UNIT 5 COMMERCIAL BANKS IN INDIA

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5.1 OBJECTIVES

After reading this Unit, you will be able to –

- Explain the structure of Commercial Banks in India,
- Describe the sources of funds for Commercial Banks and their utilisation,
- Discuss important regulatory directives issued and norms laid down by Reserve Bank of India, and
- Identify the problem of non-performing assets of banks.

5.2 INTRODUCTION

Commercial Banks are the oldest and the largest banking institutions in India. Some of them are more than hundred years old. Their branches are spread all over the country and have penetrated in the countryside as well.

Commercial Banking has passed through three distinct phases in India since Independence. The period 1955-1970 witnessed the genesis of public sector in Indian banking commencing with the setting up of the State Bank of India in 1955 and ending with the nationalisation of 14 major banks in 1969.

The two decades after nationalisation of banks i.e. the seventies and eighties witnessed the conversion of class banking into mass banking. During this period branch expansion took place on a large-scale, followed by recruitment of large number of bank employees, expansion in priority sector advances, especially for the poor and neglected sectors. Loan Melas were the main features of this period. On the other hand, the Reserve Bank of India's regulatory control intensified over various facets of banking operations.

The post-nationalisation era was not without its resultant problems. With poor training, employee efficiency and productivity went down, problem of non-recovery of loans cropped up, and pre-emption of funds in meeting statutory requirements went up, resulting in reduced profitability of banks.

It was such a situation in 1991 when the new economic policies were launched by the Government. A Committee on financial sector under the Chairmanship of Shri M. Narashimham was appointed which suggested measures of far-reaching significance to improve efficiency, productivity and profitability of banks. These measures have been largely implemented. In this Unit, you will study the position of Commercial Banks in India in the present situation, after the reform measures have largely been implemented.

5.3 CLASSIFICATION OF COMMERCIAL BANKS

On the basis of ownership and control over management commercial banks in India are classified into two broad categories i.e.

i) *Public Sector Banks*, and
ii) *Private Sector Banks.*

Public Sector banks account for the major share of the banking business in India and are sub-classified into two categories i.e.

a) *State Bank of India Group*, and
b) *Nationalised Banks.*

5.3.1 Public Sector Banks

5.3.1.1 State Bank of India Group

This group comprises State Bank of India and its seven subsidiaries which is the largest commercial bank in India. State Bank of India came into existence in 1955 when the Government converted the then existing Imperial Bank of India into State Bank of India under the State Bank of India Act, 1955. At that time, about 93% of its shares were held by the Reserve Bank of India. State Bank of India acts as the agent of Reserve Bank of India at places where the latter has no office of its own. In 1959, eight state associated banks were converted into the subsidiaries of State Bank of India under the State Bank of India (Subsidiary Banks) Act 1959. Later, one of them was merged with another. Thus, State Bank Group comprises of eight banks. The objective of formation of State Bank Group was to accelerate the extension of banking facilities in the countryside.

5.3.1.2 Nationalised Banks

After about a decade, in July 1969, 14 major commercial banks in India were nationalised by the enactment of Banking Companies (Acquisition and Transfer of Undertakings) Act 1970. A decade later in 1980, 6 more commercial banks were nationalised with deposits of Rs. 200 crore each. One of them was subsequently merged with another, thus, the total number of nationalised banks is 19 at present.

The decision to nationalise the major commercial banks was taken with the objective of opening a large number of branches throughout the country, especially in the rural areas and to mobilise deposits on a massive scale for the purpose of lending to productive purposes. These were the projects, which had remained neglected so far, i.e. agriculture, small industries and small businesses, weaker sections, etc. Initially, cent percent ownership of nationalised banks was vested in the Government of India. Subsequently, after the amendment in the Act, private share holding has also been permitted with the provision that the share of the Government shall not fall below 51%. A few banks have since issued shares to the public, with the result the Government shareholding percentage has been reduced.

5.3.2 Private Sector Banks

5.3.2.1 Privately Owned Banks

Private Sector banks fall in two categories. Those private sector banks which were in existence at the time of nationalisation are 23 and are called Old Private Sector Banks. Till 1993 no new bank could be established in India. In 1993, 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 norm of 8% from the very beginning. Nine new banks were set up according to these guidelines. One of them was subsequently merged with another. After the merger of ICICI Ltd., one of the All India Development Banks in India, with its subsidiary ICICI Bank Ltd. on March 30, 2002, ICICI Bank Ltd. has become the second largest commercial bank in India after the State Bank of India. It is obviously the largest bank in the private sector. In 2001, these guidelines were revised with the effect that the amount of capital has been raised to Rs. 200 crore (to be further raised to Rs. 300 crore) and capital adequacy norm was raised to 9%.

5.3.2.2 Foreign Banks

At present there are 41 foreign banks from 21 countries operating in India. They are the branches of banking companies incorporated outside India. There were 194 branches of foreign banks operating in India as on June 30, 2001.

5.3.3 Scheduled Banks

According to Section 42 of the Reserve Bank of India Act, 1934, banks—both public sector and private sector banks, are given the status of a Scheduled Banks, if their names are included in the Second Schedule to the Reserve Bank of India Act. For this purpose, the bank must satisfy the following conditions:

i) It must have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs,

ii) It must satisfy the Reserve Bank of India that its affairs are not being conducted in a manner detrimental to the interest of its depositors, and

iii) It must be a State Co-operative Bank or a company or an institution notified by the Central Government in this behalf, or a corporation, or a company incorporated under any law.

Thus, besides Commercial Banks, Regional Rural Banks, State Co-operative Banks and Urban Co-operative Banks are also entitled to get the status of a Scheduled Banks.

Check Your Progress 1

1) List various categories of Commercial Banks in India.

....

....

....

2) Fill up in the blanks:

i) Commercial Banks in India have passed throug! .... phases since Independence.

ii) State Bank group comprises of .... Banks.

iii) The total number of Nationalised Banks at present is ....

iv) .... bank is the largest Bank in the private sector.

3) Which are the conditions required to be satisfied by a bank for placing it under the category of Scheduled Bank under Section 42 of RBI Act 1934?

....

....

....

5.4 RESOURCES OF COMMERCIAL BANKS

Banking business essentially lies in the acceptance of deposits for the purpose of lending and investment. Acceptance of deposits thus, constitutes the main source of funds for them. Their own funds constitute a small percentage of their total resources. As we shall see later, efforts are being made during recent years to increase the owned funds of the banks also.

5.4.1 Paid Up Capital and Reserves

The authorised capital of nationalised banks is Rs. 1500 crore each. The Central Government has subscribed to the 100% paid-up capital in case of some banks, while in other cases, its percentage holding has declined with the issuance of shares to the public.

Banks transfer 20% (now 25%) of their net profits to a Statutory Reserve Fund every year. Besides, they also maintain other Reserve Funds, e.g. Capital Reserves, Share Premium, Revenue and other reserves and Investment Fluctuation Reserve.

5.4.2 Deposits

Deposits from the public, institutions, and organizations constitute the bulk of the resources of commercial banks. They accept deposits under three types of deposit accounts:

i) Fixed Deposits: the minimum period of such deposits is 15 days

ii) Savings Deposits

iii) Current Deposits

No interest is payable on current deposits, while interest on savings bank accounts is prescribed by Reserve Bank of India. Currently it is payable @ 4% p.a. Interest is calculated on the minimum balance held in the savings accounts from 11^{th} day of the month till the last day of the month.

Interest rates on fixed deposits were prescribed by Reserve Bank of India till a few years ago. Now, such interest rates are completely deregulated. Banks are permitted to prescribe their own interest rates for fixed deposits of different maturities. At the stance of the Reserve Bank of India, banks pay slightly higher rates on bulk deposits of Rs. 15 lakh and above and on deposits held in the names of senior citizens (i.e. persons of age 60 years and above).

Deposits with Commercial banks, as well as with Regional Rural Banks and Co-operative banks are insured by Deposit Insurance and Credit Guarantee Corporation of India upto an amount of Rs. 1 lakh in each account. These banks pay the insurance premium @ 5 paise per cent to the corporation for this insurance.

Scheduled Commercial Banks also solicit large deposits through certificates of deposits. The outstanding amount of CDs issued by them stood at Rs. 1695 crore as on October 20, 2000, but declined to Rs. 823 crore as on October 5, 2001.

5.4.3 Borrowings

Banks augment their resources by borrowings also. Sources of such borrowings are:

i) Reserve Bank of India

ii) Other Banks

iii) Other Institutions and Agencies.

Reserve Bank of India provides refinance for export credit and also provides short-term funds under its Liquidity Adjustment Facility (explained fully in Unit on Money Market). Moreover, banks get refinance from other Apex Banks like Exim Bank, IDBI etc.

5.5 EMPLOYMENT OF RESOURCES

As you have seen, bulk of banks' funds are raised in the form of deposits, which are repayable on demand or after a specified period. Banks, therefore, employ these funds partly in liquid assets like cash balances with themselves and other banks and money at call and short notice and the rest of the amount is either invested in securities or given in the form of loans and advances.

i) **Cash and Balances with other Banks**

These are the most liquid assets of a bank and are called the first line of defence, because banks can immediately repay the claims of the depositors with these balances. Banks keep a reasonable amount of cash, say 10% or so of deposits, in such balances.

ii) **Money at Call and Short Notice**

The surplus money with the banks is lent to other banks which are in need of funds for a day or a few days. Banks earn interest on such amount lent to other banks. The interest rate varies from day to day on the basis of demand for and supply of funds.

iii) **Cash Reserves with Reserve Bank of India**

Under Section 42 of the Reserve Bank of India Act, 1934, scheduled commercial banks are required to maintain at least 3 % of their net demand and time liabilities with the Reserve Bank of India. This is the statutory minimum limit, Reserve Bank of India is empowered to raise it to a higher percentage of upto 20%.

With effect from June 1, 2002, the Cash Reserve Ratio (CRR) is required to be maintained @ 5% (reduced from 5.5%). In recent years, Reserve Bank of India has gradually reduced this rate. With every reduction in CRR, Commercial Banks' balances with Reserve Bank of India are released to them, thereby increasing their liquidity. Reserve Bank of India pays interest at bank rate on eligible balances i.e. balances held in excess of statutory 3% limit.

iv) **Investments**

Banks invest substantial portion of their deposit liabilities in investments. Primarily, banks are under compulsion to invest in Government and other approved securities to meet the Statutory Liquidity requirement under section 24 of the Banking Regulation Act, 1949.

Besides, Reserve Bank of India has also permitted the banks to invest in corporate securities, i.e. equity shares, convertible bonds and debentures within the ceiling of 5% of their total outstanding advances as on March 31 of the previous year. Thus, commercial banks do invest in corporate securities, predominantly, bonds and debentures.

