

In the monetary system of all countries, the central bank occupies an important place. The Central bank of a country enjoys a special status in the banking structure of the country. It is an apex institution of the monetary system, which seeks to regulate the functioning of the commercial banks of a country. It is a monetary authority of the country and has to function in a manner so as to promote economic stability and development. The Central Bank of India is called the Reserve Bank of India which was set up in 1935.

Macro economic environment in India is affected by the monetary policy and fiscal policy. Monetary policy refers to the regulation and control of money supply and credit by the monetary authority of a country. This chapter analyzes history of Reserve Bank of India, functions of RBI, instruments of credit control and main features of Reserve Bank of India.

## 6.2 Unit objectives :

i) To discuss the functions of Reserve Bank of India.

ii) To study various instruments of credit control.

iii) To acquaint the readers with the main features of monetary policy since independence.

## 6.3 History of Reserve Bank of India :

The Reserve Bank of India was inaugurated on 1st April, 1935 under the Reserve Bank of India, Act, 1934. It was inaugurated with a share capital of Rs. 5 Crore, divided into shares of Rs.100 each fully paid. In the beginning, the entire share capital was owned by private share holders. The Reserve Bank was nationalized in 1949. the Banking Regulation Act, 1949 is an important landmark in the history of Central Banking in the country. This act armed the Reserve Bank of India with special power of exercising direct control over the operations of the Commercial banks of India.

The general superintendence and direction of the bank is entrusted to Central Board of Directors of 20 members, consisting of the Governor and 4 Deputy Governors. Besides the Central Board, there are four local boards with headquarters at Bombay, Calcutta, Madras and New Delhi.

## 6.4 Functions of Reserve Bank of India :

Reserve Bank of India is the Central Bank of the country. It is the apex of the banking institutions. The Reserve Bank of India was inaugurated in April 1935, since

its inception in 1935 as a private share holder's bank and its nationalization in 1949, working and functions of the Reserve Bank have been expanded a lot. By the Reserve Bank of India Act of 1934, all the important functions of a central bank have been entrusted to the Reserve Bank of India. As the central banking authority, the Reserve Bank of India performs numerous functions. It is the apex monetary and financial institution responsible for the efficient working of the monetary mechanism, which is indispensable for the rapid development of a country's economy. One of following functions is the regulation and control of the aggregate money supply – currency and credit in the economy. The Reserve Bank of India Act, 1934 and banking regulation Act, 1949 have in effect armed the Reserve Bank of India with almost dictatorial powers over the country's banking system with regard to the regulation and control of money supply and credit in the country. Following are the important functions of a central bank, i.e. Reserve Bank of India-

i) Monopoly of Note-issue

ii) Banker to Government

iii) Banker's bank and supervision of banks

iv) Controller of credit

v) Custodian of foreign exchange reserves

### 6.4.1 Monopoly of Note-issue :

Under Section 22 of the Reserve Bank of India Act, the Reserve Bank has the sole right for the issue of currency in India other than one rupee coins and notes and subsidiary coins. The Reserve Bank follows the minimum reserve system of note issue. According to Reserve Bank of India (Second Amendment) Act, 1957, Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs.200 Crore, of this the value of gold was not to be less than Rs.115 Crore and the balance of Rs.85 Crore to be held in the form of foreign securities. In India with the exception of 1 rupee notes, which are issued by the ministry of finance of the Government of India, the entire note issue is done by the Reserve Bank of India. Thus Central bank of the country i.e. Reserve Bank of India has the monopoly of issuing notes or paper currency to the public.

### 6.4.2 Banker to the Government :

The second important function of the Reserve Bank of India is to act an Government banker, agent and adviser. As banker to the Government, the Reserve Bank performs various functions such as transact the general banking business of the Government, manages treasury bills, sells treasury bills, maker to the Central

and State Government of advances and acts as an advisor to the Government not only in banking and financial matters, but also on a wide range of economic issues etc. All the balances of the Government are kept with the Central bank. On these balances the Central bank pays no interest. Thus, the Central bank performs a number of services to the Government.

### 6.4.3 Banker's bank and supervision of banks :

Under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, the Reserve Bank of India acts as the bankers' bank. Reserve Bank of India regulates and controls the credit position in the country with the help of various instruments such as cash reserve ratio (CRR) statutory liquidity ratio (SLR) and bank rate. The bank rate is taken as the rate at which the Reserve Bank extends advances to the Commercial banks. Cash reserve ratio refers to that portion of total deposits of a Commercial bank, which it has to keep with Reserve Bank in the form of cash reserves. Statutory liquidity ratio (SLR) refers to that portion of total deposit of a Commercial bank, which it has to keep with itself in the form of liquid assets. The Commercial bank gets the benefit of borrowing from the Reserve Bank on the basis of the eligible security in times of need.

### 6.4.4 Controller of Credit :

The chief objective of the Central bank is the regulation and control of the aggregate money supply, currency and credit in the economy. The Reserve Bank of India is the controller of the credit, i.e. it has the power to influence the volume of credit created by banks. The banks have made use of both traditional and quantitative methods of credit control and selective or qualitative control.

### 6.4.5 Custodian of foreign exchange reserves :

The important function of the Reserve Bank is to reserve foreign exchange. The foreign exchange reserves consist of gold and foreign assets of the Reserve Bank and some government balances held abroad, the Reserve Bank of India has the responsibility of maintaining the exchange value of the rupee.

One of the essential central banking functions performed by the Reserve Bank is that of maintaining the external value of the rupee. After India become a member of International Monetary Fund (IMF) in 1946, the Reserve Bank has the responsibility of maintaining fix exchange rate with all other member countries of the International Monetary Fund.

The Reserve Bank now performs a variety of developmental and promotional functions such as institutionalization of savings though promotion of Banking habit

and the extension of banking system, territorially and functionally and extend banking facility to rural and semi-urban area and establish and promote new specialized financial agencies such as Industrial Finance Corporation of India (IFCI) and State Finance Corporation (SFC); Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India (IDBI) in 1964, the Agricultural Refinance Corporation of India in 1963, Industrial Reconstruction Corporation of India in 1972 and National Bank for Agricultural and Rural Development in 1982.

The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 have given the RBI wide power of supervision and control over all banking system relating to licensing and establishment, branch expansion, managements and methods of working, liquidity of their assets, amalgamation, reconstruction and liquidation. The supervisory function of Reserve Bank of India helps a great deal in influencing the standard of banking in India.

## 6.5 Instruments of credit control :

Broadly speaking, instruments or techniques of monetary policy can be divided into two categories – qualitative methods and quantitative methods.

### 6.5.1 Quantitative Methods :

These methods affect the total quantity of credit and affect the economy generally. These are three in number: (i) Changing the bank rate, (ii) Open market operations, (iii) Variable reserve requirement.

#### 6.5.1.1 Bank rate :

The Bank rate also known as the Discount Rate, is the oldest instrument of monetary policy, the bank rate is the standard rate at which the bank is prepared to buy rediscount bills of exchange or other commercial papers eligible for purchase under Reserve Bank of India Act. Practically the bank rate is taken as the rate, at which Reserve Bank extends advances to the commercial banks. The bank rate or the Central banks rediscount rate is an important monetary instrument in modern economics. The rate has been used to influence the availability and cost of credit. By changing the bank rate, the credit and further money supply can be affected. During the course of inflation, monetary authority raises the bank rate to curb inflation. During the course of depression the monetary authority lowers the bank rate to pull economy out of depression. Therefore, bank rate or discount rate can be used in both types of situation as inflation and depression.

The first important condition for the successful working of the bank rate policy is that all other rates should follow the bank rate in its movement so that bank

credit should expand or contract as desired. The second is the proper responsiveness of businessman to the changes in the lending rates of interests.

### 6.5.1.2 Open market operations :

Open market operations are another important instrument of credit control, especially in the developed countries. Open market operations refer broadly to the purchase and sale by the central bank of a variety of assets, such as foreign exchange, gold, govt. securities and other securities.

By open market operations, we mean the sale or purchase of government security. According to Reserve Bank of India Act, it refers "broadly to the purchase and sale by the central bank of a variety of assets such as foreign exchange, gold, government security and even company shares. During depression, when prices are falling, the Central bank purchases government securities in the economy resulting in expansion of credit and aggregate demand also increases and prices are also risen and vice-versa. It appears that Reserve Bank of India has actively used open market operations as an instrument of monetary policy and not simply to support the market of government bonds.

### 6.5.1.3 Variable reserve requirement :

The Reserve Bank of India also uses this method to control credit supply. By changing the ratios of reserves, the Reserve Bank seeks to influence the credit creation power of the commercial banks. Variable reserve requirements are of two kinds, viz. (i) Cash Reserve Ratio (CRR) and (ii) Statutory Liquidity Ratio (SLR).

