BANKING

INTRODUCTION

- A bank is generally understood as an institution which provides fundamental financial services such as accepting deposits and lending loans.

- The banking system significantly contributes for the development of any country.

Historical Development

- The Ricks Banks of Sweden, which had sprung from a private bank established in 1656 is the oldest central bank in the world. It acquired the sole right of note issue in 1897

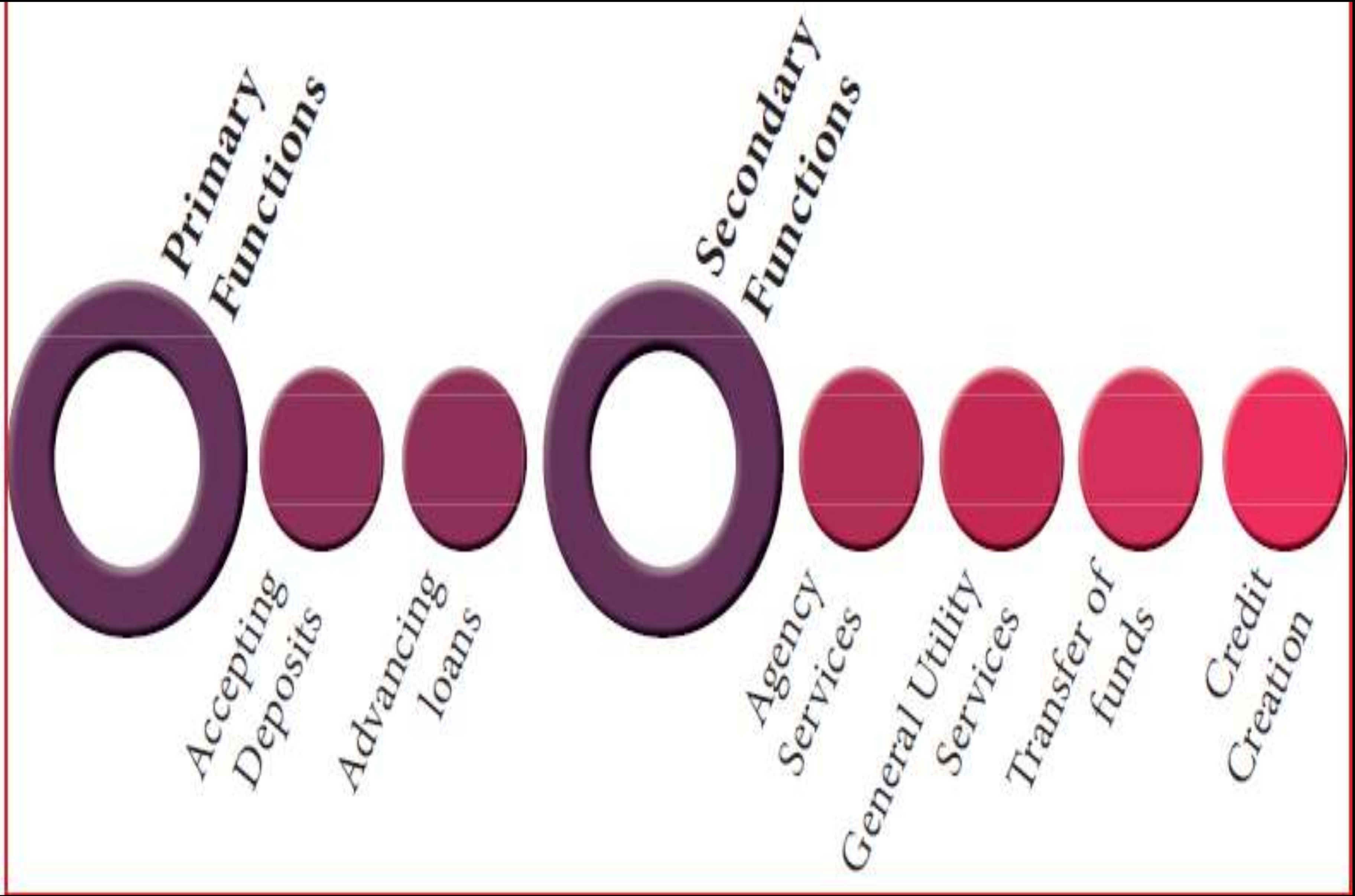
- A large number of central banks were established between 1921 and 1954 in compliance with the resolution passed by the International Finance Conference held at Brussels in 1920

Commercial banks

- Commercial banks are institutions that conduct business with profit motive by accepting public deposits and lending loans for various investment purposes.