Investments of banks are shown under the following head in their Balance Sheets :

1) Government Securities
2) Other approved securities
3) Shares
4) Debentures and Bonds
5) Subsidiaries and Joint Ventures
6) Others (Commercial Paper, Indira Vikas Patras, Units of UTI and Mutual Funds)

Though the Statutory Liquidity Requirement at present is 25% of net demand and time liabilities, banks do invest more than this percentage, which is mainly due to their investments in corporate bonds and debentures. The investment-deposit ratio of Scheduled Commercial banks (on an outstanding basis) was 38.5% as on March 23, 2001.

v) **Loans and Advances**

Granting loans and advances is the principal business of commercial banks. There are three forms in which such loans are granted :

a) Bills purchased and discounted,
b) Cash credits, overdrafts and loans repayable on demand, and
c) Term loans.

a) **Bill of exchange** arises out of genuine trade transactions. When the bills are payable at sight or presentment, banks purchase them from customers (i.e. drawers' of the bills). In case of time bills or usance bills banks discount them.

b) **Cash Credit** is a running account wherein a cash credit limit is prescribed for a customer. He is permitted to withdraw the amount any time he likes and may return the money whenever he is able to do so. Interest is charged on the actual amount lent and for the period of loan.

Overdraft is a temporary facility which is granted to account holders. They are permitted to draw more than their deposits for some exigency or urgent work. Short-term loans are granted to the customers, which are repayable on demand.

c) **Term loans** are loans for medium to long periods. Such loans are granted by banks either singly, or jointly with term lending institutions. These loans are meant for investment in fixed assets or for expansion, modernisation, etc.

On the basis of security taken by banks, loans are divided into:

i) Secured by Tangible Assets (including advances against book debts)

ii) Covered by Bank/Government guarantees

iii) Unsecured

Bulk of loans fall in (i) above, and the least in (iii) above.

vi) **Interest Rate Policy**

Reserve Bank of India has introduced financial sector reforms to provide operational flexibility to the banks. Till 1994 interest rates charged by banks on their advances were regulated by Reserve Bank of India. In October 1994, Reserve Bank introduced the Prime Lending Rate (PRL) as the minimum lending rate chargeable by banks to their borrowers with Credit Limit above Rs. 2 lakhs. Thereafter, banks were given autonomy to fix their own PLR and maximum spread thereon. At present, banks are permitted to determine their own PLR. They are also permitted to offer tenor linked PLRs, i.e. different PLRs for loans with different maturities, with effect from April 19, 2001. Commercial banks have been permitted to lend at rates below PLR to exporters and other credit worthy borrowers including public enterprises.

vii) **Sectoral Deployment of Bank Credit**

Commercial banks serve the needs of different sectors of the economy. They not only provide finance to industry and trade, but are also engaged in the business of granting consumer credit, retail credit and housing loans, etc. Their priority sector advances constitute over 40% of the bank credit. The following table shows the sectoral employment of outstanding bank credit as on July 27, 2001.

Table-5.1
Sectoral Deployment of Bank Credit as on July 27, 2001

Sectors	**Amount (in Rs. crore)**
1. Industry (Medium & Large)	1,60,175
2. Wholesale Trade (other than foodprocurement)	16,567
3. Public Food Procurement Credit	51,027

	(in Rs. crore)
4. Priority Sectors :	
(i) Agriculture	52,076
(ii) Small Industries	53,241
(iii) Other Priority Sectors	48,839
Total	**1,54,156**
5. Other Sectors	
(i) Housing	17,891
(ii) Consumer Durables	6,793
(iii) Non-Banking Finance Companies	7,491
(iv) Loans to individuals	1,454
(v) Real Estate Loans	1,912
(vi) Other Non-Priority Sector Personal Loan	18,415
(vii) Advances against fixed deposits	19,383
(viii) Tourism & Tourism related hostels	1,473
Total	**98,723**
6. Export Credit	3,227
Total	**3,39,477**

Source : Report on Trend & Progress of Banking in India (2000-01).

Check Your Progress 2

1) Identify the main sources of augmentation of banks' resources by borrowings.

....

....

2) What is the maximum limit to which Cash Reserve Ratio (CRR) can be increased by RBI?

....

....

3) List the various forms in which loans are granted?

....

....

5.6 RESERVE BANK'S DIRECTIVES AND NORMS

5.6.1 Priority Sector Advances

Indian commercial banks (both in public and private sectors) are under an obligation to provide loans to the priority sectors as per the following targets laid down by Reserve Bank of India :

Total Priority Sector Advances	:	40% of the net bank credit
Total Agricultural Advances	:	18% of the net bank credit
Advances to Weaker Section	:	10% of the net bank credit

For foreign banks the targets are as follows:

Total Priority Sector Advances	:	32% of the net bank credit
Advances to Small Scale Industries	:	10% of the net bank credit
Export Credit	:	12% of the net bank credit

Priority sectors advances include advances to agriculture (direct and indirect), small-scale industries, transport operators, retail trade and small business, professional and self-employed persons, housing loans to weaker sections, and others, and investment in specified bonds of HUDCO, NABARD and National Housing Bank.

5.6.2 Prudential Norms

To bring about reforms in the functioning of commercial banks, Reserve Bank of India has prescribed prudential norms for banks as follows :

1) **Non-Performing Assets**

An asset shall be treated as non-performing asset in the following circumstances :

i) Interest and/or instalment of principal remain overdue for a period of more than 180 days in respect of a term loan.

ii) An account remains out of order for a period of more than 180 days in respect of overdraft and Cash Credit Account.

iii) A bill of exchange remains overdue for a period of more than than 180 days.

iv) Interest and/or principal of short-term agricultural loan remains overdue for two harvest seasons.

The above-mentioned period of 180 days shall be reduced to 90 days from the year ending March 31, 2004.

5.6.3 Income Recognition

Banks are required not to take to income account interest on any non-performing asset. But, interest on advances against term deposits, Indira Vikas Patra, Kisan Vikas Patra and Life Policies may be recognised, provided adequate margin is available in the accounts. If government guaranteed advances become NPA, interest on such advances should not be taken to income account unless the interest has been realised.

5.6.4 Asset Classification and Provisioning

All non-performing assets in the advances portfolio are to be classified into the following three categories :

i) *Sub-Standard Asset* : If the asset has been an NPA for a period less than or equal to 18 months.

ii) *Doubtful Asset* : If it remains NPA for a period exceeding 18 months.

iii) *Loss Asset* : Where loss has been identified by the bank/ internal/external auditor but the amount has not been written off wholly..

The above will not apply to :

i) State Government guaranteed advances where guarantee is not involved, and

ii) Central Government advances where the Central Government has not repudiated the guarantee.

All performing assets will be classified as standard assets.

Banks are required to make provisions in their books as follows:

i) *Standard Assets*: 0.25% on global portfolio basis

ii) *Sub-standard Assets*: 10% of the outstanding balance

iii) *Doubtful Assets*: 100% on unsecured portion and the following percent on the secured portion--

20% if the doubtful asset is upto 1 year

30% if the doubtful asset is over 1 year and upto 3 years

50% if the doubtful asset is over 3 years

iv) *Loss Assets*: 100% of the outstanding amount

I) Exposure Norms

To minimise the risks inherent in lending, Reserve Bank of India has prescribed Exposure Norms for the Commercial

Banks. Under these norms, the maximum amount that can be granted to a single borrower and/or group of borrowers by way of fund based and non-fund based facilities as well as in investment in their shares (upto the prescribed ceiling discussed below) are prescribed as follows with effect from March 2002.

i) *Individual Borrowers* : 15% of capital funds of the bank (paid up capital and free reserves).

ii) *Group Borrowers* : 40% of capital funds (it can go up by additional 10% in case of financing infrastructure projects alone).

II) **Norm for Exposure to Capital Market**

Banks invest their funds in corporate securities and lend against shares to individuals, brokers, etc. Reserve Bank of India has prescribed the norms for their exposure to capital market. Such exposure in all forms has been restricted to 5% of total outstanding advances (including commercial paper) as on March 31 of the previous year. The ceiling of 5% thus covers (w.e.f. May 11, 2001) :

a) Direct investments in equity share and convertible bonds and debentures,

b) Advances against shares to individuals for investment in equity shares, bonds, debentures, units of equity oriented mutual funds, and

c) Secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers.

5.6.5 Capital Adequacy Norms

Reserve Bank of India has prescribed Capital Adequacy Norms for Commercial Banks since 1992. All banks are required to maintain Capital adequacy norm of 9% with effect from March 31, 2000 (raised from earlier norm of 8%).

The basic objective of prescribing these norms is to compel the banks to increase their capital funds (as defined below) with the increase in the risks associated with different types of assets. For this purpose different assets of the bank are assigned different risk weights—from 0 to 100. The risk-adjusted values of assets are, thus, arrived at. The capital funds of the banks should be at least equal to the prescribed percentage of risk-adjusted values of the assets. This ratio is, therefore, called **Capital to Risk-Weighted Asset Ratio (CRAR)**. Presently this required percentage is 9%.

Capital funds include the following:

Tier I Capital includes :

i) Paid up capital, statutory reserve and other disclosed free reserves, if any, and

ii) Capital reserves representing surplus arising out of sale proceeds of assets.

The total of (i) and (ii) above will be reduced by :

a) Equity investments in subsidiaries of the bank,

b) Intangible assets, and

c) Losses in the current period and previous periods.

Tier II Capital includes :

i) Undisclosed reserves and cumulative perpetual preference shares,

ii) Revaluation reserves (at a discount of 55%),

iii) General provision and loss reserves (including general provisions on standard assets not more than 1.25%),

iv) Hybrid debt capital instruments, and

v) Subordinated debt (upto 50% of their I Capital eligible for this purpose).

Capital to Risk-weighted Assets Ratio (CRAR)

As at the end of March 2001, 23 out of the 27 Public Sector banks had capital in excess of 10% risk-weighted assets. Among the remaining, 2 had the ratio between 9 and 10%, one between 4% and 9% and one had negative CRAR.

Amongst the 23 old private sector banks, 16 had CRAR in excess of 10%, four between 9 and 10%, one between 4 and 9%, while 2 had negative CRAR. Amongst the new private sector banks only 1 had CRAR between 9% and 10% while the other 7 banks had CRAR in excess of 10%

5.7 THE PROBLEM OF NON-PERFORMING ASSETS

The Commercial Banks' biggest problem at present is the existence of huge amount of non-performing assets. The gross non-performing assets of Scheduled Commercial Banks increased from Rs. 60,408 crore as at end March 2000 to Rs. 63,883 crore at March end 2001. The net NPAs at these dates were Rs. 30,073 crore and Rs. 32,468 crore respectively. All categories of banks—public sector, private sector and foreign banks face this problem. The Government of India and the Reserve Bank of India have taken various initiatives to reduce the magnitude of NPAs.

These initiatives include:

i) **Establishment of Debts Recovery Tribunals**

After the enactment of the Recovery of Debts due to Banks and Financial Institutions Act 1993, twenty-three Debt Recovery Tribunals have been established at various places in India. These Tribunals ensure expeditious adjudication and recovery of debts due to banks and financial institutions. Recently, these Tribunals have been granted more powers for this purpose. These Tribunals deal with claims of banks exceeding Rs. 10 lakhs each.

ii) **Proposed Establishment of Asset Reconstruction Companies**

Government has issued an ordinance in June 2002 permitting the setting up of Asset Reconstruction Companies. These companies will take over the non-performing assets from banks and financial institutions and will try to realise hem as soon as possible.

Check Your Progress 3

1) Fill up in the blanks:

   i) RBI has laid down that .... per cent of the net bank credit should be advanced to weaker section.

   ii) The foreign banks are obliged to provide............ per cent of the net banks credit to priority sector advances.

2) Identify the circumstances in which an asset is treated as non-performing asset.

   ....

   ....

   ....

