ARULMIGU PALANIANDAVAR ARTS COLLEGE

FOR WOMEN, PALANI

PG DEPARTMENT OF ECONOMICS

LEARNING RESOURCES

BANKING

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BANKING

ORIGIN AND DEVELOPMENT OF BANKING

The banking history is interesting and reflects evolution in trade and commerce. It also throws light on living style, political and cultural aspects of civilized mankind. The strongest faith of people has always been religion and God. The seat of religion and place of worship were considered safe place for money and valuables. The history of banking begins with the first prototype banks of merchants of the ancient world, which made grain loans to farmers and traders who carried goods between cities. This began around 2000 BC in Assyria and Babylonia. In olden times people deposited their money and valuables at temples, as they are the safest place available at that time. The practice of storing precious metals at safe places and loaning money was prevalent in ancient Rome.

However modern Banking is of recent origin. The development of banking from the traditional lines to the modern structure passes through Merchant bankers, Goldsmiths, Money lenders and Private Banks.

Merchant Bankers were originally traders in goods. Gradually they started to finance trade and then become bankers.

Goldsmiths are considered as the men of honesty, integrity and reliability. They provided strong iron safe for keeping valuables and money. They issued deposit receipts (Promissory notes) to people when they deposit money and valuables with them. The goldsmith paid interest on these deposits. Apart from accepting deposits, Goldsmiths began to lend a part of money deposited with them. Then they became bankers who perform both the basic banking functions such as accepting deposit and lending money.

Money lenders were gradually replaced by private banks. Private banks were established in a more organised manner. The growth of Joint stock commercial banking was started only after the enactment of Banking Act 1833 in England.
India has a long history of financial intermediation. The first bank in India to be set up on modern lines was in 1770 by a British Agency House. The earliest but short-lived attempt to establish a central bank was in 1773. India was also a forerunner in terms of development of financial markets. In the beginning of 18th century, British East India Company launched a few commercial banks. Bank of Hindustan (1770) was the first Indian bank established in India. Later on, the East India Company started three presidency banks, Bank of Bengal (1806), Bank of Bombay (1840) and Bank of Madras(1843) These bank were given the right to issue notes in their respective regions. Allahabad bank was established in 1865 and Alliance Bank in 1875. The first bank of limited liability managed by Indians was Oudh Commercial Bank founded in 1881. Subsequently, the Punjab National Bank was established in

1894. In the Beginning of the 20th century, Swadeshi movement encouraged Indian entrepreneurs tostart many new banks in India.

Another landmark in the history of Indian banking was the formation of Imperial bank of India in 1921 by amalgamating 3 presidency banks It is the Imperial Bank which performed some central banking functions in India. A number of banks failed during the first half of the 20th Century. It affected the people's belief and faith in Banks.

Reserve bank of India was nationalized in the year 1949. The enactment of the BankingCompanies Act 1949 (Later it was renamed as Banking Regulation Act) was a bold step in the history of banking in India. In 1955, Imperial Bank of India was nationalized and renamed as State bank of India (SBI). The SBI started number of branches in urban and rural areas of the country.

By independence, India had a fairly well developed commercial banking system in existence. In 1951, there were 566 private commercial banks in India with 4,151 branches, the overwhelming majority of which were confined to larger towns and cities. Savings in the form of bank deposits accounted for less that 1 per cent of national income, forming around 12 per cent of the estimated saving of the household sector. The Reserve Bank of India (RBI) was originally established in 1935 by an Act promulgated by the Government of India, but as a shareholder institution like the Bankof England. After India's independence, in the context of the need for close integration between its policies and those of the Government, the Reserve Bank became a state - owned institution from January 1, 1949. It was during this year that the Banking Regulation Act was enacted to provide a framework for regulation and supervision of commercial banking activity.

In 1967, Govt introduced the concept of social control on banking sector. Nationalization of 14 commercial banks in 1969 was a revolution in the history of banking in India. Six more commercial banks were nationalized in 1980. Other landmarks in the history of Indian banking were the establishment of National Bank for Agricultural and Rural Development (1988), merger of New Bank of India with Punjab National Bank (1993), merger of State Bank of Sourashtra with SBI (2008) and the merger of State Bank of Indore with SBI (2010). At present, there are 27 Public sector banks, 20 private sector banks, 30 foreign banks and 82 Regional Rural Banks in India.

MEANING AND DEFINITION OF BANK

Finance is the life blood of trade, commerce and industry. Now-a-days, banking sector acts as the backbone of modern business. Development of any country mainly depends upon the banking system. The term bank is either derived from old Italian word ***banca*** or from a French word ***banque*** both mean a **Bench** or **money exchange table**. In olden days, European money lenders or money changers used to display (show) coins of different countries in big heaps (quantity) on benches or tables for the purpose of lending or exchanging. A bank is a financial institution which deals

with deposits and advances and other related services. It receives money from those who want to save in the form of deposits and it lends money to those who need it.

Definition of a Bank

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

According to H. L. Hart, a banker is "one who in the ordinary course of his business honours cheques drawn upon him by person from and for whom he receives money on current accounts".

Banking Regulation Act of 1949 defines banking as "accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise".

Types of Banks

Retail banks deal specifically with retail consumers. These banks offer services to the general public and are also called personal or general banking institutions. Retail banks provide services such as checking and savings accounts, loan and mortgage services, financing for automobiles, and short-term loans like overdraft protection. Most retail banks also offer credit card services to their customers, and may also supply their clients with foreign currency exchange. These banks also cater to high-net-worth individuals, by giving them specialty services such as private banking and wealth management. Examples of retail banks include TD Bank and Citibank.

Commercial or corporate banks provide specialty services to their business clients from small business owners to large, corporate entities. Along with day-to-day business banking, these banks also provide their clients with other things such as credit services, cash management, commercial real estate services, employer services, and trade finance. JPMorgan Chase and Bank of America are two popular examples of commercial banks.

Investment banks focus on providing corporate clients with complex services and financial transactions such as underwriting and assisting with merger and acquisition (M&A) activity. As such, they are known primarily as financial intermediaries in most of these transactions. Clients commonly range from large corporations, other financial institutions, pension funds, governments, and hedge funds. Morgan Stanley and Goldman Sachs are examples of U.S. investment banks.

Unlike the banks listed above, central banks are not market-based and don't deal directly with the general public. Instead, they are primarily responsible for currency stability, controlling inflation and monetary policy, and overseeing a country's money supply. They also regulate the capital and reserve requirements of member banks. Some of the world's major central banks include the U.S. Federal Reserve Bank, the European Central Bank, the Bank of England, the Bank of Japan, the Swiss National Bank, and the People's Bank of China.

COMMERCIAL BANKS

Meaning

A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit. In fact, commercial banks, as their name suggests, axe profit-seeking institutions, i.e., they do banking business to earn profit.

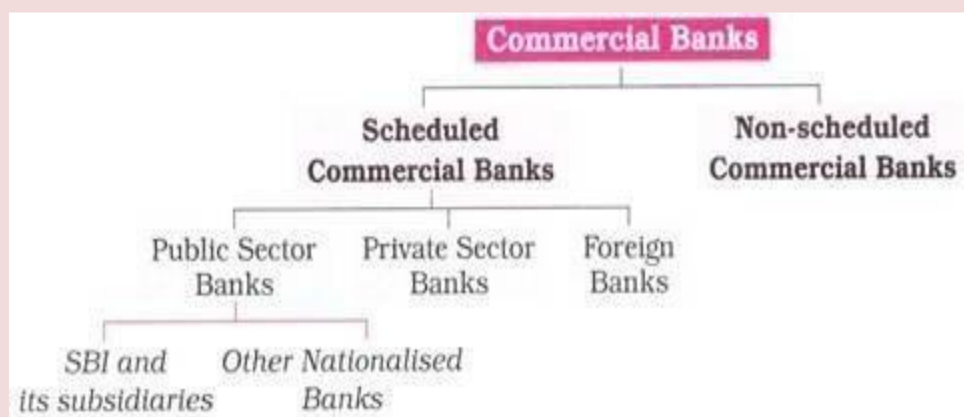
They generally finance trade and commerce with short-term loans. They charge high rate of interest from the borrowers but pay much less rate of Interest to their depositors with the result that the difference between the two rates of interest becomes the main source of profit of the banks. Most of the Indian joint stock Banks are Commercial Banks such as Punjab National Bank, Allahabad Bank, Canara Bank, Andhra Bank, Bank of Baroda, etc.

Types of Commercial Banks

Commercial Banks are regulated under the Banking Regulation Act, 1949 and their business model is designed to make profit. Their primary function is to accept deposits and grant loans to the general public, corporate and government. Commercial banks can be divided into-

Commercial Banks can be further classified into public sector banks, private sector banks, foreign banks and Regional Rural Banks (RRB). On the other hand, cooperative banks are classified into urban and rural. Apart from these, a fairly new addition to the structure is a payments bank.

The following chart depicts main types of commercial banks in India.



A.SCHEDULED BANKS

Scheduled banks are covered under the 2nd Schedule of the Reserve Bank of India Act, 1934. To qualify as a scheduled bank, the bank should conform to the following conditions:

- A bank that has a paid-up capital of Rs. 5 Lakh and above qualifies for the schedule bank category
- A bank requires to satisfy the central bank that its affairs are not carried out in a way that causes harm to the interest of the depositors

- A bank should be a corporation rather than a sole-proprietorship or partnership firm

1. Public Sector Banks

These are the nationalised banks and account for more than 75 per cent of the total banking business in the country. Majority of stakes in these banks are held by the government. In terms of volume, SBI is the largest public sector bank in India and after its merger with its 5 associate banks (as on 1st April 2017) it has got a position among the top 50 banks of the world.

