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BANKING AND FINANCE-AN OVERVIEW

STRUCTURE AND FUNCTIONS OF INDIAN FINANCIAL SYSTEM

- **Financial System** is a structure through which financial surpluses in the economy are mobilized from surplus sectors and transferred to needy sectors.
- That means **Savings** of certain sections of society are transformed in to **Investments** or as **Consumption** or used for **Productive purpose**.
- So **Financial system** helps transform **Savings in to Productive Investments**. For example, a person with surplus income has many options to create some wealth by putting his surpluses **either in to investments or in to savings**. If he wants to save, he saves with a bank. If he wants to invest, then he can buy some shares/mutual fund units or can choose any other investment options. But ultimately his surplus would be used by **financial intermediaries such as banks for lending loans to others or by companies as a part of capital**.
- A financial system **facilitates the flow of funds from the areas of surplus to the areas of deficit**. Thus the financial needs of certain people/institutions are met from different sources and agencies like **Banks/NBFCs/ Primary Dealers/Mutual Fund Companies etc**. **Indian financial system** consists of **Financial Markets, Credit market, Money Market, Forex Market and other relevant markets which are run by the intermediation of various Financial Intermediaries**.
- **In this process various long term and short term Financial Instruments** are issued and various **Financial Services** are rendered by important **Financial Intermediaries** in the system.

Mainly Financial system comprises of

- ⇨ **Financial Markets**
- ⇨ **Financial Intermediaries**
- ⇨ **Financial Instruments**
- ⇨ **Financial Services**

Financial Markets

- ⇨ A **Financial Market** can be defined as the market in which **'Financial assets'** and **Financial Liabilities** are created in the process of channeling funds from lender savers to borrower spenders, through various financial instruments Such as **Share/stocks/Deposits etc**. Here **Financial Institutions** like **Banks/NBFCs/ Pension Funds/Mutual Fund Companies/Insurance Companies/Corporate Companies** tap the investments or surpluses of the people and transfer them for loan seekers.
- ⇨ Thus financial markets perform the essential economic function of channeling funds from savers who have an excess of funds to spenders who have a shortage of funds. **Here every financial asset has a corresponding financial liability that gives financial asset its value**. Let us summarize how financial markets create **Financial Assets and Financial Liabilities**.
- ⇨ If **'A'** has surplus funds to save with a bank, he opens a deposit with a bank. For **'A'** it is a **Financial Asset** since he expects some **'Interest'** on his deposit. On the other side for the **Bank** the deposit is a **liability** since **bank has the obligation to pay back when A demands** his deposit back. Interestingly, the same **liabilities (Deposits)** can be used by the banks for the purpose of **'Lending'** to other borrowers, where bank expects some interest in return. So here the **Loans given by a bank** are its **Financial Assets** and for the **borrower** it is a **Liability**. Thus financial markets make available funds for **capital formation/creation of economic wealth**.
- ⇨ People make **deposits with banks to get interest** and banks use such deposits for the purpose of lending and to get **more interest** in return. This is how **Credit is created and this is Credit market**
- ⇨ People invest in the **shares/Debentures of a company to get Dividend or Interest**. Companies use such **investments as capital** to do their business and get some profits on. This is how **capital is formed and is called Capital market**

Financial Markets mainly comprises of

- 1) **The Credit Market** which is dominated by **commercial banks and is regulated by RBI**
- 2) **The Money Market** with **call notice money** forming a sizeable proportion controlled by **RBI**.
- 3) **The Equity and Debentures Market** consisting of shares/Debentures/Derivatives segments controlled by **SEBI**
- 4) **The Corporate Debt Market** comprising Public Sector Unit bonds and corporate debentures controlled by **SEBI**
- 5) **The Gilt-edged Market for Government Securities regulated by RBI**
- 6) **The Housing Finance Market** is regulated by RBI appointed **Quasi regulator called National Housing Bank(NHB)**
- 7) **The Hire Purchase and Leasing Finance Market** wherein the **non-bank financial companies (NBFCs)** predominate and this is regulated by **RBI**
- 8) **The Insurance Market** the main players being insurance companies and regulated by **IRDAI**
- 9) **The Foreign Exchange Market**-It is regulated by **RBI**

Capital Market

A capital market provides **long term finance for business**. Capital Market refers to the facilities and institutional arrangements for **borrowing and lending long-term funds as well as raising capital by way of issuing shares to interested investors.**"

Capital Market can be divided into following groups

1. Corporate Debt/ Corporate Bond/Securities/Share Market :

It is a market for industrial securities. Corporate securities are **equity and preference shares, debentures and bonds of companies**. It can be divided into two groups: **Primary and Secondary Market**

- **Primary Market:** It is a market for **new issue of securities, which are issued to the public for first time**. It is also called as **Initial Public Offering (IPO)**
- **Secondary Market:** In the secondary market, there is a sale of secondary securities. It is also called as **Stock/Share Market**. It facilitates buying and selling of securities **through stock Exchanges**.

2. Government Securities Market (G-SECs)

In this market, government securities are bought and sold. It is also called as **Gilt-Edged Securities Market**. The securities are issued in the form of **bonds and credit notes**. The buyers of such securities are **Banks, Insurance Companies, Provident funds, RBI and Individuals**. These securities may be of short-term or long term.

- **A primary dealer** is a **bank or securities broker-dealer** that may **trade directly with the government securities in Open Market Operations (OMO)**. RBI regulates and licenses primary Dealers and governs all rules pertaining to **securities Market**. **Currently 21 primary dealers are permitted by RBI to work in securities Market**.

3. Money Market

This Market consists of many **financial instruments** such as **Treasury Bills, Commercial Paper (CP), Certificate Of Deposit (CD), Call Money, Commercial Bills etc.**

- **Treasury Bills:** To raise short term funds treasury bills are issued by Government. It is purchased by Commercial Banks. At present, Government issues **91 days, 182 days and 364 days treasury bills**.
- **Commercial Paper (CP):** **Commercial paper** is issued by **High Net worth Companies (HNC)** who are listed on Stock Exchange. CP is issued at **discount and repaid at face value**. The maturity period ranges from **7 days to one year**. **CP's are issued in multiple of 5 lakhs**. The company issuing CP must have tangible net worth of at least **4 crores**.
- **Certificate Of Deposit (CD):** CD's are used by Commercial Banks and Financial Institutions to raise finance from the market. The maturity period for CD's is between **7 days to 1 year**. CD's is issued at a discount and repaid at face value. CD's is issued for a minimum of **25 lakhs**.
- **Call Money Market:** A loan which is taken or given for a very short period that is **for one day is called Call Money Market**. It involves lending and borrowing of money on a daily basis. No security is required for these very short-term loans.
- **Commercial Bill Market (CBM):** This market deals with **Bills of exchange**. The drawer of the bill can get the bills discounted with Commercial Banks. **The Commercial Banks can get the bills rediscounted with RBI at the rate called 'Bank Rate' which is also called 'Rediscounting Rate'**.

FOREX Market

The Forex market deals with the **multicurrency requirements**, which are met by the exchange of currencies. Depending on the exchange rate, the transfer of funds takes place in this market. This market is must facilitating **International Trade**.

Credit Market

Credit market is a place where **Commercial banks and NBFCs** provide **short, medium and long-term loans to corporate and individuals**.

Financial intermediaries

Financial Intermediaries are those who undertake the **intermediation** between **Investors and Spenders/Borrowers**. Thus a **Financial intermediary** is a **financial institution such as bank, insurance company, investment bank or a Pension fund company** etc. which offers a **service to help an individual/ firm to save or borrow money**. The term **financial intermediary** thus refers to an institution, firm or individual who performs intermediation between two or more parties in a financial context. Typically the first party is a **provider of a product or service and the second party is a consumer or customer**.

Financial intermediaries are **banking and non-banking institutions** which transfer funds from economic agents with **surplus funds (surplus units)** to economic agents (**deficit units**) that would like to utilize those funds. FIs are basically **two types**:

- **Bank Financial Intermediaries, BFIs (Central banks and Commercial banks) and Non-Bank Financial Intermediaries**
- **NBFIs (Insurance companies, Mutual trust funds, Investment companies, Pensions funds, Discount houses and Bureaux de change).**

Important Regulatory agencies in India

- ❖ **Reserve Bank of India (RBI)** regulates credit products, savings and remittances; Money market, Forex market
- ❖ **The Securities and Exchange Board of India (SEBI)** regulates Share market, investment products, Mutual Fund Companies etc
- ❖ **The Insurance Regulatory and Development Authority (IRDA)** regulates All insurance products such as Life/General/Medical/Fire/Marine, **Unit linked Insurance Plans (ULIPS)** except **Deposit insurance**. **Deposit insurance is regulated by RBI and insurance on bank deposits are covered by Deposit credit Guarantee Corporation of India (DICGCI)**
- ❖ **The Pension Fund Regulatory and Development Authority (PFRDA)** regulates pension products.
- ❖ **The Forward Markets Commission (FMC)** working under the Ministry of Consumer Affairs regulates **commodity-based exchange-traded futures and commodity exchanges**. **Now this commodity market regulator is merged with SEBI recently.**

Quasi-Regulatory agencies

There are other government bodies which perform **quasi-regulatory functions**, including **National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), and National Housing Bank (NHB)** etc.

- **NABARD supervises Regional Rural Banks (RRBs) as well as State and District Rural cooperative Banks.**
- **NHB regulates housing finance companies**
- **SIDBI regulates the State Finance Corporations (SFCs)**
- **Rural Cooperative banks, which, except in terms of their ownership structure, are very much, like other banks. They take deposits and give loans. Still, their management is largely left to the Registrar of cooperatives of the state and statutory supervision to NABARD.**
- **Financial Sector Development Council (FSDC)**, which replaced the **High Level Committee on Capital Markets**. FSDC, which is convened by Ministry of Finance, does not have statutory authority, and would be expected to resolve inter-agency disputes.