Cash reserve ratio refers to that portion to total deposits of a commercial bank which it has to keep with the Reserve Bank in the form of cash reserves. The Reserve Bank is empowered to vary the cash reserve ratio between 3 percent and 15 percent of the total demand and time liabilities.

### 6.5.2 Qualitative method :

Qualitative credit control methods affect certain select sectors. These methods aim at changing the volume of a specific type of credit. In other words, under the qualitative methods, certain qualitative distinctions are made between different sectors and segments of the economy; and selectivity is applied in regulating the flow of credit.

Qualitative controls are used to control the volume of credit and indirectly to control the inflationary and deflationary pressures caused by expansion and contraction

of credit. Under the Banking Regulation Act, 1949, section 21 empowers RBI to issue directives to the banking system regarding their advances.

The following powers of selective controls have been exercised by the Reserve Bank of India:

i) Reserve Bank can determine the limit of the credit granted to a particular industry and trade.

ii) RBI can fix quota of credit.

iii) RBI can refuse rediscount facility or loan to those banks that are not following its directives.

iv) RBI can change the margin requirement to control and release funds.

v) RBI can regulate consumer credit. During depression period, more credit facilities are allowed so that consumer may spend more and more to pull the economy out of depression and vice-versa.

vi) RBI has used moral suasion as a tool of credit control.

vii) RBI can lay down the maximum amount of advances that can be made by commercial banks to any borrower.

## 6.6 Monetary policy of Reserve Bank of India :

Monetary policy refers to those policy measures, which the monetary authority of country (Central Bank) adopts to control and regulate the volume of currency and credit in a country. According to Prof. Crowther, "Monetary policy consists of the steps taken or efforts made to reduce to a minimum the disadvantages that flow from the existence and operation of the monetary system. It is a policy to regulate the flow of monetary resources in the economy to attain certain specific objectives."

According to Paul Einzig, "Monetary Policy is an effort to reduce to a minimum the disadvantages and increase the advantages resulting from the existence and operation of a monetary system."

According to Prof. A.G. Hart, "Through monetary policy and through fiscal measures, the monetary authorities or the government can reduce or increase the flow of resources into private consumption or government expenditure and thereby increase or reduce the availability of resources for investment and capital accumulation which of course will have a direct bearing on the rate of growth of the economy.

### 6.6.1 Objectives of Monetary Policy :

In an underdeveloped country the monetary policy must be necessarily different from what it is in developed economies. Therefore economists have conflicting and divergent views as regards the objectives of monetary policy in a developed and developing economy. As the objective of monetary policy varies from country to country and from time to time, a short listing of the same has been as following:

i) Neutrality of money

ii) Exchange stability

iii) Price stability

iv) Full employment

v) Economic growth

**i) Neutrality of Money** : Any monetary change is the root cause of all economic fluctuations. So monetary authority should aim at neutrality of money in the economy.

**ii) Exchange Stability** : Most of the underdeveloped or developing countries have to import capital goods, equipment, machinery etc. in the initial stages of their economic development. Consequently, their imports exceed the exports, making the balance of payments unfavourable. So monetary authority should aim at maintaining stability in exchange rates and removing disequilibrium in the balance of payments.

**iii) Price Stability** : Fluctuations in prices either upward direction or downward direction distort economic system and expectations and produce different effects on different sections of the society. So, the price stability should be an important objective of monetary policy for a developing economy.

**iv) Full Employment :** The most suitable and favourable monetary policy should be followed to promote full employment through increased investment, which in turn have multiplier and acceleration effects.

**v) Economic Growth :** Economic growth refers to a process whereby an economy's real national income increases over a long period of time. It implies an increase, in the total physical or real output, production of goods for the satisfaction of human wants. So, monetary policy in a developing economy should be directed towards achieving high rate of economic growth.

In the Indian context, the objective of monetary policy has been to accelerate economic development in an environment of reasonable price stability. The Reserve Bank of

India (Central Bank of India), being primarily, concerned with money matters, so organizes currency and credit that it sub-serves the broad economic objectives of the country.

### 6.6.2 Main Features of Monetary Policy since Independence :

The Reserve Bank has used bank rate tool only sparingly e.g. the bank rate was raised to 9 percent in 1974; it was revised upwards to 11 percent in July 1991. Presently, it stands at 9 percent ($29^{th}$ July 2008 policy of RBI). The reduction of the bank rate was to help in the reduction of other interest rates and the stimulate borrowing from banks.

Open market operations as an instrument of credit control have proved to be quite successful in regulating the availability of credit in developed countries. Open market operations have been employed by the Reserve Bank primarily to assist the Government in its borrowing operations and to maintain orderly conditions in the gilt-edged market.

Indian economy was facing a severe liquidity problem since 1995-96 which was adversely affecting investment and production. So RBI reduced CRR successively to 5 percent in June 2002. Presently, it stands 9 percent ($29^{th}$ July, 2008 policy of RBI). Statutory liquidity ratio refers to that portion of total deposits of a commercial bank which it has to keep with itself (under RBI Act 1934) in the form of liquid assets, cash, gold and unencumbered approved securities equal to not less than 25 percent of their total demand and time deposit liability. This is in addition to statutory cash reserve requirements. The Reserve Bank has been authorized to change the statutory liquidity requirements. After accepting Narasimham Committee (1991) recommendations, RBI reduced the SLR by successive steps to 25 percent in Oct. 1997 (which was 38.5 percent earlier). There is now a demand to abolish SLR altogether.

In India monetary policy is announced twice in a year (October, for October to March, and April, for April to September to coincide with the busy and the lean seasons respectively of agriculture) till 1998-99. Beginning with 1999-2000, Reserve Bank of India started making an annual policy statement in April with a review of the same in October. Reserve Bank of India has adopted a policy known as controlled expansion which implies two things; (a) expansion in the supply of money and (b) restraint on the secondary expansion of credit.

These two sets of objectives have been pursued for long. In relation to expansion in the supply of money in a developing economy money supply has to be expanded sufficiently to match the growth of real national income. Secondly Government outlays constitute an important source of monetary expansion in India.

The Reserve Bank has also a positive responsibility for channelising credit into desired sectors; the sectors which have received special attention are primary sectors (agriculture, small sector industry etc.), food grains (rice, wheat etc.) core industries (coal, iron, steel and engineering etc.) and weaker sections of population.

## 6.7 Summary :

Monetary policy refers to the regulation and control of money supply and credit by the monetary authority of a country. There is no denying fact that monetary policy plays a key role to accelerate the rate of economic development in underdeveloped and developing countries. Monetary policy can influence growth by helping to create favorable environment for saving and investment. The success of monetary policy depends on several factors such as co-ordination between the Government and the Central bank, Central bank and the other constituents of money market and capital market.

## 6.8 Self Assessment Questions :

**A) Essay type of questions.**

1. What is monetary policy? Explain the objectives of monetary policy in India.
2. Distinguish between quantitative and selective credit controls. Which of the two do you consider to be more effective to control credit in India?
3. What methods of credit control have been used by the Reserve Bank of India?
4. What are the functions of Reserve Bank of India?

**B) Write short notes.**

1. Define monetary policy.
2. Define bank rate.
3. Distinguish between quantitative control and selective credit control.
4. What are quantitative controls?
5. What are selective credit controls?
6. What is CRR?
7. What is SLR?

## 6.9 Further readings :


1. RBI (November 2006) : 'Macroeconomic and Monetary Developments : Mid term review 2006-7' Reserve Bank of India Bulletin, P.1246.
2. Vaish M.C. (2003) : Monetary policy, Vikas Publishing House Pvt. Ltd., New Delhi.
3. Harry G. Johnson (June 1962) : Monetary theory and policy. The American Economic Review, Vol. I,II, PP. 335 – 384.
4. James R. Schlesinger (Dec. 1960) : "Monetary policy and its critics", The Journal of Political Economy, Volume LXVIII, pp. 601-616.
5. Agrawal A.N. (2007) : Indian Economy, 34th edition Wishwa Prakashan, New Delhi.
6. Dhingra and Garg (2006) : Macro Economics and Indian Economic Environment, Sultan Chand and Sons, New Delhi.
7. Ruddar Datta and K.P.M. SUNDHARAM (2007); Indian Economy : 55th revised edition, S. Chand and company Ltd., New Delhi.
8. Jalan Bimal (2002) : "Indias Economy in the New Millennium, selected Essays." UBS Publishers and Distributors, New Delhi.