There are a total of 12 nationalised banks in the country namely below:

Bank of Maharashtra	Indian Bank
Bank of Baroda	Punjab & Sind Bank
Bank of India	Punjab National Bank
Canara Bank	State Bank of India
Central Bank of India	Union Bank of India
Indian Overseas Bank	UCO Bank

2. Private Sector Banks

These include banks in which major stake or equity is held by private shareholders. All the banking rules and regulations laid down by the RBI will be applicable on private sector banks as well. Given below is the list of private-sector banks in India-

Axis Bank	IndusInd Bank
Bandhan Bank	Jammu and Kashmir Bank
City Union Bank	Karnataka Bank
Dhanlaxmi Bank	Kotak Mahindra Bank
DCB Bank	Karur Vysya Bank
Federal Bank	CSB Bank Ltd.
HDFC Bank	Nainital Bank
ICICI Bank	RBL Bank
IDFC Bank	South Indian Bank
IDBI Bank	Tamilnad Mercantile Bank
YES Bank	

3. Foreign Banks

A foreign bank is one that has its headquarters in a foreign country but operates in India as a private entity. These banks are under the obligation to follow the regulations of its home country as well as the country in which they are operating. Given below is the list of foreign banks operating in India

List of Foreign Banks in India		
Australia and New Zealand Banking Group Ltd.	DBS Bank India Limited	SBM Bank (India) Limited

Bank of Bahrain & Kuwait BSC	AB Bank Ltd.	Sonali Bank Ltd.
Bank of Nova Scotia	Industrial & Commercial Bank of China Ltd.	BNP Paribas
Credit Agricole Corporate & Investment Bank	Societe Generale	Deutsche Bank
HSBC Bank	PT Bank Maybank Indonesia TBK	Mizuho Bank Ltd.
Sumitomo Mitsui Banking Corporation	MUFG Bank, Ltd.	Cooperative Rabobank U.A.
Doha Bank Q.P.S.C	Qatar National Bank (Q.P.S.C.)	JSC VTB Bank
Sberbank	United Overseas Bank Ltd	FirstRand Bank Ltd
Shinhan Bank	Woori Bank	KEB Hana Bank
Industrial Bank of Korea	Bank of Ceylon	Credit Suisse A.G
CTBC Bank Co., Ltd.	Krung Thai Bank Public Co. Ltd.	Abu Dhabi Commercial Bank Ltd.
Mashreq Bank PSC	First Abu Dhabi Bank PJSC	Emirates Bank NBD
Barclays Bank Plc.	Standard Chartered Bank	Bank of China
American Express Banking Corporation	Bank of America	Citibank
J.P. Morgan Chase Bank N.A.	Kookmin Bank	

4. **Regional Rural Banks**

These are also scheduled commercial banks but they are established with the main objective of providing credit to weaker sections of the society like agricultural labourers, marginal farmers and small enterprises. They usually operate at regional levels in different states of India and may have branches in selected urban areas as well. Other important functions carried out by RRBs include,

- Providing banking and financial services to rural and semi-urban areas
- Government operations like disbursement of wages of MGNREGA workers, distribution of pensions, etc.
- Para-Banking facilities like debit cards, credit cards and locker facilities

5. **Small Finance Banks**

This is a niche banking segment in the country and is aimed to provide financial inclusion to sections of the society that are not served by other banks. The main customers of small finance banks include micro industries, small and marginal farmers, unorganized sector entities and small business units. These are licensed under Section 22 of the Banking Regulation Act, 1949 and are governed by the provisions of RBI Act, 1934 and FEMA.

AU Small Finance Bank Ltd.	Jana Small Finance Bank Ltd.
Capital Small Finance Bank Ltd.	North East Small Finance Bank Ltd.
ESAF Small Finance Bank Ltd.	Suryoday Small Finance Bank Ltd.
Equitas Small Finance Bank Ltd.	Utkarsh Small Finance Bank Ltd.
Fincare Small Finance Bank Ltd.	Ujjivan Small Finance Bank Ltd.
Shivalik Small Finance Bank Ltd.	Unity Small Finance Bank Ltd.

6. Payments Bank

This is a relatively new model of bank in the Indian Banking industry. It was conceptualised by the RBI and is allowed to accept a restricted deposit. The amount is currently limited to Rs. 1 Lakh per customer. They also offer services like ATM cards, debit cards, net-banking and mobile-banking.

7. Co-operative Banks

Co-operative banks are registered under the Cooperative Societies Act, 1912 and they are run by an elected managing committee. These work on no-profit no-loss basis and mainly serve entrepreneurs, small businesses, industries and self-employment in urban areas. In rural areas, they mainly finance agriculture-based activities like farming, livestock and hatcheries.

- Urban Co-operative Banks
- State Co-operative Banks

Urban Co-operative Banks

Urban Co-operative Banks refer to the primary cooperative banks located in urban and semi-urban areas. These banks essentially lent to small borrowers and businesses centered around communities, localities work place groups.

According to the RBI, on 31st March, 2003 there were 2,104 Urban Co-operative Banks of which 56 were scheduled banks. About 79% of these are located in five states, – Andhra Pradesh, Gujarat, Karnataka, Maharashtra and Tamil Nadu.

State Co-operative Banks

A State Cooperative Bank is a federation of the central cooperative bank which acts as custodian of the cooperative banking structure in the State.

Banks can also be classified on the basis of Scheduled and Non-Scheduled Banks. It is essential for every individual to check if they are holding their savings or deposit account with a Scheduled Bank or Non-Scheduled Bank. Scheduled Banks are also covered under the depositor insurance program of Deposit Insurance and Credit Guarantee Corporation (DICGC), which is beneficial for all the account holders holding a savings and fixed / recurring deposit account. Under DICGC, bank deposits of up to Rs 1 lakh, including the fixed, savings, current and recurring deposits, per depositor per bank in the event of bank failure are insured.

B.NON-SCHEDULED BANKS

Non-scheduled banks refer to the local area banks which are not listed in the Second Schedule of Reserve Bank of India. Non-Scheduled Banks are also required to maintain the cash reserve requirement, not with the RBI, but with them.

FUNCTIONS OF COMMERCIAL BANK

Functions of a Commercial Bank can be classified into three.

A. Principal/ Primary/ Fundamental functions
B. Subsidiary/ Secondary/ Supplementary functions
C. Innovative functions.

A. Principal functions

Commercial banks perform many functions. They satisfy the financial needs of the sectors such as agriculture, industry, trade, communication, so they play very significant role in a process of economic social needs. The functions performed by banks, since recently, are becoming customer-centred and are widening their functions. Generally, the functions of commercial banks are divided into two categories; primary functions and the secondary functions. Two 'acid test' functions of commercial banks are Accepting deposits and Lending loans. These functions along with credit creation, promotion of cheque system and investment in Government securities form basic functions of commercial banks. The secondary functions of commercial banks include agency services, general utility services and innovative services.

***1.* Receiving deposits**

Most important function of a commercial bank is to accept deposit from those who can save but cannot profitably utilise this savings themselves. By making deposits in bank, savers can earn something in the form of interest and avoid the danger of theft. To attract savings from all sorts of customers, banks maintain different types of accounts such as current account, Savings bank account, Fixed Deposit account, Recurring deposit account and Derivative Deposit account.

Features of Current Accounts

- It is generally opened by trading & industrial concerns.
- It is opened not for profit or savings but for convenience in payments
- Introduction is necessary to open the account.
- Any number of transactions permitted in the account.
- Withdrawals are generally allowed by cheque Deposit is repayable on demand.
- No interest is allowed but incidental charges claimed.
- Minimum balance requirement varies from bank to bank.

Features of Saving Bank (SB)accounts

- It is generally opened by middle/low income group who save a part of their income forfuture needs
- Introduction is necessary to open the account if cheque facility is allowed.
- There are some restrictions on number of withdrawals.
- Fair interest (less than FD) is offered on the deposits of thisaccount.

Features of Fixed Deposit accounts

- It is generally opened by small investors who do not want to invest money in risky industrialsecurities like shares.
- No introduction is necessary to open the account.

- No maximum limit for investing.
- Minimum period of investment is 15 days
- Withdrawal is allowed only after the expiry of a fixed period.
- Withdrawal is generally allowed by surrendering FD Receipt
- Higher rate of interest is offered on the deposits of this account,

Features of Recurring Deposit accounts

- This account is meant for fixed income group, who can deposit a fixed sum regularly.
- The amount is paid back along with interest after a specified period.
- High rate of interest is offered on recurring deposits.
- Passbook is the means through which deposits and withdrawals are made

Features of Home Safe Account

- Promoting saving habits among the people
- A safe is supplied to the depositor to keep it at home and to put his small savings in it
- Periodically, the safe is taken to the bank where the amount of safe is credited to his account.

1. Lending of funds

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income. Modern banks give mostly secured loans for productive purposes. In other words, at the time of advancing loans, they demand proper security or collateral. Generally, the value of security or collateral is equal to the amount of loan. This is done mainly with a view to recover the loan money by selling the security in the event of non-refund of the loan.

Commercial banks lend money to the needy people in the form of Cash credits, Term loans, Overdrafts (OD), Discounting of bills, Money at call or short notice etc.

(i) Cash Credits:

In this type of credit scheme, banks advance loans to its customers on the basis of bonds, inventories and other approved securities. Under this scheme, banks enter into an agreement with its customers to which money can be withdrawn many times during a year. Under this set up banks open accounts of their customers and deposit the loan money. With this type of loan, credit is created.

(ii) Term loans:

A term loan is a monetary loan that is repaid in regular payments over a set period of time. In other words, a loan from a bank for a specific amount that has a specified repayment schedule and a floating interest rate is called Term loan.The interest is charged for entire amount of the loan is repaid either on maturity or installments. Term loans usually last between one and ten years, but may last as long as 30 years in some cases. It may be classified as short term, medium term and long term loans.

(iii) Over-Drafts:

It is the extension of credit from a bank when the account balance reaches zero level. Banks advance loans to its customer's up to a certain amount through over-drafts, if there are no deposits in the current account. For this, banks demand a security from the customers and charge very high rate of interest. Overdraft facility will be allowed only for current account holders.

(iv) Discounting of Bills of Exchange:

This is the most prevalent and important method of advancing loans to the traders for short-term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. While discounting a bill, the Bank buys the bill(i.e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a discount charge to the customer's account. The transaction is practically an advance against the security of the bill and the discount represents the interest on the advance from the date of purchase of the bill until it is due for payment. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

(v) Money at Call and Short notice:

Money at call and short notice is a very short-term loan that does not have a set repayment schedule, but is payable immediately and in full upon demand. Money-at-call loans give banks a way to earn interest while retaining liquidity. These are generally lent to other institutions such as discount houses, money brokers, the stock exchange, bullion brokers, corporate customers, and increasingly to other banks. 'At call' means the money is repayable on demand whereas 'At short notice' implies the money is to be repayable on a short notice up to 14 days.

2. Investment of funds in securities

Banks invest a considerable amount of their funds in government and industrial securities. In India, commercial banks are required by statute to invest a good portion of their funds in government and other approved securities. The banks invest their funds in three types of securities—Government securities, other approved securities and other securities. Government securities include both, central and state governments, such as treasury bills, national savings certificate etc. Other securities include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks, units of UTI, shares of Regional Rural banks etc.

3. Credit Creation

When a bank advances a loan, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus a loan creates an equal amount of deposit. Creation of such deposit is called credit creation. Banks have the ability to create credit many times more than their actual deposit.

4. Promoting cheque system

Banks also render a very useful medium of exchange in the form of cheques.

Through a cheque, the depositor directs the banker to make payment to the payee. In the modern business transactions by cheques have become much more convenient method of settling debts than the use of cash. Through promoting cheque system, the banks ensure the exchange of accounted cash. At present, CTS (Cheque Truncation System) cheques are used by Indian Banks to ensure speedy settlement of transactions in between banks. In contrast to the declining importance of cheques, the use of electronic payment instruments at the retail level has been growing rapidly.

B. Subsidiary functions

1. **Agency services:** Banks act as an agent on behalf of the individual or organisations. Banks, as an agent can work for people, businesses, and other banks, providing a variety of services depending on the nature of the agreement they make with their clients. Following are the important agency services provided by commercial banks in India.