5.8 LET US SUM UP

Major portion of commercial banking in India is undertaken in the public sector. Within the public sector, the State Bank of India and its subsidiaries constitute State Bank Group on the basis of their ownership pattern. New private sector banks include ICICI Bank Ltd, which is the second biggest bank after State Bank of India. Banks get the status of Scheduled Banks on the fulfilment of prescribed conditions.

The main sources of banks' funds are deposits. Interest Rates on deposits are now completely deregulated (except savings). Borrowings from Reserve Bank and other institutions also augment their funds.

Commercial Banks employ their funds in liquid assets, semi-liquid assets and profit earning assets like loans and advances. They are required to maintain a prescribed percentage of deposits with Reserve Bank of India as CRR and also to maintain Statutory Liquidity Ratio of 25%.

Funds are lent for diversified purposes—priority sector advances constitute over 40% of total advances. They also lend for housing, consumer durables, real estate financing and other personal purposes also.

Reserve Bank of India has prescribed prudential norms to be followed by the commercial banks. Capital Adequacy Norm of 9% is to be fulfilled by them.

The biggest problem of Commercial Banks presently is the existence of huge amount of non-performing assets. Efforts are being made to solve it through Debt Recovery Tribunals and otherwise also. Banking Sector Reforms have been undertaken since 1991, still further reforms are needed to improve the functioning of commercial banks.

5.9 KEY WORDS

Authorised Capital : Authorised Capital of a company is the maximum amount of capital, which it is authorised to raise from shareholders. It is fixed at the time the companies incorporated and is specified in its Memorandum of Association.

Capital to Risk-weighted Assets Ratio : According to Capital Adequacy norms, banks have to maintain capital (as defined in the norms) at a certain percentage of the risk-adjusted values of their assets. This ratio at present is 9% and is called Capital to Risk-Weighted Asset Ratio (CRAR).

Hybrid Debt Capital Instrument : Those debt instruments which have some characteristic of equity also are called Hybrid Debt Capital Instrument.

Intangible Assets : Certain assets which do not exist in physical form are called intangible assets, e.g. goodwill, patents, rights etc. Other assets are called Tangible Assets.

Paid-up Capital : Paid-up Capital is that amount of capital, which the shareholders of a company have actually paid. Companies generally issue a part of the authorised capital, which is called, issued capital. Out of this, the capital actually subscribed to by the shareholders is called subscribed capital and the actual amount paid by them is called Paid-up Capital.

Preference Shares : Preference shares refer to the shares paid prior to the equity shares in the event of dissolution of a company. They carry at a rate of dividend, which must be paid to them before any dividend is declared to equity shareholder.

Prime Lending Rate : Prime Lending Rate is the rate of interest which a commercial bank charges on its advances to a first rate borrower, i.e. the most credit worthy borrower. This is the minimum rate that banks determine individually.

Risk Weighted Assets: According to the Capital Adequacy norms laid down by Reserve Bank of India, bank assets are assigned different risk-weights according to the degree of risk involved therein. These risks weights are from 0 to 100. Thus, the risk adjusted values of assets is calculated.

Standard Assets : According to Reserve Banks's directives, banks are required to classify their assets into 4 categories. Standard Assets are those assets, which are not non-performing, i.e. banks recover interest and principal amount from the borrower regularly.

Statutory Reserve Fund : Banking Regulation Act, 1949 requires every banking company to transfer at least 20% of the projects to a reserve fund every year. This fund is called Statutory Reserve Fund.

Tenor Linked PLR : Banks are permitted by Reserve Bank of India to fix different Prime

Lending Rates for advances of different maturities. Such rates are called Tenor Linked PLR.

5.10 SOME USEFUL BOOKS

Bhole, L.M. (2000): *Financial Institutions and Markets*. Tata Mc Graw Hills, New Delhi.

Machiraju, H.R. (1998): *Indian Financial System*, Vikas Publications, Delhi.

Sundharam, K.D.S. and Varshney, P.N. (2000) – *Banking and Financial System*, Sultan Chand & Sons, Delhi.

Varshney, P.N. (1999): *Indian Financial System and Commercial Banking*, Sultan Chand & Sons, Delhi.

5.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Broadly Commercial Banks are categorised into two groups: (i) Public Sector Banks (ii) Private Sector Banks. Again, Public Sector Banks are subdivided into two categories: (i) State Bank of India, (ii) Nationalised Banks.

2) (i) 3 (ii) 8 (iii) 19 (iv) ICICI Bank Ltd.

3) See Sub-section 5.3.3 on Scheduled Banks.

Check Your Progress 2

1) The main sources of borrowings are:

   i) Reserve Bank of India, ii) Other Banks, iii) Other institutions and agencies

2) 20%

3) i) Bills purchased

   ii) Cash credits, overdrafts and loans repayable on demand

   iii) Term loans

Check Your Progress 3

1) (i) 10% (ii) 32%

2) See Section 5.6

UNIT 6 REGULATORY FRAMEWORK FOR BANKS AND NON-BANKING FINANCE COMPANIES

Structure

6.0 Objectives
6.1 Introduction
6.2 Reserve Bank of India : Its Functions as a Central Bank
6.3 Regulations over Commercial Banks
6.4 Regulations over Co-operative Banks
6.5 Regulations over Non-Banking Finance Companies
6.6 Let Us Sum Up
6.7 Key Words
6.8 Some Useful Books
6.9 Answers/Hints to Check Your Progress

6.0 OBJECTIVES

After going through this Unit, you will be able to –

- Name the various participants in the money market,
- Identify the principal regulatory authorities for banks and non-banking finance companies,
- Explain the main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks and non-banking finance companies, and
- Describe the powers vested with Reserve Bank of India under Reserve Bank of India Act, 1934 to regulate Commercial Banks and non-banking finance companies.

6.1 INTRODUCTION

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. We have, in India, two principal regulatory authorities, namely, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). They are entrusted with the responsibilities of development and regulation of the money market and capital market respectively. These regulators derive their powers from various legislative enactments and exercise their discretion as well. The financial system thus functions within the regulatory framework. The objective of this and the next Units are to give you a broad account of such regulatory framework. In this Unit, we shall deal with the regulatory environment for the money market and the participants therein, i.e. the Commercial Banks, the Co-operative Banks, financial institutions and the non-banking finance companies.

6.2 RESERVE BANK OF INDIA : ITS FUNCTIONS AS A CENTRAL BANK

Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations over the Commercial Banks, the non-banking finance companies and the financial institutions. The Banking Regulation Act 1949 contains various provisions governing the Commercial Banks in India. Many of these provisions are also applicable to the Co-operative Banks. The State Bank of India, its subsidiary banks and the nationalised banks are also governed by the status under which they have been incorporated. In the subsequent sections of this Unit, we shall deal with the regulatory framework.

First, we shall discuss the main functions performed by the Reserve Bank of India. The Reserve Bank of India was established on April 1, 1935 under the Reserve Bank of India Act, 1934. As the country's Central Bank, the Reserve Bank of India performs the following function:

a) **Issuer of Currency Notes:** Reserve Bank of India is the sole authority to issue currency notes, except one-rupee note and coins of smaller denominations. Within the RBI, all functions relating to the issuance of notes are undertaken by the **'Issue Department'**, which is responsible for issue of notes and the maintenance of eligible assets of equivalent value to back the notes issued.

b) **Banker to the Government:** RBI acts as banker to the Central Government under the Reserve Bank of India Act, and to the State Governments, under agreements with them. As the banker to the Government, RBI provides services, such as acceptance of deposits, withdrawal of funds, receipts and payments on behalf of the Government, transfer of funds and the management of public debt.

c) **Banker's Bank:** The Reserve Bank of India controls the volume of resources at the disposal of the Commercial Banks through the various measures of credit control. This checks the ability of banks to create/squeeze credit to the industry, trade and commerce.

d) **Supervisory Authority:** RBI has the powers to supervise and control Commercial Banks. It issues licenses for starting new banks and for opening new branches. It has the power to vary the reserve ratios, to inspect the working of banks, and to approve the appointment of Chairman and Chief Executive Officers of the banks.

e) **Exchange Control Authority:** The Reserve Bank of India regulates the demands for foreign exchange in terms of the Foreign Exchange Management Act, besides maintaining the external value of Indian rupee.

f) **Regulation of Credit:** One of the most important functions of the Reserve Bank of India is to regulate the flow of credit to industry. This is achieved by measures such as the Bank rate, Reserve Requirements, Open Market Operations, selective credit controls and moral suasion.

6.3 REGULATIONS OVER COMMERCIAL BANKS

Main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks, are as follows:

1) **Establishment**

It is essential for every banking company—Indian or foreign, to acquire a licence from the Reserve Bank of India, before it commences its business in India. Reserve Bank of India issues a licence, if it is satisfied that the company fulfils the following conditions:

i) the company is/or will be in a position to pay its present or future depositors in full as their claims accrue,

ii) the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors,

iii) the general character of the proposed management of the company will not be prejudicial to the public interest, or the interests, of its depositors,

iv) the company has adequate capital structure and earning prospects,

v) public interest will be served by the grant of a licence to the company to carry on banking business in India,

vi) the grant of licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth, and

vii) any other condition to ensure that the carrying on of the banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.

A foreign bank must, in addition, satisfy the following conditions:

i) the carrying on of banking business by such company in India will be in the public interest,

ii) the Government or the law of the country in which it is incorporated does not discriminate in any way against banking companies in India, and

iii) the company complies with all the provisions of the Act applicable to such companies.

2) **Opening of Branches**

Every banking company (Indian as well as foreign) is required to take Reserve Bank's prior permission for opening a new place of business in India or outside India, or to change the location of an existing place of business in India or outside. Reserve Bank, before granting its permission, takes into account –

i) the financial condition and history of the company,

ii) the general character of its management,

iii) the adequacy of its capital structure and earning prospects, and

iv) whether public interest will be served by the opening/ change of location of the place of business.

3) **Business Permitted and Prohibited**

Section 6 contains a list of businesses which may be undertaken by a banking company. Under Clause 'O', any other business may also be specified by the Central Government as the lawful business of a banking company.

But, a banking company is prohibited from undertaking, directly or indirectly, trading activities and trading risks (except for the realisation of the amount lent or in connection with the realisation of bills for collection/negotiations).

4) **Subsidiary Company**

A banking company may establish a subsidiary company for undertaking any business permitted under Section 6, or for carrying on the business of banking exclusively outside India, or for undertaking any other business, which in the opinion of Reserve Bank, would be conducive to the spread of banking in India or to be useful in public interest.

5) **Paid-up Capital**

The Act stipulates the minimum aggregate value of its paid-up capital and reserves for banks established before 1962. Minimum amount of capital was raised to Rs. 5 Lakhs for banks set up after 1962. The revised guidelines issued by Reserve Bank for establishing new private sector banks prescribed minimum paid-up capital for such bank at Rs. 200 crore, which shall be increased to Rs. 300 crore in the next three years, out of which promoter's contribution will be 25% (or 20% in case paid-up capidal exceeds Rs. 100 crore). Non-Resident Indians may participate in the equity of a new bank to the extent of 40%.

The authorised capital of a nationalised bank is Rs. 1500 crore, which may be raised to Rs. 3000 crores. These banks are allowed to reduce the capital also but nor below Rs. 1500 crore. These banks are permitted to issue shares to the public also, but the share of the Central Government is not allowed to be less than 51% of the paid-up capital. The paid-up capital may be reduced at any time so as to render it below 25% of the paid-up capital as on 1995.