• • •

# Unit – 7

# Problems and Policies of Allocation of Institutional credit and Interest Rates.

## Index :


7.1 Objectives

7.2 Introduction

7.3 Problems of credit in the public & private sector

7.4 Inter-sectoral and inter-regional problems of credit

7.5 Problems of large and small borrowers

7.6 Pressurized transactions resulting from struggle in the pre-nationalization and post-nationalization working methods

7.7 Various interest rates in India

7.8 Summary

7.9 Terms to remember

7.10 Check your progress

7.11 Some important question/exercise

7.12 Reference books


## 7.1 Objectives :

1) Studying problems and policies of allocation of institutional credit
2) Studying problems of credit in the public & private sector
3) Understanding inter-sectoral and inter-regional problems of credit
4) Studying the problems of small & large borrowers
5) Studying the change in the working method of banks during pre and post nationalization period
6) Studying various interest rates in India and their structure

## 7.2 Introduction :

Economic development of a country and supply of finance are positively co-related and are dependent on each other. Adequate and timely credit helps in economic development and economic development leads to the development of financial institutions. During the early years of economic development, financial institutions are created; new projects are undertaken, which leads to capital formation in the economy. Different sectors get developed, which in turn lead to economic development. Finance, therefore, is an important factor in the process of economic development.

Supply of credit is an important factor in the context of economic development. Adequate and secured finance is must for the development of agriculture, industry, business, trade and services. An organized financial system, consisting of commercial banks, co-operative banks, development banks and corporations, is required for ensuring continuous flow of credit to different sectors. The financial institutions decide their financial policies in accordance with the Central Bank's policy. Private sector financial institutions function with the objective of profit and decide their policies accordingly. These institutions assign more importance to the safety of their loans and therefore, consider the credit and repaying capacity of the borrower and economic viability of the project to be financed. Financial institutions also follow different criteria while extending loans to different sectors. For example, different criteria are applied while extending loans to business units in public and private sector. Generally these criteria include safety, economic position and repaying capacity of the borrower mortgage, credit of the borrower, economic feasibility of the project etc.

- **Problems of financial institutions in the allocation of loans** : Financial institutions face many problems while allocating loans to individuals and business entities. Change in govt.'s policy forces them to change the rules of loan allocation, interest rates, term of the loan etc. The stance of RBI's monetary policy also decides the extent of loans to be allocated and the cost.

Sometimes, political interference, like compulsion of lending to priority sector, concessional rate of interest on certain loans and loan waiver, creates problems for the financial institutions.

Increase in competition to the industrial units financed by banks leads to poor performance of those units and difficulties in recovering loans.

Banks and financial institutions are sometimes forced to extend loans at concessional rates of interest to the priority sector, (i.e. small and village industries, artisans, farmers etc.). This leads to fall in profits, weak economic position of the banks, profitability of banks is also adversely affected if govt. administers the rates of interest and forces them to provide loans at such rates.

Banks are also compelled to lend funds to weak agricultural and industrial units of the backward region at concessional rates. This also lowers the profits of banks and other institutions.

Banks also face problems if they do not follow sound banking norms and lend to non-viable units.

In India, commercial banks, co-operative banks and development banks have been engaged in financing Indian agriculture, industry, trade and commerce, infrastructural facilities etc., in the post-independence period. Public sector received more attention and credit, as govt. wanted to develop the economy on socialist lines. During 1950 to 1990, Indian economy was closed and highly regulated. This period saw the dominance of public sector financial institutions in the financial system. The 1991's new economic policy altered the situation and allowed the private banks and financial institutions to compete with public sector financial institutions. As a result, many problems have cropped up with regard to credit allocation, credit policy, repayment of loans, over-dues etc. These problems are termed as problems in the allocation of credit.

## 7.3 Credit allocation problems in the public and private sector :

After independence govt. of India adopted mixed economic system, in which both public and private sector were assigned their responsibilities and roles. Public sector was to shoulder the responsibility of developing heavy and capital goods industries, economic and social infrastructure, and defense industries. The industrial policy of 1956 assigned commanding heights to the public sector and set before it objectives like accelerating the rate of economic growth, making required financial resources available for development, redistributing national income and wealth, facilitating employment generation, removing regional imbalances, developing small and complementary industries, promoting exports and substituting imports etc. For the fulfillment of these objectives, govt. started enlarging public sector by setting up industrial units in it. In 1951, only 5 industrial units were in the public sector, this number increased to 242 in 2004. during the same period, public sector investment increased from Rs.29 Crores to Rs.3,49,209 Crores.

Due to govt.'s preference to the public sector, commercial banks, financial institutions and development banks favoured public sector business units in the allocation of loans. Banks and financial institutions also favoured public sector business units, as lending to them was safe due to govt.'s backing. As a result, public sector enjoyed larger share of the total loans distributed. Private sector however, opposed this type of discrimination in the allocation of loans, in interest rates charged; as such this policy had adverse effect on private sector's profitability.

Banks and financial institutions were forced to favour the public sector in the allocation of loans, even when many public sector units incurred losses, became sick and inefficient. As a result, banks and other financial institutions faced problems in recovering their loans and therefore, were left with large magnitude of non-performing assets (NPA's) and low or negative profits. Govt.'s policy was thus responsible for putting the commercial banks and financial institutions like IDBI, IFCI in to danger.

After 1991, economic reforms were initiated in various sectors. These reforms reduced the role of public sector and allowed private sector to enter into almost all areas, leading to stiff competition and adoption of professional approach in the allocation of loans. The preference given to public sector enterprises has disappeared and now banks and other financial institutions extend loan assistance only to those business units, which exhibit prospect for growth and profits. Profit has emerged as the decisive factor in the allocation of loans.

The following table shows how the credit flow to private sector has changed over the years:

**Table : 7.1**

**Loan assistance to private sector** :

| Year | As % of GDP | Year | As % of GDP |
|---|---|---|---|
| 1980 | 25 | 2001 | 33 |
| 1985 | 30 | 2002 | 37 |
| 1990 | 30 | 2003 | 37 |
| 1995 | 29 | 2004 | 41 |
| 2000 | 32 | 2005 | 47 |

*Source : RBI's Report on Currency and Finance (2005-06)*

The above table shows the loan assistance as % of GDP extended to the private sector during 1980 to 2005. The loan assistance to private sector, which was 25% of GDP in 1985, increased to 32% in 2000 and further to 47% in 2005. This increase is the result of change in economic environment that new economic policy (1991) has brought with it.

## 7.4 Inter-Sectoral and Inter-Regional Credit Allocation Problems :

The economy of the country is divided in different sectors and sub-sectors. For example, agriculture, industry, trade, rural and urban sector, public and private sector etc. Indian banks extended loans to the private sector on priority basis during British rule and this bias continued even after independence until 1969. Industry and trade

sector received nearly 80% of the total loan assistance extended by banks until the nationalization of banks in 1969. Agricultural sector received only 2 to 3% of total loan assistance from banks. Bank's nationalization altered this situation and increased flow of credit towards agriculture. This is clear from the following table:

**Table : 7.2**

**Sectoral Distribution of Loans (in %)**

| Year | Agriculture | Industry | Trade Sector | Priority | Small Scale Industry |
|---|---|---|---|---|---|
| 1951 | 2.10 | 34.00 | 36.00 | — | — |
| 1968 | 2.20 | 60.60 | 19.20 | — | — |
| 1969 | 14.00 | 52.20 | 10.00 | — | 7.90 |
| 1990 | 18.10 | 17.40 | 11.80 | 40.10 | 14.90 |
| 2000 | 9.90 | 46.50 | 15.60 | 35.00 | — |
| 2005 | 10.80 | 38.80 | 11.20 | 38.20 | 7.50 |

*Source : RBI's Report on Currency & Finance 2005-06, RBI's Report on Trend and Progress of Banking in India.*

The above table indicates the sectoral distribution of loans of commercial banks during 1951 to 2005. Only main sectors are considered in the above table.

**1) Agricultural Sector** : Commercial banks had neglected the agricultural sector during pre-nationalization period. However, after bank nationalization in 1969, flow of credit to agriculture increased and was 10.8% of the total in 2005. In other words, agriculture received more financial assistance from banks in the post-nationalization period.

**2) Industrial Sector** : The industrial sector has always been recipient of largest percent of total loans distributed by banks. It received 34% of total loan assistance in 1951, which increased to 60.60% in 1968, but declined thereafter to 17.40% in 1990. Industrial sector received 38.80% of total loan assistance from the banks in 2005.

**3) Trade Sector** : This sector received maximum short term loan assistance from commercial banks. In 1951, trade sector received 36% of total loan assistance from banks. It however, declined thereafter to 19.20% in 1968, 10.00% in 1969. It was 15.6% in 2000 and 11.20% in 2005.

**4) Priority Sector** : For achieving balanced development of all the sectors, govt. of India declared neglected sectors like agriculture and allied activities, small scale industries and handicrafts as priority sector and asked commercial banks to increase the flow of credit to this sector. This sector started receiving loan assistance from commercial banks after 1969. Of the total loans distributed, priority sector accounted for 40.10% loans in 1990. In 2000 and 2005, this sector received 35% and 38.20% respectively of total loan assistance.