Functions of Commercial Banks

- Primary functions
- Secondary Functions
- Other Functions



Primary Functions
Accepting Deposits
Advancing loans
Secondary Functions
Agency Services
General Utility Services
Transfer of funds
Credit Creation

(a) Primary Functions

1. **Accepting Deposits-** It implies that commercial banks are mainly dependent on public deposits.

- **(i) Demand Deposits** It refers to deposits that can be withdrawn by individuals without any prior notice to the bank
- **(ii) Time Deposits** It refers to deposits that are made for certain committed period of time. Banks pay higher interest on time deposits
- 2. **Advancing Loans** It refers to granting loans to individuals and businesses. Commercial banks grant loans in the form of overdraft, cash credit, and discounting bills of exchange.

(b) Secondary Functions

Agency function

- (i) Collecting Cheques
- (ii) Collecting Income
- (iii) Paying Expenses

General utility function

- (i) Providing Locker Facilities
- (ii) Issuing Traveler's Cheques
- (iii) Dealing in Foreign Exchange

Transferring funds

Letter of credit

- i)Underwriting securities
- ii)Electronic banking

OTHER FUNCTIONS

(i) Money Supply

It refers to one of the important functions of commercial banks that help in increasing money supply

(ii) Credit Creation - Credit Creation means the multiplication of loans and advances

(iii) Collection of Statistics:

Banks collect and publish statistics relating to trade, commerce and industry. Hence, they advice customers and the public authorities on financial matters.

Mechanism / Technique of Credit Creation by Commercial Banks

Bank credit refers to bank loans and advances. Money is said to be created when the banks, through their lending activities, make a net addition to the total supply of money in the economy.

Banks have the power to expand or contract demand deposits and they exercise this power through granting more or less loans and advances and acquiring other assets. This power of commercial bank to create deposits through expanding their loans and advances is known as credit creation.

Primary / Passive Deposit and Derived / Active Deposit

The modern banks create deposits in two ways. They are **primary deposit** and **derived deposit**. When a customer gives cash to the bank and the bank creates a book debt in his name called a deposit, it is known as a “primary deposit’.

when a deposit is created, without there being any prior payment of equivalent cash to the bank, it is called a ‘derived deposit

Primary Deposits

- It is out of these primary deposits that the bank makes loans and advances to its customers.
- The initiative is taken by the customers themselves. In this case, the role of the bank is passive.
- So these deposits are also called “Passive deposits”.

Role of Commercial Banks in Economic Development of a Country

Role of Commercial Banks Economics in Development of a Country

1. **Capital Formation**: commercial banks mobilize small savings of the public scattered over a wide area through various branches and used it for productive purposes. Nowadays banks offer attractive schemes to increase the savings habits of the public.

2. **Creation of Credit**: Banks create credit for the purpose of providing more funds for development projects and stimulate economic development.

3. **Channelizing the Funds towards Productive Investment**: Banks allocating the pooled savings to various sectors of the economy with the view to increase the productivity and accelerate economic development.

4. **Encouraging Right Type of Industries:** Banks tries to develop industrialisation by giving loan to the right type of persons. They grant loans and advances to manufacturers whose products are in great demand and encourages manufacturers to apply new methods of production and there by accelerate economic development.

5. Banks Monetize Debt

As banks are lending money by discounting bills of exchange, business concerns are able to carry out the economic activities without any interruption. Otherwise production may

be reduced.