6) **Maintenance of Liquid Assets**

Section 24 required every banking company to maintain in India in cash, gold or unencumbered approved securities an amount which shall not, at the close of business on any day, be less than 25% of the total of its net demand and time liabilities in India. Reserve Bank of India is empowered to step up this ratio, called **Statutory Liquid Ratio (SLR)**, upto 40% of the net demand and time liabilities. When this ratio is raised, banks are compelled to keep larger proportion of their deposits in these specified liquid assets.

SLR is to be maintained on a daily basis. The amount of SLR is calculated on the basis of net demand and time liabilities as on the last Friday of the second preceding fortnight. Reserve Bank also possesses the power to decide the mode of valuation of the securities held by banks, i.e. valuation may be with reference to cost price, market price, book value or face value as may be decided by Reserve Bank of India from time to time.

Approved securities mean the securities in which the trustees may invest trust funds under **Section 20** of the Indian Trusts Act 1882. The securities should be unencumbered i.e. free of charge in favour of any creditor.

The Act also provides for penalties for default in maintaining the liquid assets under **Section 24**. At present SLR is to be maintained @ 25% of net demand and time liabilities (which excludes net inter bank liabilities).

7) **Maintenance of Assets in India**

Section 25 requires that the assets of every banking company in India at the close of business on the last Friday of every quarter shall not be less than 75% of its demand and time liabilities.

8) **Inspection by Reserve Bank**

Under Section 35, the Reserve Bank may, either at its own initiative or at the instance of the Central Government, cause an inspection to be made by one or more of the officers, of any banking company and its books and accounts. If, on the basis of the inspection report submitted by the Reserve Bank, the Central Government is of the opinion that the affairs of the banking company are conducted to detriment the interests of its depositors, it may prohibit the banking company from receiving fresh deposits or direct the Reserve Bank to apply for the winding up of banking company.

9) **Reserve Bank's Power to Issue Directions**

Reserve Bank of India is vested with wide powers under **Section 35** A to issue direction to banking companies generally, or to any banking company, in particular:

i) in the public interest or in the interest of banking policy, or

ii) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or

iii) to secure proper management of any banking company generally.

The banking company shall be bound to comply with such directions.

Section 36 empowers the Reserve Bank to caution or prohibit banking companies against entering into any particular transaction or class of transactions and generally give advice to the banking company.

Reserve Bank also possesses the powers to ask the banking company to call a meeting of Board of Directors, to depute its officers, to watch the proceedings of the meetings of the Board, to appoint its officers as observers and to require the banking company to make changes in the management on suggested lines.

10) **Management of Banks**

The constitution of the Board of Directors of the private sector commercial banks must be in accordance with the provisions of the Banking Regulation Act, 1949. **Section 10 A** lays down the Board of Directors be constituted in such a way that not less than 51% of the total number of members shall consist of persons who satisfy the following two conditions:

i) they have special knowledge or practical experience in respect of accountancy, agriculture, rural economy, banking, co-operation, economics, finance, law, small scale industry, or any other related matter.

ii) they do not have substantial interest in, or be connected with any company or firm which carries on any trading, commercial or industrial concern (this excludes those connected with small-scale industries or companies registered under Section 25 of the Companies Act).

Reserve Bank of India has conferred the power to direct a banking company to reconstitute the Board, if it is not constituted as above. It may remove a Director and appoint a suitable director also. A person cannot be a Director of two banking companies or a Director of a banking company, if he is a Director of companies which are entitled to exercises voting rights in excess of 25% of the total voting rights of all shareholders of the banking company.

The Act also requires that the Chairman of a banking company shall be a person who has special knowledge and practical experience of the working of a bank or financial institution, or that of financial, economic or business administration. But he shall not be a Director of a company, partner in a firm or have substantial interest in any company or firm. If, the Reserve Bank of India is of the opinion that a person appointed as Chairman is not a fit/proper person to hold such office, it may request the bank to elect another person. If it fails to do so, the Reserve Bank of India is authorised to remove the said person and to appoint a suitable person in his place.

Reserve Bank's approval is also required to appoint, re-appoint, or terminate the appointment of a Chairman, Director, or Chief Executive Officer. Reserve Bank has the power to remove top managerial personnel of the banking companies, if the Bank feels it necessary in the public interest, or for preventing the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors. Reserve Bank may appoint a suitable person in place of the person so removed. Moreover, Reserve Bank is also empowered to appoint Additional Directors not exceeding five or one third of the maximum strength of the Board, whichever is less.

The Board of Directors of the nationalised banks, are to be constituted in accordance with the provisions of Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or 1980. It provides for appointment as Directors or officials of RBI, Central Government, other financial institutions and from amongst the officers and workmen of the bank concerned. Moreover, six Directors are to be nominated by the Central Government, and two to six directors are to be elected by shareholders other than Central Government. These Directors are required to be experts in, or have practical experience in the subjects enumerated above in case of private banks' Directors. If the Reserve Bank is of the opinion that any Director elected by the shareholders (other than Government) does not fulfil the aforesaid requirement, it can remove such Director, and the Board of Directors shall co-opt another person in his place.

The nationalised banks are under an obligation to comply with the guidance given by the Central Government. According to **Section 8** of the (Nationalisation) Act, "every nationalised bank shall, in the discharge of its functions, be guided by such directions in regard to matters of policy, involving public interest as the Central Government may, after consultation with the Governor of the Reserve Bank, give".

11) **Control over Advances**

Section 21 confers wide powers on the Reserve Bank of India to issue directive to the banking companies with regard to the advances to be granted by the banking companies either generally or by any of them in particular. These directions may relate to any or all of the following:

a) the purposes for which advances may, or may not be, granted,

b) the margins to be maintained in respect of secured advances,

c) the maximum amount of advance to any one company, firm, individual or association of persons,

d) the maximum amount upto which guarantees may be given by the banking company on behalf of any company or firm, and

e) the rate of interest and other terms and conditions, on which advances may be made or guarantees may be given.

The directive issued under this Section is called **Selective**

Credit Control Directives, if they relate to advances on the security of selected commodities. Banks are bound to comply with these directives.

12) **Restrictions on Loans and Advances**

A banking company is prohibited from sanctioning loans and advances on the security of its own shares. Restrictions are also imposed under **Section 20** on the loans granted by banks to the persons interested in the management of banks.

13) **Maintenance of Cash Reserve with Reserve Bank**

Section 42 of the Reserve Bank Act, 1934 requires every scheduled bank to maintain with the Reserve Bank of India an average daily balance, the amount of which shall not be less than 3% of the net demand and time liabilities of the bank in India. Reserve Bank of India is empowered to increase this rate upto 20% of the net demand and time liabilities. If a bank fails to maintain the cash balance as required by the Reserve Bank, penalty may be imposed as prescribed in the Act. This provision applies to all scheduled banks, commercial banks, state co-operative banks, and Regional Rural Banks.

With effect from December 29, 2001, commercial banks are required to maintain Cash Reserve Ratio @ 5.5% of their net demand and time liabilities of the second preceding fortnight. It was reduced by 2 percentage points from 7.5% to 5.5% with effect from that date and further to 5% w.e.f. June 1, 2002. Reserve Bank of India pays interest on eligible cash reserves as per the Bank Rate (6.5%).

6.4 REGULATIONS OVER COOPERATIVE BANKS

The category of co-operative banks comprises of the central and state co-operative banks and urban co-operative banks. They are organised co-operative societies, which are registered and governed by State Governments under the respective Cooperative Societies Act. Thus, matters relating to registration, administration, recruitments, liquidation and amalgamation are controlled by State Governments. As they perform the functions of a bank, certain provisions of the Banking Regulation Act, 1949 also apply to them. Thus, they are regulated by Reserve Bank of India so far as matters relating to banking are concerned.

Reserve Bank's supervision and control over urban co-operative banks is far weaker. They are subject to dual control, which remains a problem. Reserve Bank has, however, prescribed prudential norms relating to income recognition, asset classification and provisioning. Exposure norms, similar to commercial banks, have also been prescribed for urban co-operative banks.

Check Your Progress 1

1) List the factors which are taken into consideration by Reserve Bank of India while permitting banking company to open a new place of business.

....

....

2) Fill in the blanks:

   i) The authorised capital of a nationalised bank is ....

   ii) Reserve Bank of India is empowered to raise the Statutory Liquidity Ratio (SLR) upto the extent of .... of net demand and time liabilities.

   iii) Section .... empowers RBI to issue directives to banking companies.

   iv) Cash Reserve Ratio is an important instrument of ....

3) Which functions are performed by the RBI?

....

....

6.5 REGULATIONS OVER NON-BANKING FINANCE COMPANIES

The Non-Banking Finance Companies perform very important financial intermediation function in India. They supplement the role of the banking institutions, as they cater to the needs of those borrowers who remain beyond the purview of the banking institutions and mobilise the savings from the depositors. Hire purchase finance and leasing companies, loans and investment companies and housing finance companies are the important categories of such Non-Banking Finance Companies (NBFCs).

In view of the significant role played by NBFCs, regulatory framework has been devised, particularly to safeguard the interests of the depositors. Chapter III B of the Reserve Bank of India Act, 1934 provides for such regulatory framework over NBFCs. Significant amendments to this Chapter were made in January, 1997, vesting more powers in the Reserve Bank of India to regulate the activities of such companies. We shall first deal with the provisions of Chapter III B, following by the important provisions of the directives issued by the Reserve Bank of India in this regard.

1) **Reserve Bank of India Act, 1934**

The powers vested in the Reserve Bank of India Act under Chapter III B of Reserve Bank of India Act, 1934 are as follows:

i) **To regulate or prohibit issue of prospectus**

In the public interest, the Reserve Bank of India may regulate or prohibit the issue by any non-banking company of any prospectus or advertisement soliciting deposits of money from the public. The Bank may also give directions to these companies as to the particulars to be included in such advertisements.

ii) **To collect information as to deposits and to give direction**

The Reserve Bank of India is empowered to direct every non-banking institution to furnish to it information or particulars relating to the deposits received by it. The Bank may also issue directions in the public interest, to such institutions generally, or to any institution in particular, or group of such institutions in particular, on any of the matters connected with the receipt of deposits. If any such institution fails to comply with any direction, the Bank may prohibit the acceptance of deposits by such institutions.

iii) **To conduct inspection**

The Reserve Bank of India may, at any time, cause an inspection to be made of any non-banking institution to verify the correctness/completeness of the particulars furnished to the Bank or to obtain any such particulars, if not submitted.

iv) The Reserve Bank of India (Amendment) Act, 1997, has conferred explicit powers on the Reserve Bank of India as follows:

a) A new NBFC cannot operate unless it is registered with Reserve Bank of India and has a minimum owned funds of Rs. 25 lakhs. Reserve Bank has been vested with the power of enhancing the minimum Net Owned Funds (NOF) of NBFCs to Rs. 2 crore in case of companies which are incorporated on or after April 20, 1999, and which seek registration with Reserve Bank of India.

b) Every NBFC is required to create a Reserve Fund and transfer not less than 20% of its net profit each year to such fund before declaring any dividend.

c) Reserve Bank of India is given the power to prescribe the minimum level of liquid assets, as a percentage of the deposits, to be maintained in unencumbered approved securities (i.e. government securities/guaranteed bonds).

d) The Company Law Board has been empowered to direct NBFCs to repay deposits that have matured, if it finds that the company is unable or unwilling to repay the depositors.

e) Powers have been conferred upon the Reserve Bank of India to:

- give directions to the NBFCs regarding prudential norms,
- give directions to the NBFCs and their auditors on matters relating to balance sheets and cause special audit as well as to impose penalty on erring auditors,
- prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and to direct NBFCs not to alienate their assets,
- file winding up petition against erring NBFCs,
- impose penalty directly on the erring NBFCs.