The above analysis shows as to how the credit flow to different sectors has changed during post-nationalization period compared to pre-nationalization period. The sectors like agriculture, small industries and priority sector, which were neglected earlier, received more credit flow in the post-nationalization period.

**Inter-regional Problems in Credit Allocation** : Inter-regional distribution of loans implies distribution of loans among different regions and states of the country. A look at state-wise distribution of bank loans indicates inequality. Some states have always been favoured against others in the allocation of loans. The following table reflects rural and urban division of loan assistance given by commercial banks:

**Table : 7.3**

**Commercial Banks' Loan Assistance to Rural & Urban Sector.**

(as % of GDP)

| Year | Rural Sector | Urban Sector |
|---|---|---|
| 1981 | 13.0 | 20.0 |
| 1991 | 17.3 | 24.8 |
| 2001 | 15.8 | 31.1 |
| 2005 | 22.3 | 45.0 |

*Source : RBI's Report on Currency & Finance (2005-06)*

The above table shows the loan assistance as % of GDP provided by commercial banks to rural and urban sector during 1981 to 2005. During the above period, rural sector received loan assistance as % of GDP of 13.0%, 17.3%, 15.8% and 22.3% respectively, while urban sector received 20.0%, 24.8%, 31.1% and 45.0% respectively. It is clear that commercial banks favoured urban sector against rural sector in the allocation of loan assistance.

The following table shows region-wise credit-deposit ratio of commercial banks.

**Table : 7.4**

**Region-wise Credit-deposit Ratio. (%)**

| Year | North Region | North-Eastern Region | East Region | Central Region | West Region | South Region |
|---|---|---|---|---|---|---|
| March-2003 | 55.5 | 48.2 | 42.8 | 38.6 | 71.5 | 71.2 |
| March-2004 | 56.8 | 33.7 | 45.2 | 39.9 | 63.2 | 72.7 |
| March-2005 | 62.2 | 44.6 | 50.4 | 45.8 | 71.8 | 83.9 |
| March-2006 | 65.5 | 39.3 | 49.7 | 45.2 | 91.5 | 83.6 |
| Average | 60 | 41.45 | 47.02 | 42.37 | 74.42 | 77.85 |

*Source : RBI's Report on Trend & Progress of Banking in India 2005-06.*

It can be seen from the above table that south region had highest average credit-deposit ratio of 77.85%, whereas it was lowest (i.e.41.45%) for north-eastern region. The south region consists states like Andhra Pradesh, Karnataka, Kerala, Tamilnadu, Lakshdwip and Pondecherri. During last 35 years, commercial banks have extended maximum loan assistance to the southern states. The north-eastern region, which comprises states like Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura has received relatively less loan assistance from commercial banks.

The average credit-deposit ratio for western region, northern region, eastern region and central region have been 74.42%, 60%, 47.02% and 42.37% respectively. So, the region-wise distribution of loan assistance provided by commercial banks, shows inequality. Some regions have been favoured against others.

The state-wise distribution of loans of commercial banks for the years 1969, 2005 and 2006 is shows in the below table. States like Tamilnadu, Maharashtra, Andhra Pradesh, Karnataka etc. have received relatively more loans compared to Uttar Pradesh, Bihar, Assam and other eastern states.

(See table on next page)

**Table : 7.5**

**State-wise distribution of loans. (%)**

| States | 1969 | 2005 | 2006 |
|---|---|---|---|
| Andhra Pradesh | 4.0 | 83.3 | 82.0 |
| Assam | 0.4 | 41.9 | 42.0 |
| Bihar | 1.7 | 31.4 | 30.2 |
| Gujarat | 6.4 | 60.9 | 56.4 |
| Hariyana | 0.7 | 63.2 | 57.4 |
| Karnataka | 4.7 | 80.5 | 76.8 |
| Kerala | 2.5 | 57.7 | 61.7 |
| Madhya Pradesh | 2.0 | 61.2 | 60.0 |
| Maharashtra | 30.0 | 75.9 | 101.4 |
| Orissa | 0.5 | 74.7 | 65.2 |
| Punjab | 1.6 | 49.7 | N.A. |
| Rajasthan | 1.2 | 76.5 | 78.4 |
| Tamil Nadu | 10.2 | 105.4 | 105.9 |
| Uttar Pradesh | 5.0 | 42.2 | 42.0 |
| West Bengal | 17.3 | 56.8 | 57.20 |

*Source : i) Statistical Cutline of India : 2002-04*

*ii) RBI's Report on Trend and Progress of Banking in India 2005-06.*

Note : The figures for 1969 are loans granted by commercial banks to states as percentage of total loans; while the figure for 2005 and 2006 are credit deposit ratios for different states.

## 7.5 Problems of large and small borrowers :

After independence, economic planning was adopted and provisions were made for the development of small, medium and large industries. However, large and medium enterprises benefited most, while small scale sector did not receive due

attention. Industrial policy reserved some items for the production in small scale industries; small scale sector receives finance from state finance corporation's, SIDBI, lead banks, RRBs etc. Commercial banks also lend to the sector under priority sector lending. In spite of these efforts of the govt. towards making finance available to the small scale sector, this sector doesn't receive financial assistance while the ease that large and medium sector receive it with ease. As a result, small scale sector continues to face finance related problems. The reasons are as below:

1) Small borrowers don't have right mortgage to offer.
2) Small borrowers do not get timely and adequate financial assistance due to their low credit in the market.
3) Banks are reluctant to lend to small scale sector because there are no guarantors.
4) Loans to the small sector are considered risky because of their limited ability to cope up with business problems, lack of management skills etc.
5) Banks are reluctant to lend to small sector as they can't be pressurized for repaying the loan.
6) Experience of State Finance Corporations and SIDBI is not satisfactory. As a result, banks and financial institutions do not come forward to lend to small entities.

Commercial banks and other financial institutions prefer to lend to the large industries or borrowers as against small industries.

## 7.6 Pressurized transactions resulting from struggle between the pre-nationalization and post-nationalization working methods :

Since in the past, banking sector has been at the centre of discussions around issues like the nature of banking, role of banks in economic development, branch expansion etc. opinions have also been expressed about whether banks should be under govt. control or in the private sector. The philosophical and practical struggle that emerged out of these discussions and debates created a kind of pressure in the banking transactions.

**Nature of the pressure in the pre-nationalization period** : Govt. of India nationalized 14 large private commercial banks on 19th July 1969. Govt. took over these banks under a special Act. In fact, this nationalization decision had a big background behind it. In 1920 imperial Bank came into existence with the merger of three regional banks, namely- Bank of Bengal (1809), Bank of Madras (1840) and Bank of Bombay (1843). Private banking flourished in India after 1904. These private banks were lending to private business, trade and service organizations and were

controlled by private industrialists and merchants. They were deliberately neglecting the rural sector and small entities. British govt. turned a blind eye towards all these practices of private banks.

After independence, economic planning was adopted with the objective of establishing economic and social equality. As a result, pressure started building on banks for lending to agriculture, small industries, projects of rural development, irrigation, agro-processing industries, self-employment, people from scheduled castes and scheduled tribes, weak and destitutes, marginal farmers etc. The pressure finally culminated in the nationalization of banks in 1969.

**Nature of pressure in the post-nationalization period** :

The decision of nationalization was followed by strong opposition from banks. But govt. stood confirmed on its decision and took the banks under it's control through a separate Act. Banks were forced to function in accordance with the policies and objectives of the govt., emphasis was laid on expansion of branches into rural areas. Mortgage norms were also relaxed. Public sector banks were compelled to lend 40% of their advances to the priority sector defined to include agriculture (18%), handicrafts (10%) and weak social units (10%). In short, banks experienced increasing pressure for following things.

1) Branch expansion in the rural areas,

2) Extending loans for the rural development,

3) Providing loans to economically and socially weak units.

As a result, the flow of credit increased to the rural sector. Banks always functioned under a kind of pressure. This is called as the pressurized banking transactions during post-nationalization period.

## 7.7 Various Interest Rates in India :

Due to different reasons, Indian money market exhibits various interest rates. These reasons include investment risk, repaying capacity of the borrower, maturity period, market conditions and the size of the loan. The various interests found in the market make up the structure of interest rates in India.

Interest rate is the price paid by debtor to the creditor for the use of money for a specific period. Interest rate has been defined by different economists in different ways. In the opinion of Prof. Wicksell, the amount paid for the productive use of the capital is the rate of interest. According to Mayor, interest rate is the price paid for the use of loanable funds. Prof. Carver states that the income received by the capitalist is called rate of interest. Keynes defined rate of interest as the reward for

parting with liquidity. In sum, interest rate is the price paid to the capitalist for the use of his capital. Demand and supply of capital are what determine the rate of interest in the economy. There are three theories about the rate of interest. They are- 1) Classical theory, 2) Neo-classical Loanable funds theory, and 3) Keynesan theory.