Important stake holders in Capital /Equity/Pension Funds/Debt Market

- **Asset Management Company:** the Company which handles the day to day operations and investment decisions of a **unit trust**.
- **Broker:** A member of a **Stock Exchange** who acts as an agent for clients and buys and sells shares on

their behalf in the market. Though strictly a stock broker is an agent, yet for the performance of his part of the contract both in the market and with the client, he is **deemed as a principal, a peculiar position of dual responsibility.**

- **Broker dealer:** Any person, other than a bank engaged in the business of buying or selling securities on its own behalf or for others
- **Collective Investment Management Company:** A company incorporated under the provisions of the Companies Act, 1956 and registered with SEBI under the **SEBI (Collective Investment Schemes) Regulations, 1999**, whose object is to organize, operate and manage a **Collective Investment Scheme.**
- **Debenture Trustee:** A trustee of a trust set up for undertaking any issue of debentures of a company on its behalf.
- **Depository:** A **Depository facilitates holding of securities in the electronic form (DEMAT form)** and enables securities transactions to be processed by book entry. Ex: **National Securities Depository Limited (NSDL) and Central Depository Services (India) Ltd. (CDSL).**
- **Depository Participant (DP):** is an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the **Depositories Act.** In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the sub section **1A of Section 12 of the SEBI Act.**
- **Foreign institutional investor (FII) :** An institution established or incorporated outside India which proposes to make investment in India in **Share/securities, market** or domestic **Asset Management Company or domestic portfolio manager** who manages funds raised or collected or brought from outside India for investment in India on behalf of a ***sub-account**, shall be deemed to be a Foreign Institutional Investor.
- **Subaccount:** Sub-account includes foreign corporates or foreign individuals and those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a **Foreign Institutional Investor**
- **Mutual Funds /Unit Trusts:** Mutual Fund is a mechanism for **pooling the resources by issuing units to the investors and investing funds** in securities in accordance with objectives as disclosed in offer document. A fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities.
- **Pension Fund Managers(PFMs) or Pension Funds(PFs):** Pension fund” means an intermediary which has been granted license by **Pension Fund Regulatory Authority of India(PFRDAI)** for receiving contributions from pension seeking investors, accumulating them and investing them in the manner as may be specified by the PFRDAI and making payments to the subscriber from time to time.

Stake Holders in Credit Market

The Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934 authorize the RBI to regulate the banking sector in India.

- **Commercial banks:** Commercial banking sector comprises of **public sector banks, private banks and foreign banks. Co-operative Banks and Regional Rural Banks** too makes up entire banking segment in India.
- **Development banks:** In India, there is also **Development banks** which are special **re-financial institutions established for the development specific sectors of economy by providing them refinance and Development credit.** These are constituted by Government of India by **respective special legislations.** These are typically set up for financing and refinancing various sectors for which they are created for. **These are not commercial banks since they will neither receive deposits from Public nor lend them directly.** These development banks provide **Refinance to commercial banks** and other financial organizations, enabling them to lend in turn to public later. Ex: **NABARD/SIDBI/NHB/EXIM banks**
- **All India financial institutions (AIFIs):** India has a **two-tier structure of Development financial institutions** with **All India financial institutions (AIFIs) at National level and State Financial Institutions (SFCs)** at the state level. **All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including Public sector insurance Institutes.** Government holds majority shares in these financial institutions, **All India Financial Institutions (AIFIs) are the Development Finance Institutions (DFIs) and Investment Institutions,** which play a pivotal role in the financial market.
- **All India Financial Institutions (AIFIs):** All-India Financial Institutions (AIFIs) comprise **five All-India Development Banks (AIDBs), viz., Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India Ltd. (IFCI), ICICI Bank Ltd., Infrastructure Development Finance Corporation**

(IDFC), Small Industries Development Bank of India (SIDBI) and Industrial Investment Bank of India (IIBI, erstwhile Industrial Reconstruction Bank of India or IRBI), three Specialized Financial Institutions (SFIs) viz., IVCF (erstwhile Risk Capital and Technology Corporation or RCTC), ICICI Venture (erstwhile TDICI) and Tourism Finance Corporation of India (TFCI) and three Insurance cum Investment institutions viz., Life Insurance Corporation of India (LIC), Unit Trust of India (UTI) and General Insurance Corporation (GIC).

- A set of **parallel, financial institutions**, known as the State Financial Corporation's (SFCs), were set up at the State level in 1951 to extend the benefits of long-term loans to medium and small sized industrial undertakings in the respective states. State level institutions comprise of **State Financial Institutions(SFCs) and State Industrial Development Corporations (SDCs)** providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate.
- Non-banking Financial Institutions (NBFCs) provides loans and hire-purchase finance, mostly for **retail assets** and are **regulated by RBI under provisions of RBI Act 1934**. The Reserve Bank of India is entrusted with the **responsibility of regulating and supervising the Non-Banking Financial Companies** by virtue of powers vested in **Chapter III B of the Reserve Bank of India Act, 1934**.

Different types/categories of NBFCs registered with RBI

- 1) **NBFC-Asset Finance Company(NBFC-AFC)** : An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments etc
- 2) **NBFC-Investment Company (NBFC-IC)**: IC means any company which is a financial institution carrying on as its principal business **the acquisition of securities and shares**.
- 3) **NBFC-Loan Company (NBFC-LC)**: LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by **making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company**.
- 4) **NBFC-Infrastructure Finance Company (NBFC-IFC)**: IFC is a non-banking finance company a) which deploys at least **75 per cent of its total assets in infrastructure loans**, b) has a minimum Net Owned Funds of Rs. 300 crore
- 5) **NBFC-Systemically Important Core Investment Company (NBFC-CIC-ND-SI)**: CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:
 - It holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in core industries.
 - Its asset size is Rs 100 crore or above and It accepts public funds
- 6) **NBFC-Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC)**: IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum **5 year maturity**. **Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.**
- 7) **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI)**: NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:
 - loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. **60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000**
 - Loan amount does not exceed Rs. **35,000 in the first cycle and Rs. 50,000 in subsequent cycles**. Total indebtedness of the borrower does not exceed **Rs. 50,000 and** tenure of the loan **not to be less than 24 months** for loan amount in excess of Rs. **15,000 with prepayment without penalty**
 - Loan to be extended **without collateral and** Loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower
- 8) **Non-Banking Financial Company – *Factors (NBFC-Factors)**: NBFC-Factor is a **non-deposit taking NBFC** engaged in the **principal business of factoring**. The financial assets in the factoring business should constitute at least 75 percent of its total assets and its income derived from factoring business should not be less than 75 percent of its gross income.
 - * **Factoring** is a transaction in which a company sells its **accounts receivable, or invoices, to a third party commercial financial company**, also known as a **“factor.”** This is done so that the business can receive cash more quickly than it would by waiting for a customer payment. Factoring is sometimes called **“accounts receivable**

financing.” Here NBFC-Factor buys the accounts receivable, or invoices, from companies at discount and later recovers such ‘receivables’ at full value to make profit.

Regulatory Framework for NBFCs

- No companies can carry out NBFC business **without obtaining Certificate of Registration from RBI**
- Minimum Net Owned Fund(NOF)to start a NBFC is **Rs. 2 crore**
- For NBFC-MFI minimum NOF = **Rs. 5 crore**
- For NBFC-Factor minimum NOF = **Rs. 5 crore**
- For Mortgage Guarantee Company minimum NoF = **Rs. 100 crore**
- Deposit accepting NBFCs have to invest **15% of their public deposits in statutory liquid assets like government bonds. Of 15%, 10% in unencumbered approved securities and the remaining 5% in term deposits with Scheduled Commercial Banks**
- As per section **45-IC of RBI Act 1934**, every non-banking financial company shall create a reserve fund and transfer thereto a sum not less than **20 per cent of its net profit every year as disclosed in the profit and loss account before declaring any dividend(Called capital Reserve)**
- Maximum Interest Rate payable on public deposits by NBFCs should be **12.5 per cent per annum**
- All deposit taking NBFCs and non-deposit taking systemically important NBFCs **should maintain minimum CRAR of 15 per cent**

Introduction to Banking

The Banking Regulation Act, 1949 defines a banking company as a company which transacts the business of banking in India. **Banking is defined as accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise. Section 49A** of the Act prohibits any institution other than a banking company to accept deposits from the public withdrawable by cheque.

The Meaning of Banking

Bank is defined as an entity which carries on the business of banking. **Banking is “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, and order or otherwise.”**

- **Acceptance of deposits from public,**
- **Lending or investing the same**

Essential functions which are primary to any commercial bank

- a) Accepting deposits
- b) Granting loans and advances

Secondary functions

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These are as follows -

- 1) **Facilitating Payments:** Banks facilitate Payments through cheques which are a very convenient and safe mode of making payments. Cheques serve as a ready proof of the fact that the payment has been made.
- 2) **Issuing letters of credit:** Banks issue letters of credit, thus enabling businessmen to deal with strangers because payment is guaranteed by Bank so that both traders can undertake the business with mutual trust.
- 3) **Providing documentary and letter of credit,** guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposures.
- 4) **Discounting of Bills:** The banks lend money by discounting bills. Discounting a bill of exchange means the advancing of a loan against a promise to pay in future. This is a very popular method of lending as the loans are self liquidating.
- 5) **Collection of Cheques.** Banks also undertake to collect the amount of cheques, drafts, bills of exchange etc. on behalf of its customers.
- 6) **Transacting with foreign exchange** by either selling or purchasing foreign Exchange
- 7) **Remittance of Money:** If money is to be remitted to any other place, it can be done quickly through banks. Transferring money from one place to another; and from one branch to another branch of the bank is now easy with **NEFT/RTGS system.**
- 8) **Standing guarantee** on behalf of its customers, for making payments for purchase of goods, machinery, consignment

etc.

- 9) **Issuing Traveler's cheques**, circular notes etc to the travelers who can travel without carrying much currency and can withdraw money easily at any of the bank branches across the country by redeeming the traveler's cheques.
- 10) **Providing Investment, Portfolio management Services** to its customers
- 11) **Providing Lease and Hire purchase:** A **lease** is the use of an asset which belongs to some other person. In a **lease contract**, the possession and use of asset vests with the user called the '**lessee**', whereas the **ownership remains with the provider called the 'lessor'**. In simple words, **leasing is a method** by which a person gets the right to use an asset by paying a predetermined amount of money called '**rental**' periodically over a period of time. A **Hire purchase** is such a method, where in a buyer if cannot afford to pay the asked price for an item of property (Such as Vehicles) as a lump sum but can afford to pay a percentage as a deposit or **EMIs (Equated Monthly Installments)**, a **hire-purchase contract originates**. It allows the buyer to hire the goods for a monthly rent/EMI. When a sum equal to the original full price plus interest has been paid in equal installments, the buyer gets the option to own the product at a predetermined price or In case of default, Lessor gets back his product.
- 12) **Selling mutual Funds** and other Insurance products (Selling its own Insurance products or of other partner Insurance company to its customers by a bank is called **Bank Assurance**
- 13) **Providing Merchant banking Services:** Merchant banking division of a bank offers to industrial and business houses, under one roof, a wide range of non-banking services such as conducting of economic, technical and financial feasibility studies. It helps such organize and undertake market surveys. It helps its clients to obtain from the Government and other departments' **letters of intent, licences and permission** required for setting up the industrial projects. This service also includes advising the clients as to the **methods and terms of raising capital, organizing the public issue arranging for the underwriting, etc.**
- 14) **Underwriting Services:** This is a way of buying a newly issued stocks or bonds, from the share issuing company, if the banker has the underwriting agreement with the issuer and when the issuer could not find the enough investors, banks retain the unsubscribed portion of shares at a predetermined discounted price.
- 15) Customized services in accordance with the requirements of the customer (**Called Private Banking**)
- 16) **Providing 'Demat' Services (De-materialization of Shares)** to its customers
- 17) **Distribution or Brokerage**, with or without advice, of insurance, unit trusts and similar financial products as a "financial supermarket"
- 18) **Providing ASBA accounts:** ASBA (**Applications Supported by Blocked Amount**) is a process developed by the Stock Market Regulator **SEBI** enabling the investors to apply **Initial Public Offering (IPO)** without their bank account debited until shares are allotted to them.