6. **Finance to Government**: Banks provide long-term credit to Government by investing their funds in Government securities and short –term finance by purchasing Treasury Bills especially in underdeveloped countries Ex. RBI gave Rs68000 crores to government of India in the year2018-19.

7. **Employment Generation**: Opening up of new branches leads to

the creation of new employment opportunities.

8. **Banks Promote Entrepreneurship**: By inducing new entrepreneur to take up the well-formulated projects and provision of counsellingservices like technical and managerial guidance banks try to promoteentrepreneurship. They provide 100% credit for worthwhile projects also.

Non-Banking Financial Institution

1.They are the financial institutions that do not have a full banking license or are not supervised by the central bank.

2. The NBFI s do not carry on pure banking business but they will

carry on other financial transactions. They undertake borrowing and

lending. They operate in both the money and the capital markets.

3. They mobilize peoples' savings and use the funds to finance

expenditure on investment activities.

4. **Two types**: Stock Exchanges and other Financial Institutions like

Finance Companies, Finance Corporations, Chit Funds, Building societies,

Issue Houses, Investment Trusts and Unit Trust and Insurance companies

In short, they are institutions which undertake borrowing and lending. They operate in both the money and the capital markets.

Classification of NBFI

NBFI

- Stock Exchange
  - Bombay stock exchange (BSE)
  - National stock exchange (NSE)
- Other Financial institutions
  - Finance Companies, Finance Corporations, Chit Funds, Building Societies, Issue Houses, Investment Trusts and Unit Trusts and Insurance Companies.

Central Bank

- A central bank, reserve bank, or monetary authority is an institution that manages a state’s currency, money supply, and interest rates. Central banks also usually oversee the commercial banking system of their respective countries.

Functions of Central Bank

1.Monetary Authority

2. The issuer of currency

3. The issuer of Banking license

4.Banker to the Government

5. Banker's Bank

6. Lender of last resort

7.Act as clearing house

8. Custodian of foreign exchange reserves

9. Regulator of Economy

10. Managing Government

11. Regulator and Supervisor of Payment and Settlement Systems

12. Developmental Role

13. Publisher of monetary data and other data

14. Exchange manager and controller

15. Banking Ombudsman Scheme

16. Banking Codes and Standards Board of India

- **1. Monetary Authority**: It controls the supply of money in the economy to stabilize exchange rate, maintain healthy balance of payment, attain financial stability, control inflation, strengthen banking system.
- **2. The issuer of currency**: The objective is to maintain the currency and credit system of the country. It is the sole authority to issue currency. It also takes action to control the circulation of fake currency.
- **3. The issuer of Banking License**: As per Sec 22 of Banking Regulation Act, every bank has to obtain a banking license from RBI to condubanking business in India. ct

4. Banker to the Government: It acts as banker both to the central and the state governments. It provides short-term credit

- **5. Banker's Bank**: RBI is the bank of all banks in India as it provides loan to banks, accept the deposit of banks, and rediscount the bills of banks

6. Lender of last resort: The banks can borrow from the RBI by keeping eligible securities as collateral at the time of need or crisis, when there is no other source.

7. Act as clearing house: For settlement of banking transactions, RBI manages 14 clearing houses. It facilitates the exchange of instruments and processing of payment instructions

8. Custodian of foreign exchange RBI buys and sells foreign currency to maintain the exchange rate of Indian rupee v/s foreign currencies.

9. Regulator of Economy: It controls the money supply in the system, monitors different key indicators like GDP, Inflation, etc.

10. Managing Government securities: RBI administers investments in institutions when they invest specified minimum proportions of their total assets/liabilities in government securities.

11. Regulator and Supervisor of Payment and Settlement Systems - RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms.

12. Developmental Role: This role includes the development of the quality banking system in India and ensuring that credit is available to the productive sectors of the economy

13. Publisher of monetary data and other data: RBI maintains and provides all essential banking and other economic data, formulating and critically evaluating the economic policies in India

14. Exchange manager and controller: RBI represents India as a member of the International Monetary Fund

15. Banking Ombudsman Scheme: RBI introduced the Banking Ombudsman Scheme in 1995. Under this scheme, the complainants can file their complaints in any form.