Interest rate is an important macro economic variable influencing savings and investment in the economy. A change in the rate of interest brings change in savings and investment. Nominal interest rate is paid by the debtor to the creditor. It is charged on following things.

1) Govt. securities, 2) Industrial securities,

3) Industrial deposits, 4) Bank deposits etc.

Financial market exhibits various interest rates on account of liquidity of deposits, risk in deposits, maturity of deposits and loans. Interest rate and risk are said to be positively related, while interest rate and liquidity of the asset are inversely related. The expectation theory of interest states that the long term interest rate is the geometrical mean of the short term interest rate and expected interest in future. The market segment theory states that market for short-term funds and market for long-term funds are independent and therefore, short-term interest rate and long-term interest rates are not related. There are different theories, which seek to explain the 'structure of interest rates'. Bank deposits are relatively liquid and less risky and therefore, fetch low rate of interest. Deposits with industrial concerns are more risky and therefore, offer higher rate of interest. Govt. securities also fetch low interest rate due to low risk involved, while industrial securities offer high interest rate owing to high risk. So, interest rates differ due to differences in risk, liquidity and maturity period.

Two more interest rates are found in the market. They are- 1) Bank Rate & 2) Call Money Rate.

**1) Bank Rate** : It is the interest rate charged by Central bank on the commercial banks. It is the lending rate of Central bank.

**2) Call Money Rate** : It is the rate of interest charged on borrowing and lending, which takes place even for a day among the banks.

**Kinds of Interest Rates** :

1) Bond Rates, 4) Administered Rates,

2) Deposit Rates, 5) Market Determined Rates.

3) Lending Rates,

**1) Bond Rate** : There are two types of bonds : i) Govt. bonds and (ii) Private Bonds.

The interest offered by Govt. (State or Central) or private institutions is called bond rate. Sometimes, central or state govts. raise funds by issuing bonds of different maturities. A certain rate of interest is announced on these bonds by the govt. These bonds are nothing but the loan receipts or promissory notes, which contain information about amount of loan maturity period, rate of interest and maturity sum. Issuers of bond are committed to repay the amount of loan along with the interest to the investor. Govt. bonds carry low rate of interest as they are less risky and highly liquid. The interest rate on govt. bonds is kept low so that govt. can access funds at cheaper rate. This is also done to keep rate of interest low on loans offered by govt. to various entities.

Bonds are issued by companies like Reliance, TISCO, Tata Motors and also by govt. owned institution like IDBI, UTI, SBI, etc. for raising funds from the market. Such bonds are highly risky and less liquid and therefore, carry high rate of interest. Govt. offers tax benefits to the investors in govt. and semi-govt. bonds. These bonds are beneficial to the large investors.

**2) Deposit Rate** : Deposits of different maturities and of different types are kept with commercial banks, nationalized banks, co-operative banks and post offices. Current, savings and time/fixed deposits are some types of deposits. Interest rate on these deposits varies with the change in the maturity period of the deposit. Current deposits carry low rate of interest, whereas it is highest on fixed deposits. The deposit rates are linked with the bank rate of the Central bank. Depending on the maturity, bank and post office deposit rates are found in the range of 6% to 10% at present.

Many times, industrial entities like TISCO, Reliance etc. accept deposits for the funds. The interest rate offered on such deposits is relatively higher as these are more risky and less safer than bank deposits. Industrial entities offer different interest rates depending upon their economic condition and tenure of the deposits. Large companies offer higher interest than smaller ones. Deposit rates vary with the changes in Reserve Bank’s policy.

**3) Lending Rates** : Lending rate is the interest rate charged by the commercial banks on loans of different maturities. The lending rates are determined on the basis of – i) liquidity of loan, ii) safety of loan, and iii) maturity / repayment period. The lending rates charged are high for loans, which are less safe and liquid; while they are low for highly safe and liquid loans. Risky loans carry high rate of interest, while less risky loans carry low rate of interest.

**4) Administered Rates of Interest** : The interest rates, which are decided by the monetary authority of the country and not by the market forces of demand and supply, are called administered interest rates. During 1969 to 1985, interest rates in India were decided by the RBI. Interest rates of large and small banks, co-operative banks, Regional banks and on industrial securities, preference shares etc. were determined by the RBI. The interest rates on demand deposits and loans are decided by the Indian Bank Association. Interest rates on treasury bills and long term govt. securities are set by the govt.

The interest rates were administered for following reasons :

i) In a developing country like India, interest rates were administered so as to keep them low for boosting the rate of capital formation.

ii) Interest rates were also administered so that govt. can have access to cheap funds.

iii) Interest rates were regulated in order to ensure flow of low cost credit to those sectors of the economy which enjoy preference in govt.'s scheme of development.

iv) Interest rates were administered with the intention of avoiding unnecessary competition among banks, to bring uniformity in the interest rates, to avoid frequent changes in bank rate and to make economic policy successful.

The monetary authority of the country enjoys the power of regulating or administering all types of interest rates for above mentioned reasons.

**5) Market determined Interest Rates** : Market rate of interest is the one, which is determined by the demand and supply of loans. Interest rates remain high, if demand exceeds supply and remain low, when demand falls short of supply. Equilibrium rate of interest is the one which is determined by the equality between demand and supply of loans. The interest rates on the deposits, bills of exchange, debentures, etc. are determined in the same manner. In short, market interest rates are determined by the market forces of demand and supply and not by any govt. or authority.

The following table indicates the determination of interest rates.

(Please see table on next page)

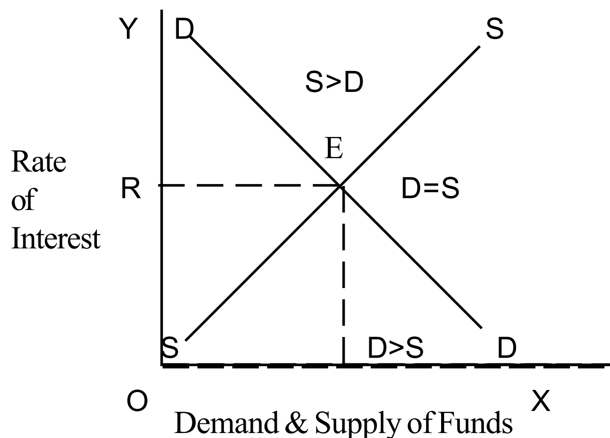
**Table : 7.6**

(Rs. In Crores)

| Demand for Funds | Supply of funds | Interest Rate |
|---|---|---|
| 100 | 50 | High |
| 100 | 100 | Equilibrium Interest rate |
| 100 | 200 | Low |

The accompanying table shows how the interest rate is determined by the demand and supply of funds. For example, if demand for funds is Rs.100 Crores and supply for funds is Rs.50 Crores, interest rate will remain high. Reverse will happen if demand is less than supply.

The determination of interest rate is also described in the following diagram.




In the above diagram, 'DD' as the demand curve and 'SS' as the supply, intersect at point 'E' and determine equilibrium rate of interest equal to 'OR'.

In this way, various interest rates are found in India.

(Please see the table showing various interest rates in India on next page)

**Table : 7.7**

**Various Interest Rates in India**

(in % per annum)

| | Particulars | 1970-71 | 1980-81 | 1990-91 | 1998-99 | March 2003 |
|---|---|---|---|---|---|---|
| 1 | Bank Rate | 5-6 | 9.0 | 10.0 | 8.0 | 6.0 |
| 2 | Call Money Rate | 6.38 | 7.12 | 11.49 | 7.83 | 4.5 |
| 3. | Deposit Rate of Commercial Banks | 6-6.5 | 7.5-8.5 | 9-10 | 9-11 | 3-8 |
| 4. | Treasury Bill Rate | — | — | — | 8.57 | 4.57 |
| 5. | Commercial Bank's Lending Rate | 7-8.5 | 16.5 | 16.5 | 12.14 | 5-17.5 |
| 6. | Central govt.'s Bond Rate | — | 7.03 | 11.41 | 11.86 | 4.79 |
| 7. | Corporate Bond Rate | — | — | — | — | 5.54 |

*Source : Handbook of Statistics on Indian Economy, RBI various issues.*

## 7.8 Summary :

Economic development of a country and supply of loanable funds are interdependent and positively co-related. Supply of funds leads to the development of sectors like agriculture, industry, trade, services etc. and thus of the whole economy.

The loans extended by the commercial banks are decided on the basis of factors like safety of loan, repaying capacity of the borrower, appropriate security, economic viability of the project, type of the loan etc. Commercial banks, while extending loans face several problems like change in govt.'s policy, change in RBI's policy, political interference, emergence of competitor to the industry financed by the banks, industrial sickness, concessional lending rates to the priority sector, unviable project funding etc. Commercial banks should always therefore, be careful while extending loans, failing which will put them into danger.