- Commercial Banks collect cheques, drafts, Bill of Exchange, interest and dividend on securities, rents etc. on behalf of customers and credit the proceeds to the customer's account.
- Pay LIC premium, rent, newspaper bills, telephone bills etc
- Buying and selling of securities
- Advise on right type of investment
- Act as trustees (undertake management of money and property), executors (carry out the wishes of deceased customers according to will) & attorneys (collect interest & dividend and issue valid receipt) of their customers.
- Serve as correspondents and representatives of their customers. In this capacity, banks prepareI-Tax returns of their customers, correspond with IT authorities and pay IT of their customers.

2. **General Utility Services :** In addition to agency services, modern banks performs many general utility services for the community. Following are the important general utility services offered by Commercial Banks

- Locker facility: Bank provide locker facility to their customers. The customers can keep their valuables such as gold, silver, important documents, securities etc. in these lockers for safe custody.
- Issue travellers' cheques: Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. It enable tourists to get fund in all places they visit without carrying actual cash with them.
- Issue Letter of Credits: Banks issue letter of credit for importers certifying their credit worthiness. It is a letter issued by importer's banker in favour of exporter informing him that issuing banker undertakes to accept the bills drawn in respect of exports made to the importer specified therein.
- Act as referee: Banks act as referees and supply information about the financial standing of their customers on enquiries made by other businessmen.

- Collect information: Banks collect information about other businessmen through the fellow bankers and supply information to their customers.
- Collection of statistics: Banks collect statistics for giving important information about industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.
- Underwriting securities: Banks underwrite securities issued by government, public or private bodies.
- Merchant banking: Some bank provide merchant banking services such as capital to companies, advice on corporate matters, underwriting etc.

C. Innovative Functions

The adoption of Information and Communication technology enable banks to provide many innovative services to the customers such as;

***1.* ATM services**

Automated Teller Machine (ATM) is an electronic telecommunications device that enables the clients of banks to perform financial transactions by using a plastic card. Automated Teller Machines are established by banks to enable its customers to have anytime money. It is used to withdraw money, check balance, transfer funds, get mini statement, make payments etc. It is available at 24 hours a day and 7 days a week.

***2.* Debit card and credit card facility**

Debit card is an electronic card issued by a bank which allows bank clients access to their account to withdraw cash or pay for goods and services. It can be used in ATMs, Point of Sale terminals, e-commerce sites etc. Debit card removes the need for cheques as it immediately transfers money from the client's account to the business account. Credit card is a card issued by a financial institution giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short- term financing.

***3.* Tele-banking**

Telephone banking is a service provided by a bank or other financial institution, that enables customers to perform financial transactions over the telephone, without the need to visit a bank branchor automated teller machine

***4.* Internet Banking**

Online banking (or Internet banking or E-banking) is a facility that allows customers of a financial institution to conduct financial transactions on a secured website operated by the institution. To access a financial institution's online banking facility, a customer must register with the institution for the service, and set up some password for customer verification. Online banking can be used to check balances, transfer money, shop onlline, pay bills etc.

***5.* Bancassurance**

It means the delivery of insurance products through banking channels. It can be done by making an arrangement in which a bank and an insurance company

form a partnership so that the insurance company can sell its products to the bank's client base. Banks can earn additional revenue by selling the insurance products, while insurance companies are able to expand their customer base without having to expand their sales forces

***6.* Mobile Banking**

Mobile banking is a system that allows customers of a financial institution to conduct a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant. It allows the customers to bank anytime anywhere through their mobile phone. Customers can access their banking information and make transactions on Savings Accounts, Demat Accounts, Loan Accounts and Credit Cards atabsolutely no cost.

***7.* Electronic Clearing Services**

It is a mode of electronic funds transfer from one bank account to another bank account using the services of a Clearing House. This is normally for bulk transfers from one account to many accounts or vice- versa. This can be used both for making payments like distribution of dividend, interest, salary, pension, etc. by institutions or for collection of amounts for purposes such as payments to utility companies like telephone, electricity, or charges such as house tax, water tax etc

***8.* Electronic Fund Transfer/National Electronic Fund Transfer(NEFT):**

National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. In NEFT, the funds are transferred based on a deferred net settlement in which there are 11 settlements in week days and 5 settlements in Saturdays.

***9.* Real Time Gross Settlement System(RTGS):**

It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis . 'Real Time' means the processing of instructions at the time they are received rather than at some later time. It is the fastest possible money transfer system in the country.

NEFT	RTGS
• Based on Deferred Net Settlement(DNS) • Fastest method of money transfer • Complete transactions in batches • There is no minimum limit of transactions. • Settlement on hour basis. (11 settlements from9am to 7pm)	• Based on Gross Settlement • Slower than RTGS transfer • Complete transactions individually • Minimum amount to be remitted is 2 lakhs • Settlement in real time (at the time the transfer order is processed)

ROLE OF COMMERCIAL BANKS IN A DEVELOPING ECONOMY

A well developed banking system is necessary pre-condition for economic development of any economy. Apart from providing resources for growth of industrialisation, banks also influence direction in which these resources are utilised. In underdeveloped and developing nations banking facilities are limited to few developed cities and their activities are focussed on trade & commerce paying little attention to industry & agriculture. Commercial banks contribute to a country's economic development in the following ways.

1. Capital formation

Most important determinant of economic development is capital formation. It has 3 distinctive stages

- Generation of savings
- Mobilisation of savings
- Canalisation of saving

Banks promote capital formation in all these stages. They promote habit of savings by offering attractive rate of return for savers. Banks are maintaining different types of accounts to mobilise savings aiming different types of customers. They make widespread arrangements to collect savings by opening branches even in remote villages. Moreover, banks offer their resources for productive activities only.

2. Encouragement to entrepreneurial innovations

Entrepreneurs in developing economies, generally hesitate to invest & undertake innovations due to lack of fund. Bank loan facilities enable them to introduce innovative ideas and increase productive capacity of the economy.

3. Monetisation of economy

Monetisation means allow money to play an active role in the economy. Banks, which are creators and distributors of money, help the monetisation in two ways;

- They monetise debt i.e., buy debts (securities) which are not as acceptable as money and convert them to demand deposits which are acceptable as money.
- By spreading branches in rural areas they convert non-monetised sectors of the economy tomonetised sectors.

4. Influencing economic activity

They can directly influence the economic activity & pace of economic development through itsinfluence on

(a) The rate of interest (reduction in rates make investment more profitable and stimulateseconomic activity)

(b) Availability of credit. (Through Credit creation banks helps in increasing supply ofpurchasing power)

5. Implementation of monetary policy

Well developed banking system is necessary for effective implementation of monetary policy. Control and regulation of credit is not possible without active co-operation of banks.

6. Promotion of trade and industry

Economic progress of industrialised countries in last 2 centuries is mainly due to expansion in trade & industrialisation which could not have been made possible without development of a good banking system. Use of cheques, drafts and BoE as a medium of exchange has revolutionalised the internal and international trade which in turn accelerated the pace of industrialisation.

7. Encouraging right type of industries

In a planned economy it is necessary that banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialisation as adopted in the plan.

8. Regional development

Banks can play role in achieving balanced development in different regions of the economy. They can transfer surplus funds from developed region to less developed regions, where there is shortage of funds.

9. Development of agricultural & other neglected sectors

Under developed economies primarily agricultural economies and majority of the population live in rural areas. So far banks were paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must diversify their activities not only to extend credit to trade, but also to provide medium and long term loans to industry and agriculture.

CREDIT CREATION BY COMMERCIAL BANKS

A central bank is the primary source of money supply in an economy through circulation of currency. It ensures the availability of currency for meeting the transaction needs of an economy and facilitating various economic activities, such as production, distribution, andconsumption.

However, for this purpose, the central bank needs to depend upon the reserves of commercial banks. These reserves of commercial banks are the secondary source of money supply in an economy. The most important function of a commercial bank is the creation of credit.

Therefore, money supplied by commercial banks is called credit money. Commercial banks create credit by advancing loans and purchasing securities. They lend money to individuals and businesses out of deposits accepted from the public. However, commercial banks cannot use the entire amount of public deposits for lending purposes. They are required to keep a certain amount as reserve with the central bank for serving the cash requirements of depositors. After keeping the required amount of reserves, commercial banks can lend the remaining portion of public deposits.

According to Benham's, "a bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits"

The process of credit creation by commercial bank is related with the help of an example.

Suppose you deposit Rs. 10,000 in a bank A, which is the primary deposit of the bank. The cash reserve requirement of the central bank is 10%. In such a case, bank A would keep Rs. 1000 as reserve with the central bank and would use remaining Rs. 9000 for lending purposes.

The bank lends Rs. 9000 to Mr. X by opening an account in his name, known as demand deposit account. However, this is not actually paid out to Mr. X. The bank has issued a check- book to Mr. X to withdraw money. Now, Mr. X writes a check of Rs. 9000 in favor of Mr. Y to settle his earlier debts.

The check is now deposited by Mr. Y in bank B. Suppose the cash reserve requirement ofthe central bank for bank B is 5%. Thus, Rs. 450 (5% of 9000) will be kept as reserve and the remaining balance, which is Rs. 8550, would be used for lending purposes by bank B.

Thus, this process of deposits and credit creation continues till the reserves with commercialbanks reduce to zero.

This process is shown in the Table-1:

Table-1: Credit Creation Process

Bank	New Deposits/ Primary Deposits	Demand Deposits	Derivative deposits / Loans
Bank A	10000	1000	9000
Bank B	9000	450	8550
Bank C	8550	855	7695
Bank N	-	-	-
Total	**50000**	**10000**	**40000**

From Table-1, it can be seen that deposit of Rs. 10,000 leads to a creation of total deposit of Rs.50,000 without the involvement of cash.

The process of credit creation can also be learned with the help of following formulae:

Total Credit Creation = Original Deposit * Credit Multiplier Coefficient

Credit multiplier coefficient= 1 / r where r = cash reserve requirement also called as CashReserve Ratio (CRR)

Credit multiplier co-efficient = 1/10% = 1/ (10/100) = 10Total credit created = 10,000*10 = 100000

If CRR changes to 5%,

Credit multiplier co-efficient = 1/5% = 1/ (5/100) = 20Total credit creation = 10000 * 20 = 200000

Thus, it can be inferred that lower the CRR, the higher will be the credit creation, whereas higher the CRR, lesser will be the credit creation. With the help of credit creation process, money multiplies in an economy. However, the credit creation process of commercial banks is not free from limitations.