16. Banking Codes and Standards Board of India: To measure the performance of banks against Codes and standards based on established global practices, the RBI has set up the Banking Codes and Standards Board of India (BCSBI

Credit Control Measures

Credit control is the primary mechanism available to the Central banks to realize the objectives of monetary management

I. Quantitative or General Methods:

1. Bank Rate Policy

- The bank rate is the rate at which the Central Bank of a country is prepared to re-discount the first class securities.
- For example: If the Central Bank wants to control credit, it will raise the bank rate. As a result, the deposit rate and other lending rates in the money-market will go up. Borrowing will be discouraged, and will lead to contraction of credit and vice versa.

- **2. Open Market Operations: In narrow sense**, the Central Bank starts the purchase and sale of Government securities in the money market

In Broad Sense, the Central Bank purchases and sells not only Government securities but also other proper eligible securities like bills and securities of private concerns.

3. Variable Reserve Ratio:

a) Cash Reserves Ratio: Under this system the Central Bank controls credit by changing the Cash Reserves Ratio. For example, if the Commercial Banks have excessive cash reserves ,the central bank will raise the cash reserve ratio with a view to decrease the lending capacity of the commercial banks.

- Similarly, to bring about an economic revival in the economy , the central Bank will lower down the Cash Reserve Ratio with a view to expand the lending capacity of the Commercial Banks.

- **Statutory Liquidity Ratio**

  Statutory Liquidity Ratio (SLR) is the amount which a bank has to maintain in the form of cash, gold or approved securities

Qualitative or Selective Method of **Credit Control**

1. Rationing of credit

Credit rationing is employed to control and regulate the purpose for which credit is granted by the commercial banks.

It takes two forms

a)variable portfolio ceilings

wherein central bank fixes ceiling on the aggregate portfolios of the commercial bank. They cannot advance loans beyond this ceiling.

b) The variable capital asset ratio: It refers to the system by which the central bank fixes the ratio which the capital of the commercial bank should have to the total assets of the bank.

2. Direct Action

Direct Action refers to directives of the central bank to enforce the commercial banks to follow a particular policy. The central bank gives direction to commercial banks in respect of

i) Lending policies

ii) The purpose for which advances may be made

iii) The margins to be maintained in respect of secured loans

3. Moral Suasion

- This method is frequently adopted by the Central Bank to exercise control over the Commercial Banks. Under this method Central Bank gives advice, then requests. and persuades the Commercial Banks to co-operate with the Central Bank in implementing its credit policies

4. Publicity

Central Bank in order to make their policies successful, take the course of the medium of publicity

5. Regulation of Consumer's Credit

The down payment is raised and the number of installments reduced for the credit sale.

- **6. Changes in the Marginal Requirements on Security Loans:**

This system is mostly followed in U.S.A. Under this system, the Board of Governors of the Federal Reserve System has been given the power to prescribe margin requirements for the purpose of preventing an excessive use of credit for stock exchange speculation.

The Repo Rate and the Reverse Repo Rate are the frequently used tools with which the RBI can control the availability and the supply of money in the economy.

Repo Rate: (RR)	Reverse Repo Rate: (RRR)
The rate at which the RBI is willing to lend to commercial banks is called Repo Rate.	The rate at which the RBI is willing to borrow from the commercial banks is called reverse repo rate
As a tool to control inflation, RBI increases the Repo Rate, making it more expensive for the banks to borrow from the RBI. Similarly, the RBI will do the exact opposite in a deflationary environment.	The banks prefer to park their money with the RBI as it involves higher safety. This naturally leads to a higher rate of interest which the banks will demand from their customers for lending money to them.

Reserve Bank of India and Rural Credit

In a developing economy like India, the Central bank of the country cannot confine itself to the monetary regulation only, and it is expected that it should take part in development function in all sectors especially in the agriculture and industry.