Other Banking Services

Accepting deposits is not only one activity of a bank. Banks offer various other services to customers. In the context of banking, the services offered by a bank can be extremely wide.

Some of these are listed below:

Fund-based Services

Banks accept deposits and lends with the intention of deploying the money for a profit.

- ❖ The income that a bank earns, as a percentage of its loans and investments, is its **Gross Yield**.
- ❖ The interest it pays as a percentage of the resources mobilized is its **cost of funding**.
- ❖ **Gross Yield less the Cost of Funding** represents its **Gross Spread**.
- ❖ **Gross Spread less Administrative and Other Costs** is its **Net Spread**.

Fund-based services are thus a key determinant of the bank's spreads. The lending takes several forms.

Fund-based Services for Business People:

- 1) **Bank Overdraft:** It is a facility where the **account holder is permitted to draw more funds** that the amount in his **current account**
- 2) **Cash Credit:** It is an arrangement where the **working capital requirements of a business are assessed based on financial projections of the company**, and various norms regarding debtors, inventory and creditors. Accordingly, a **total limit is sanctioned**. At regular intervals, the actual drawing power of the business is assessed and accordingly, **funds are made available crediting the sanctioned amount in to his account directly**.
- 3) **Bill Purchase / Discount:** When **Party A supplies goods to Party B**, the payment terms may provide for a **bill**

of exchange (traditionally called **hundi**). A bill of exchange is an **unconditional written order from one person (the supplier of the goods) to another (the buyer of the goods), signed by the person giving it (supplier), requiring the person to whom it is addressed (buyer) to pay on demand or at some fixed future date, a certain sum of money, to either the person identified as payee in the bill of exchange, or to any person presenting the bill of exchange.**

- ❖ When payable on demand, it is a **Demand Bill**
- ❖ When payable at some fixed future date, it is a **Usance Bill**.

Thus the supplier of the goods can receive his money even before the buyer makes the payment, through a **Bill Purchase / Discount facility** with his banker. It would operate as follows:

- ❖ The supplier will submit **the bill of exchange**, along with Transportation Receipt to his bank.
- ❖ The supplier's bank **will purchase the bill (if it is a demand bill) or discount the bill (if it is a usance bill) and pay the supplier.**
- ❖ The supplier's bank will send the bill of exchange along with **Transportation Receipt to the buyer's bank, which is expected to present it to the buyer for payment, if it is a demand bill and for acceptance, if it is a usance bill.**
- ❖ The buyer will receive the Transportation Receipt only on payment or acceptance, as the case may be.

Fund-based Services for Individuals

- ❑ **Bank credit for individuals could take several forms, such as:**
- ❑ **Credit Card:** The customer swipes the credit card to make his purchase. His seller will then submit the details to the card issuing bank to collect the payment. **The bank will deduct its margin and pay the seller. The bank will recover the full amount from the customer (buyer). The margin deducted from the seller's payment thus becomes a profit for the card issuer.** So long as the customer pays the entire amount on the due date, he does not bear any financing cost. **He may choose to pay only the minimum amount specified by the bank.** In that case, the customer chooses to pay after due date, it is considered as a credit availed of by him. The bank will charge **him interest on the credit.** Such a mechanism of availing of credit from the credit card is called **revolving credit.** It is one of the **costliest sources of finance – upwards of 3% p.m.** Besides, even for a few days of delay in payment, the bank charges penalties. Similarly, penalties are charged if the credit card outstanding crosses the limit specified by the bank.
- ❑ **Personal Loan :** This is a form of **unsecured finance given by a bank to its customer based on past relationship.** The finance is given for 1 to 3 years. Cheaper than credit card, but costly. It is not uncommon to come across interest rates of 1.5% p.m. plus 2-3% upfront for making the facility available plus 3-5% foreclosure charges for amounts pre-paid on the loan. Normally such a loans are given for **salaried employees or taxpaying citizens.**
- ❑ **Vehicle Finance :** This is finance which is made available for the specific purpose of buying a car or a two-wheeler or other automobile. The finance is secured through **hypothecation of the vehicle financed.**
- ❑ **Home Finance :** This is finance which is made available against the security of real estate. The purpose may be to buy a new house or to repair an existing house or some other purpose. **The finance is secured through a mortgage of the property.**

Non-Fund-based Services

- ❑ **These are services, where there is no outlay of funds by the bank when the commitment is made. At a later stage however, the bank may have to make funds available. Since there is no fund outflow initially, it is not reflected in the balance sheet.** However, the bank may have to pay at later stages. Therefore, it is reflected as a **contingent liability in the Notes to the Balance Sheet.** Therefore, such exposures are called **Off Balance Sheet Exposures.** When the commitment is made, the bank charges a fee to the customer. Therefore, it is also **called fee-based business.**

Non-Fund-based Services for Business

- ❑ **Letter of Credit:** When **Party A supplies goods to Party B,** the payment terms may provide for a Letter of Credit. In such a case, **Party B (buyer or opener of L/C) will approach his bank (L/C Issuing Bank)** to pay the beneficiary (seller) the value of the goods, by a specified date, against presentment of specified documents. The bank will charge the **buyer a commission, for opening the L/C.** The L/C thus allows the **Part A to supply goods to Party B, without having to worry about Party B's credit-worthiness.** It only needs to trust the bank that has issued the L/C. It is for the L/C issuing bank to assess the credit-worthiness of Party B. Normally, the L/

C opener has a finance facility with the L/C issuing bank. **The L/C may be inland (for domestic trade) or cross border (for international trade).**

- ❑ **Bank Guarantee:** In business, parties make commitments. How can the beneficiary of the commitment be sure that the party making the **commitment (obligor)** will live up to the commitment? This comfort is given by a guarantor, whom the beneficiary trusts. Banks issue various guarantees in this manner, and recover a guarantee commission from the obligor. The guarantees can be of different kinds, such as **Financial Guarantee, Deferred Payment Guarantee and Performance Guarantee**, depending on how they are structured.
- ❑ **Whole sale banking for making available Project Finance:** ‘Whole sale banking’ means lending to very large institutions/corporate companies/Industries. Banks also perform the role of **working capital financing for big corporate companies/Industries**. Banks would assess the viability of the project, arriving at a suitable debt financing facilities. At times, **the main banker may form a syndicate with other banks** to meet the huge project finance requirements. This is called **Loan Syndication/Bank Syndication or Consortium Banking**.

For Individuals

- ❑ Sale of Financial Products such as **mutual funds and insurance is another major service offered by commercial banks**. Such services are known as **Bancassurance Services**.
- ❑ Financial Planning and Wealth Management
- ❑ Executors and Trustees – a department within banks – help customers in managing succession of assets to the survivors or the next generation. Lockers – a facility that most Indian households seek to store ornaments and other valuables.

Different Modes of Money Remittance Services

Demand Draft / Banker's Cheque / Pay Order

Suppose A needs to make a payment to B. In the normal course, A would sign a cheque for the requisite amount and give it to B.

- ❖ If it is a **bearer cheque**, B can go to A's bank and withdraw the money.
- ❖ If it is a **crossed cheque**, B will deposit the cheque in his bank account or can **endorse (Transfer)** that cheque on any other's name. But cheque is payable only through a bank account.
- ❖ If it is an **A/C Payee only** cheque B will deposit the cheque in his bank account but he cannot endorse it on to any other person. Because endorsement of cheque is restricted by issuer writing ‘A/C Payee only’

B wants to be sure that the money would be received i.e. the cheque would not be bounced for any reason. In such a situation, B will insist on a **Demand Draft / Banker's Cheque**. **If both A and B are in the same city, then the bank would issue a Pay Order**. A will have to buy the instrument from a bank, bearing the prescribed charges. A will then send it to B, who will deposit it in his bank account.

National Electronic Funds Transfer (NEFT)

- ❑ **What is NEFT?** - **National Electronic Funds Transfer (NEFT)** is a nation-wide payment system facilitating **one-to-one funds transfer**. Under this Scheme, individuals, firms and corporates can **electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country**. For being part of the NEFT funds transfer network, a bank branch has to be NEFT-enabled
- ❑ **Who can transfer funds using NEFT?** -Individuals, firms or corporates maintaining accounts with a bank branch can transfer funds using NEFT. Even such **individuals who do not have a bank account (walk-in customers)** can also deposit cash at the NEFT-enabled branches with instructions to transfer funds using NEFT. However, such cash remittances will be restricted to a maximum of **Rs.50,000/- per transaction**. Such customers have to furnish full details including complete address, telephone number, etc
- ❑ **What is IFSC?**- In order to issue the instruction, the transferor should know not only the beneficiary's bank account no. but also the **IFSC (Indian Financial System Code)** of the concerned bank. **IFSC is an alpha-numeric code that uniquely identifies a bank-branch participating in the NEFT system. This is an 11 digit code with the first 4 alpha characters representing the bank, and the last 6 numeric characters representing the branch. The 5th character is 0 (zero)**. The settlement of funds between originating and receiving banks takes places centrally at **Mumbai**. **IFSC is used by the NEFT system** to route the messages to the destination banks / branches. Once the NEFT instruction has been issued, it will be affected between the concerned banks in the next settlement. During weekdays, between **8 am and 7 pm, there are 12 settlements i.e. every hour**. On Saturdays, there are **6 hourly settlements between 8 am and 1 pm**.