Limitations of credit creation

Some of the limitations of credit creation by commercial banks are shown in Figure-2:

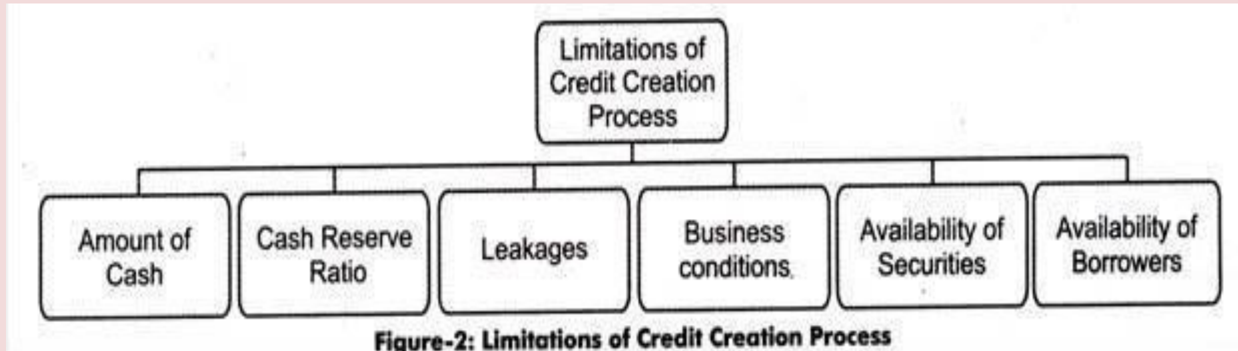


Figure-2: Limitations of Credit Creation Process

Bank cannot expand deposits to an unlimited extent by granting loans and advances even though this process of granting loans and advances is profitable to them. Their power to create credit is subject to the following limitations:

1. **Amount of Cash available with the Bank:** Credit creation depends on the amount of cash available with bank. Larger the amount of cash with the banking system, greater will be the credit creation and vice versa.

2. **Cash Reserve Ratio:** CRR is the minimum cash required to be maintained by a bank with RBI. CRR sets the limit for the creation of credit. Higher the CRR smaller will be the credit creation and vice versa.

3. **Security for loans:** The securities acceptable to bank places a limit on credit creation by the banks. While lending, the banks insist upon the securities from the customers. All type of assetsis not acceptable to banks as securities. If borrower is not able to provide sufficient security, credit creation is not possible.

4. **Credit policy of banks:** If banks want to create excess reserves, the credit creation will be limited to that extent.

5. **Monetary Policy of the Central Bank:** The capacity of credit creation by banks is largely depends upon the policies followed by the Central Bank from time to time. The total supply of cash depends upon the policy of the Central Bank.

6. **Banking habit of the people:** The banking habit of the people also sets the limit for the capacity of banks to create credit. The volume of employed population, monetary habits, etc., determines the amount of cash that the public wishes to hold. If people prefer to make transactions by using cash instead of using cheques, the banks will be left with smaller amount of cash and there will be lesser credit creation.

7. **Effect of Trade Cycle:** The effects of trade cycles also place the limitation on the credit creation, i.e., the conditions of inflation and deflation set a limit on the creation. During the period of economic prosperity there will be greater demand for bank loans and therefore, they can create greater volume of credit. But in times of recession, there is no prosperity and the business people will hesitate to borrow.

8. **Leakages:** It simply the outflow of cash. The credit creation process may suffer from leakages of cash.

   The different types of leakages are discussed as follows:

   (i) Excess Reserves:

   It takes place generally when the economy is moving towards recession. In such a case, banks may decide to maintain reserves instead of utilizing funds for lending. Therefore, in such situations, credit created by commercial banks would be small as a large amount of cash is resented.

   (ii) Currency Drains:

   It simply that the public does not deposit all the cash with it. The customers may hold the cash with them which affects the credit creation by banks. Thus, the capacity of banks to create credit reduces.

9. **Availability of Borrowers:** It affects the credit creation by banks. The credit is created by lending money in form of loans to the borrowers. There will be no credit creation if there are no borrowers.
10. **Availability of Securities:** It refers to securities against which banks grant loan. Thus, availability of securities is necessary for granting loan otherwise credit creation will not occur. According to Crowther, "the bank does not create money out of thin air; it transmutes other forms of wealth into money."
11. **Business Conditions:** It implies that credit creation is influenced by cyclical nature of an economy. For example, credit creation would be small when the economy enters into the depression phase. This is because in depression phase, businessmen do not prefer to invest in new projects. In the other hand, in prosperity phase, businessmen approach banks for loans, which lead to credit creation.

NATIONALISATION OF BANKS

The progressive nationalisation of banks has increased the role of public sector banking in the country. On July 19, 1969, the Government of India through an Ordinance nationalised 14 major commercial banks in the country, with deposits exceeding Rs. 50 crores each. Again on April 15, 1980, 6 more commercial banks (now 5 banks because New Bank of India was merged with Punjab National Bank in September 1993) were nationalised. The State Bank of India and its seven subsidiaries had already been nationalised. The regional rural banks from their very inception are in the public sector. Thus, about 90 per cent of the country's commercial banking system is now in the public sector.

Arguments for Nationalisation.

Whether nationalisation of banks is desirable or not is a debatable question. The case for bank nationalisation in India is mainly based on the defective ownership, biased credit deployment policy and unhealthy practices of the banks in the pre-

nationalised period. The main arguments in favour of bank nationalisation in the country are as given below:

1. Ownership and Control of a Few.

Indian banks were owned and controlled by a few big share holders. They generally influenced the pattern of allocation of bank credit in accordance with their own interests. According to an unpublished Reserve Bank sample survey, at the end of 1965, of the total equity capital of Rs. 21.4 crores of 9 large banks, about 40 percent was held by only 33 accounts and the rest by more than 88,000 accounts The nationalisation of banks would bring banks under the control of the government for meeting the general interest of the public.

2. Concentration of Wealth and Power.

The banks in India were controlled by a few industrial houses which used the public funds of the banks to build up huge industrial estates. According to an estimate, in mid-sixties, 70 per cent of total industrial advances went to only one per cent of the total number of borrowal accounts, each with credit outstanding of over Rs. 5 lakh, whereas 12 per cent of the accounts with credit outstanding of less than Rs. 10,000 each received only 4 per cent of the total. This led to the growth of wealth and power in few hands.

3. Credit to Directors.

The resources of the banks were made available to the directors of these banks at concessional rates. These directors also had connections with other business concerns. According to an official survey, 188 persons serving on the Boards of 20 leading banks had 1452 directorships of other companies also. In this way, the funds of the banks were not utilised for the economic development of the country but for the promotion of the interests of the directors. Bank nationalisation would check favourable attitude of the banks towards directors.

4. Speculative Activities

Previously, the funds of the banks were mostly used for hoarding and speculative purposes. Anti social elements were able to receive the bank loans to make large profits by creating artificial shortages of essential goods. Such misuse of bank resources would be controlled by the nationalisation of banks.

5. Discrimination against Small business.

Indian banks had adopted a general policy of providing finance to large industries. Small businesses were not able to approach these banks for meeting their credit needs and were usually discriminated against. Nationalisation was favoured in order to extend financial help to the small business units.

6. Indifference to Agricultural Sector.

The agricultural sector was almost ignored by the commercial banks. Most of the banks and their branches existed in the urban areas and were catering the needs of the industry and trade. Little efforts were made by the banks to meet the credit requirements of agriculture which is the backbone of Indian economy. Nationalisation of banks was hoped to contribute to the development of agriculture.

7. Financing Economic Plans.

It was argued that the nationalised banks' would make their resources available to the government for financing economic plans of the country. In this way, the banks contribute to the development of the economy.

8. Safety of Depositors.

Nationalisation will provide 100 per cent safety to the deposits of the people. This will inspire public confidence in the banking system and thus increase the bank deposits.

9. Other Arguments.

Some other arguments given in favour of the nationalisation of banks are as follows:

- Nationalisation eliminates wasteful competition and raises the efficiency of the working of the banks.
- Integrated monetary policy and its effective implementation requires unified control of both the central and the commercial banks.
- Nationalisation of banks is necessary for achieving socialism; nationalisation of industry is not possible without bank nationalisation.

Arguments against Nationalisation

Those who oppose nationalisation of banks give the following arguments:

1. Reduction in Efficiency.

The experience of other nationalised institutions indicates that the nationalisation of the commercial banks will reduce the efficiency of these banks. Moreover, political interference will also impair the smooth working of these institutions.

2. No control or Monopolies.

The root cause of the growth of monopolies and the concentration of wealth and power lies in the existing economic system. Therefore, the remedy requires the changing and reforming of the economic system and not the nationalisation of banks.

3. Other Ways to Remove Malpractices.

Malpractice of privately owned banks can be checked by adopting appropriate monetary and fiscal policies and through efficient supervision by the Reserve Bank of India. There is no need to take such drastic step of bank nationalisation of banks.

4. Risky Lending to Agriculturists.

Extending loans to agriculture and small scale industries is risky andless remunerative. Such loans are against the sound banking rules and may weaken the economic viability othese institutions.

5. **No Need of Security to Deposits**.

It is pointed out that there is no need to provide 100 per cent security to the depositors in India through nationalisation of banks. Institutions like Indian Deposit Insurance and Credit Guarantee Corporation are functioning quite efficiently and providing enough relief to the depositors.

6. Burden of Compensation.

Nationalization involves huge amounts of money to be paid as compensation to the shareholders. This puts additional financial burden on the government. Moreover, it is also argued that nationalisation will not bring much revenue to the state.

7. **Nationalisation is no Socialism**.

It is argued that nationalisation may not lead to socialism. State capitalism is not socialism. Moreover, there is a general tendency to treat public property not as sacred national property, but as no one's property. As such, it is misused and destroyed like anything.

Objectives of Bank Nationalisation in India

According to the Banking Companies Act 1970, the aim of nationalisation of banks in India is "to control the heights of the economy and to meet progressively and serve better the needs of development of the economy in conformity with national policy and objectives". More specifically, the important objectives of bank nationalisation as outlined by the Prime Minister in the parliament on July 21, 1969 are:

a. to mobilise savings of people to the largest possible extent and to utilise them for productive purposes:
b. to ensure that the operations of the banking system are guided by a larger social purpose and are subject to close public regulation;

c. to ensure that the legitimate credit needs of private sector, industry and trade, big or small, are met;
d. to ensure that the needs of productive sectors of the economy and in particular those of farmers, small scale industrialists and self-employed professional groups are met;
e. to actively foster the growth of the new and progressive entrepreneurs and create fresh opportunities for hitherto neglected and backward areas in different parts of the country; and
f. to curb the use of bank credit for speculative and other unproductive purposes.

EMERGING TRENDS IN BANKING

In 1990's Indian banking sector saw a great emphasis on the replacement of technolog y with the new innovations. Banks began to use these new technologies to provide better and quick services to the customers at a great speed. Some of the innovations techniques introduced in Indian banking sector in post reform era are as follows:

E-Banking

E-banking involves information technology based banking. Under this I.T system, the banking services are delivered by way of a Computer-Controlled System. This system does involve direct interface with the customers. The customers do not have to visit the bank's premises.

Online banking, also known as internet banking, e-banking or virtual banking, isan electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website. The online banking system will typically connect to or be part of the core banking system operated by a bank and is in contrast to branch banking which was the traditional way customers accessed banking services. Fundamentally and in mechanism, online banking, internet banking and e-banking are the same thing.