2) **NBFCs Acceptance of Public Deposits (Reserve Bank) Directions**

In exercise of the powers vested in it under Chapter III B, the Reserve Bank of India, issued these directions to NBFCs regarding acceptance of deposits from the public. These directions were substantially revised in January, 1998 to include prudential norms to be followed by NBFCs. The salient features of RBI Directions, as further revised in December, 1998 are as follows:

i) For regulatory purposes, NBFCs have been classified into three categories:

a) those accepting public deposits,

b) those not accepting public deposits, but engaged in financial business ,

c) core investment companies, with 90% of their total assets in investments in the securities of their group/holding/subsidiary companies.

The thrust of RBI regulation is on companies accepting public deposits (category (a) above).

ii) Public deposits have been defined to include fixed/recurring deposits received from public, deposits received from relatives and friends, deposits from shareholders by a public limited company and money raised by issue of unsecured debentures and bonds to shareholders and the public. Public Deposits exclude money raised by way of issue of secured debentures and bonds, borrowings from banks and financial institutions (including by way of unsecured debentures), deposits from directors, inter-corporate deposits, deposits from foreign citizens, deposits received by private limited companies from their shareholders, security deposits from employees, advance receipt of lease and hire purchase instalments.

iii) NBFCs with net owned funds (NOF) of less than Rs. 25 lakh (with or without credit rating) are not allowed to accept public deposits.

iv) Ceilings on public deposits for NBFCs, with NOF of Rs. 25 lakh and above, have been prescribed as follows. These ceiling limits were enforced in December, 1998. Prior to that, these limits were based on the credit rating (effective January, 1998).

A) **Equipment Leasing and Hire Purchase Finance Companies**

a) for unrated and under-rated (i.e. rating below the minimum investment grade) NBFCs—1.5 times of their NOF or Rs. 10 crore, whichever is less (provided their CRAR is 15%, or above, as per their last audited balance sheet).

b) for NBFCs with minimum investment grade credit rating—4 times of their NOF (provided they have CRAR of not less than 10% as on 31.3.1998 and not less than 12% as on 31.3.1999). They are required to increase CRAR to 15% as early as possible.

B) **Loan and Investment Companies**

a) unrated and under-rated—not entitled to accept public deposits (irrespective of their NOF and CRAR).

b) with minimum Investment Grade Credit Rating—1.5 times of NOF (provided they have CRAR of 15% or above).

Further, it has been stipulated that loan and investment companies which do not have minimum CRAR of 15% as on date, but otherwise comply with all the prudential norms and

a) have credit rating of AAA may accept or renew public deposits upto the level outstanding as on December 18, 1998 or 1.5 times of the NOF whichever is more, subject to the condition that they should attain CRAR or 15% by 31st March, 2000 and bring down the excess deposits, if any, by December 31, 2000, and

b) have credit rating of AA/A may accept or renew public deposits as per the existing provisions of Directions (i.e. 0.5 or 1 time of their NOF), but they should attain the minimum CRAR of 15% on or before 31st March, 2000 as per their audited balance sheet, failing which they should regularise their position by repayment or otherwise by December 31, 2001.

The above benefit will not be available to those companies whose CRAR is presently 15% and above but slips down below the minimum level of 15% subsequently.

v) The maximum permissible interest rate on public deposits has been fixed at 16% per annum. NBFCs can pay uniform maximum brokerage of 2% on deposits for 1 year to 5 years. Brokers may also be reimbursed other expenses not exceeding 0.5% of the collected deposits.

vi) Only those NBFCs, which are accepting public deposits, are required to submit to Reserve Bank annual statutory returns and financial statements. Other NBFCs are exempted from this requirement.

3) Prudential Norms for NBFCs

Reserve Bank of India issued guidelines prescribing the prudential norms for NBFCs in June, 1994. Companies accepting public deposits have to comply with all the guidelines, while leasing, hire purchase finance, loan and investment companies, not accepting public deposits, are required to comply with prudential norms other norms on capital adequacy and credit/investment concentration. Similarly, investment companies holding not less than 90% of their assets being securities of their group/holding/subsidiary companies and not accepting public deposits are exempted from prudential norms. These guidelines are as follows:

i) Income Recognition

NBFCs are required not to take into books income due but not received within a period of six months, till it is actually received.

ii) Classification of Assets

NBFCs are required to classify their assets as non-performing assets if payment of principal/instalment is due but not received within six months. For leasing, hire purchase finance companies such assets are to be treated as NPAs, if lease rentals and hire purchase instalments remain past due for 12 months. Guidelines regarding classification of assets into 4 categories and provisioning issued to commercial banks, are applicable to NBFCs also.

iii) Capital Adequacy Norm

In January 1998, the capital adequacy requirement for NBFCs with net owned funds of Rs. 25 lakhs and above and having public deposits had been raised from 8% to 10% (effective 31.3.1998), and further to 12% (effective 31.3.1999). The composition of capital and risk weights attached to assets and conversion of off Balance Sheet items are the same as applicable to banks.

iv) **Credit/Investment Concentration Norms**

Registered finance companies are required not to lend more than 15% of their net owned funds to a single borrower and not more than 25% of their owned funds to a group of borrowers. These limits are also applicable to investment in a single company or a single group of companies. Composite limits of credit to and investment in a single company or a single group of companies have been prescribed at 25% and 40% respectively of its owned funds. NBFCs are not permitted to lend on the security of their own shares.

The ceiling on investment in unquoted shares of companies other than their group/subsidiary companies has been fixed at 10% of their owned funds for equipment leasing and hire purchase finance companies and 20% of the owned funds for loan and investment companies.

NBFCs are advised not to invest more than 10% of their owned funds in land and building except for their own use.

NBFCs are requied to dispose off excess of the assets over the indicated ceilings within three years.

v) **Liquid Assets**

NBFCs are required to maintain certain percentage of their deposits in liquid assets to ensure their liquidity and to safeguard the interests of the depositors. With effect from January 2, 1998, the ratio of liquid assets is uniform for all NBFCs accepting public deposits. It has been prescribed at 12.5% with effect from April 1, 1998 and at 15% with effect from April 1, 1999. The liquid assets are to be maintained with relation to public deposits only.

NBFCs are required to keep Government securities and Government guaranteed bonds in the custody of a scheduled bank at the place of its head office. These securities are permitted to be withdrawn for repayment to depositors or for replacing them by other securities or in the case of reduction of deposits.

The above account shows that the Reserve Bank of India has instituted a comprehensive regulatory framework for NBFCs. Out of 8802 applications of NBFCs which were eligible for registration on the basis of Minimum Net Owned Funds of Rs. 25 lakh, registration has been granted to 7555 NBFCs. Out of them only 584 NBFCs have been permitted to accept public deposits. Applications of 1030 companies have been rejected. 28676 companies with NOF below Rs. 25 lakh have been given time upto January 8, 2000 to achieve the minimum NOF. Thus, an era of consolidating and strengthening the Non-Banking Financial Companies has commenced and better results may be expected in future.

Check Your Progress 2

1) Identify the powers vested in RBI under Chapter 3, III B of RBI Act 1934.

....

....

2) State whether following statements are true or false:

i) NBFCs with owned fund of less than Rs. 25 lakh are not allowed to accept public deposits. (T/F)

ii) For regulatory purpose NBFCs have been classified into four categories. (T/F)

iii) Unrated and under-rated loan and investment companies are not entitled to accept public deposits. (T/F)

iv) NBFCs are advised not to invest more than 10% of their owned funds in Land and building except for their own use. (T/F)

3) Are Non-Banking Finance Companies required to observe capital adequacy and credit/investment concentration norms? Why?

....

....

6.6 LET US SUM UP

In this Unit we have studied the regulatory framework under which the banks and non-banking finance companies in India function. There are two regulatory authorities in this field, viz. the Reserve Bank of India and the Securities and Exchange Board of India. They have been entrusted with the responsibilities of development and regulation of the money market and capital market respectively.

The Reserve Bank of India is the regulatory authority over the commercial banks, co-operative banks, non-banking finance companies and the financial institutions. It derives its powers from the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. Exercising its discretionary powers, the Reserve Bank of India issues directives to these institutions from time to time. In this Unit, we have studied institution-wise regulatory framework.

Reserve Bank exercises control over the commercial banks through the provisions of the Banking Regulation Act, 1949, relating to licensing of banks, opening of branches, establishment of subsidiaries, paid-up capital, maintenance of liquid assets. Reserve Bank of India has the power to inspect the banks, to issue the directives, to exercise control over the top management and advances granted by them. Cash Reserves are maintained by banks with the Reserve Bank of India under Section 42 of the Reserve Bank of India Act, 1934. Reserve Bank of India has also issued directives regarding priority sector advanced, capital adequacy ratio, exposure norms, assets classification, provisioning, etc.

Co-operative Banks are under the dual control of the State Government concerned and the Reserve Bank of India. Reserve Bank of India has been vested with the powers to regulate the non-banking finance companies and the financial institutions. Directives have been issued by Reserve Bank of India to NBFCs regarding acceptance of public deposits and Prudential Norms have been prescribed for both NBFCS and financial institutions.

6.7 KEY WORDS

Call/Notice/Term Money Market : These are three sub-divisions of the money market. When funds are lent for very short-period of time, say a day or two, or are repayable on call by the lender, it is called a transaction in the call money market. Banks are generally participants in call money market.

When funds lent are repayable after a short notice or 3 or 7 days, it constitutes notice money market. When funds are lent for a fixed but short period, say 15 or 30 days, it is term money market.

Cash Reserve Ratio : Banks are required to maintain a certain percentage of their net demand and time liabilities as cash balance with Reserve Bank of India. The statutory minimum ratio is 3%, but Reserve Bank of India can raise it upto 20%. At present it is 5.0% (effective from June 1, 2002).

Capital Adequacy Norms : Reserve Bank of India has laid down this norm for banks and financial institutions to ensure that they possess adequate capital funds of their own, vis-à-vis their assets, which are adjusted for the risk involved therein.

Credit Rating : Credit Rating is a symbol assigned by Credit Rating Agency to a debt instrument of a company like bond, debentures, fixed deposits and commercial paper, depicting the quality of the instrument in terms of safety of principal and possibilities of payment of interest etc.

Exposure Norms : These norms are also fixed by Reserve Bank of India for banks and financial institutions. These norms lay down the maximum limit on advances to be granted by a bank/ non-banking company or financial institution, together with any other stake undertaken by them in respect of one single borrower and/or a group of borrowers. This norm is expressed as a percentage of the net-owned funds of the bank/FI. Such norm is also laid down by a bank's exposure in a single industry. Its purpose is to restrict the banks from over-lending to a single borrower/group of borrowers.

Liquid Assets : Banks maintain a certain portion of their deposits in cash with themselves or in current account with other banks or with Reserve Bank of India. Besides, they invest in gilt, edged securities also which can be converted in cash easily. Such assets of a bank are called liquid assets.