Owing to the Indian govt's policy in the post-independence period, commercial banks favoured projects in the public sector as against those in the private sector. Despite the opposition of the private sector to this policy, it continued until 1991. This led to the unsatisfactory growth of the private sector. The public sector, which received ample financial assistance, sometimes at concessional rates, however, failed miserably, endangering thereby the banking business in the country. The policy of

1991 de-regulated the banking business and allowed commercial banks to follow sound banking principles while conducting their business.

The pre-bank nationalization period experienced commercial banks neglecting agriculture and other small business units, retarding their growth. In order to direct the flow of credit from banks to the so far neglected sectors like agriculture, small industries, etc. govt. of India nationalized 14 commercial banks in 1969.

Inequality has been observed in the loans extended by commercial banks to different sectors and regions. Urban sector has been favoured against rural sector, western and southern states against other states, and states like Maharashtra Andhra Pradesh, Karnataka & Tamilnadu against other states like Uttar Pradesh, Bihar, Assam and other North-eastern states. Further large and medium borrowers have been assisted more compared to small borrowers.

Various interest rates prevail in Indian money market. These are determined by the factors like liquidity, risk, maturity etc. The types of interest include : i) deposit rates, ii) lending rates, iii) administered interest rates, iv) market rates. Deposit rates are the interest rates offered by banks on deposits; while lending rates are those charged on loans extended by banks. Administered interest rates are those interest rates which are administered by the govt. or monetary authority of the country. Market rates of interest are determined by the demand and supply of funds in the market.

## 7.9 Terms to Remember :

1) **Public Sector** - The sector belonging to the govt.
2) **Private Sector** - The sector belonging to the private entities.
3) **Nationalization**- Establishing govt. ownership.
4) **Administered Interest Rate** - Interest rate determined by the govt. or monetary authority.
5) **Market Interest Rate** - Interest rate determined by market forces of demand and supply.
6) **Bond Rate** - Interest rate offered on govt. or private bonds.

## 7.10 Check Your Progress.

**A) Fill in the blanks.**

1) Supply of funds and economic development are … … co-related.
2) Public sector is owned by the … …

3) Commercial banks were nationalized in India on … …

4) During pre-nationalization period, commercial banks extended maximum loan assistance to … … and … …

5) Administered interest is decided by the … …

**Answers** : 1) Positively, 2) Govt. 3) 19th July 1969, 4) Trade & Industrial Sector, 5) Government.

**B) State whether true or false.**

1) Change in the govt.'s policy creates problems for commercial banks in the allocation of loans.

2) Commercial banks favoured public sector against private sector during pre-nationalization period.

3) Flow of credit to the private sector increased after 1991.

4) Commercial banks have not discriminated among different sectors and regions or states.

5) Small borrowers were neglected by commercial banks during pre-nationalization period.

6) After nationalization, commercial banks felt pressure from the govt. to lend to the sectors like agriculture, small industries and priority sector.

7) Administered interest rates are determined by the market mechanism.

**Answers** : 1) True, 2) True, 3) True, 4) False,

5) True, 6) True, 7) False.

## 7.11 Exercise :

1) What is institutional credit? Explain the problems of allocation with respect to public and private sector.

2) Explain the inter-sectoral & inter-regional credit allocation problems.

3) Explain the nature of pressure experienced by commercial banks during pre and post nationalization period.

4) What is interest rate? Explain the types of interest rtes.

5) Short Notes :

a) Criteria of institutional credit,

b) Credit allocation problems of banks

c) Credit allocation problems with respect to small & large borrowers

d) Administered interest rate

e) Market rate of interest

## 7.12 Field Work :

Prepare a table showing various deposit and lending rates charged by your bank.

## 7.13 Reference books :


1) M.L. Seth, “Monetary Economics”, Laxmi Narayan Agarwal Publishers, Agra.

2) L.M. Bhole, “Financial Institutions & Markets”, Tata McGraw Hill Company Ltd., New Delhi.

3) G.S. Gupta, “Macro-Economics”, Tata McGraw Hill Company Ltd., New Delhi.

4) Dr.P.K.Deshmukh, “Money & Financial System”, Phadake Prakashan, Kolhapur.

5) R.Datta & K.P.M. SUNDARAM, “Indian Economy”, S.Chand & Company Ltd., New Delhi.


• • •

# Unit – 8

# Practical Banking Operations

## Contents :

8.1 Introduction
8.2 Objectives
8.3 Bank customers
8.4 Opening, transferring and closing a bank account
8.5 Demand draft, telegraphic transfer, mail transfer and negotiable instruments
8.6 Rights and responsibilities of a bank
8.7 Credit card, debit card, ATM, e-banking
8.8 Summary
8.9 Self study questions
8.10 Field work
8.11 Further readings

## 8.1 Introduction :

Modern economies are characterized by autonomous as well as planned economic development. For economic development innovators and bankers are required. Modern banking through credit supply and mobility of funds through money market and capital market contributes substantially to the process of economic development. Modern banking, finance, trade, industry, agriculture as also long term and short term credit needs of individuals in a variety of ways. Banking in a sense constitutes the blood circulation in the economic system. Recently modern banking has undergone revolutionary changes in its functional style mainly because of the technological facilities emerging from information technology. Due to IT banking has become more efficient, faster and is in a position to provide vastly expanded multiple facilities and services to the customers. This in a way accelerates the dynamism of the entire economic system

## 8.2 Objectives :

The study of this unit will enable the reader to understand :

1. Importance of customer oriented banking services,
2. Opening, transferring and closing a bank account,
3. Demand draft, telegraphic transfer, mail transfer,
4. Rights and responsibilities of a bank,
5. Credit card, debit card, ATM, e-banking and other technology based services of the banking.

## 8.3 Bank customer :

Banking, now has become a highly competitive industry of the economy. One of the main reasons is access to information technology available to the banking system. The managements of private banking, the Reserve Bank of India as also government of India through its agencies are trying to meet the traditional and emerging demands of various types of bank customers. It is through information technology that banking units are competing each other to make available to their customers a variety of services at consistently increasing standards of quality at reasonable prices and thus, attract bank customers. This is applicable to nationalized banks, old and new generation private banks, foreign banks as well as co-operative banks. Gradually, banking is reaching the stage of development, where bank customers will carry out their banking transaction from their homes with the help of IT. It is, of course, necessary that elderly bank customers will have to pick up some minimum level of IT skills and it is now evident that younger generation is already more or less well versed in using IT for banking purposes.

Bank customers keep their deposits in various forms in the banks. These depositors are individuals, professionals, various types of business firms, farmers, co-operative institutions as also government institutions. It is through these deposits that banks extend short-term, medium term and even long-term loans and advances to needy individuals, traders, industrialists and professionals. Such banks pay a certain rate of interest to the depositors and charge a higher rate of interest from various borrowers, which help them maximize profits, if they maintain a proper level of operational efficiency. Accepting deposits and advancing loans are not the only functions carried out by bankers, to attract an ever increasing flow of customers, both depositors and borrowers. Banks extend to their customers a variety of services. Banks accept deposits on current account, saving account, time account as also, recurring account. Current accounts are useful to business enterprises. Saving accounts are useful to the families and middle class people. The same is true in

case of recurring deposits. Fixed and time deposits are useful for all. Banks make available cash credit facility, over-draft facility as also regular loans and advances. In certain cases banks invest their portion of funds in govt. securities and in securities, which are available in money and capital market. Banks also make educational advances, personal advances and advances for purchase of durables like two-wheelers, four-wheelers and white goods.

In 1975, Government of India through Reserve Bank of India appointed a committee under the Chairmanship of Shri Talwar and in 1990, another committee under the Chairmanship of Goiporia was appointed to make recommendations regarding improvement in customer service of the banks. The main recommendations of these committees are given below :

- **Talwar Committee :**
  1. Two officers of the bank must sign on demand draft, whose value is more than Rs.10,000/-
  2. The banks must intimate depositors with fixed deposits about the completion of the maturity period.
  3. In case a bank customer forgets or keeps his passbook in the bank, the bank must arrange for its safe dispatch through post-office to the customers.
- **Recommendations of Goiporia Committee** :
  1. Banks must accept currency notes of lower denominations.
  2. Banks must make available easy, fairly priced and secure facility of safe lockers to the customers.
  3. Banks must improve their own image through better customer relations.
  4. Banks must observe strict time limitations in providing services to the customers.
  5. A cheque of more than Rs.5,000 from a different town deposited by customer should be encashed immediately.
  6. Every bank must have a “help counter”.
  7. Banks must be compelled by law to accept damaged currency notes.