To access a financial institution's online banking facility, a customer with internet access would need to register with the institution for the service, and set up a password and other credentials for customer verification. The credentials for online banking is normally not the same as for telephone or mobile banking. Financial institutions now routinely allocate customers numbers, whether or not customers have indicated an intention to access their online banking facility. Customers' numbers are normally not the same as account numbers, because a number of customer accounts can be linked to the one customer number. The customer number can be linked to any account that the customer controls, such as cheque, savings, loan, credit card and other accounts.

The customer visits the financial institution's secure website, and enters the online banking facility using the customer number and credentials previously set up. The types of financial transactions which a customer may transact through online

banking usually includes obtaining account balances, lists of the latest transactions, electronic bill payments and funds transfers between a customer's or another's accounts. Most banks also enable a customer to download copies of bank statements, which can be printed at the customer's premises (some banks charge a fee for mailing hardcopies of bank statements). Some banks also enable customers to download transactions directly into the customer's accounting software. The facility may also enable the customer to order cheque-books, statements, report loss of credit cards, stop payment on a cheque, advise change of address and other routine actions.

Features of E-Banking

Online banking facilities typically have many features and capabilities in common, but alsohave some that are application specific.

The common features fall broadly into several categories:

❖ A bank customer can perform non-transactional tasks through online banking,including –
  - Viewing account balances
  - Viewing recent transactions
  - Downloading bank statements, for example in PDF format
  - Viewing images of paid cheques
  - Ordering cheque books
  - Download periodic account statements
  - Downloading applications for M-banking, E-banking etc.

❖ Bank customers can transact banking tasks through online banking, including –
  - Funds transfers between the customer's linked accounts
  - Paying third parties, including bill payments (see, e.g., BPAY) and third partyfund transfers (see, e.g., FAST)
  - Investment purchase or sale
  - Loan applications and transactions, such as repayments of enrollments
  - Credit card applications
  - Register utility billers and make bill payments

❖ Financial institution administration

❖ Management of multiple users having varying levels of authority

❖ Transaction approval process

❖ Some financial institutions offer special internet banking services, for example: Personal financial management support, such as importing data into personal accounting software. Some online banking platforms support account aggregation to allow the customers to monitor all of their accounts in one place whether they arewith their main bank or with other institutions.

Advantages of E-Banking

1. The operating cost per unit services is lower for the banks.
2. It offers convenience to customers as they are not required to go to the bank's premises. There isvery low incidence of errors.
3. The customer can obtain funds at any time from ATM machines.

4. The credit cards and debit cards enables the Customers to obtain discounts from retail outlets.
5. The customer can easily transfer the funds from one place to another place electronically.

Popular services covered under E-Banking

- Automated Teller Machines,
- Credit Cards,
- Debit Cards,
- Smart Cards,
- Electronic Funds Transfer (EFT) System,
- Mobile Banking,
- Internet Banking,
- Tele-banking
- Home banking
- Demat facility
- Cheques Truncation Payment System

1. Automated Teller Machine:

An ATM is a computerized Tele-communication device which provides the customers the access to financial transactions in public places without human inter-mention. It enables the customers to perform several banking operations such as withdrawals of cash, request of mini- statement etc. The advantages of ATM are:

a) ATM provides 24 hours service:

ATMs provide service round the clock. The customer can withdraw cash up to a certain a limit during any time of the day or night.

b) ATM gives convenience to bank's customers :

ATMs provide convenience to the customers. Now- a-days, ATMs are located at convenient places, such as at the air ports, railway stations, etc. and not necessarily at the Bank's premises.

c) ATM reduces the workload of bank's staff:

ATMs reduce the work pressure on bank's staff and avoids queues in bank premises.

d) ATM provide service without any error:

ATMs provide service without error. The customer can obtain exact amount. There is no human error as far as ATMs are concerned.

e) ATM is very beneficial for travellers:

ATMs are of great help to travellers. They need not carry large amount of cash with them.

f) ATM may give customers new currency notes:

The customer also gets brand new currency notes from ATMs. In other words, customers do not get soiled notes from ATMs.

g) ATM provides privacy in banking transactions:

Most of all, ATMs provide privacy in banking transactions of the customer.

2. Electronic Transfer of Funds:

This is an electronic debit or credit of customers account. Bank customers can buy goods and services without caring cash by using credit or debit cards. There cards are issued to the customersby the bankers. This system works on a pin (personal identification number).

The Customer swipes the card by using the card reader device to make the transactions. The development of electronic banking and internet banking helped the customers to utilize their services.

3. Tele-Banking:

It is increasingly used in these days. It is a delivery channel for marketing, banking services. A customer can do non-cash business related banking over the phone anywhere and at any time. Automatic voice recorders are used for rendering tale-banking services.

4. Mobile Banking:

It is another important service provided by the banks recently. The customers can utilize it with the help of a cell phone. The bank will install particular software and provide a password to enable a customer to utilize this service.

5. Home Banking:

It is another important innovation took place in Indian banking sector. The customers can perform a no. of transactions from their home or office. They can check the balance and transfer the funds with the help of a telephone. But it is not that popularly utilized in our country.

6. Internet Banking:

It is the recent trend in the Indian banking sector. It is the result of development took place in information technology. Internet banking means any user or customer with personal computer and browser can get connected to his banks website and perform any service possible through electronic delivery channel. There is no human operator present in the remote location to respond. All the services listed in the menu of bank website will be available.

7. Demate Banking:

It is nothing but de-materialization. This is a recent extant in the Indian banking sector. The customer who wants to invest in stock market or in share and stock needs to maintain this account with the commercial banks. The customer needs to pay certain annual charges to the banks for maintaining this type of accounts.

8. Credit Cards

A credit card is a small plastic card issued to users as a system of payment. It allows its holder to buy goods and services based on the holder's promise to pay for these goods and services. The issuer of the card creates a revolving account and grants a line of credit to the consumer (or the user) from which the user can borrow money for payment to a merchant or as a cash advance to the user. A credit card is different from a charge card: a charge card requires the balance to be paid in full each month. In contrast, credit cards allow the consumers a continuing balance

of debt, subject to interest being charged. A credit card also differs from a cash card, which can be used like currency by the owner of the card. Most credit cards are issued by banks or credit unions.

9. Debit Card

A debit card (also known as a bank card or check card) is a plastic card that provides the cardholder electronic access to his or her bank account/s at a financial institution. Some cards have a stored value against which a payment is made, while most relay a message to the cardholder's bank to withdraw funds from a designated account in favour of the payee's designated bank account. The card can be used as an alternative payment method to cash when making purchases. In some cases, thecards are designed exclusively for use on the Internet, and so there is no physical card. In many countries the use of debit cards has become so widespread that their volume of use has overtaken or entirely replaced the check and, in some instances, cash transactions. Like credit cards, debit cards are used widely for telephone and Internet purchases. However, unlike credit cards, the funds paid using a debit card are transferred immediately from the bearer's bank account, instead of having the bearer pay back the money at a later date.

Credit Card Vs Debit Card

Credit card	Debit card
It is a "pay later product"	It is "pay now product"
The card holder can avail of credit for30-45 days	Customers account is debited immediately
No sophisticated communication system is required for credit card operation	Sophisticated communication network/system is required for debit card operation (eg.ATM)
Opening bank account and maintaining required amount are not essential	Opening bank account and maintaining required amount are essential
Possibility of risk of fraud is high	Risk is minimised through using PIN

10. Smart Card

A smart card resembles a credit card in size and shape, but inside it is completely different. First of all, it has an inside -- a normal credit card is a simple piece of plastic. The inside of a smart card usually contains an embedded microprocessor. The microprocessor is under a gold contact pad on one side of the card.

Smarts cards may have up to 8 kilobytes of RAM, 346 kilobytes of ROM, 256 kilobytes of programmable ROM, and a 16-bit microprocessor.

The most common smart card applications are:

- Credit cards
- Electronic cash
- Computer security systems

- Wireless communication
- Loyalty systems (like frequent flyer points)
- Banking
- Satellite TV
- Government identification

11. Cheques Truncation Payment system (CTPS)

Truncation is the process of stopping the flow of the physical cheque issued by a drawer to the drawee branch. The physical instrument will be truncated at some point en- route to the drawee branch and an electronic image of the cheque would be sent to the drawee branch along with the relevant information like the MICR fields, date of presentation, presenting banks etc. Thus with the implementation of cheque truncation, the need to move the physical instruments across branches would not be required, except in exceptional circumstances. This would effectively reduce the time required for payment of cheques, the associated cost of transit and delay in processing, etc., thus speeding up the process of collection or realization of the cheques.

12. Social Banking

Social banking means banking policy to meet the socio-economic obligations of the country. It includes allocation of credit according to the requirements of the planned economic development of the country.

13. No frills Account

Now a day, RBI has advised the banks to allow people to open no-frills accounts, i.e., accountswith nil balance or very low minimum balance.

14. Off-shore Banking

Off –shore bank is a bank located outside the country of residence of the depositor , typically in a low tax area that provides financial and legal advantages.

15. Banking Ombudsman Scheme

16. Capital Adequacy Norms

CENTRAL BANK

Meaning of Central Bank:

It is very difficult to suggest a precise definition of a central bank. However, a central bank can best be defined with reference to its functions.

It can be defined as the bank which stands as the leader of the money market—also called the financial market—issues notes and coins, supervises, controls and regulates the activities of the banking system and acts as the banker of the government. In our pyramidal financial structure, the central bank sits at the top.

A central bank is a bank which constitutes the apex of the monetary and banking structure. It manages the economy in the interest of general public welfare, but not maximization of profit. According to W. A. Shaw, the central bank is the bank which controls credit.

Samuelson defines central bank "…as a bank of bankers. Its duty is to control the monetary base and through control of this 'high-powered money' to control the community's supply of money." But as a private citizen, no one—even the Head of the country—either can open a bank account or borrow money from the central bank.

Origin of the Central Bank:

The establishment of a central bank in a modern economy is essential as it is the apex institution of a country's financial as well as monetary system. Its action affects money supply, the volume of credit, interest rates, etc. All these have direct impacts not only on financial markets but also on national output and inflation (deflation). Thus the central bank plays an important role in any economy.

In fact, every independent country must have a central bank for organizing, running, supervising, regulating and developing the monetary- financial system of the country.

Implementation of the government's economic policy requires the presence of the central bank which stands as the undisputed leader of the money market. In view of this, some people feel that the central bank is one of the great inventions of modern civilization.

In most countries, the central bank is a nationalized institution. It is the main agent of the government for the purpose of administering its monetary and

banking policies. Unlike commercial banks, its aim is not to make profit for its shareholders. So, it does not compete with the commercial banks for ordinary banking business.

The first central bank was established in the 18th century. Though the Riks Bank of Sweden was set up in 1656 and the Bank of England in 1694, the Bank of England started functioning as the central bank of England in 1844. It is said that the Bank of England is the oldest central bank of the world.