Money Market : Money Market is that segment of the financial market wherein transactions in short-term funds are undertaken, i.e. where funds are low and borrowing is for short periods.

Nationalised Banks : There are 19 Commercial Banks in India which are nationalised banks. The ownership of such banks is vested in Government of India. A few of them have in recent years issued capital to the public also.

Priority Sector : Reserve Bank of India has designated certain sectors of the economy as priority sectors. Banks have been asked to provide at least 40% of their credit to these sectors. These sectors include small industries, export, small business and small transporters and self-employed persons and so on. These sectors had remained neglected by the banks in the past.

Prudential Norms : To improve the financial position of the banks and their efficiency and productivity, Reserve Bank of India has prescribed certain norms (i.e. principles or standards) to be followed by banks. These norms are called prudential norms as they are intended to lead to prudential practices.

Repo and Reverse Repo Deals : Repo means repurchase. A person or institution may borrow money for a short period on repo basis also. It means that he sells to the lender his securities with the condition that he may buy back his securities within a certain period and repay the amount of the loan taken/sale proceeds of the security. In such case, he will pay interest for the period for which he has utilised the money. It is called 'repo rate'.

'Reverse repo' is opposite to 'Repo'. In this case the lender lends the money (or purchases the securities) on the condition that he may sell the securities back to the same person, who shall take them back and pay the 'reverse repo' rate to the lender.

Selective Credit Control : Reserve Bank of India has the power to issue directives to the banks determining the amounts, terms and conditions, the rate of interest etc. on advances granted on the security of selected commodities. Such directives are called selective credit control directives.

Statutory Liquid Ratio (SLR) : Reserve Bank of India prescribes a ratio of liquid assets to net demand and time liabilities of a bank. Such ratio is called SLR. At present it is 25% (i.e. minimum prescribed by law).

6.8 SOME USEFUL BOOKS

Bhole, L.M. (2000) –*Financial Institutions and Markets*, Tata McGraw Hills, New Delhi.

Khan, M. (2000) –*Financial Services*, Chapter 1.

Machiraju, H.R.(1998)–*Indian Financial System*, Vikas Publishing House, Delhi

Reserve Bank of India–*Functions and Working* (1983), RBI.

Reserve Bank of India–*Various Reports on Currency and Finance.*

Varshney, P.N. (1999)–*Indian Financial System and Commercial Banking*, Sultan Chand & Sons, Delhi.

Varshney, P.N. & Mittal, D.K., 4th Edition (2002) – *Indian Financial System*, Sultan Chand & Sons, Delhi.

6.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) i) The financial condition and history of the company.

   ii) The general characteristics of its management.

   iii) The adequacy of its capital structure and earning prospects.

   iv) Impact on public interest.

2) (i) Rs. 1500 crore (ii) 20% (iii) Section 35 A (iv) Credit Control

3) See Section 6.2

Check Your Progress 2

1) i) Regulation of issue of prospectus.

   ii) Collection of information relating to deposits received by any NBFC.

   iii) Conducting of inspection of any NBFC to verify correctness/completeness of the particulars furnished to the bank.

2) (i) True (ii) False (iii) True (iv) True

3) See Section 6.5

UNIT 7 MONEY MARKET IN INDIA

Structure

7.0 Objectives
7.1 Introduction
7.2 Participants in Money Market
7.3 Reserve Bank of India
    7.3.1 Interim Liquidity Adjustment Facility
    7.3.2 Liquidity Adjustment Facility
7.4 Money at Call and Short Notice
    7.4.1 Move towards Pure Inter Bank Call Money Market
7.5 Treasury Bills
    7.5.1 Discount and Finance House of India and Treasury Bills
    7.5.2 Commercial Bills of Exchange
7.6 Certificates of Deposits
7.7 Commercial Paper
7.8 Let Us Sum Up
7.9 Key Words
7.10 Some Useful Books
7.11 Answers/Hints to Check Your Progress

7.0 OBJECTIVES

This unit deals with the money market in India—its participants and instruments. After going through this Unit, you will be able to –

- Explain the meaning and significance of the money market,
- Describe nature and mechanism of various instruments used in the money market, and
- Discuss role of the regulator—Reserve Bank of India, over the money market.

7.1 INTRODUCTION

We have learned in the previous Units that the financial market plays a very important role in the economy of a country. These markets are broadly classified into two categories namely, Money Market and Capital Market, primarily based on the duration for which dealing in funds are transacted. In this Unit, we will discuss the money market in India. The Capital Market will be taken up in the next Unit. Money Market is the market for short-term funds, generally ranging from overnight to a year. It helps in meeting the short-term and very short-term requirements of banks, financial institutions, firms, companies and also the Government. On the other hand, the surplus funds for short periods, with the individuals and other savers, are mobilised through the market and made available to the aforesaid entities for utilisation by them. Thus, the money market provides a mechanism for evening out short-term liquidity imbalances within an economy. The development of the money market is, thus, a prerequisite for the growth and development of the economy of a country.

7.2 PARTICIPANTS IN MONEY MARKET

The major participants who supply the funds and demand the same in the money market are as follows:

i) **Reserve Bank of India:** Reserve Bank of India is the regulator over the money market in India. As the Central Bank, it injects liquidity in the banking system, when it is deficient and contracts the same in opposite situation.

ii) **Banks:** Commercial Banks and the Co-operative Banks are the major participants in the Indian money market. They mobilise the savings of the people through acceptance of deposits and lend it to business houses for their short-term working capital requirements. While a portion of these deposits is invested in medium and long-term Government securities and corporate shares and bonds, they provide short-term funds to the Government by investing in the Treasury Bills. They employ the short-term surpluses in various money market instruments.

iii) **Discount and Finance House of India Ltd. (DFHI):** DFHI deals both ways in the money market instruments. Hence, it has helped in the growth of secondary market, as well as those of the money market instruments.

iv) **Financial and Investment Institutions:** These institutions (eg. LIC, UTI, GIC, Development Banks, etc.) have been allowed to participate in the call money market as lenders only.

v) **Corporates:** Companies create demand for funds from the banking system. They raise short-term funds directly from the money market by issuing commercial paper. Moreover, they accept public deposits and also indulge in inter-corporate deposits and investments.

vi) **Mutual Funds:** Mutual funds also invest their surplus funds in various money market instruments for short periods. They are also permitted to participate in the Call Money Market. Money Market Mutual Funds have been set up specifically for the purpose of mobilisation of short-term funds for investment in money market instruments.

7.3 RESERVE BANK OF INDIA

As the Central Bank of the country, the Reserve Bank of

India plays a very significant role in the Indian Money Market. The various tasks being performed by the Reserve Bank have been explained in Unit 6. Let us recall that Reserve Bank is the banker to the banks and Central and State Governments. It manages the liquidity in the money market by granting refinance facilities to the banks and by stipulating the reserve requirements. **Cash Reserve Ratio (CRR)** and **Statutory Liquidity Requirements (SLR)** are the principal tools to affect the liquidity with the banks. When the banking system has excess liquidity, Reserve Bank of India raises the **Cash Reserve Ratio (CRR)** and thus, impounds the surplus liquidity and vice-versa. Statutory Liquidity requirement is raised to divert bank funds mainly to Government and other approved securities and thereby reducing liquidity with banks.

Reserve Bank of India has been providing in the past refinance facilities to the banks through different schemes, which were in operation from time to time. The **Narsimham Committee on Banking Sector Reforms, 1998** recommended that the Reserve Bank of India should provide support to the market through a Liquidity Adjustment Facility (LAF). Reserve Bank of India accordingly introduced LAF effective from June 5, 2000, which was preceded by interim liquidity facility, w.e.f. April, 1997.

7.3.1 Interim Liquidity Adjustment Facility (ILAF)

Under the ILAF facility, liquidity was managed through a combination of:

i) Repos

ii) Export credit refinance

iii) Collateralised lending facilities

iv) Open market operations at set rate of interest

Repo is a method of borrowing against certain securities for a short period. The borrower undertakes a commitment to purchase back (or to take back) the same securities after the specified period at a pre-determined price. The difference between the two prices is treated as interest on the amount borrowed.

Reserve Repo is the opposite practice wherein the lender lends against the securities with the commitment to take back the securities from the borrower against payment at a specified price. Thus by reverse repos the Reserve Bank contracts liquidity from the system.

Collateralised Lending Facility: Under this facility, banks were provided funds upto 0.25% of their fortnightly average outstanding aggregate deposits in 1997-98. This facility was available for two weeks at the Bank rate. An **Additional Collateralised Lending Facility (ACLF)** for an equivalent amount at the Bank rate plus 2% was also made available to banks. These funds could be utilised beyond two weeks at a penal rate of 2.0%. Similarly, Primary Dealers were provided Level I Liquidity Support (equal to CLF for banks) against **collateral of Government securities** for period upto 90 days. They were also provided Additional Level II Liquidity Support (equal to ACLF) at Bank rate plus 2% for a period up to two weeks at a time. Thus, the Reserve Bank managed liquidity under the Interim Liquidity Adjustment Facility which was later on converted into full-fledged Liquidity Adjustment Facility.

7.3.2 Liquidity Adjustment Facility (LAF)

This facility was introduced with effect from June 5, 2000 and will be completed in three phases as follows:

1) The ACLF for banks and Level II liquidity support to Primary Dealers, as stated above, have been replaced by variable reverse repo auctions. The fixed rate repo has been replaced by variable rate repo auctions.

2) In the second stage, CLF for banks and Level I support to Primary Dealers will be replaced by variable rate reverse repo auctions.

3) In the third stage the LAF will be operated at different timings of the same day, if necessary.

Thus, after the second stage, repos and reverse repos, together with open market operations, will become the main instruments of affecting liquidity in the system.

At present repo/reverse repo auctions are conducted on a daily basis except Saturdays with a tenor of one day except on Fridays and days preceding the holidays. Bids are invited by Reserve Bank of India which are accepted either wholly or partially.

Interest rates in respect of both repos and reverse repos are decided through cut off rates emerging from auctions on uniform price basis. In August 2000, repo auctions of tenor between 3 to 7 days were also introduced.

When market liquidity happens to be easy, there are heavy bids at the Reserve Bank's repos auctions. Repo rate is an overnight rate. In the beginning of March 2002, Reserve Bank of India reduced the cut off rate for one-day repo auctions from 6.5% to 6%. Thus, repo rate is considered as the floor rate for the call rates. It was further reduced to 5.75% w.e.f. 27th June, 2002.

Reserve Bank of India infuses liquidity by accepting bids at the Reverse Repo auctions. The chief advantage of the system of LAF is the quantum of adjustment and also the rates of interest would be flexible depending upon the needs of the system. Moreover, funds lent by Reserve Bank of India under this facility are intended to meet primarily the day-to-day liquidity mis-match in the system and will not be permitted to be used for meeting the normal financing requirements of the banks and other institutions.

Check Your Progress 1

1) What do you understand by Money Market? Who are the major participants in this Market?

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2) What are the salient features and significance of the Liquidity Adjustments Facility implemented by the Reserve Bank of India?