- ❑ **Transfer of Funds through RTGS system: RTGS stands for Real Time Gross Settlement.** It is quite similar to the **NEFT or National Electronic Fund Transfer system.** However, the key difference is how long a transaction takes to be completed. As the name suggests, in the RTGS system, **transactions are processed and settled continuously in real time and funds are transferred immediately.** In the **NEFT system, payments are deferred.**
- ❑ NEFT transactions are processed on an hourly basis when conducted during operable hours. **NEFT** is an electronic fund transfer system that operates on a **Deferred Net Settlement (DNS) basis** which settles transactions in batches. In DNS, the settlement takes place with all transactions received till the particular **cut-off time.** These transactions are netted (payable and receivables) in NEFT whereas in RTGS the **transactions are settled individually.** For example, currently, NEFT operates in hourly batches. **[There are twelve settlements from 8 am to 7 pm on week days and six settlements from 8 am to 1 pm on Saturdays.]** Any transaction initiated under NEFT, after a designated **settlement time** would have to wait till the next designated settlement time. Contrary to this, in the **RTGS transactions are processed continuously throughout the RTGS business hours.**
- ❑ **What is the essential information that the remitting customer would have to furnish to a bank for the remittance to be effected?-** The remitting customer has to furnish the following information to a bank for initiating a RTGS remittance:
 - a) Amount to be remitted
 - b) Remitting customer's account number which is to be debited
 - c) Name of the beneficiary bank and branch
 - d) The IFSC Number of the receiving branch
 - e) Name of the beneficiary customer
 - f) Account number of the beneficiary customer
 - g) Sender to receiver information, if any

Transfer Funds through IMPS using Mobile Number and MMID

- ❑ The key requirement for sending money through RTGS or NEFT payment systems is to add the payee's details. This often takes an entire day to process. If you do not want to wait, and instead would want to send the money immediately, the **Immediate Payment Service (IMPS)** is for you. As many as 60 banks offer this service, according to the **National Payments Corporation of India**
- ❑ **The IMPS system** is available on both the phone and the computer, but is predominantly used by those opting for **mobile banking services.** The key requirement for an IMPS transaction is not your bank account number, but your mobile number. You will need to register your mobile number and generate your MMID. The **Mobile Money Identifier (MMID)** is a **7 digit code** issued by a participating bank to their customer registered for mobile banking. Every account will have a unique **MMID**
- ❑ This ensures its identification and security. So, to transfer money, **both the sender and receiver need to generate their MMID.** Then, you can log on to your bank's internet or mobile banking portal, and click on fund transfer via IMPS. Enter details of the mobile number, the MMID and the transaction amount. Then, punch in your transaction passwords and debit card details to verify the transaction. That's it. You are now done. **This can be done 24x7 unlike NEFT and RTGS transactions.** Banks may charge a small amount between Rs 2.5 and 15 for such transactions. **This is excluding the service tax**
- ❑ **How to Transfer Funds through IMPS using Account Number and IFSC Code?-**The IMPS system needs both the recipient and sender to register their mobile numbers and generate the MMID. **But what if the recipient is not registered or may be has no valid mobile number?**
To help such customers, an IMPS transaction can also be conducted using the **recipient's bank account number and IFSC Code**
- ❑ **The Indian Financial System Code (IFSC)** is a unique code that helps identify which bank the account belongs to and the branch details. Once this is identified, the payment is directly transferred to the bank account. This can also be done 24x7. The bank charges may be the same as an IMPS transfer using mobile number and **MMID**

Indian Financial Network

The **INDIAN FINANCIAL NETWORK [INFINET]** is the **communication backbone for the Indian Banking and Financial Sector.** All banks in the public sector, private sector, cooperative, etc., and the premier financial institutions in the country are eligible to become members of the INFINET. The INFINET is a Closed User Group Network for the exclusive use of member banks and financial institutions and is the communication backbone for the

National Payments System, which caters mainly to inter-bank applications like RTGS, Delivery Vs Payment, Government Transactions, Automatic Clearing House, etc.

International electronic Fund transfer through SWIFT

- ❑ **SWIFT** – ‘Society for Worldwide Interbank Financial Telecommunications’ is solely a carrier of messages between the banks exchanging their financial data pertaining to their electronic fund transfers. **It does not hold funds nor does it manage accounts on behalf of customers, nor does it store financial information on an on-going basis.**
- ❑ As a data carrier, SWIFT transports messages between two financial institutions. This activity involves the secure exchange of proprietary data while ensuring its confidentiality and integrity. SWIFT, which has its headquarters in **Belgium, has developed an 8-alphabet Bank Identifier Code (BIC).**
- ❑ For instance **HDFCINBB** stands for: HDFC = HDFC Bank, IN = India, BB = Mumbai. Thus, the **BIC** helps identify the bank. **A typical SWIFT instruction would read as follows:** Please remit [amount in US\$] by wire transfer To HDFC Bank Mumbai from Account Number V801-890-0330-937 with Bank of New York, New York [Swift code IRVTUS3N] for further credit to account number XXXXXXXXXXXXXXXX of Advantage-India Consulting Pvt. Ltd with HDFC Bank, Bhandra East Branch, Mumbai 400077, India.

Different Channels of e-payments in India

Automated Teller Machines (ATMs)

Initially, all banking services were offered from the bank branches. **Automated Teller Machines (ATMs)** made it possible for customers to handle their transactions at multiple ATM locations across the country. For transacting at an ATM, the customer inserts /swipes his/her Card in the ATM and enters his/her Personal Identification Number (PIN) issued by his/her bank. As per RBI guidelines, customers are entitled to **5 FREE transactions (Financial and Non-Financial) in a calendar month (for Savings Bank account holders only). Reserve Bank had put a Rs 10,000 cap** per withdrawal from ATMs not owned by the bank in which the customer has an account, besides limiting such transactions to five in a month. **Rs 20/- per transaction is charged beyond this limit.** In the last three years, the number of ATMs has more than doubled to 1, 62,543 from 74,355.

ATM Features:

- ❖ **Cash Withdrawal:** The most popular service on our ATMs enables customers to withdraw up to a daily limit of Rs. 40,000/- (limit on Classic Debit Card. Higher value cards permit daily withdrawal limits of up to Rs. 1 lakh per day)
- ❖ **Fast Cash:** A service which enables you to withdraw your preferred amounts with just a touch. The options in the denomination of 100, 200, 500, 1000, 2000, 3000, 5000, 10,000 are available.
- ❖ **Pin Change:** One can change password at regular intervals.
- ❖ **Balance Enquiry:** One can view the balance which is displayed on the screen else can get a transaction receipt by selecting print.
- ❖ **Mini statement: one can keep** track of the transactions in their account by availing this service. Mini-statement gives an insight into the last 10 transactions in your account.
- ❖ **Card to Card Transfer:** Send cash in a flash from Debit Card to the other. Using this free and easy service, one can transfer up to Rs. 30,000/- per day instantly to anyone. All one need is Bank’s debit card cum ATM Card, PIN and the beneficiary’s debit card number. (Per transaction limit of Rs. 15,000/-).
- ❖ **Credit Card Payment:** Use this service to pay the bill of any Visa credit card.
- ❖ **Mobile Top-up:** One can recharge mobile prepaid connection from ATMs.
- ❖ **Cheque Book Request:** Order your cheque book without visiting the branch or filling in any transaction slips
- ❖ **Trust Donation: one can** make a donation to favorite charity.
- ❖ **Bill payment: One can** Use ATMs to pay their utility bills viz. bills of State Electricity Boards/Telephone bills/Tax authorities etc
- ❖ **Inter-mobile Mobile Payment System:** One can register for the IMPS service at all ATMs. This service allows one to transfer money to any other person with a registered IMPS number instantly.
- ✓ **White label ATM:** These are ATM’s which are not owned by banks but by private ATM service providers. Customers from any bank can deposit or withdraw money from such ATM’s. Banks pay a service fee to **White label ATM providers.**
- ✓ **Brown label ATMs:** The ATM is named under the brand of the sponsor bank but the ATM machine is not owned by the bank.

Some other different Types of ATMs which are deployed by banks and other financial institutions for specific purposes are as Follows:

- 1) **On site ATM** within the premises of bank
- 2) **Off site ATM** Outside the bank premises
- 3) **Worksite ATM** located within the premises of an organization and is generally meant only for the Employees of the organization.
- 4) **Cash Dispenser** Allows only cash withdrawals, balance enquiry and mini statement requests, cash
- 5) **Mobile ATM** refers to an ATM that moves in various areas for the customers.
- 6) **White Label ATM** Provided by NBFC
- 7) **Green Label ATM** Provided for Agricultural Transaction
- 8) **Orange Label ATM** Provided for Share Transactions
- 9) **Yellow Label ATM** provided for E-commerce
- 10) **PINK label ATM** For women banking

National Financial Switch (NFS) is the largest network of shared **Automated teller machines (ATMs)** in India. It was designed, developed and deployed by the **Institute for Development and Research in Banking Technology (IDRBT), Hyderabad**. It is run by the **National Payments Corporation of India (NPCI)**.

- * The first ATM in India was set up in 1987 by the **Hongkong and Shanghai Banking Corporation in Mumbai**.
- * In 1997, the **Indian Banks' Association (IBA) set up Swadhan**, the first network of shared ATMs in India.
- * After the collapse of **Swadhan, Bank of India, Union Bank of India, Indian Bank, United Bank of India and Syndicate Bank** formed an ATM-sharing network called **Cash Tree**.
- * Later **Citibank, the Industrial Development Bank of India, Standard Chartered Bank and UTI Bank** formed a similar network called **Cashnet**.
- * **MITR** is a Multi lateral ATM Network Sharing arrangement of 6 member Banks in India namely Punjab National Bank (PNB), Oriental Bank of Commerce (OBC), Indian Bank, Karur Vysya Bank, IndusInd Bank, UCO Bank
- * **RuPay is an Indian domestic card scheme** conceived and launched by the **National Payments Corporation of India (NPCI)**. It was created to fulfill the **Reserve Bank of India's desire to have a own, domestic, open loop, and multilateral system of payments in India**. RuPay facilitates electronic payment at all Indian banks and financial institutions, and competes with **MasterCard and Visa in India**. NPCI maintains ties with **Discover Financial to enable the card scheme to gain international acceptance**.
- * **Bharat Bill Payment System (BBPS)** is an integrated bill payment system in India offering interoperable and accessible bill payment service to customers through a network of agents, enabling multiple payment modes, and providing instant confirmation of payment.
- * The **Kisan Credit Card Scheme** was launched by **NABARD** in order to meet the credit needs of farmers, so that they can be free of paper money hassles and use only plastic money.

General Principles of Banking as regulated by RBI

- **The Reserve Bank of India** was established on **April 1, 1935** in accordance with the provisions of the **Reserve Bank of India Act, 1934**. The Central Office of the **Reserve Bank** was initially established in **Calcutta** but was permanently moved to **Mumbai in 1937**.
- The **Central Office is where the Governor sits and where policies are formulated**. Though originally privately owned, since **nationalization in 1949**, the Reserve Bank is fully owned by the Government of India.
- **Central Board:** The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act. **Appointed/nominated for a period of four years**
- It comprises **one Governor and not more than four Deputy Governors and Non-Official Directors** Nominated by Government who are ten in numbers and are drawn from various fields and two government Officials. There are also four Directors, one each from four local boards representing 4 corners of the country namely Mumbai, Calcutta, Chennai and New Delhi. It has 19 regional offices, most of them in **state capitals and 9 Sub-offices**.
- It also has **five training establishments** of which two, namely, **College of Agricultural Banking and Reserve Bank of India Staff College** are part of the Reserve Bank. Others are autonomous, such as, **National Institute for Bank Management, Indira Gandhi Institute for Development Research (IGIDR), Institute for Development and Research in Banking Technology (IDRBT)**

- It also have Fully owned subsidiaries namely **Deposit Insurance and Credit Guarantee Corporation of India(DICGC) Mumbai, Bharatiya Reserve Bank Note Mudran Private Limited(BRBNMPL) Mysore.**
- The **Reserve Bank of India** performs various functions under the guidance of the **Board for Financial Supervision (BFS)**. The Board was constituted in November 1994 as a committee of the Central Board of Directors of the Reserve Bank of India. Primary objective of BFS is to undertake **consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies (NBFCs)**. The Board is required to meet normally **once every month**.