In America, Federal Reserve Banks started functioning as the central bank in 1913. The post-World War II period witnessed a phenomenal growth of central banks all over the world. At present, there are more than 150 central banks operating in various countries.

It will not be out of place to mention here that in the USA, there is a federal form of central banking. The USA is the exception in as much as there is not one central bank; there are 12 central banks, called Federal Reserve Banks.

The coordinating central body of these 12 banks is the Federal Reserve Board. One mustnot call the Federal Reserve Board the central bank. The Reserve Bank of India—the central bank of our country— was set up in 1935. The Bank of Pakistan is the name of the central bank of Pakistan.

On the question of issuing notes one can we trace the evolution of central banking. In the 19th century, commercial banks were entrusted to issue notes. But notes issued by them involved difficulties, like lack of uniformity and over-issue or under-issue of notes.

To avoid these difficulties, the note-issuing power was given to the central bank. The Central Bank of Holland in 1814 and the Bank of England in 1844 were given the monopoly power of note issue. Thus, the central bank is defined as the note-issuing authority.

FUNCTIONS OF CENTRAL BANK:

One can find some differences in the style of functioning of a central bank. Its functions in an underdeveloped country differ from those in a developed country. But the central bank performs the following common but vital functions in every country.

The most important ones are:

(a) Monopoly Power of Note Issue:

In the 19th century, commercial banks in many countries enjoyed the right to issue notes. As the notes issued by them lacked uniformity, governments could

not be prevented from over-issuing (or under-issuing) of notes. In view of these problems, the central bank has been given the monopoly power of note issue. It has been empowered to do so in the interest of uniformity and to bring a balance between demand for money and supply of money (i.e., prevention of over-issue or under-issue of notes).

The notes issued by the central bank are considered as legal tender money of the country and form the cash basis of the credit of commercial banks. Being the sole supplier of money in the economy, the central bank regulates the volume of currency of the country. It hasalso the power to withdraw worn and torn notes from circulation in exchange for new ones, so that good quality notes and coins circulate in the economy.

(b) Bankers' Bank:

Commercial banks are required, by law or convention, to keep a certain percentage of their deposits are serves with the central bank. In this way, it acts as a custodian of cash reserves. Banks draw cash balances from the central bank as and when the situation demands.

As a bankers' bank, it acts as a lender of the last resort. If commercial banks face serious liquidity crisis they approach the central bank and it stretches its lending hand to them—either by discounting bills or buying securities from them. This sort of accommodation makes the central bank a lender of the last resort. This is essential to prevent bank failure.

It gives advice to banks on good/sound banking practice. A central bank usually discusses government policy with them and reports back to the government. Thus, a central bank closely monitors the activity of commercial banks.

(c) Banker, Agent and Adviser to the Government:

The central bank acts as a banker, agent and adviser to any government. As a banker of the government, it has to maintain banking accounts of both central and state governments. It makes and receives payments on behalf of the government as it acts as the agent of the government. Truly speaking, government (central, state, and union territories) expenditure (say, on road building, hospital construction, etc.,) and revenue (say from income tax, excise duty, etc.,) pass through the central bank. In brief, it performs merchant banking functions for the government.

It also provides short-term loans and advances (known as ways and means advances) to the government to enable the latter to tide over its financial difficulties. It also advises the government on necessary monetary and financial

matters such as market borrowing, loan repayment, deficit financing, control of inflation.

(d) Controller of Credit:

The central bank of a country prescribes broad parameters of banking operations withinwhich the country's banking and finance system operates. In a modern credit-oriented economy, credit is an important component of money supply. Being profit-making institutions, commercial banks may adopt the policy of undue expansion or contraction of credit to suit theirneeds.

This may lead to inflation or deflation. Neither of the two is desirable. To ensure price stability, credit supply is to be regulated. And, this task has been entrusted with the central bank. The central bank, through its credit control policy, intends to curb the lending potential ofcommercial banks.

Actually, it keeps the creation of credit within limits. It is accepted that this is its most important function. However, for controlling credit, it uses several official instruments like the bank rate, open market operations, and so on.

(e) Custodian of Foreign Exchange Reserves:

With the aim of facilitating foreign trade and payment and promoting orderly development and maintenance of foreign exchange market, a central bank acts as the manager of foreign exchange. The central bank acts as the sole custodian of gold and foreign currencies for the purpose of issuing notes and for correcting an adverse balance of payments situation.

In this connection, one may note that, by holding gold and foreign currencies, the central bank intends to stabilize foreign exchange rate. Like internal price stability, stability in foreign exchange rate is equally vital. A central bank aims at affecting the foreign exchange rate (i.e., the rate at which one currency is converted into another currency) by buying and selling foreign currencies in the foreign exchange market.

In addition to these functions, the central bank:

I. Acts as a clearing house for the settlement of accounts of commercial banks;

II. Studies different aspects of economic problems, compiles data and information and publishes reports and periodicals, etc.

(f) Promotional and Developmental Functions:

In an underdeveloped economy, a central bank, in addition to the above noted traditional functions, acts as a potential development agency. It is not only a

controller and regulator of credit but also a promoter.

Its task in LDCs is:

(i) To develop the money and capital markets

(ii) To strengthen the banking structure

(iii) To meet the genuine financial needs of agriculture and industry, and so on.

It protects the interest of depositors and provides cost-effective banking services to the public. In brief, it corrects the defects and removes the inefficiencies of the country's monetary- financial system. These activities are called promotional or non-traditional activities of a central bank of LDCs. Thus, the pattern of economic development in low-income countries like India is largely determined by the central bank.

To conclude, it is futile to single out the most important function of a central bank. In fact, all its functions are important from the point of view of developing countries. Further, as far as the objective of growth with stability is concerned, there is no hard and fast rule to delimit the functions of a central bank. Its role and functioning keep on changing with the passage of time.

ROLE OF CENTRAL BANK IN DEVELOPING COUNTRIES

In the developing countries, the central bank has to play a much wider role. Besides performing the traditional functions, the central bank has to undertake responsibility of economic growth with stability in these economies. Moreover, since the developing countries do not have well-organised money and capital markets, the central bank has a crucial function to develop the banking and financial system of the country .The central bank performs the following developmental and promotional functions in the developing countries

1. Traditional Functions:

The central banks in the developing countries perform both traditional and non-traditional functions. The traditional functions of the central bank are: having the monopoly of note-issue acting as banker to the government, serving as bankers' bank; functioning as the lender of the last resort, controlling and regulating the credit; and maintaining the external stability.

2. Economic Growth:

The central banks in the developing countries should aim at promoting the process f economic growth. Economic growth requires sufficient financial resources. The central bank can ensure adequate monetary expansion in the

country. Moreover, as a banker to the government, the central bank can provide funds for initiating investment in the public sector.

3. Internal Stability:

Along with the objective of economic growth, the central bank should also attempt to maintain internal price stability. The developing countries are susceptible to inflationary pressures mainly due to supply inelasticities in the short period. The central bank should adopt such a monetary policy that can control inflationary tendencies and ensure price stability.

4. Development of Banking System:

The developing and underdeveloped countries do not have well-developed banking system. In such an economy, the central bank should not only take measures to develop an integrated commercial banking system, but also should not hesitate undertaking directly the commercial Banking functions.

5. Branch Expansion:

In developing countries, the commercial banks generally concentrate their branches in the urban areas. In order to extend credit facilities to the agricultural sector, the central bank should prepare programme for branch expansion in the rural areas.

6. Development of Financial Institutions:

Development of the leading sectors of the economy such as agriculture, industry, foreign trade, etc. requires long-term finances. For this, the specialised financial institutions should be established which provide term-loans to these sectors.

7. Development of Banking Habits:

Through its various credit control instruments (ie., bank rate, variable cash reserve ratio, etc.) and by providing discounting facilities to the commercial banks, the central bank exercises full control over the activities of commercial banks.this crates public confidence in the banking system and helps in the development of banking habits of the people.

8. Training Facilities:

A major difficulty in developing the banking system in developing countries is the lack of trained staff. The central bank can provide training facilities to meet the personnel requirements of the banks

9. Proper Interest Rate Structure:

The central bank can help in establishing a suitable interest rate structure to influence the direction of investment in the country. In underdeveloped countries, a policy of low interest rate is necessary for encouraging investment and promoting

development activities. Again, by adopting different interest rates, the central bank can increase productive investment and discourage unproductive investment

10. Other Promotional Roles:

The central bank can provide a number of other promotional facilities. For example, (a) it can adopt policies to provide help to the various priority sectors , such a agriculture cooperative sector, small scale sector, export sector, etc. (b) it can provide guidelines to be followed by the planners about some definite patterns of economic and investment policies; (c) it can publish information Regarding the state of the economy and promote research in money and banking.

Conclusion.

In short, the central bank has to play not only regulatory, but also developmental role in the developing countries. In the words of Planning Commission of India, the central bank has to take "a direct active role (a) in creating or helping to create the machinery needed for financing development activities all over the country, and (b) in ensuring that the finance available flows in the directions intended."

METHODS OF CREDIT CONTROL

The various methods or instruments of credit control used by the central bank can be broadly classified into two categories: (a) quantitative or general methods, and (b) qualitative or selective methods

A. Quantitative or General Methods:

The methods used by the central bank to influence the total volume of credit in the banking system, without any regard for the use to which it is put, are called quantitative or general methods of credit control. These methods regulate the lending ability of the financial sector of he whole economy and do not discriminate among the various sectors of the economy.

The important quantitative methods of credit control are: (a) bank rate, (b) open market operations, and (c) cash-reserve ratio.

a) Bank Rate Policy.

- It is an indirect method of influencing the volume of credit in the economy. It first influences the cost and availability of credit to the commercial banks and thereby, influences the willingness of the businessmen to borrow and invest.
- It does not produce immediate effect on the cash reserves of the commercial banks
- It is suitable when only marginal changes are desired in the cash reserves of the commercial banks.
- It is flexible. It is applicable to a narrower sector of the banking system and therefore can be varied according to the requirement of local situation.

b) Open market Operations.

- It is a more direct method because it controls the volume of credit by influencing the cash reserves of the commercial banks.
- It affects the cash reserves of the commercial banks through the purchase and sale of securities. So the success of this policy depends on the existence of a well-developed securities market in the economy.
- It is suitable when marginal adjustments are needed in the cash reserves of the commercial banks
- It is not flexible. It can be applicable to a narrower sector of the banking system and therefore cannot be changed easily and quickly.

c) Variable Cash Reserve Ratio.

- It is the most direct method because it controls the volume of credit by directly influencing the cash reserves of the commercial banks.
- It produces immediate effect on the cash reserves of the commercial banks.
- It is suitable when large changes in the cash reserves of the commercial banks are required.
- It is not as flexible as the open market operations policy is. Since it is applicable to the entire banking system, therefore, it cannot be varied in accordance with the requirements of the local situation.