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3) Distinguish between:

(i) Money Market and Capital Market

(ii) Repos and Reverse Repos

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7.4 MONEY AT CALL AND SHORT NOTICE

Market at call and short notice is an important constituent of the money market. It deals with short-term funds repayable at call or at a short notice. Initially the commercial banks used to be the participants in this market. Hence, this market was called the Inter Bank Call Money Market. The necessity for such inter-bank borrowings arise because some banks feel the need for short-term liquidity at a certain time, while other banks have surplus liquidity at that time which they can spare for a short period, e.g. a day or a few days, and thereby, they intend to earn income.

During the last two decades, the Reserve Bank of India has permitted other financial institutions also to participate in the Call Money Market, but only as lenders. Such institutions include the Life Insurance Corporation of India, the Unit

Trust of India, the General Insurance Corporation of India, the Industrial Development Bank of India, the National Bank for Agriculture and Rural Development, and Mutual Funds. Further, the Reserve Bank of India also permitted all such entities which have bulk lendable resources and not having outstanding borrowings from banks, to lend in the Call Money Market through Primary Dealers. The Discount and Finance House of India plays a very significant role in the Call Money Market and participates both as a lender and a borrower. Its leading role in this market may be gauzed only by the fact that its aggregate lending in the Call, Notice and Term Money Market amounted to Rs. 6,57,094 crore during 2000-01 and Rs. 6,77,922 crore during the previous year. It offers two rates–Bid Rate and Offer Rate with a small difference between the two. For example as on 29th November, 2001 its bid rate was 6.70%, while the offer rate was 6.40%.

Till May 1984 the Call rates were administered by Indian Banks' Association by imposing a ceiling rate. Since then, it is now determined by the demand for and supply of bankable funds in the market. The Call rates are very volatile in behaviour—they shoot up when there is dearth of liquidity and ease with abundant supply of funds. This is the case with the Call lending rates announced by the Discount and Finance House of India Ltd also. For example, during the year 2000-01 the minimum rate touched the level of 0.50% during the fortnight ended on 20th April 2000 and the maximum rate went up to 35% during the fortnight ended 29th June, 2000.

7.4.1 Move Towards Pure Inter-Bank Call Money Market

As we have already noted above, several non-bank entities such as financial institutions and corporates (which lend in the call money market through Primary Dealers) were permitted to lend in the call/notice money market. Accepting the recommendation of the Narasimham Committee II, Reserve Bank of India has decided to move towards a pure inter-bank (including Primary Dealers) call/notice money market. In its credit policy of April 2001, Reserve Bank of India announced the steps to gradually phase out these institutions. Permission to corporates to route their call transactions through Primary Dealers was given upto June 30, 2001. Non-bank institutions are required to gradually reduce their participation in call market in four stages. With effect from May 5, 2001 non-banks have been allowed to lend upto 85% of their average daily lending in call market during 2000-01. Their participation will be reduced to 70%, 40%, 10% and 0% of their average daily lending during 2000-01 with effect from the dates to be fixed by Reserve Bank. The exclusion of the non-banks from the call money market is expected to reduce the volatility in the market. Instead, it is intended to develop the repo-market so that the non-banks can park their excess funds there.

In its credit policy announced on April 29, 2002, Reserve Bank of India decided to reduce banks' relance on call/ notice money market. For this purpose, the following limits have proposed:

i) **Scheduled Commercial Banks' daily lending** in the Call/ notice money market will be restricted to 25% of their owned funds as at the end of March of the previous financial year.

ii) Their daily borrowings in the call/notice money market will be restricted to 100% of their owned funds or 2% of their aggregate deposits at the end of March of the previous financial year, whichever is higher. This will be implemented by August, 2002.

7.5 TREASURY BILLS

A Treasury Bill is an instrument for short-term borrowing by the Government of India. It is issued by the Reserve Bank of India on behalf of the Government of India in the form of a promissory note. The necessity for issuing treasury bills arises because of the periodic nature of receipts of Government while the Government expenditure is on a continuing basis. Taxes are payable to the Government after quarterly intervals or so, but Government has to meet its expenditure on daily or monthly basis. Thus, to bridge this mis-match between the timings of Government receipts and expenditure, Government borrows money on short-term basis by issuing Treasury Bills.

The Treasury Bills are issued for different maturity periods. Till May 14, 2001, the maturity periods were 14 days, 91 days, 182 days and 365 days. But with effect from May 14, 2001 auctions of 14 days and 182 days Treasury Bills have been discontinued. The Treasury Bills are sold through auctions. While auctions of 91 days Treasury Bills take place on a weekly basis, the auctions for 364 days Treasury Bills are held on a fortnightly basis. The Reserve Bank of India also notifies the amounts in respect of the Treasury Bill auctions. The notified amounts for 14 days, 91 days Treasury Bills auctions are Rs. 100 crores each. The notified amount for 364 day Treasury Bills was raised from Rs. 500 crores to Rs. 750 crores during 2000-01 and has been further raised to Rs. 1000 crores for auctions to be held during 2002-03.

Out of the bids received by it, the Reserve Bank of India accepts bids upto the notified amount after determining its cut-off rate. The bids may be accepted for a lower amount also. In such cases, the rest of the amount (i.e. unsubscribe amount) devolves on the Reserve Bank of India. On the basis of the cut-off price, a yield on the Treasury bill is calculated. For example, in the auction for 14 day Treasury Bills held on 26th Dec., 2000, 18 bids were received but only 5 were accepted for Rs. 30 crore at the cut–off price of Rs. 99.68 giving a yield of 8.37% which was equal to the yield in previous auction. Thus, Rs. 70 crores were devolved on the Reserve Bank of India. The yield on Treasury Bills depends upon the price at the cut off level. There has been significant drop in the yield on Treasury Bills in the Financial Year 2001-02 as shown in the Table below:

Table: 7.1
Yield on Treasury Bills

	364 days Bill		91 days Bill	
Month	**2000-01**	**2001-02**	**2000-01**	**2001-02**
April	9.27	8.83	8.05	8.06
May	9.15	8.33	8.46	7.65
June	9.24	7.83	8.91	7.26
July	9.77	7.37	8.86	7.07
August	10.81	7.22	10.29	6.91
September	10.85	7.21	10.17	7.01
October	10.46	7.05	9.67	6.86
November	10.15	6.75	9.08	6.71
December	10.02	7.13	8.90	6.89

Source: Economic Survey 2001-02

7.5.1 Discount and Finance House of India and Treasury Bills

Discount and Finance House of India (DFHI) was set-up by the Reserve Bank of India jointly with public sector banks and All-India Financial Institutions. It was incorporated on March 8, 1988 under the Companies Act, 1956 and commenced its business operations from April 25, 1988. The main objective of establishing DFHI was *"to facilitate the smoothening of the short-term liquidity imbalances by developing an active money market, and integrating the various segments of the money market."* DFHI has a share capital of Rs. 200 crores which has been subscribed by Reserve Bank of India, public sector banks and Financial Institutions.

The activities of DFHI include the following:

a) **Dealing in Treasury Bill:** Treasury Bills are issued by the Reserve Bank of India on behalf of the Government of India. DFHI regularly participates in the auctions through which these Treasury bills are sold. DFHI provides a ready market for these Treasury Bills by offering buy/sell quotes.

b) **Re-discounting short-term commercial bills:** DFHI aims to impart liquidity to commercial bills, which have already been discounted by commercial banks or Financial Institutions. For this purpose, it announces its bid and re-discount rates on a fortnightly basis.

c) **Participating in the Inter-Bank call money, notice money and term deposit market:** DFHI has been permitted by the Reserve Bank of India to operate in the inter-bank call money market both as a lender and borrower of funds ranging from overnight money to money for 14 days.

d) **Dealing in Commercial Papers, Certificates of Deposits and Government Securities:** DFHI offers its bid rates in respect of Commercial Papers and Certificates of Deposit. The Bid rate is the discount rate at which DFHI is ready to buy CDs/CPs from the market. DFHI also participates in auctions of Government dated securities.

Discount and Finance House of India Ltd. provides liquidity in the money market by dealing in the money market instruments, including Treasury Bills. It deals in Treasury Bills in the primary market and secondary market as well. The following table shows the figure of its turnover of such bills during the financial year 2000-01:

Table: 7.2 : DFHI's Turnover in Treasury Bills

	Rs. crore
(A) Primary Market Turnover	**2410.98**
(i) Purchase at auctions (including developments)	2186.43
(ii) Maturities	224.55
(B) Secondary Market Turnover	**22082.08**
(i) Outright	3946.52
(ii) Repos	18135.56
Total Turnover (A + B)	**24493.06**

DFHI participates in all auctions of treasury bills and a minimum bidding commitment for each treasury bills auction is prescribed. During 2000-01 the extent of minimum commitment was fixed at 18% as against 15% for the previous year. During 2000-01 DFHI achieved a success rate of 42.11% much above the prescribed minimum. DFHI also earned underwrite fee on Treasury Bills during the year. But with effect from June 2000, Reserve Bank of India has discontinued the practise of payment of this fee.

DFHI's turnover (i.e. purchase and sale) in Treasury Bills in the Secondary Market comprises both on outright basis and on repo basis. The Repos imply sale/purchase of Treasury Bills on the condition that the buyers/sellers will sell or buy the Treasury bills from the Discount House on a pre-determined price in the coming days. Discount House of India provides two-way quotes for this purpose—one for bids and the other for offer. These rates were 6.9% and 6.85% respectively as on 30th November, 2001 indicating a very small difference between the two.

Check Your Progress 2

1) What do you understand by Call Money Market?

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2) Why are Treasury Bills issued and by whom?

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3) Discuss the role of Discount and Finance House of India developing a Secondary Market for Treasury Bills.

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7.5.2 Commercial Bills of Exchange

Commercial Bills of Exchange arise out of genuine trade transactions and are drawn by the seller of the goods on the buyers (i.e. debtors), where goods are sold on credit. They are called 'Demand Bills', when payable on demand or on presentment before the buyer, who is called the 'drawee' of the bill. Alternatively, the bills may be payable after a specified period of time, e.g. 30, 60 or 90 days. Such bills are called 'Usance Bills' and need acceptance by the drawee. By accepting the bills, the drawee gives his consent to make payment of the bills on the due date. Thus, payment of the bills is assured on the dates of maturity. These bills are, therefore, called self-liquidating in nature.

The drawee of the bill (i.e. the seller of the goods) generally discounts the bill with a commercial bank. By discounting is meant that the bill is endorsed in favour of the banker, who makes payment of the amount of the bill less discount (i.e. interest on the amount for the period of the bill) to the drawee. Thus, the drawee gets payment of the bill (less discount) immediately. The discounting banker, however, recovers the money from the acceptor of the bill on the due date of the bill. The bill is thereafter extinguished.

Commercial Bill of Exchange is a negotiable instrument i.e. it may be negotiated (or endorsed/transferred) any number of times till its maturity. When the discounting bank falls short of liquidity, it may negotiate the bill in favour of any other bank/financial institution or the Reserve Bank of India and may receive payment of the bill less re-discounting charges (i.e. interest for the unexpired period of the bill). This process is called re-discounting of Commercial Bills and may be undertaken several times, till the date of maturity of the bill.

The Reserve Bank of India introduced a Bills Re-discounting Scheme in 1970. Under this scheme bills are re-discounted by Reserve Bank of India or by any scheduled bank/financial institution/investment institution/mutual fund. But important pre-conditions are that the bill should arise out of a genuine trade transaction, must be accepted by the buyer's banker either singly or jointly with him and the period of maturity should not exceed 90 days.