Legal Framework of RBI

Umbrella Acts

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

Acts governing specific functions

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

Acts governing Banking Operations

- ❖ **Companies Act, 1956**:Governs banks as companies
- ❖ **Banking Companies (Acquisition and Transfer of Undertakings) Act,**

- ❖ **1970/1980**: Relates to nationalization of banks
- ❖ **Bankers’ Books Evidence Act 1891**
- ❖ **Negotiable Instruments Act, 1881**
- ❖ **State Bank of India Act, 1954**
- ❖ **The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003**
- ❖ **The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993**
- ❖ **National Bank for Agriculture and Rural Development Act 1981**
- ❖ **National Housing Bank Act 1987**
- ❖ **Deposit Insurance and Credit Guarantee Corporation Act 1961(Amended 2006)**
- ❖ **The Foreign Contribution (Regulation) Act (FCRA), 2010**
- ❖ **The Credit Information Companies (Regulation) Act, 2005**
- ❖ **The Prevention of Money- Laundering Act, 2002 / The Government Securities Act, 2006**
- ❖ **The Securities Contracts (Regulation) Amendment Act, 2007**

How RBI Functions to regulate Banking and Finance sector?

The Reserve Bank is the central bank or Apex bank for numerous activities, all related to the nation’s financial sector, encompassing the following functions there by controlling entire banking sector.

Regulation and supervision of the financial system

RBI is the regulator and supervisor of the financial system. Its objectives are to maintain **efficient financial system, protect depositors’ interest and provide cost-effective banking services to the public.** RBI now covers the regulation of **Commercial banks (91), All India Financial Institutions (5),Credit Information Companies (4), Regional Rural Banks (56) and Local Area Banks (4)** The tools used by RBI for regulation are **statutory, prudential regulation, other regulatory guidelines and moral suasion through speeches of Governor, Deputy Governors and periodic meetings, seminars, etc.**

Regulation of commercial banks in India by RBI

- a) **Licensing of commercial banks:** To do a business of commercial banking in India, **whether it is India or Foreign, a license from RBI is required. Opening of Branches is handled by the Branch Authorization Policy.** This policy was made easier in recent times and an important provision is that **Indian banks no longer require a license from the Reserve Bank for opening a branch at a place with population of below 50,000.**
- b) **Corporate Governance:** RBI policy ensures high quality corporate governance in banks. Even in approving appointments of chief executive officers (private sector and foreign banks) and their compensation packages, RBI has a role now.RBI also **oversees the amalgamation, reconstruction and liquidation of banking companies.**
- c) **Monitoring maintenance of SLR and CRR by banks: CRR and SLR, these are called Statutory Pre-**

emptions. Commercial banks are required to maintain a certain portion of their **Net Demand and Time Liabilities (NDTL)** in the **form of cash with the Reserve Bank**, which is called **Cash Reserve Ratio (CRR)** and in the form of investment in approved government securities and certain liquid assets to meet bank's daily liquidity requirements. It is called **Statutory Liquidity Ratio (SLR)**.

- d) **Interest Rates:** The **interest rates** on most of the categories of deposits and lending transactions. These have been **deregulated and are largely determined by banks**. Now Reserve Bank regulates the interest rates on **deposits of non-resident Indians (NRI), small loans up to rupees two lakh, export credits and a few other categories of advances**.
- e) **Prudential Norms:** RBI issues **"Prudential Norms"** to be followed by the commercial banks to strengthen the balance sheets of banks. RBI has issued its guidelines under the **Basel II /III** for risk management. Now all banks are required to disclose in their annual reports about capital adequacy, asset quality, liquidity, earnings aspects and penalties, if any, imposed on them. Similarly, the **KYC norms (Know Your Customer) Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) guidelines** are some of the major issues on which RBI keeps issuing its norms and guidelines
- f) **Annual Onsite Inspection:** RBI undertakes annual on-site inspection of banks to assess their financial health and to evaluate their performance in terms of quality of management, capital adequacy, asset quality, earnings, liquidity position as well as internal control systems.
- g) Based on the findings of the inspection, banks are assigned supervisory ratings based on the **CAMELS rating**. (C- **Capital adequacy/A -Asset quality/ M - Management quality/ E – Earnings/ L – Liquidity/S-Sensitivity to Market Risk**)
- h) **OSMOS:** OSMOS refers to **Off Site Surveillance and Monitoring System**. The RBI requires banks to submit detailed information periodically under **OSMOS**. On the basis of **OSMOS**, RBI **analyzes the health of the banks**.
- i) **Policy issues:** Issues relating to **customer service, Anti-Money Laundering and Combating Financing of Terrorism and issuing of instructions regarding KYC etc are from time to time issued by RBI**

General Framework of Regulation by RBI

The existing regulatory framework under the Banking Regulations Act 1949 can be categorized as follows:

- a) Business of Banking Companies
- b) Licensing of new banking companies whenever RBI feels necessary at a time **but not on a regular scale**.
- c) Control over Management of Banks
- d) **Merger and Acquisition (M&A)** of the Undertakings of banking companies in certain cases
- e) Restructuring and Resolution including winding up operation
- f) Penal Provisions

Licensing of banks

In terms of **Sec 22 of the Banking Regulation Act**, no company shall carry on banking business in India, unless it holds a license issued in that behalf by Reserve Bank.

Business of banking: As per **Section 5 (b) of Banking Regulation Act, 1949** 'Banking' means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.

Policy of issuing license to banks in India

Licensing of foreign banks

Procedurally, foreign banks are required to apply to RBI for **opening their branches in India**. Foreign banks' application for opening their maiden branch is considered under the provisions of **Sec 22 of the BR Act, 1949**. Before granting any license under this section, RBI may require being satisfied that the Government or the law of the country in which it is incorporated does not discriminate in any way against banks from India.

- **Foreign banks** are required to bring an assigned capital of **US \$25 million up front at the time of opening the first branch in India**.
- **As against the requirements of achieving 40 per cent of net bank credit as target for lending to priority**

sector in case of domestic banks, it has been made mandatory for the foreign banks having less than 20 branches to achieve the minimum target of 32% of net bank credit for priority sector lending. For the foreign banks having more than 20 branches Priority sector lending of 40 per cent of net bank credit is mandatory.

- Within the PSL target two sub targets in respect of advances (a) to small scale sector (minimum of 10%), and (b) exports (minimum of 12%) have been fixed. The foreign banks are not mandated for targeted credit in respect of agricultural advances.
- There is no regulatory prescription in respect of foreign banks to open branches in rural and semi-urban centres.

Foreign Direct Investments in Indian Banks

- The RBI has allowed **Foreign Direct Investment (FDI)** up to **74%** in the Indian private banks. The FDI limit in Indian private banks has been increased to **74% from the previous 49%** in the mini-budget, 2004-2005. The FDI hike is only available to a *regulated wholly owned subsidiary of a foreign bank* in India. **The 74% limit in Indian private bank can only be through direct or portfolio route (that means through acquisition of shares in the secondary market (share market) without any management interest only).**
- The 74% foreign holding would include **FDI; Foreign Institutional Investment (FII), NRIs, initial public offer, private placements and ADRs/GDRs.** Interested foreign investors should have mandatory credit rating and permission from the RBI.
- The **current FDI norms** are not applicable to **Public Sector Banks (PSBs)** where the **foreign investment ceiling is fixed to 20%**. Earlier the limit of **foreign participation through FDI route was 49%** and through **Foreign Institutional Investment (FII) it was same 49%** totaling to **98%** of foreign participation, which is now **decreased to 74%**.
- In **March 2006**, the **Reserve Bank of India** allowed **Warburg Pincus** to increase its stake in **Kotak Mahindra Bank to 10%**. This is the first time a **foreign investor** has been allowed to **hold more than 5% in a private sector bank since the RBI announced norms in 2005** that any stake exceeding 5% in the private sector banks would need to be approved by them.
- In **1991**, **Reserve Bank of India** formulated **guidelines for the establishment of new private sector banks in India.** According to these guidelines, a **new bank** was required to have a **minimum capital of Rs. 100 crore** and to observe the **Capital Adequacy Ratio (CAR) norm of 8% from the very beginning.**
- In **2001**, these guidelines were revised with the effect that the amount of capital has been raised to **Rs. 200 crore (further raised to Rs. 500 crore recently)** and **capital adequacy Ratio** was raised to **9%**.
- **Recently RBI has mooted proposal for Licensing New Private sector banks and it is proposed that minimum capital** requirement for a private bank would be **Rs. 500 crore**
- The **minimum authorized capital of nationalized banks** is **Rs. 1500 crore each.** The Central Government has subscribed to the **100% paid-up capital** in case of some banks (Currently **Government holds 100% shares in Bharatiya Mahila Bank (BMB)**), while in other cases its percentage holding has declined with the issuance of shares to the public.
- **Every commercial Bank must transfer 20% (now 25%) of their net profits to a Statutory Reserve Fund every year mandatorily.**

New guidelines for issuing new bank licenses

The Reserve Bank of India (RBI) released the final guidelines for issuing new bank licenses on February 22, 2013 and later as per industry queries finalized the guide lines on June 5th 2013. The key features of the guidelines are:

1. **Eligible promoters:** Entities/groups in the private sector, entities in public sector and **non-banking financial companies (NBFCs)** shall be eligible to set up a bank through a wholly-owned **Non-operative financial holding company (NOFHC).**
2. **'Fit and proper' criteria:** Entities/groups should have a past record of sound credentials and integrity, be financially sound with a successful track record of 10 years. For this purpose, the RBI may seek feedback from other regulators and enforcement and investigative agencies.
3. **Corporate structure of the NOFHC:** The NOFHC shall be wholly owned by the promoter/promoter group.

The NOFHC shall hold the bank as well as all the other financial services entities of the group.