## 8.4 Opening, transferring and closing a bank account :

**A) Opening a bank account** : When a person wants to open a bank account either for deposit purposes or for borrowing purposes, he has to complete

following procedure-

1. He has to submit an application in prescribed form for opening an account duly signed.
2. He must deposit a certain amount through this application form with a pay in slip for opening the account.
3. He must fill up a specimen signature card with his full name, full address and specimen signature and submit the same to the bank.
4. Depending upon the nature of the account, some additional documents will be required, e.g. photograph, ration card, PAN card etc.
5. He must give references of two respectable persons through whom bank may examine credit capacity, character and capital of the person to ensure regular transactions with the bank.

Depending upon the nature of the account the bank customer will have to give in his application following information-

1. Type of account,
2. Initial amount to be deposited and the type of deposit,
3. Full name, age, profession etc.
4. Names of the persons who will operate the account and their specimen signatures,
5. Identification reference of the customer,
6. Nominee for the account.

We give blow a broad specimen of an application form for opening an account in a bank-

(H.O. State Bank of India,
Branch- Laxmipuri, Kolhapur)

Dear Sir,

I/We declare that State Bank of India Saving Banks Rules have been read by we/us and that I/we accept them as binding upon me/us.

I/We also declare that the Account will be operated upon and the balance will be payable to … … of us.

If the account be closed before the completion of one year, I/We agree to pay a charge of Rs. …. …. To cover the cost of Pass book.

Yours faithfully,

(Signature)

**Matter on the other side of the form.**

Operation Instructions –

Full Name 1. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. ..

2. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. .. ..

Standing Instructions :

Specimen Signatures :

1. .. .. .. .. .. .. .. .. .. ..

2. .. .. .. .. .. .. .. .. .. ..

Introduced by … … … … … .. …. … .. … .. Occupation … .. … … … … … …. Account No. … … … … … … .. Address … … … … … …. …. …. …. …. …. …. … … … … … … … … … … … Date.:

**B) Transfer of Account** : When a customer of a bank in a city moves to some other city due to job change, transfer or shifting, he can transfer his bank account to the branch of the same bank in the same city where he moves. For example, Mr. R.R.Patil who has a bank account in State Bank of India in Pune, can transfer his account to branch of State Bank of India in Kolhapur in case he is transferred from Pune to Kolhapur. For this purpose, he will have to complete following procedure :

1. He will have to apply to SBI branch Pune to transfer his account to Kolhapur SBI branch.
2. Along with this application he will have to surrender his pass book and unused checkbook to the State Bank of India, branch office in Pune.
3. After receiving this application and related papers the Pune branch officer of SBI will calculate interest on deposits, credit it to the pass book and with a remark on the pass book "A/c. transferred to Kolhapur branch on ….. …..", return the pass book to Mr. Patil, but cheque book will not be returned.
4. The Pune office of SBI will record all these matters in his books and send through an appropriate channel to the Kolhapur branch office, along with the original application form for opening account, specimen signature card of Mr. Patil.
5. After receipt of these papers, Kolhapur branch will open an account in the name of Shri Patil.

**C) Closing of Account** : Under provisions of Indian law, particularly Banking Regulation Act, a bank customer can close his bank account in any bank for following reasons-

1. Change of residence.
2. Displeasure with the treatment given by bank officers and employees.
3. On maturity of a fixed deposit.
4. In case of a defaulter a judicial order can cancel or close any bank account.
5. If a customer doesn't accept the regulations and rates of interest of a bank.
6. If a customer is doubtful about the financial health of the bank.
7. A bank also can close an account of a defaulter for his frequent deception and unreliable behavior.
8. A bank account can be closed on the death of a depositor with proper documentary evidence from the relatives, whereby the balance will be transferred to the rightful heir.
9. A bank account also can be closed if a bank customer becomes or is declared unsound in mind.

For closing a bank account, following steps are necessary –

1. The customer must submit an application to the bank in the prescribed form.
2. The passbook and unused cheques will have to be returned.
3. The bank will calculate up to the date of closer interest on the balance in the account and deduct marginal amount as incidental charges and return the entire amount to the depositor.
4. After this, a remark "Account closed" is endorsed on the first page of the pass book, a similar entry made in the ledger and a remark is entered in the pass book that there is no balance in the account.

## 8.5 Demand draft, telegraphic transfer, mail transfer and negotiable instruments:

Modern banks are not only collectors of deposits and distributors of credit, nor are they only stores of national wealth but more importantly they are the facilitators of growth and development. Modern banks make social, economic and even political

system of a nation more productive. Modern banks provide a number of secondary facilities to the society, which include exchange of credit letters, sale and purchase of shares and debentures, working as trustee and transfer of funds.

Banks help in transferring small or big amounts for customers from one place to another place through a variety of instruments for a nominal charge. These instruments are – i) Demand Draft, ii) Mail Transfer and iii) Telegraphic transfer.

**i) Demand Draft** : For safer and less costly transfer of funds compared to money order the banks use the instruments of demand draft. Demand draft is an order given by one bank to another bank on the request of a customer. At present normally, following steps are involved in the use of demand draft.-

a) A person with a bank account or even without a bank account can apply to the bank in a printed form for the purchase of demand draft. This form contains the name of the branch of the bank, the amount required, and the name of the person along with his address to whom the amount is to be paid.

b) The applicant will submit the said amount and the necessary commission to the bank.

c) The demand draft is prepared by the bank and after crossing it, it is delivered to the person concerned who deposits it with the bank indicated and collects the money.

d) Normally, at the top of the Draft in the left hand corner 'Not over Rs. ….' Is printed.

An example of the demand draft :

| | |
|---|---|
| No. Amg 114 | NOT OVER Rs.1000/- Code No.X22 |
| Date: 28.04.12008 | BANK OF INDIA<br>KOLHAPUR |
| Draft on Mumbai Branch in favour of | No.Amg. 113<br>28.04.08 |
| Mr.Desai S.S. on Account of Miss Rohini. | On demand pay to the order of Mr. S.S. Desai the sum of Rs.1,000/- only for the value received.<br>**Rs.1,000/-** |
| | To,<br>BANK OF INDIA. For<br>KOLBAPUR BRANCH BANK OF INDIA |
| Accountants | ................Agent.<br>............. Accountant |

**ii) Mail Transfer** : Sometimes a demand draft may be displaced or lost. There may be postal delays. When money to be transferred is urgently required, the method of mail transfer is used. In this case also document similar to a demand draft is prepared. But is known as credit note, which includes the name of the payee, his account number, amount and the name of the payer. In case the payee doesn't have account, the bank sends him a cheque, which can be encashed. Following is the example of credit note required for mail transfer.

**Bank of India, Mumbai Branch.**

**Credit Note**

**Kolhapur Branch**

Mail to

Dept.DD/MT/TT **Credit Note No. 3980**

MT.Mumbai - 113.

Credit under advice to the saving bank<br>A/c.No.321 of Mr.S.S.Desai with you.<br>Remitter - Miss Rohini.

| | Rs. | Paise |
|---|---|---|
| | 1,000 | 00 |
| Total : | 1,000 | 00 |

Accountant Manager

**iii) Telegraphic Transfer** : In the case of telegraphic transfer one bank remits money to another bank by a telegraphic message informing the name of the payee and the amount to be paid. For this also one has to apply to the Bank in a printed form giving information about the amount, the payee etc. fee of certain amount for telegraphic transfer is to be paid. The bank after receiving this application gives a message to another bank, where the amount is immediately credited to the account of the payee and in the absence of account, the said amount is paid after confirming the identity of person.

**iv) Negotiable Instruments** : In a modern banking system, certain paper documents are used as money or almost money. These include -

a) Bill of Exchange,

b) Cheque,

c) Promissory Note

These are known as negotiable instruments.

A negotiable instrument is a document signed by person ordering without any conditions a certain amount under signature to a payee. In a way, this definition applies to bill of exchange, cheque and promissory note. Some bills of exchange are domestic bills of exchange and some are foreign trade related bills of exchange. Bills of exchange, which are used for settling external payments, are known as foreign bills of exchange. According to section 6 of Negotiable Instruments Act, a bill for the certain amount, whereby a amount is payable on demand is a cheque. A bank customer submits a cheque personally or through some other customer. Cheque is a written contract, when a cheque is tendered to a bank, the amount mentioned is to be paid immediately in cash or to be credited to the account of the payee. Payment by cheque is safe because it is recorded in pass book and is quick also. The possibility of misappropriation is almost absent.