Conclusion

The comparative study of the three quantitative methods of credit control shows that each method has its own merits and demerits. No method, taken alone, can produce effective results. The correct approach is that, instead of selecting this method of that method, all the three methods should be judiciously combined in right proportions to achieve the objectives of credit control effectively.

B. Qualitative or Selective Methods

The methods used by the central bank to regulate the flows of credit into particular directions of the economy are called qualitative or selective methods of credit control. Unlike the quantitative methods, which affect the total volume of credit, the qualitative methods affect the types of credit extended by the commercial banks; they affect the composition rather than the size of credit in the economy.

The important qualitative or selective methods of credit control are; (a) marginal requirements, (b) regulation of consumer credit, (c) control through directives, (d) credit rationing. (e) moral suasion and publicity, and (f) direct action.

a) Marginal Requirements.

The method of regulating marginal requirements on security loans was first used in the U.S.A. under the Securities Exchange Act of 1934. Control over marginal requirements means control over down payments that must be made in buying securities on credit. The marginal requirement is the difference between the market value of the security and its maximum loan value if a security has a marker value of Rs.100 and if the marginal requirement is 60% the maximum loan that can be advanced for the purchase of security is Rs. 40. Similarly, a marginal requirement of 80% would allow borrowing of only 20% of the price of the security and the marginal requirement of 100% means that the purchasers of securities must pay the whole price in cash. Thus, an increase in the marginal requirements will reduce the amount that can be borrowed for the purchase of a security.

This method has many advantages:

a. It controls credit in the speculative areas without affecting the availability of credit in the productive sectors.

b. It controls inflation by curtailing speculative activities on the one hand and by diverting credit to the productive activities on the other.

c. It reduces fluctuations in the market prices of securities.

d. It is a simple method of credit control and can be easily administered. However, the effectiveness of this method requires that there are no leakages of credit from productive areas to the unproductive or speculative areas.

b) Regulation of Consumer Credit.

This method was first used in the U.S.A. in 1941 to regulate the term And conditions under which the credit repayable in instalments could be extended to the consumers for Purchasing the durable goods. Under the consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash. The balance is financed through the bank credit which is payable by the consumer in instalments. The central bank can control the consumer credit (a) by changing the maximum Period over which the instalments can be extended.

This method seeks to check the excessive demand for durable consumer goods and, thereby, to control the prices of these goods. It has proved very useful in controlling inflationary trends in developed countries where the consumer credit system is widespread. In the underdeveloped countries, however, this method has little significance where such a system is yet to develop.

c) Rationing of Credit.

Credit rationing is a selective method of controlling and regulating the purpose

for which credit is granted by the commercial banks. Rationing of credit may assume two forms: (a) the central Bank may fix its rediscounting facilities for any particular bank; (b) the central bank may fix the minimum ratio Regarding the capital of a commercial bank to its total assets.

4. Moral Suasion.

According to Chandler, "In many countries with only a handful of commercial banks, the central bank relies heavily on moral suasion to accomplish its objectives." Moral suasion means advising. Requesting and persuading the commercial banks to cooperate with the central bank in implementing its central bank in implementing its general monetary policy. Through this method, the central bank merely uses its moral influence to make the commercial bank to follow its policies. For instance, the central bank may request the commercial banks not grant loans for speculative purposes. Similarly, the central bank may persuade the commercial banks not to, approach it for financial accommodation. This method is a psychological method and its effectiveness depends upon the immediate and favourable response from the commercial banks

5. Publicity:

The central banks also use publicity as a method of credit control. Through publicity, the central bank seeks (a) to influence the credit policies of the commercial banks; (b) to educate people regarding the economic and monetary condition of the country, and (c) to influence the public opinion favour of its monetary policy. The central banks regularly publish the statement of their assets and liabilities reviews of credit and business conditions reports on their own activities, money market and banking reviews of credit and business conditions; reports on their own activities, money market and banking conditions; From the published material the banks and the general public can anticipate the future changes in the policies of the central bank. But, this method is not very useful in the less developed countries where majority of the people are illiterate and do not understand the significance of banking statistics.

6. Direct Action

The method of direct action most extensively used by the central bank to enforce both quantitative as well as qualitative credit controls .This method is not used in isolation; it is often used supplement other methods of credit control. Direct action refers to the directions issued by the central bank to the commercial banks regarding their lending and investment policies Direct action may take different forms: (a) The central bank may refuse to rediscount the bills of exchange of the commercial banks whose credit policy is not in line with the general monetary policy of the central bank .(b) The central bank may charge a penal rate of interest,

over and above the bank rate, on the money demanded by the bank beyond the prescribed limit. (c) The central bank may refuse to grant more credit to the banks whose borrowings found to be in excess of their capital and reserves.

In practice, direct action as a method of controlling credit has certain limitations:

a. The method of dire action involves the use of force and creates an atmosphere of fear. In such conditions, the central bank cannot expect whole-hearted and active cooperation from the commercial banks

b. It may be difficult for the commercial banks to make clear-cut distinction between essential and non-essential industries, productive and unproductive activities, investment and speculation.

c. It is difficult for the commercial banks to control the ultimate use of credit by the borrowers.

d. Direct action, which involves refusal of rediscount facilities to the commercial banks, is in conflict with the function of the central bank as the lender of the last resort according to which the central bank cannot refuse such facilities.

Importance of Selective Credit Controls

In modem times, the selective credit controls have become very popular, particularly in the developing countries. They serve to achieve the following objectives:

(i) The selective credit control measures divert credit from nonessential and less urgent uses to essential and more urgent uses.
(ii) The measures influence only the particular areas of the economy (eg, speculative activities) without affecting the economy as a whole.
(iii) The selective credit controls discourage excessive consumer spending on durable goods financed through the hire-purchase schemes.
(iv) The selective credit controls are particularly useful in the developing countries where quantitative methods are not so much effective because of underdeveloped money market.
(v) Through selective measures, the central bank can give preferential treatment to the backward and priority sectors, such as agricultural sector, small scale sector, export sector, of the developing economies by providing special credit facilities to these sectors.
(vi) The selective credit controls are helpful in ensuring balanced economic growth. They play an important role in removing various types of imbalances which tend to emerge in an economy during the process of economic development.

(vii) Selective credit controls may also be used in curbing inflationary tendencies in the developing economics. This may be done by encouraging productive investments and restricting unproductive investments.

Limitations of Selective Credit Controls

The selective controls suffer from the following limitations:

(i) The selective credit controls are effective only in influencing the credit policies of the commercial banks and not of the other non bank financial institutions. These non-bank financial institutions also create a large proportion of total volume of credit and are not under the control of the central bank.

(ii) Through selective credit controls, the monetary authority seeks to divert bank credit from unproductive to productive activities. But, it is not easy for the commercial banks to distinguish between productive and unproductive.

(iii) Even if the commercial banks are able to provide loans for productive purposes, it is not possible for them to control the ultimate use of these loans.

(iv) The borrowers may use these loans for unproductive loans from the banks.

(v) Under the selective credit control policy, there is no restriction on clean credit. This, the selective measures, like higher marginal requirements, may be violated by the borrower who can obtain clean loans from the banks.

(vi) The commercial banks, motivated by higher profits, may manipulate their accounts and advance loans for prohibited uses.

(vii) The selective credit controls are not so effective under unit banking system as they are under branch banking system.

(viii) The selective credit controls are also not effective in the indigenous and unorganized banking sector of the developing economics.

Conclusion:

Despite these limitations, the selective credit controls are an important tool with the central bank and are extensively used as a method of credit control. However, for effective and successful monetary management, both the quantitative and qualitative credit control methods are to be combined judiciously. The two types of credit control are not competitive; they are supplementary to each other.

RESERVE BANK OF INDIA

The Reserve Bank of India is India's central bank. It is the apex monetary institution which supervises, regulates, controls and develops the monetary and financial system of the country. The Reserve bank was established on April 1, 1935 under the Reserve Bank of India Act, 1934 in Calcutta, eventually moved permanently to Mumbai. Initially, it was constituted as a private share-holders' bank with a fully paid-up capital of Rs. 5 crore. But, it was nationalised on January 1, 1949.

Management

The management of the Reserve Bank is under the control of Central Board of Directors consisting of 20 members: (a) The executive head of the Bank is called Governor who is assisted by four Deputy Governors. They are appointed by the Government of India for a period of five years. The head office of the Reserve Bank is at Bombay. (b) There are four local boards at Delhi, Calcutta, Madras and Bombay representing four regional areas, i.e., northern, eastern, southern and western respectively. These local boards are advisory in nature and the Government of India nominates one member each from these boards to the Central Board. (c) There are ten directors from various fields and one government official from the Ministry of Finance.

The Reserve Bank of India Act, 1934 requires that there must be at least six meetings in a year and the gap between two meetings must not exceed three months. The Governor of the Reserve Bank can call a meeting of the Central Board whenever he feels it necessary. The Governor and the Deputy Governors are full-time officials of the Reserve Bank and are paid prescribed salaries and allowances. Other directors are part-time officials and are given fare and allowance to participate in the meetings.

Organisation

The Reserve Bank’s affairs are governed by a central board of directors. The board is appointed by the Government of India for a period of four years, under the Reserve Bank of India Act.

1. Full-time officials: Governor and not more than four Deputy Governors. The current Governor of RBI is Mr.Shaktikanta Das. There are 3 Deputy Governors presently – Shri.M.Rajeshwar Rao, Dr.M.D. Patra and Shri M.K.Jain.
2. Nominated by Government: ten Directors from various fields and two government Officials
3. Others: four Directors – one each from four local boards

Organisationally, the Reserve Bank operates through various departments. They are:

1. **Issue Department**. Its main function is to issue and distribute the paper currency.

2. **Banking Department**. This department (a) deals with the government transactions, manages public debt and arranges for the transfer of government funds; (b) maintains the cash reserves of the scheduled banks, provides financial accommodation to the banks and functions as a clearing house.

3. **Department of Banking** Development. It aims at expanding banking facilities in unbanked and rural areas

4. **Department of Banking** Operations. Its function is to supervise, regulate and control the working of the banking institutions in the country. It grants licenses for opening new banks or the new branches of the existing banks.

5. **Agricultural Credit Department.** It deals with the problems of agricultural credit and provides facilities of rural credit to state governments and state cooperatives.

6. **Industrial Finance Department.** Its main objective is to provide financial help to the small and medium scale industries.

7. **Non-Banking Companies Department**. It supervises the activities of non-banking companies financial institutions in the country

8. **Exchange Control Department.** It conducts the business of sale and purchase of foreign exchange.

9. **Legal Department.** It provides advice to various departments on legal issues. It also gives legal advice

10. **Department of Research and Statistics**. The objective of this department is (a) to conduct research on the implementation of banking laws in the country. problems relating to money, credit, finance, production, etc., (b) to collect important statistics relating to various aspects of the economy; and (c) publish these statistics.

11. **Department of Planning and Re-organisation**. It deals with the formulation of new plans or reorganisation of existing policies for making them more effective.

12. **Economic Department.** It is concerned with framing proper banking policies for better implementation of economic policies of the government.