Role of RBI in agricultural credit

- RBI has been playing a very vital role in the provision of agricultural finance in the country. The Bank's responsibility in this field had been increased due to the predominance of agriculture in the Indian economy and the inadequacy of the formal agencies to cater to the huge requirements of the sector.

Functions of Agriculture Credit Department

a) To maintain an expert staff to study all questions on agricultural credit;

b) To provide expert advice to Central and State Government, State Co-operative Banks and other banking activities.

c) To finance the rural sector through eligible institutions engaged in the business of agricultural credit and to co-ordinate their activities.

- The RBI was providing medium-term loans also for a period exceeding 15 months to 5 years for reclamation of land, construction of irrigation works, purchase of machinery, etc.
- The Reserve Bank of India was also providing long-term loans to fiancé permanent changes in land and also for the redemption of old debts.

Functions of Agriculture Credit Department

a) To maintain an expert staff to study all questions on agricultural credit;

b) To provide expert advice to Central and State Government, State Co-operative Banks and other banking activities.

c) To finance the rural sector through eligible institutions engaged in the business of agricultural credit and to co-ordinate their activities.

- The RBI was providing medium-term loans also for a period exceeding 15 months to 5 years for reclamation of land, construction of irrigation works, purchase of machinery, etc.
- The Reserve Bank of India was also providing long-term loans to fiancé permanent changes in land and also for the redemption of old debts.

Regional Rural Banks (RRBs)

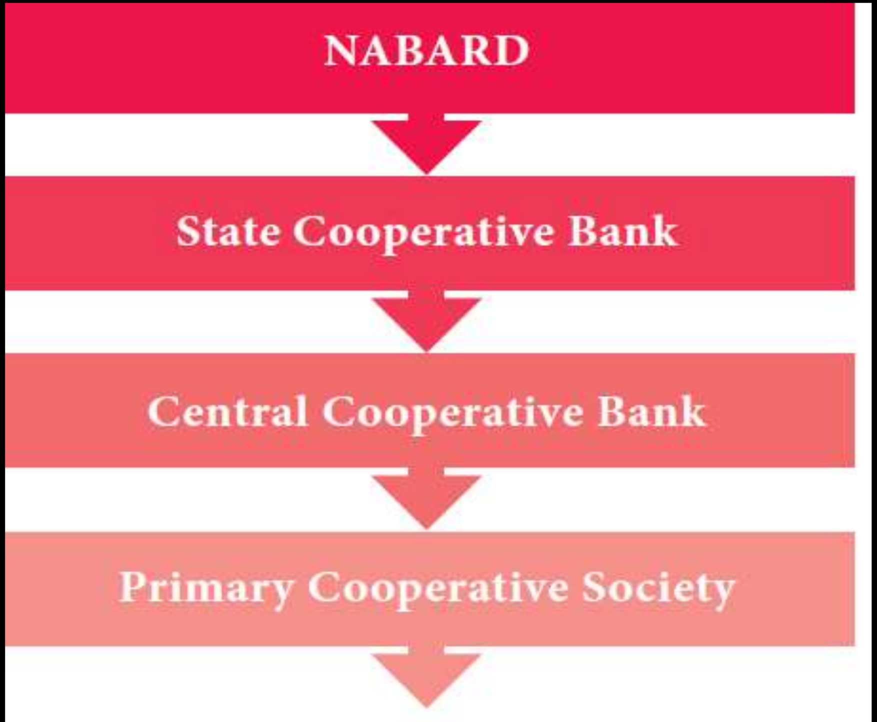
The Government of India setup Regional Rural Banks (RRBs) on 1975. The share capital of RRB is subscribed by the Central Government (50%), the State Government concerned (15%), and the sponsoring commercial bank (35%).

The main objective of the RRBs is to provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs so as to develop agriculture, trade, commerce, industry and other productive activities in the rural areas.

- The RBI has been granting many concessions to RRBs:
- (a) They are allowed to maintain cash reserve ratio at 3 per cent and statutory liquidity ratio at 25 per cent; and
- (b) They also provide refinance facilities through NABARD.