4. **Minimum voting equity capital requirements for banks and shareholding by NOFHC:** The initial minimum paid-up voting equity capital for a bank shall be Rs. 5 billion. The NOFHC shall initially hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of five years and which shall be brought down to 15 per cent within 12 years. The bank shall get its shares listed on the stock exchanges within three years of the commencement of business by the bank.
5. **Regulatory framework:** The bank will be governed by the provisions of the relevant Acts, relevant Statutes and the Directives, Prudential regulations and other Guidelines/Instructions issued by RBI and other regulators. The NOFHC shall be registered as a **non-banking finance company (NBFC)** with the RBI and will be governed by a separate set of directions issued by RBI.
6. **Foreign shareholding in the bank:** The aggregate non-resident shareholding in the new bank shall not exceed 49 per cent for the first 5 years after which it will be as per the extant policy.
7. **Corporate governance of NOFHC:** At least 50 per cent of the directors of the NOFHC should be independent directors. The corporate structure should not impede effective supervision of the bank and the NOFHC on a consolidated basis by RBI.
8. **Prudential norms for the NOFHC:** The prudential norms will be applied to NOFHC both on stand-alone as well as on a consolidated basis and the norms would be on similar lines as that of the bank.
9. **Exposure norms:** The NOFHC and the bank shall not have any exposure to the promoter group. The bank shall not invest in the equity/debt capital instruments of any financial entities held by the NOFHC.
10. The bank shall open at least **25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census)**

Regulating of Co-operative Banking

- The **rural co-operative credit system in India** is primarily mandated to ensure **flow of credit to the agriculture sector**. It comprises **short-term and long-term co-operative credit structures**.
- The **short-term co-operative credit structure** operates with a '**three-tier system**'
 - 1) **Primary Agricultural Credit Societies (PACS) at the village level**
 - 2) **Central Cooperative Banks (CCBs) at the district level**
 - 3) **State Cooperative Banks (StCBs) at the State level.**
- **PACS are outside the purview of the Banking Regulation Act, 1949 and hence not regulated by the Reserve Bank of India.**
- **StCBs/DCCBs are registered under the provisions of State Cooperative Societies Act of the State concerned and are regulated by the Reserve Bank. Powers have been delegated to National Bank for Agricultural and Rural Development (NABARD) under Sec 35-A of the Banking Regulation Act (As Applicable to Cooperative Societies) to conduct inspection of State and Central Cooperative Banks.**
- **Primary Cooperative Banks (PCBs), also referred to as Urban Cooperative Banks (UCBs), cater to the financial needs of customers in urban and semi-urban areas. UCBs are primarily registered as cooperative societies under the provisions of either the State Cooperative Societies Act of the State concerned or the Multi State Cooperative Societies Act, 2002 if the area of operation of the bank extends beyond the boundaries of one state.**
- **Though the Banking Regulation Act came in to force in 1949, the banking laws were made applicable to cooperative societies only in 1966 through an amendment to the Banking Regulation Act, 1949. Since then there is duality of control over these banks with banking related functions being regulated by the Reserve Bank and management related functions regulated by respective State Governments/Central Government.**
- The Reserve Bank regulates the banking functions of **StCBs/DCCBs/UCBs under the provisions of Sections 22 and 23 of the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies (AACS)).**
- Recently, to **revive Cooperative banking structure**, The Reserve Bank, in close co-ordination with other regulators, such as, Registrar of Co-operative Societies and Central Registrar of Co-operative Societies, tries to bring in **financial discipline in cooperative banking**. As part of the arrangements under MoU, the Reserve Bank constitutes a State-level **Task Force for Co-operative Urban Banks (TAFUCB) for Urban Co-operative Banks (UCBs)** which operate only in one State. A Central TAFUCB is constituted for the Multi-State UCBs.

Regulation of Regional Rural Banks (RRBs)

- **Regional Rural Banks (RRBs) were established in 1975 under the provisions of the Ordinance promulgated on the 26th September 1975 and followed by Regional Rural Banks Act, 1976 with a view to develop the rural economy and to create a supplementary channel to the ‘Cooperative Credit Structure’ with a view to develop institutional credit for the rural and agriculture sector.**
- **The RRB structure is different from other scheduled commercial banking structure and is under dual control of RBI and NABARD.**
- **Regional Rural Banks are supervised and regulated by National Bank for Agriculture and Rural Development (NABARD). Only aspects of ‘banking business ‘and other rules applicable to any other commercial banks are also made applicable to RRBs, as issued by RBI from time to time. Normally, Government of India, the concerned State Government and the Bank, which had sponsored the RRB, contributes to the share capital of RRBs in the proportion of 50%, 15% and 35%, respectively.**
- **Thus every bank was to be sponsored by a “Public Sector Bank”, however, RRBs were planned as the self sustaining credit institution procuring various sources of funds comprising of owned fund, deposits, borrowings from NABARD, Sponsor Banks and other sources including SIDBI and National Housing Bank etc.**
- **The area of operation of the RRBs is limited to notify few districts in a State.**
- **The Regional Rural Banks (Amendment) Bill, 2014 was introduced by the Minister of Finance, Mr. Arun Jaitley, in Lok Sabha on December 18, 2014. The Bill seeks to amend the Regional Rural Banks Act, 1976. The Act mandates that of the capital issued by a RRB, 50% shall be held by the central government, 15% by the concerned state government and 35% by the sponsor bank. The Bill allows RRBs to raise their capital from sources other than the central and state governments, and sponsor banks.**
- **In such a case, the combined shareholding of the central government and the sponsor bank cannot be less than 51%. Additionally, if the shareholding of the state government in the RRB is reduced below 15%, the central government would have to consult the concerned state government.**
- **The RBI in 2001 constituted a Committee under the Chairmanship of Dr V S Vyas on “Flow of Credit to Agriculture and Related Activities from the Banking System” which examined relevance of RRBs in the rural credit system and the alternatives for making it viable. The consolidation process thus was initiated in the year 2005 as per recommendation of Dr. Vyas Committee.**
- **First phase of amalgamation was initiated Sponsor Bank-wise within a State in 2005 and the second phase was across the Sponsor banks within a State in 2012. As a result of amalgamation, number of the RRBs has been reduced from 196 to 56 as of now.**
- **Reserve Bank of India had recently laid down ceilings on the rate of interest to be charged by these RRBs. However from August 1996 the RRBs have been granted freedom to fix rates of interest, which is usually in the range of 14-18% for advances.**

New differentiated bank structure-Payments Banks

On 23 September 2013, **Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, headed by Nachiket Mor** has recommended the formation of a new category of bank called **Payments banks**.

The objectives of setting up of payments banks will be to further financial inclusion by providing (i) **small savings accounts** and (ii) **payments/remittance services to migrant labor workforce, low income households, small businesses, other unorganized sector entities and other users.**

Eligible promoters for Payments Banks

- a) **Existing non-bank Pre-paid Payment Instrument (PPI) issuers (Like Airtel Money/Voda phone m-pesa) and other entities such as individuals / professionals; Non-Banking Finance Companies (NBFCs), corporate Business Correspondents(BCs), mobile telephone companies, super-market chains, companies, real sector cooperatives; that are owned and controlled by residents; and public sector entities may apply to set up payments banks.**
- b) **A promoter/promoter group can have a joint venture with an existing scheduled commercial bank to set up a**

payments bank. However, scheduled commercial bank can take equity stake in a payments bank to the extent permitted under **Section 19 (2) of the Banking Regulation Act, 1949.**

- c) Promoter/promoter groups should be **'fit and proper'** with a sound track record of professional experience or running their businesses for at least a period of five years in order to be eligible to promote payments banks.

What are of Payment the functions Banks?

- Acceptance of demand deposits. Payments bank will initially be restricted to holding a maximum balance of Rs. 100,000 per individual customer.
- Issuance of ATM/debit cards. Payments banks, however, cannot issue credit cards.
- Payments and remittance services through various channels.
- Business Correspondent (BC)** of another bank, subject to the Reserve Bank guidelines on BCs.
- Distribution of non-risk sharing simple financial products like mutual fund units and insurance products, etc.

What are the statutory requirements of Payment Banks?

- The payments bank **cannot undertake lending activities**
- Apart from amounts maintained as **Cash Reserve Ratio (CRR)** with the Reserve Bank on its outside demand and time liabilities, it will be required to invest minimum **75 per cent of its "demand deposit balances"** as **Statutory Liquidity Ratio (SLR)** in eligible **Government securities/treasury bills** with maturity up to one year and hold maximum **25 per cent in current and time/fixed deposits** with other scheduled commercial banks for operational purposes and liquidity management.
- Capital requirement: The minimum paid-up equity capital for payments banks shall be **Rs. 100 crore**. The payments bank should have a leverage ratio of not less than **3 per cent, i.e., its outside liabilities should not exceed 33.33 times its net worth (paid-up capital and reserves)**.

Small Finance Banks (SFBs)

- These are a type of **new differentiated banks in India which are to be licensed by RBI soon**. Banks with a **small finance bank license can provide basic banking service of acceptance of deposits and lending**. The aim behind these to provide financial inclusion sections of the economy not being served by other banks, **such as small business units, small and marginal farmers, micro and small industries and un organized sector entities**.
- The firms must have a **capital of 100 crore**. Existing **non-banking financial companies (NBFC), micro-finance institutions (MFI) and local area banks (LAB)** are allowed to set up small finance banks.
- The promoters should **have 10 years experience in banking and finance**. The promoters of stake in the **paid-up equity capital will 40%** initially which must be brought down to 26% in 12 years. Joint ventures are not permitted. Foreign share holding will be allowed in these banks as per the rules for FDI in private banks in India.
- The banks will not be restricted to any region. **75% of its net credits should be in priority sector lending and 25% of the loans in its portfolio must in 25 lakh range**.

RBI as an Issuer of Currency

- Under **Section 22 of the Reserve Bank of India Act**, the Bank has the **sole right to issue bank notes of all denominations**.
- However the distribution of **one rupee notes and coins and small coins all over the country** is undertaken by the **Reserve Bank as agent of the Government**.
- The Reserve Bank has a separate **Issue Department** which is entrusted with the issue of **currency notes**. The **assets and liabilities of the Issue Department** is kept separate from those of the Banking Department.
- **The Reserve Bank has the authority to issue notes up to value of Rupees Ten Thousand**.
- **Originally, the Issue Department** was required to **maintain some proportionate gold and Pound sterling reserves** to the total issue of currency. In other word it means that of the **value of the proposed volume of currency to be printed and circulated, not less than two-fifths or 40% of gold bullion or sterling securities had to be kept as security assets**. The remaining **three-fifths of the assets might be held in currency, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India**. This method was called as **Proportional Reserves Method**.