Commercial bill of exchange, thus, is an instrument through which the banks/financial institutions/mutual funds may park their surplus funds for a shorter period as they can afford. Thus liquidity imbalances in the financial system are removed or minimised. Reserve Bank of India has taken several steps in the past, but the practice of drawing bills has not become very popular in India. The obvious reason is the strict discipline that it imposes on the acceptor of the bill to make payment of the bill on the due date. Bills purchased and discounted by Scheduled Commercial Banks in India as on March 31, 2001 constituted just 3.88% of their total assets (i.e. Rs. 50224 crores). But the outstanding amount of commercial bills re-discounted by them with various financial institutions was Rs. 1013 crores as on the same date. This shows that bills re-discounting with other financial institutions is to a limited extent only.

7.6 CERTIFICATES OF DEPOSITS

A Certificate of Deposit is a receipt for a deposit of money with a bank or a financial institution. It differs from a fixed Deposit Receipt in two respects. First, it is issued for a big amount and second, it is freely negotiable. The Reserve Bank of India announced the scheme of Certificates of Deposit in March 1989. The main features of the scheme are as follows:

i) Certificate of Deposits can be issued by Scheduled Commercial Banks (excluding Regional Rural Banks) and the specified All-India Financial Institutions like Industrial

Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IDBI), and the Export Import Bank of India (Exim Bank).

ii) Certificates of Deposits can be issued to Individuals, Associations, Companies and Trust Funds.

iii) Certificates of Deposits are freely transferable by endorsement and delivery after an initial lock-in period of 15 days after which they may be sold to any of the above participants or to the Discount and Finance House of India (DFHI).

iv) The maturity period of Certificate of Deposits issued by Banks may range from 3 months to 12 months while those issued by specified Financial Institutions may range from 1 to 3 years.

v) Certificate of Deposits are to be issued at a discount to the face value.

vi) Presently there is no limit on the amount which a Bank may raise through Certificate of Deposits. Initially, though, there was a limit linked to the fortnightly aggregate average deposits of the bank.

vii) The minimum amount for which they may be issued is now pegged at Rs. 5 Lacs. (Reduced from Rs. 25 Lacs).

viii) The minimum size of issue of Certificate of Deposits to a single investor is Rs. 5 Lacs, thereafter they can be issued in multiples of Rs. 1 Lac. (with effect from October 1997).

ix) Banks and Financial Institutions are required to issue CDs only in dematerialised form with effect from June 30, 2002. The existing CDs are to be converted into demat forms by October 2002.

Certificate of Deposits are a popular avenue for companies to invest their short-term surpluses because Certificate of Deposits offer a risk-free investment opportunity at rates of interest higher than Treasury bills and term deposits, besides being fairly liquid. For the Issuing Banks, Certificate of Deposits provide another source of mobilizing funds in bulk.

The outstanding amount of Certificate of Deposits of scheduled commercial banks declined perceptibly to a level of Rs. 12,134 crores for the fortnight ended March 28, 1997 from Rs. 16,316 crores for the fortnight ended March 29, 1996. Due to lack of demand for funds and the general decline in the interest rates, the discount rates range on

Certificate of Deposits declined substantially from 12.00—22.25% for the fortnight ended March 29, 1996 to 7.00—15.75% for the fortnight ended March 28, 1997 and further to 7.30—12.50% for the fortnight ended September 12, 1997.

In subsequent years, the total amount of outstanding CDs has been continuously on the decline. The amount of such CDs declined from Rs. 14,584 crores during the fortnight ending May 5, 2000. Thereafter there has been a slight revival in the amount of outstanding CDs, when the figure touches Rs. 1,695 crores on October 20, 2000. The effective rate of interest on CDs has also witnessed sharp decline from 8.25 to 24% to 6.30% to 14.06% range during this period.

7.7 COMMERCIAL PAPER

Commercial Paper is a short-term usance promissory note with fixed maturity, issued by creditworthy and highly rated corporations. It is negotiable by endorsement and delivery. The Reserve Bank of India permitted its introduction in January 1990 as an additional source of short-term finance to corporates and also as an avenue for investment of funds by large investors.

Reserve Bank of India has issued guidelines for issuance of commercial paper. These guidelines, as amended in October, 2000 have the following features:

i) **Eligibility:** Commercial Paper may be issued by Primary Dealers, Secondary Dealers and All India Financial Institutions, besides the corporates.

The eligibility conditions prescribed for the corporates are:

a) Tangible net worth should be Rs. 4 crores,

b) It should have a sanctioned working Capital limit from a bank or financial institution, and

c) The borrowed account should be a standard asset.

ii) **The Instrument of Commercial Paper should have:**

a) A minimum maturity period of 15 days and the maximum period upto one year.

b) A minimum amount of Rs. 5 lakhs and thereafter in its multiplies.

c) Minimum credit rating of P_2 of CRISIL or equivalent rating by other approved credit rating agencies.

iii) **The Investors in Commercial Paper:** CPs can be held by individual banks, corporates, unincorporated bodies, Non-Resident Indians and foreign financial institutions.

iv) **Methods of Issuing Commercial Paper:** Only Scheduled Banks can act as issuing and paying agents. CPs can be issued as a promissory note or in a dematerialised form. With effect from June 30, 2001, it is mandatory that all fresh issuance and investments in CPs should be in dematerialised form. Existing CPs were also required to be converted into demat form by October 31, 2001. Underwrit is not permitted.

CPs are issued at a discount to face value. Discount rate is freely determined by the issuing company. CPs are freely transferable. The issuing company bears all expenses, e.g. dealers' fees, rating agency's fees and other charges.

CPs are required to be issued as a 'stand alone' product. It means that while the banks and financial institutions fix working capital limits for the Corporates issuing CPs, they will take into account all sources of finance available to the Company, including the CPs.

Commercial Paper in India

Issuance of Commercial Paper by the eligible corporates has now become an established practise because of its lower cost. Total outstanding amounts of CPs ranged between Rs. 5000 crores and Rs. 8000 crores during January 1999 and July 2001. The typical effective rates of discount ranged between 8% to 12% during this period and varied from time to time.

Scheduled Commercial Banks have been the predominant investors in CPs and their outstanding holding was Rs. 6,984 crores as on 23rd March, 2001 (as against the total outstanding amount of Rs. 6,991 crores as on 15.3.2001)

Check Your Progress 3

1) State the pre-condition for re-discounting a Commercial Bill by RBI under Re discounting Scheme, 1970.

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2) What are Certificates of Deposits? How do they differ from fixed deposits in banks?

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3) What do you understand by Commercial Paper? Give the salient features of the guidelines issued by Reserve Bank of India in this regard.

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7.8 LET US SUM UP

The financial markets play a significant role in the economy of a country. These markets are of two types: Money Market and Capital Market. Money Market deals in short-term funds upto the period of one-year. Commercial and Co-operative Banks, Discount and Finance House of India Ltd., financial and investment institutions, Reserve Bank of India, corporates and Mutual Funds participate in the money market. As a Central Bank, Reserve Bank of India performs various tasks including the effective regulation of financial institutions. It provides refinance facilities to the banks through the schemes like Interim Liquidity Adjustment Facility (ILAF) and Liquidity Adjustment Facility (LAF). Call Money Market and Short Notice Money Market are important constituents of the money market.

Earlier several non-bank entities such as financial institutions and selected corporates were permitted to lend directly in the call/notice money market. However, with a view to reduce the volatility in the market, RBI has taken steps to reduce the participation of non-bank institutions in the Call Money Market. Treasury Bills, Commercial Bills of Exchange, Certificates of Deposit, Commercial Paper are the important instruments for short-term borrowings in the money market.

7.9 KEY WORDS

Additional Collateralised Facility : This facility is in addition to the collateralised lending facility. It is granted at Bank rate plus 2% points.

Call Money Market : This is the market for short-term funds, generally for one-day or a few days. Banks lend their short-term surplus funds in this market to other banks. Other institutions also participate as lenders only.

Certificates of Deposits : It is a receipt for deposits made with a bank or financial institution. It is freely transferable instrument.

Collateralised Lending Facility : Under this facility, Reserve Bank of India provided funds to the Commercial Banks upto 0.25% of their fortnightly average outstanding deposits in 1997-98. Such facility was granted for two weeks at Bank rate.

Commercial Paper : It is an unseamed short-term debt instrument issued by credit worthy corporates and financial institutions. Its maturity ranges between 15 days and one year. It is negotiable instrument.

Liquidity Adjustment Facility (LAF) : At present Reserve Bank of India manages liquidity in the economy through the repo and reverse repo auctions under the Liquidity Adjustment Facility. It absorbs liquidity from the system through repos and release funds through reverse repos.

Money Market Instruments : Instruments through which funds are transacted for short-term period in the money market are called money market instruments for example, certificates of deposits, commercial papers, bills of exchange.

Refinance Facilities : The Reserve Bank of India, IDBI, SIDBI, NABARD and Exim Bank provides loans to banks against the loans granted by them. Such loans constitute refinancing.

Repo Auctions : Repo is the right to repurchase the security. Under repo auctions the borrower retains the right to take back the security by repaying the borrowed amount. Under repo auctions Reserve Bank of India sells the securities and thus, contracts liquidity, wherever there is excess liquidity.

Treasury Bills : These are instruments for short-term borrowings by Government of India and are issued on its behalf by Reserve Bank of India. At present they are issued by auction for 91 days and 365 days.

Variable Reverse Repo Auctions : Under the reverse repo auctions Reserve Bank of India releases funds in the system by buying securities in the auction.

7.10 SOME USEFUL BOOKS

L.M. Bhole (3rd Edition, 2002): Financial Institutions and Markets, *Tata McGraw Hill,* Delhi.

P.N. Varshney & D.K. Mittal (4th Edition, 2002): Financial System in India, Sultan Chand & Sons, Delhi.

Govt. of India—Economic Survey, 2000, 2001, 2002

Reserve Bank of India—Annual Reports, 2000, 2001

Report of the Working Group on Money Market (Chairman: N. Vaghul), 1987

Report of the Committee on Banking Sector Reforms (Chairman: M. Narsimham), 1998

7.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Money Market is the market which deals in short-term funds ranging from overnight to a year.

   The major participants in the money market are: Commercial and Co-operative Banks, Discount and Finance House of India Ltd (DFHI), RBI, Financial and investment institutes like LIC, UTI, GIC etc.

2) See Section 7.32

3) i) Money Market is the market for short-term funds upto one-year duration whereas capital market deals in long-term funds.

   ii) Repo is a method of borrowing against certain securities for a short period whereas reverse repo is a method of lending against the securities with the commitment to take back the securities from the borrower against payment at a specified price.

Check Your Progress 2

1) Market for money at call and short notice is knows as Call Money Market.

2) The Treasury Bills are issued to bridge the mismatch

between the timings of Government receipts and expenditure. Treasury Bills are issued by RBI.

3) See Sub-section 7.5.1

Check Your Progress 3

1) i) The bill should arise out of a genuine trade transaction.

   ii) It must be accepted by the buyer's banker either singly or jointly with him.

   iii) Period of maturity should not exceed 90 days.

2) Certificate of Deposit can be defined as a receipt for a deposit of money with a bank or a financial institution. They differ from fixed deposits in two senses:

   a) certificate of deposit is issued for a big amount,

   b) it is freely negotiable.

3) See Section 7.7