NABARD and its role in Agricultural credit

RBI extended short-term seasonal credit as well as medium-term and long-term credit to agriculture through State level co-operative banks and Land Development banks



Three Tier Cooperative Credit Structure

A National Bank for Agriculture and Rural Development (NABARD), was therefore, set up in July 1982

GOI nominates three of its Central Board Directors on the board of NABARD.A Deputy Governor of RBI is appointed as Chairman of NABARD.

Functions of NABARD

(i) NABARD acts as a refinancing institution for all kinds of production and investment credit to agriculture, small-scale industries, cottage and village industries etc.

(ii) It provides short-term, medium-term and long-term credits to state co-operative Banks (SCBs), RRBs, LDBs and other financial institutions approved by RBI.

(iii) NABARD gives long-term loans (upto 20 Years) to State Government to enable them to subscribe to the share capital of co-operative credit societies.

iv) NABARD gives long-term loans to any institution approved by the Central Government concerned with agriculture and rural development.

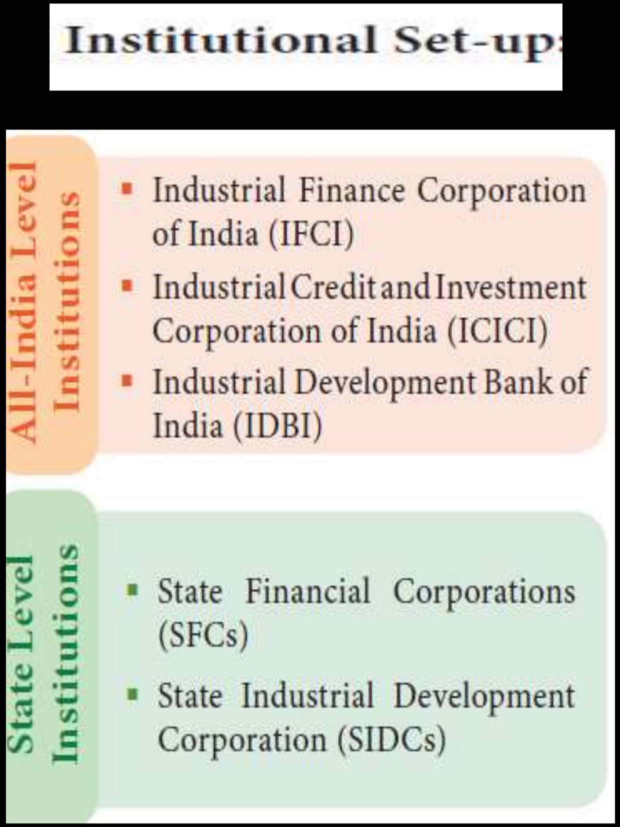
v) NABARD has the responsibility of coordinating the activities of Central and State Governments.

vi) It has the responsibility to inspect RRBs and co-operative banks, other than primary co-operative societies.

vii) It maintains a Research and Development Fund to promote research in agriculture and rural development

Reserve bank of India and industrial finance

There is a need and urgency of establishing long-term credit facilities to industries. The institutional set-up in India for financing and promoting industries are as follows



1. Industrial Finance Corporation of India (IFCI)

This was first in the chain of establishment of financial corporations to provide financial assistance for industrial development. This was established on July 1, 1948 under the Act of the Parliament. IFCI provides assistance to the industrial concerns in the following ways:

i) Long-term loans; both in rupees and foreign currencies.
ii) Underwriting of equity, preference and debenture issues.
iii) Subscribing to equity, preference and debenture issues.
iv) Guaranteeing the deferred payments in respect of machinery imported from abroad or purchased in India; and
v) Guaranteeing of loans raised in foreign currency from foreign financial institutions

Financial assistance of IFCI can be availed by any Limited Company in the public, private or joint sector, or by a co-operative society incorporated in India, which is engaged or proposes to be engaged in the specified industrial activities.