- Later these provisions were considerably modified. Since **1956**, the Reserve Bank of India is required to maintain **gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold**. This system thus prescribes merely a **minimum percentage of gold reserves** against notes and deposits and makes the notes a first charge on all the assets of the central bank. The system as it exists today is known as the **Minimum reserve Method**.
- **Four printing presses actively print notes: Dewas in Madhya Pradesh, Nasik in Maharashtra, Mysore in Karnataka, and Salboni in West Bengal**. The presses in Madhya Pradesh and Maharashtra are owned by the **Security Printing and Minting Corporation of India (SPMCIL)**, a wholly owned company of the **Government of India**. The presses in Karnataka and West Bengal are set up by **BRBNMPL**, a wholly owned subsidiary of the Reserve Bank. **Coins are minted by the Government of India**. **RBI is the agent of the Government** for distribution, issue and handling of coins. **Four mints** are in operation: **Mumbai, Noida in Uttar Pradesh, Kolkata, and Hyderabad**.
- Bank notes are legal tender at any place in India for payment without limit. **As per Indian Coinage Act 2011- Rupee coin (1 and above) can be used to pay /settle for any sum. 50 Paise can be used to pay /settle any sum not exceeding Ten Rupees**. In case of smaller coins **below 50 paise, any sum not exceeding One Rupee**
- Currently Coins in circulation: **50 paise, 1, 2, 5 and 10 Rupee**. **Notes in circulation: Rs. 5, 10, 20, 50,100, 500 and 1000**. Coins can be issued up to the denomination of **Rs.1000 in terms of The Coinage Act, 2011**.
 - **As per Section 26 of Reserve Bank of India Act, 1934**, the Bank is liable to pay the value of banknote. This is payable on demand by RBI, being the issuer. **The Bank's obligation to pay the value of banknote does not arise out of a contract but out of statutory provisions**.
 - The **One Rupee notes/coins** are issued by Government constitute the **liabilities of the Government, one rupee is also liability of the Government of India**.
 - The Reserve Bank estimates the demand for banknotes **on the basis of the growth rate of the economy, inflation rate, and the replacement demand and reserve stock requirements by using statistical models/techniques**.
 - The Government of India **decides on the quantity of coins to be minted on the basis of indents received from the Reserve Bank**.
 - **To facilitate the distribution of banknotes and rupee coins, the Reserve Bank has authorised select branches of scheduled banks to establish currency chests**. These are actually **storehouses where banknotes and rupee coins** are stocked on behalf of the Reserve Bank.
 - There are **fifteen languages appearing in the language panel** of banknotes in addition to Hindi prominently displayed in the centre of the note and English on the reverse of the banknote.
- **Offences of having Fake Notes: Counterfeiting banknotes / using as genuine, forged or counterfeit banknotes / possession of forged or counterfeit banknote / making or possessing instruments or materials for forging or counterfeiting banknotes making or using documents resembling banknotes** are offences under **Sections 489A to 489E of the Indian Penal Code**

How RBI acts as a Banker to the Government and Debt Manager

In 1935, Reserve Bank of India, on its inception became the **Banker and Debt Manager to the Government** and this is a very important function. As per the **Reserve Bank of India Act 1934**, the Central Government entrusts the Reserve Bank with all its money, remittance, exchange and banking transactions in India and the management of its public debt. The Government also deposits its cash balances with the Reserve Bank. However, Reserve Bank may also act as the banker to State Governments. This is by an Agreement. Currently, the Reserve Bank acts as banker to all the State Governments in India except Sikkim.

Role of RBI as a Banker to Government

- The Reserve Bank has well defined obligations and provides several banking services to the governments. As a banker to the Government, the Reserve Bank receives and pays money on behalf of the various Government departments.
- The Reserve Bank also undertakes to float loans and manage them on behalf of the Governments. It provides **Ways and Means Advances (WMA)**, a short-term interest bearing **90 days tenure advances** – to

the Governments, to meet temporary liquidity shortages.

- Central Government is required to maintain a minimum cash balance with the Reserve Bank. Currently, this amount is **Rs.10 crore** on a daily basis and **Rs.100 crore on Fridays**, as also at the end of **March and July**.
- **Under a scheme introduced in 1976, every ministry and department of the Central Government has been allotted a specific public sector bank for handling its transactions.**
- **Market Stabilization Scheme (MSS) In 2004, a Market Stabilization Scheme (MSS) was introduced for issuing of treasury bills and dated securities over and above the normal market borrowing programme of the Central Government for absorbing excess liquidity.**
- RBI has a well structured arrangement for **revenue collection as well as payments on behalf of Government across the country**. The banking functions for the governments are carried out by the **Public Accounts Departments** at the offices/branches of the Reserve Bank. **As it has offices and sub-offices in 29 locations, the Reserve Bank appoints other banks to act as its agents for undertaking the banking business on behalf of the governments.**
- A network comprising the Public Accounts Departments of RBI and branches of Agency Banks appointed **under Section 45 of the RBI Act** carry out the Govt. transactions. At present all the public sector banks and three private sector banks viz. **ICICI Bank Ltd., HDFC Bank Ltd. and Axis Bank Ltd.** act as RBI's agents. **Only authorized branches of Agency banks can conduct Govt. business.**
- **All money for credit to Government account** like taxes or other remittances can be made by filling the prescribed challans of the Government/Department concerned. These challans along with the requisite amount (**by way of cash, cheque or DD**) are required to be tendered with the authorized bank branches.
- **Reserve Bank of India maintains the Principal Accounts of Central as well as State Governments at its Central Accounts Section, Nagpur.**
- **RBI can work as a banker to the State Governments by agreement.** But there is **no fixed minimum reserve balance for the State Governments**. All state Governments are required to maintain a minimum reserve balance with RBI, **but it depends upon the size of the economy of the state and its budget.**
- However, there are times, when there is a **temporary mismatch in the cash flow of the receipts and payments of the State Governments**. To handle this mismatch, there is a **WMA scheme / facility which refer to Ways and Means Advances**. RBI makes WMA to the state governments for a **period of 90 Days**. The rate of interest is linked to **repo rate**.

Management of Public Debt

- RBI helps both the central **government and state governments to manage their public debt, float new loans, issue and retirement of rupee loans, interest payment on the loan and operational matters about debt certificates and their registration.**
- Under the provisions of **Government Securities Regulations, 2007**, RBI manages **all matters related to issue of Government securities (G-Secs)/Gilts/Treasury Bills (T-Bills) etc.**
- A **Government security is a tradable instrument issued by the Central Government or the State Governments**. It acknowledges the Government's debt obligation.
- Such securities are **short term (usually called Treasury bills(T-Bills), with original maturities of less than one year) or long term (usually called Government bonds/Securities(G-Secs) or Dated securities with original maturity of one year or more).**
- In India, the Central Government issues **both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs).**
- Government securities carry practically **no risk of default and, hence, are called risk-free gilt-edged instruments.**
- Government of India also issues savings instruments (**Savings Bonds, National Saving Certificates (NSCs), etc or special securities (oil bonds, Food Corporation of India bonds, fertilizer bonds, power bonds, etc)**

RBI's role as a Banker to Banks

- Since Banks are required to maintain a portion of their **Net Demand and Time Liabilities (NDTL) as cash reserves (CRR) with the Reserve Bank**, banks need to **maintain accounts with the Reserve Bank**. They

also need to keep accounts with the Reserve Bank for settling **inter-bank Transactions**, and to clear **money market transactions between banks** etc. By providing the facility of **opening accounts for banks**, the Reserve Bank becomes this common banker, known as **'Banker to Banks'** function.

- Since banks need to **settle transactions with each other occurring at various places in India**, they are **allowed to open accounts with different regional offices of the Reserve Bank**. The Reserve Bank also **facilitates remittance of funds from a bank's surplus account at one location to its deficit account at another**. Such transfers are **electronically routed through a computerized system called 'e-Kuber'**.
- **Important products and services offered by RBI to commercial banks are:**
- **Non-interest earning current accounts:** Banks hold accounts with the Reserve Bank based on certain terms and conditions, such as, maintenance of minimum balances. They can hold accounts at each of **RBI regional offices**. Banks **draw on these accounts to settle their obligations arising from inter-bank settlement systems**.
- Banks can electronically transfer payments to other banks from this account, using the **Real Time Gross Settlement System (RTGS)**.
- **According to Banking Companies Act of 1949, every scheduled Commercial Bank excepting RRBs** has to keep some proportion of their total deposits with **RBI as cash**. It is currently **four per cent of a bank's Net Demand and Time Liabilities (NDTL)**. **This does not earn them any interest**.
- Reserve Bank, having regard to the monetary stability in the country, RBI can prescribe **Cash Reserve Ratio (CRR)** for scheduled banks **without any floor rate or ceiling rate**. (Earlier Reserve Bank could prescribe **CRR for scheduled banks between 3 per cent and 20 per cent of total of their demand and time liabilities**).
- Currently, banks have to **adhere to a requirement of 95 per cent of CRR daily (including on Saturdays) and 100 per cent on a fortnightly basis**.
- Also RBI stipulates that each commercial bank should keep **minimum of 15% and not more than 40% of their deposit liabilities in the form of cash/Gold/Govt Securities** so that bank can **meet day to day liquidity demands of withdrawals and payments**. This is called **Statutory Liquidity Ratio (SLR)**. Every bank is required to maintain at the close of business every day, a **minimum proportion of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold and un-encumbered approved securities**. Thus it is the **ratio of liquid assets to demand and time liabilities which is known as Statutory Liquidity Ratio (SLR)**. **RBI is empowered to increase this ratio up to 40%**. An increase in SLR also restricts the bank's lending power to pump more money into the economy.
- **As Banker to Banks**, the Reserve Bank provides **short-term loans and advances to select banks, when necessary, to facilitate lending to specific sectors and for specific purposes**. These loans are provided against **promissory notes and other collateral given by the banks**.
- **Bank rate or Rediscounting rate:** The scheduled banks can also **borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need by rediscounting bills of exchange**. This is called **Bank rate or Rediscounting rate**.
- **Repo Rate:** **Repo (Repurchase option rate)** is the rate at which the **RBI lends shot-term money to the banks against securities**.
- **Marginal Standing Facility (MSF):** **Marginal Standing Facility Rate (MSF)** scheme has become effective from **09th May, 2011**. Under this scheme, Banks will be able to borrow **up to 1% of their respective Net Demand and Time Liabilities**". The rate of interest on the amount accessed from this facility will be **100 basis points (i.e. 1%) above the Repo rate**. Requests under this facility will be received for a minimum amount of **Rs. One crore and in multiples of Rs One crore** thereafter.
- The difference between **Liquidity adjustment facility (LAF)** and **Repo rate** is that under **Repo rate** banks can borrow from RBI any volume of money at the **Repo rate by pledging government securities over and above the statutory liquidity requirements (SLR)**. However, in case of borrowing from the **Marginal standing facility**, banks can borrow funds up to **one percentage of their net demand and time liabilities**, at **1 % more than Repo rate** and this can be within the existing **statutory liquidity ratio (SLR)**.
- **Lender of the last resort (LOLR):** Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but **also the**

lender of the last resort. The Reserve Bank **provides liquidity to banks unable to raise short-term liquid resources from the inter-bank market.** Like other central banks, the Reserve Bank considers this a critical function because it protects the interests of depositors, which in turn, has a stabilizing impact on the financial system and on the economy as a whole.