Difference between a bill of exchange and a cheque-

| Bills of Exchange | Cheque |
|---|---|
| 1. A bill of exchange is in the name of Person. | 1. Cheque is in the name of bank. |
| 2. The person in whose name bill of exchange is prepared has to accept it. | 2. A bank may accept a cheque or may not accept cheque. |
| 3. Amount of the bill of exchange is paid immediately or after sometime. | 3. Amount of the cheque is immediately payable. |
| 4. A bill of exchange cannot be crossed. | 4. A cheque can be crossed. |
| 5. Once a bill of exchange is issued, payment can not be stopped. | 5. The payment of the cheque can be stopped. |
| 6. A bill of exchange requires payment of a certain amount of stamp duty. | 6. Cheque does not require Stamp duty. |
| 7. A bill of exchange has a grace period of 3 days. | 7. In case of cheque, these is no grace period. |

**v) Promissory Note** : According to Negotiable Instruments Act, a promissory note is a written promise by a person to pay a certain amount to the bearer, the moment payment is demanded. Such a written document has legal sanction. Following is an example of a promissory note.

## Promissory Note

Kolhapur

Date : 10.08.2008

To,

Shri Vasantrao Saraf,

Kolhapur.

I, the undersigned, Shri Sadanand Tendulkar promise to pay to you or any person directed, an amount of Rs.1000/- borrowed from you today at 10 per cent interest rate at any time demanded.

Rs. 1,000/-

Signature

(Sadanand Tendulkar)

## 8.6 Rights and responsibilities of a bank :

### A) Following are the rights of a bank :

1. The bank has a right to carry out transaction in money in the form of deposits, advances, investments and transfers. In the case of a non-operating account, the bank can use the balance according to its own convenience.
2. The bank has a right to hold property pledged to it as security by the borrower till the borrowed amount is repaid.
3. A bank has a right to integrate different accounts opened by a customer in different banks in case of default. Similarly, the bank can combine two or more accounts of a customer with itself if needed.
4. Bank has a right to charge a certain rate of interest on advances and charge a certain rate of commission for facility provided.
5. Bank has a right to refuse submission of papers, documents etc. in case there is a legal dispute between a customer and bank as also between a bank and other bank.
6. Bank has a right, in case of dispute, disagreement between itself and the

customers, to close an account of a customer. Similarly, it can close an account if the customer is a regular defaulter and dishonest.

## B) Responsibilities of a bank :

1. It is the responsibility of a banker to maintain full confidentiality regarding its own customers. In fact, bank Officers have to take an oath regarding secrecy of information in respect of customers. However, in following cases banks will be required to give information :

   a) In case of tax related matters, the banks have to give information to the governments.

   b) Banks have to give information for public interest and for the purpose of recovery of loans.

   c) For transfer of property after a death of a customer to the inheritors.

   d) Banks have to give information in respect of a borrower to a person who stands guarantee for borrowing.

2. It is the responsibility of a bank to encash duly issued cheques in its name, provided there is required balance in the account.

3. Banks have to accept responsibility for various payments under limitations act.

## 8.7 Credit Card, Debit Card, ATM, E-banking :

**a) Credit Card** : Credit card is an example of plastic money. The credit card mechanism was used for the first time in 1951 by Franklin Bank in USA. After 1958, some more big banks in USA started giving credit cards to their customers because of the use of advanced electronic procedure. Credit card is a method of making credit easily available to the credit holders by a bank. A credit card is a plastic card which is electronically engraved and which can be used through a machine installed in the bank. A customer is required to move that card through a slit in the machine and giving some instructions electronically. The same credit card can be used for purchases of goods and services in shops and hotels in the same way. The payment for such purposes rests with the bank, which issued the credit card. Credit card saves time, enables a customer to use money for a period of month, he need not carry money i.e. (cash) with him all the time. Some banks use credit card for attracting new customers. Credit card becomes a status symbol. If a credit card holder is financialy disciplined, there is no serious problem, but a careless person may become a spend thrift with a credit card. If you lose a credit card, you have to

pay for a new credit card. For the use of a credit card, bank balance in your name at that particular moment is not essential, but a credit card holder has to settle his account every month beyond which he will be charged a substantial interest for the amount due.

**b) Debit Card** : Debit card is also plastic money, but of a different kind. A debit card holder can withdraw money or make purchases keeping in mind balance in his account. Immediately after the withdrawal of the money from a bank or purchase by the debit card holder, equal amount is debited from the account of the card holder. Sometimes, debit card is classified as direct debit card and deferred debit card. If debit card holders want record of his account, it is given. Debit card is issued only to a person holding an account in a bank. In case of theft, the debit card holder should intimate to the bank. Debit card holder gets a personal identity number, which is strictly confidential, which is to be used for operating the debit card. A debit card holder can withdraw a certain maximum amount per day. In case a customer closes his account with a bank, his debit card also gets automatically cancelled. A debit card holder has to maintain certain minimum balance in his account. A debit card holder also need not carry cash all the times.

**c) ATM** : ATM that is Automated Teller Machines or All time Money is a great facility made available by modern banks. Normally, banks operate for a certain number of hours day. If a customer requires money before or after office hours, he finds it very inconvenient to raise money. Sometimes a customer may find it difficult to get money easily because of distance involved in such cases. ATM, which is a computerized system makes it possible for the customers to withdraw money at any time any where provided the bank operated ATM outlet is there. Normally, major banks come together through a common computerized system, which enables credit card holders or debit card holders to withdraw money anywhere, anytime through ATM outlet operated by any bank. Normally banks open ATM outlets near share market, malls, super market, railway stations, airports etc. After a customer submits required information through an application, the customer is given a personal identity number (PIN), which gives the customer access to ATM machine. The PIN is known only to the customer and to the ATM machines. ATM machine gives latest balance statement. ATM has now become a kind of a revolutionary banking service even in India. Following chart gives information regarding growth of ATMs in India.

## Growth of ATMs in India.

No. of ATMs

| Type of Bank | In own branch | At other places | Total |
|---|---|---|---|
| 1. Nationalized Banks | 3205 | 1567 | 4772 |
| 2. SBI and its group | 1548 | 3672 | 5220 |
| 3. Old Private sector banks | 800 | 441 | 1241 |
| 4. New private sector banks | 1883 | 3729 | 5612 |
| 5. Foreign banks | 218 | 579 | 797 |
| **Total** | **7654** | **2988** | **17642** |

ATM cards are non-transferable and need to be very carefully handled.

**d) E-Banking** : Use of information technology in Indian banking is rapidly increasing. According to RBI Report on Trends on Indian Banking by March end 2005, the status of computerization in percentage in nationalized banks was as under :

| | | |
|---|---|---|
| 1. Branch offices having computerization but not with core solution | : | 60.00 |
| 2. Branches with core banking | : | 11.00 |
| 3. Computerized branches (1+2) | : | 71.00 |
| 4. Partially computerized branches | : | 21.80 |

E-banking means using internet for availing various banking facilities. E-banking means electronic banking. This is a technique developed through internet for depositing, withdrawing and transferring funds through internet 24 hours a day. It was in the year 2000 that ICICI bank started INCINET, an internet banking facility for wholesale businessmen and corporate customers.

E-banking has following benefits:

1. Makes information regarding various services and its charges easily and instantly available to the customers.
2. E-banking eliminates other agents and thus minimizes service cost.
3. E-banking minimizes cheating and deception.

4. E-banking has following limitations:
   a) E-banking is not friendly in case of identified customers with reference to geographic locations and local sensitivities.
   b) In case a customer has separate bank accounts in different banks, e-banking cannot help inter-bank transfer.
   c) E-banking services can be made available to the customers only if IT infrastructure of the bank is fairly developed.

- **Recent rends in banking** : If we consider post NEP developments in Indian banking, it is seen that (a) emphasis is now on larger banks which requires mergers and integration, (b) greater computerization and greater use of plastic money and e-money, (c) gradual spread of modern banking i.e. universal banking whereby commercial banks are expected to carry out functions besides acceptance of deposits, short term loans, advances and routine banking services, go for investment banking, merchant banking, insurance and participation in capital market on a large scale.

## 8.8 Summary :

In this unit of study we have discussed the concepts of bank customer, fundamental banking activities like opening, transfer and closing the bank account as also concepts like demand draft, telegraphic transfer, mail transfer and negotiable instruments. We also have briefly explained rights and responsibilities of a bank. This is followed by explanation of credit card, debit card, ATM and e-banking.

## 8.9 Self-study questions :

1. Explain neatly opening of a bank account, transferring of a bank account and closing a bank account.
2. Discuss legal rights of a bank.
3. Discuss legal responsibilities of a bank.
4. Explain different methods of transfer of money.
5. Write short note-
   a) Bank customer
   b) Credit card
   c) Debit card
   d) E-banking
   e) ATM

## 8.10 Field work :

Collect various forms related to bank transactions from a local bank.

## 8.11 Further readings :


1. Lalwani S.J. (Ed) (1993) : Changing Profile of Indian Banking, New Delhi, Radha Publications.
2. Report on Indian ATM Industry (May 2007): Mumbai, Banknet Publications.
3. Vaish M.C. (1984) : Modern Banking, Mumbai, RBSA Publishers.
4. White paper on Banking Systems Survey (2004) : Mumbai, Banknet Publications.


• • •