• 2. Industrial Credit and Investment Corporation of India (ICICI)

This was set up on 5th January 1955 as a joint-stock company on the advice given by a three-man mission sponsored by the World Bank and The Government of USA to the Government of India. The principal purpose of this institution is to channelize the World Bank funds to industry in India and also to help build up a capital market. The ICICI also borrows from the Industrial Development Bank of India and the Government. The major portion of its assistance has gone to the private sector

ICICI [Industrial Credit and Investment Corporation of India]

Functions of ICICI

- Assistance to industries
- Provision of foreign currency loans
- Merchant banking
- Letter of credit
- Project promotion
- Housing loans
- Leasing operations

3. Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India has been conceived with the primary object of creating an apex institution to co-ordinate the activities of other financial institutions, including banks.

Functions of IDBI: The functions of IDBI fall into two groups (i) Assistance to other financial institutions; and

(ii) Direct assistance to industrial concerns either on its own or in participation with other institutions.

A special feature of the IDBI is the provision for the creation of a special fund known as the Development Assistance Fund.

The financing of exports was also undertaken by the IDBI till the establishment of EXIM BANK in March, 1982.

State Level Institutions

1. State Financial Corporation (SFCs)

The government of India passed in 1951 the State Financial Corporations Act and SFCs were set up in many states.

The SFCs provide loans and underwriting assistance to industrial units having paid-up capital and reserves not exceeding ₹ 1 crore. The maximum amount that can be sanctioned to an industrial concern by SFC is ₹ 60 lakhs.

2. State Industrial Development Corporations (SIDCOs)

The Industrial Development Corporations have been set up by the state governments and they are wholly owned by them.

- they are entrusted with the responsibility of accelerating the industrialization of their states
- SIDCOs provide financial assistance to industrial concerns by way of loans guarantees and underwriting of or direct subscriptions to shares and debentures.
- SIDCOs take 26 percent, private co-promoter takes 25 percent of the equity, and the rest is offered to the investing public.
- SIDCOs undertake the development of industrial areas by providing all infrastructural facilities and initiation of new growth centers.
- They also administer various State government incentive schemes. SIDCOs get refinance facilities form IDBI. They also borrow through bonds and accept deposits.

Monetary Policy

- **Monetary Policy** is the macroeconomic policy being laid down by the Central Bank towards the management of money supply and interest rate. It is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

Monetary Policy: Expansionary Vs. Contractionary

Expansionary policy is cheap money policy when a monetary authority uses its tools to stimulate the economy. An expansionary policy maintains short-term interest rates at a lower than usual rate or increases the total supply of money in the economy more rapidly than usual.

The Contractionary monetary policy is dear money policy, which maintains short-term interest rates higher than usual or which slows the rate of growth in the money supply or even shrinks it. This slows short-term economic growth and lessens inflation. Contractionary monetary policy can lead to increased unemployment and depressed borrowing and spending by consumers and businesses,

The Two Faces of Monetary Policy

Inflation

Cheap Money Policy

1. Borrowing is easy
2. Consumers buy more
3. Businesses expand
4. More people are employed
5. People spend more

Recession

Dear Money Policy

1. Borrowing is difficult
2. Consumers buy less
3. Businesses Postpone expansion
4. Unemployment increases
5. Production is reduced

The specific objectives of monetary policy are

1. Neutrality of Money
2. Stability of Exchange Rates
3. Price Stability
4. Full Employment
5. Economic Growth
6. Equilibrium in the Balance of Payments

1. Neutrality of Money: a. Chief exponents – Wicksteed, Hayek and Robertson

b. Monetary changes are the root cause of all economic fluctuations

and it causes distortion and disturbances in the proper operation of the economic system of the country

- 2. Exchange Rate Stability:
- a. Traditional objective of monetary authority
- b. Under gold standard when there was disequilibrium in BOP's of
- the country it was automatically corrected by movements
- c. if there is instability in the exchange rates there will be outflow or
- inflow of gold and causes unfavourable BoP, so stable exchange rates are
- advocated

3. Price Stability:

a. Supporters – Crustave Cassel and Keynes
b. The effect of stable price – Promotes business activity and ensure
equitable distribution of income and wealth and promotes prosperity and