RBI as a Monetary Controller or Controller of Credit in India

- a) The Reserve Bank of India is also the **controller of credit** i.e. **it has the power to influence the volume of credit created by banks in India.**
- b) There are **several direct and indirect instruments** that are used in the formulation and implementation of monetary policy. RBI's framework is based on a **multiple indicator approach.**
- c) This means that *RBI monitors and analyses the movement of a number of indicators including interest rates, inflation rate, money supply, credit, exchange rate, trade, capital flows and fiscal position, along with trends in output etc.*
- d) RBI **controls the volume of credit** by using different methods or tools called '**Quantitative Credit Controls and Qualitative Credit Controls (or) Selective credit controls.**

Objectives of the monetary policy in India: **monetary policy objectives** are aimed at **price stability, ensuring adequate flow of credit to various productive sectors of the economy and achieving financial stability.**

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

Monetary policy instruments used by RBI to control credit and money supply in the economy

As a whole the monetary control or credit control tools used by RBI are divided in to **qualitative and quantitative credit control measures.**

The Quantitative measures of credit control Tools

- 1) **Cash Reserve Ratio (CRR):** The share of net demand and time liabilities that banks must maintain as cash balance with the Reserve Bank. **RBI uses CRR either to drain excess liquidity or to release funds needed for the growth of the economy from time to time.** Increase in CRR means that **banks have fewer funds available and money is absorbed out of circulation.** Thus we can say that this serves dual purposes
 - a) Ensures that a portion of bank deposits is kept with RBI and is totally risk-free,
 - b) Enables RBI to control liquidity in the system, and thereby, inflation by **tying the hands of the banks in lending money.**
- 2) **Statutory Liquidity Ratio (SLR):** The share of **net demand and time liabilities** that banks must be maintaining as safe and **liquid assets, such as government securities, cash and gold.**
- 3) **Refinance facilities:** Sector-specific refinance facilities may be provided to banks
- 4) **Liquidity Adjustment Facility (LAF):** Consists of **daily infusion or absorption of liquidity** on a **repurchase basis, through repo (liquidity injection) and reverse repo (liquidity absorption)** auction operations, using **government securities as collateral.**
 - a) **Repo Rate:** **Repo (Repurchase) rate is the rate at which the RBI lends short-term money to the banks against securities.** When the repo rate **increases borrowing from RBI becomes more expensive.** Therefore, we can say that in case, RBI wants to make it more **expensive for the banks to borrow money, it increases the repo rate** similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate.
 - b) **Reverse Repo rate** is the **rate at which banks park their short-term excess liquidity with the RBI.** The banks use this tool when they feel that they are **stuck with excess funds and are not able to invest anywhere for reasonable returns.** An increase in the **Reverse Repo Rate** means that the RBI is **ready to borrow money from the banks at a higher rate of interest.** As a result, banks would prefer to keep more and more surplus funds with RBI. Thus, we can conclude that **Repo Rate** signifies the **rate at which liquidity is injected** in the banking system by RBI, whereas **Reverse repo rate** signifies the rate at which the central bank **absorbs liquidity from the banks.** These tools are used by RBI for **short term Liquidity Adjustments**
 - c) **Open Market Operations (OMO):** **Outright sales/purchases of government securities,** in addition to LAF, as a tool to determine the level of **liquidity over the medium term.**

- 5) **Marginal Standing Facility (MSF):** was instituted under which **scheduled commercial banks can borrow over night at their discretion up to one per cent of their respective NDTL at 100 basis points(1%) above the Repo Rate** to provide a safety valve against **unanticipated liquidity drain**.
- 6) **Bank Rate:** It is the rate at which the **Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers**. It also signals the **medium-term stance of monetary policy**
- 7) **Market Stabilization Scheme (MSS):** This instrument for monetary management was introduced in 2004. Liquidity of a **more enduring nature arising from large capital flows from abroad is absorbed through sale of short-dated Government securities (G-SECs) and Treasury bills**. The mobilized cash is held in a separate government account with the Reserve Bank.

Qualitative credit controls

These are used by the RBI for selective purposes. According to the **Banking Regulation Act of 1949**, the Reserve Bank of India can also use **'Selective credit controls or Qualitative Credit Controls'** by asking any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. **Since 1956, selective controls of credit are increasingly being used by the Reserve Bank**. Some of them are

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

RBI as Custodian of Foreign Exchange Reserves and Managerial of exchange control

- The Reserve Bank of India has the responsibility to maintain the official rate of exchange.
- The statutory power for exchange control was provided by the **Foreign Exchange Regulation Act (FERA) of 1947**, which was subsequently replaced by a more comprehensive **Foreign Exchange Regulation Act, 1973**.
- This Act empowered the Reserve Bank, and in certain cases the Central Government, to control and **regulate dealings in foreign exchange payments outside India, export and import of currency notes and bullion, transfer of securities between residents and non-residents, acquisition of foreign securities, and acquisition of immovable property in and outside India, among other transactions**.
- **After Liberalization** and in view the changed environment, the **Foreign Exchange Management Act (FEMA) was enacted in 1999** to replace FERA. FEMA became effective from **June 1, 2000**.
- RBI issues licenses to banks and other institutions to act as **Authorized Dealers** in the foreign exchange market.

RBI's Authority in Approval of Foreign Investments by RBI

- **Foreign Direct investment (FDI)/Foreign Institutional Investments (FII)** in India are principally approved by RBI. The Reserve Bank has permitted **foreign investment in almost all sectors, with a few exceptions**. An Indian company may receive **Foreign Direct Investment** under the two routes as given under:
 - **Automatic Route:** FDI is allowed under the automatic route without prior approval **either of the Government or the Reserve Bank of India** in all activities/sectors as specified in the consolidated FDI Policy, issued by the Government of India from time to time.
 - **Government Route:** FDI in activities not covered under the automatic route **requires prior approval of the Government which are considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, and Ministry of Finance**.
 - **External Commercial Borrowings (ECB):** Indian companies are allowed to raise external commercial borrowings including **commercial-bank loans, buyers' credit, suppliers' credit, and securitised instruments**. **Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs)** are also governed by the ECB guidelines of RBI.

Payment and Settlement System (PSS) as governed by RBI

The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), a sub-committee of the Central Board of the Reserve Bank of India is the highest policy making body on payment systems in the country. The BPSS is empowered for authorizing, prescribing policies and setting standards for regulating and supervising all the payment and settlement systems in the country.

In India, the payment and settlement systems (PSS) are regulated by the Payment and Settlement Systems Act, 2007 (PSS Act) which was legislated in December 2007. The PSS Act as well as the Payment and Settlement System Regulations, 2008 framed there under came into effect from August 12, 2008.

In terms of Section 4 of the PSS Act, no person other than the Reserve Bank of India (RBI) can commence or operate a payment system in India unless authorized by RBI. At present, there are payments in India can be made through paper based instruments, electronic instruments and other instruments, such as, pre-paid systems, mobile banking, ATM based, Point-of-sale terminals, online transactions.

Clearing Corporation of India Limited (CCIL)

- CCIL was set up in April 2001 for clearing and settlement of trades in money market, government securities and foreign exchange markets. The Clearing Corporation plays the crucial role of a Central Counter Party (CCP) in the government securities, USD –INR forex exchange (both spot and forward segments) and Collateralised Borrowing and Lending Obligation (CBLO) markets.
- CCIL plays the role of a central counterparty whereby, the contract between buyer and seller gets replaced by two new contracts - between CCIL and each of the two parties. This process is known as 'Novation'.
- Through Novation, the counterparty credit risk between the buyer and seller is eliminated with CCIL subsuming all counterparty and credit risks. In order to minimize these risks, that it exposes itself to, CCIL follows specific risk management practices which are as per international best practices. In addition to the guaranteed settlement, CCIL also provides non guaranteed settlement services for National Financial Switch (Inter bank ATM transactions) and for rupee derivatives such as Interest Rate Swaps.

Developmental Role of RBI

Over the years, the Reserve Bank has added new institutions as the economy has evolved. Some of the institutions established by the RBI include:

- Deposit Insurance and Credit Guarantee Corporation (1962), to provide protection to bank depositors and guarantee cover to credit facilities extended to certain categories of small borrowers
 - Unit Trust of India (1964), the first mutual fund of the country
 - Industrial Development Bank of India (1964), a development finance institution for industry
 - National Bank of Agriculture and Rural Development (1982), for promoting rural and agricultural credit
 - Discount and Finance House of India (1988), a money market intermediary and a primary dealer in government securities.
 - National Housing Bank (1989), an apex financial institution for promoting and regulating housing finance
 - Securities and Trading Corporation of India (1994), a primary dealer who deals in Government securities.
- The Reserve Bank continues its developmental role, while specifically focusing on financial inclusion. Key schemes in this effort include:
- **Lead Bank Scheme:** A commercial bank is designated as a lead bank in each district in the country and this bank is responsible for ensuring banking development in the district through coordinated efforts between banks and government officials.
 - **Banking Codes and Standards Board of India:** The Reserve Bank established this board to encourage transparency in lending and fair pricing and customer servicing.
 - **Banking Ombudsman:** The Reserve Bank's *quasi-judicial authority* for resolving disputes between commercial banks, primary cooperative banks and regional rural banks and their customers. There are 15 Banking Ombudsmen being operational covering 28 states.
 - **Priority sector Lending:** Lending is an important mechanism by the Reserve Bank of India (RBI) to the banks for providing a specified portion of their lending to few specific sectors like agriculture or small scale industries. The categories under PSL are as under:
 - 1) Agriculture
 - 2) Micro, Small and Medium Enterprises
 - 3) Export Credit
 - 4) Education
 - 5) Housing
 - 6) Social Infrastructure
 - 7) Renewable Energy
 - 8) Others

Be a Logical & Seasoned Student

Ask.....It's your right

If you are planning joining a right institution for **IBPS/SSC**

If answers to **following questions** are a big 'NO'

.....then explore the **WAY to 'YES'**

- Is it possible to cover entire syllabus **with meager 3 hours of class room** coaching?
- Coaching doesn't mean '**Reasoning and Arithmetic**' only but **emphasis is to be made on English, Banking and Finance with best analytics of current Affairs**. Are all subjects are being taught daily, particularly '**Banking and current Affairs**'?
- Whether **concept wise exams** are conducted to make students attune to the methodology of questions?
- Are you being made **proficient with offline exam simulation**?

Think buddy.... 👍👍👍👍👍👍👍

In so many Institutes across

- Even not an hour dedicated for each subject daily and only 3 hours of classes are adjusted for six subjects
- Despite majority students are being disqualified in Banking and English but proper emphasis is not given to these subjects and are not taught daily
- Computer based online exams are showcased without concept teaching and without core concepts being practiced offline
- Same successful candidates adore the walls of many coaching centers across Andhra Pradesh simultaneously and you even don't surprise how come these selected candidates could have studied simultaneously in various institutes across Andhra Pradesh?
- You are being poached with corporate ambience and 'counterfeit success stories' showcased conveniently

Now it is time for being logical and got to GOOOOOOO.....

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