- welfare in the community

c. Price stability does not mean price rigidity or price stagnation. A
mild increase in the price level provides a tonic for economic growth

4. Full Employment:

a. There is unemployment during depression
b. To get full employment J.M.Keynes supported monetary policy,
so it gained full support as the chief objective of monetary policy

- 5. Economic Growth:
- a. Meaning – Increase in real per capita income for the satisfaction
- of human wants
- b. Need – Maintaining equilibrium between the total demand for money and total production capacity and creating favourable conditions
- for saving and investment

6. Equilibrium in the Balance of Payments: As the deficit in BoP reduces

- the ability of an economy to achieve other objectives less developed
- countries have to curtail their imports. So RBI makes efforts to maintain
- equilibrium in BOP

Recent Advancements in Banking Sector

Online banking, also known as internet banking, is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution’s website.

Today, “virtual banks” (or “direct banks”) have only an internet presence, which enables them to lower costs than traditional brick-and-mortar banks.

NEFT	RTGS
National electronic Fund Transfer	Real Time Gross Settlement
Transactions happens in batches hence slow	Transactions Happens in real time hence fast
Timings : 8:00 am to 6:30 pm (12: 30 pm on Saturday)	Timings : 9:00 am to 4:30 pm (1:30 pm on Saturday)
No minimum limit	Minimum amount for RTGS transfer is ₹ 2 lakhs

ATM (Automated Teller Machine)

- ATMs transformed the bank tech system when they were first introduced in 1967. The next revolution in ATMs is likely to involve contactless payments. Much like Apple Pay or Google Wallet, soon we will be able to conduct contactless ATM transactions using a smartphone.

- **Paytm**

- Payments Bank. In August 2015, Paytm received a license from RBI to launch a payments bank. The Paytm Payments Bank is a separate entity in which founder Vijay Shekhar Sharma will hold 51% share, One97 Communications holds 39% and 10% will be held by a subsidiary of One97 and Sharma.

Debit card and Credit Card

- **A Debit card** is a card allowing the holder to transfer money electronically from their bank account when making a purchase.

A credit card is a payment card issued to users (cardholders) to enable the cardholder to pay a merchant for goods and services based on the cardholder's promise to the card issuer to pay them for the amounts so paid plus the other agreed charges.

Recent Issues

Once the borrower fails to make interest or principal payments for 90 days the loan is considered to be a non- performing asset (NPA). NPAs are problematic for financial institutions since they depend on interest payments for income.

- **Merger of Banks**
- Union Cabinet decided to merge all the remaining five associate banks of State Bank Group with State Bank of India in 2017. Five associates and the Bharatiya Mahila Bank have become the part of State Bank of India (SBI) beginning April 1, 2017. This has placed State Bank of India among the top 50 banks in the world. The five associate banks that were merged are State Bank of Bikaner and Jaipur (SBBJ),
- State Bank of Hyderabad (SBH), State Bank of Mysore (SBM), State Bank of Patiala (SBP) and State Bank of Travancore (SBT).

	Money market	Capital market
1	A mechanism in which short term funds are loaned and borrowed	It is a part of financial system
2	It handles the purchase, sales and transfer of short term credit instruments	It is raising capital by dealing in shares, bonds and other long term investments
3	Commercial banks, acceptance houses, non-banking financial institutions and the central bank are the institutions catering to the requirements of short term funds in the money market	The market where investment instruments like bonds, equities and mortgages are traded in the capital market

Demonetisation

Demonitisation is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency.

On 8 November 2016, the Indian Prime Minister Mr. Narendra Modi announced the demonetization of all ₹500 and ₹1000 bank notes of the Mahatma Gandhi Series. However, more than 99% of those currencies came back to the RBI.

Objectives of Demonetisation

1. Removing Black Money from the country.
2. Stopping of Corruption.
3. Stopping Terror Funds.
4. Curbing Fake Notes

PREPARED BY

JAMUNA RANI .L

PGT ECONOMICS