13. **Inspection Department.** It undertakes the function of inspecting various offices of the commercial banks.

14. **Department of Accounts and Expenditure**. It keeps proper records of all receipts and expenditures of the Reserve Bank.

15. **RBI Services Board.** It deals with the selection of new employees, for different posts in the Reserve Bank.

16. **Department of Supervision.** A new department, i.e., Department of Supervision, was set up on December 22, 1993 for the supervision of commercial banks.

FUNCTIONS OF RESERVE BANK

The Reserve Bank of India performs various traditional central banking functions as well as undertakes different promotional and developmental measures to meet the dynamic requirements of the country. The broad objectives of the Reserve Bank are: (a) regulating the issue of currency in India; (b) keeping the foreign exchange reserves of the country; (c) establishing the monetary stability in the country; and (d) developing the financial structure of the country on sound lines consistent with the national socio-economic objectives and policies. Main functions of the Reserve Bank are discribed below:

1. **Note Issue.**

The Reserve Bank has the monopoly of note issue in the country. It has the sole right to issue currency notes of all denominations except one rupee notes. One rupee notes are issued by the Ministry of Finance of the Government of India. The Reserve Bank acts as the only source of legal tender because even the one rupee notes are circulated through it. The Reserve Bank has a separate Issue Department which is entrusted with the job of issuing currency notes. The Reserve Bank has adopted minimum reserve system of note issue. Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 crore, of which at least Rs. 115 crore should be in gold.

2. **Banker to Government.**

The Reserve Bank acts as the banker, agent and adviser to Government of India: (a) It maintains and operates government deposits. (b) It collects and makes payments on behalf of government. (c) It helps the government to float new loans and manages the public debt. (d) It sells for the Central Government treasury bills of 91 days duration. (c) It makes 'Ways and Means' advances to the Central and State Governments for periods not exceeding three months. (f) It provides development finance to the government for carrying out five year plans. (g) It undertakes foreign exchange transactions on behalf of the Central Government. (h) It acts as the agent of the Government of India in the latter's dealings with the International Monetary Fund (IMF), the World Bank, and other international financial institutions. (i) It advises the government on all financial matters such as loan operations, investments, agricultural and industrial finance, banking, planning, economic development, etc.

3. **Banker's Bank.**

The Reserve Bank acts as the banker's bank in the following respects: (a) Every Bank is under the statutory obligation to keep a certain minimum of cash reserves with

the Reserve Bank. The purpose of these reserves is to enable the Reserve Bank to extend financial assistance to the scheduled banks in times of emergency and thus to act as the lender of the last resort. According to the Banking Regulation Act, 1949, all scheduled banks are required to maintain with the Reserve Bank minimum cash reserves of 5% their demand liabilities and 2% of their time liabilities. The Reserve Bank (Amendment) Act, 1956 empowered the Reserve Bank to raise the cash reserve ratio to 20% in the case of demand deposits and to 8% In case of time deposits. Due to the difficulty of classifying deposits into demand and time categories, the Amendment to the Banking Regulation Act in September 1972 changed the provision of reserves to 3% of deposit liabilitics, which can be raised to 15% if the Reserve Bank considers it necessary. (b) The Bank provide financial assistance to the scheduled banks by discounting their eligible bills and through loans and advances against approved securities. (c) Under the Banking Regulation Act, 1949 and its Various amendments; the Reserve Bank has been given extensive powers of supervision and control over the banking system. These regulatory powers relate to the licensing of banks and their branch expansion; liquidity of assets of the banks; management and methods of working of the banks; amalgamation, reconstruction and liquidation of banks; inspection of banks; etc.

4. **Custodian of Exchange Reserves.**

The Reserve Bank is the custodian of India's foreign exchange reserves. It maintains and stabilises the external value of the rupee, administers exchange controls and other restrictions imposed by the government, and manages the foreign exchange reserves. Initially, the stability of exchange rate was maintained through selling and purchasing sterling at fixed rates. But after India became a member of the international Monetary Fund (IMF) in 1947, the rupee was delinked with sterling and became a multilaterally convertible currency. Therefore the Reserve Bank now sells and buys foreign currencies, and not sterling alone, in order to achieve the objective of exchange stability. The Reserve Bank fixes the selling and buying rates of foreign currencies. All Indian remittances to foreign countries and foreign remittances to India are made through the Reserve Bank.

5. **Controller of Credit**

As the central bank of the country, the Reserve Bank undertakes the responsibility of controlling credit order to ensure internal price stability and promote economic growth. Through this function, the Reserve Bank attempts to achieve price stability in the country and avoids inflationary and deflationary tendencies in the country. Price stability is essential for economic development. The Reserve Bank regulates the money supply in accordance with the changing requirements of the economy. The Reserve Bank makes extensive use of various quantitative and qualitative techniques to effectively control and regulate credit in the country.

6. **Ordinary Banking Functions**.

The Reserve Bank also performs various ordinary banking functions:(a)It accepts deposits from the central government, state governments and even private individuals without interest. (b) It buys sells and rediscounts the bills of exchange and promissory notes of the scheduled banks without restrictions. (c) It grants loans and advances to the central government, state governments, local authorities, scheduled banks and state cooperative banks, repayable within 90 days. (d) It buys and sells of the Government of India and foreign securities. (e) It buys from and sells to the scheduled banks foreign exchange for a minimum amount of Rs. 1 lakh. (f) It can borrow from any scheduled bank in India or from any foreign bank. (g) It can open an account in the World Bank or in some foreign central bank.(h) It accepts valuables, securities, etc., for keeping them in safe custody. (i) It buys and sells gold and silver.

7. **Miscellaneous Functions:**

In addition to central banking and ordinary banking functions, the Reserve Bank performs the following miscellaneous functions: (a) Banker's Training College has been set up to extend training facilities to supervisory staff of commercial banks. Arrangements have been made to impart training to the cooperative personnel. (b) The Reserve Bank collects and publishes statistical information relating to banking, finance, credit, currency, agricultural and industrial production, etc. It also publishes the results of various studies and review of economic situation of the country in its monthly bulletins and periodicals.

8. **Forbidden business:**

Being the central bank of the country, the Reserve Bank (a) should not compete with member banks and (b) should keep its assets in liquid form to meet any situation of economic crisis. Therefore, the Reserve Bank has been forbidden to do certain types of business: (a) It can neither participate in, nor directly provide financial assistance to any business, trade or industry. (b) It can neither buy its own shares not those of other banks or commercial and industrial undertakings. (c) It cannot grant unsecured loans and advances. (d) It cannot give loans against mortgage security. (e) It cannot give interest on deposits. It cannot draw or accept bills not payable on demand. (g) It cannot purchase immovable property except for its own offices.

9. **Promotional and Developmental Functions**.

Besides the traditional central banking functions, the commercial banks to expand their branches in the semi-urban and rural areas, the Reserve Bank helps (i)to reduce the dependence of the people in these areas on the defective unorganized sector of indigenous bankers and money lenders, and (i) to develop the banking habits of the people (b) By establishing the Deposit Insurance Corporation, the Reserve Bank helps to develop the banking system of the country, in stills confidence of the depositors and

avoids bank failures. (e) Through the institutions like Unit Trust of India, the Reserve Bank helps to mobilize savings in the country. (d) Since its inception, the Reserve Bank has been making efforts to promote institutional agricultural credit by developing cooperative credit institutions. (e) The Reserve Bank also helps to promote the process of industrialization in the country by setting up specialized institutions for industrial finance. (f) It also undertakes measures for developing bill market in the country.

ACHIEVEMENTS AND FAILURES OF RESERVE BANK

Contributions to Economic Development

Since its inception in 1935, the Reserve Bank of India has functioned with great success, not only as the apex financial institution in the country, but also as the promoter of economic development. The major contributions of the Reserve Bank to economic development are as follow:

1. **Promotion of Commercial Banking.**

The Banking Regulation Act, 1949, has given the Reserve Bank vast powers of supervision and control of commercial banks in the country. The Reserve Bank has been using these powers (a) to strengthen the commercial banking structure through liquidation and amalgamation of banks, and through improvement in their operational standards; (b) to extend the banking facilities in the semi-urban and rural areas; and (c) to promote the allocation of credit in favour of the priority sectors such agriculture, small-scale industries, exports, etc.

2. **Development of Bill Market.**

The Reserve Bank introduced the bill market scheme in 1952 with a view o extend loans to the commercial banks against their demand promissory notes. The scheme, however, was not based on the genuine trade bills, but upon the conversion of loans and advances of the banks into usance bills. In 1970, the Reserve Bank introduced the new bill market scheme which covered the genuine trade bills representing sale or despatch of goods. The bill market scheme has helped a lot in developing the bill market in the country.

3. **Promotion of Rural Credit.**

Reforming the rural credit system and providing adequate institutional Finance for agricultural and rural activities has been Reserve Bank's special responsibility ever since its establishment. The Reserve Bank has taken the following efforts to promote rural credit: (a) It has set up Agricultural Credit Department to expand and coordinate credit facilities to the rural areas. (b) On the recommendations of its Rural Credit Survey Committee, the Reserve Bank has been attempting all necessary measures to strengthen the cooperative credit system with a view to meet the financial needs of the rural

people. (c) In 1956, the Reserve Bank set up two funds, ie, the National Agricultural Credit (Long-term Operations) Fund, and National Agricultural Credit (Stabilisation) Fund, for providing medium-term and long term loans to the state cooperative banks. (d) One of the main objectives of nationalisation of commercial banks was to expand bank credit facilities in rural areas. (c) Regional rural banks have been established and agriculture has been included in the priority sector. (f) Recently the National Bank forAgriculture and Rural Development has been established in 1982 as the apex institution for agriculture finance.

4. **Promotion of Cooperative Credit**

Promotion of cooperative credit movement is a function of the Reserve Bank. The Bank appointed the Rural Credit Survey Committee in 1951 to explore possibilities of promoting the cooperative credit system to meet the credit requirements of rural people the recommendation of the committee, the Reserve Bank has taken a number of measures to strength structure of cooperative credit institutions throughout the country to liberalise the cooperative credit increase the share of cooperative credit especially in the rural areas. The Reserve Bank does not provide financial assistance to the agriculturists directly, but through cooperative institutions. Thus, the reserve has infused a new life into the cooperative credit movement country.

5. **Promotion of Industrial Finance**.

In 1957, Reserve Bank set up a separate Industrial Finance development which has rendered useful service in extending financial and organisational assistance to the institution providing long-term Industrial finance. The Reserve Bank has been instrumental in the establishment various industrial finance institutions such as the Industrial Development Bank of India, Industrial finance Corporation of India, the State Finance Corporations, the State Industrial Development Corporations Industrial Credit and investment Corporation of India etc. The Reserve Bank also encourages bank credit the small scale industries Small scale industries have been recognised as a priority sector.

6. **Promotion of Export Credit**.

The Reserve Bank has been instrumental in promoting export finance through various measures: (a) It has been providing refinance facilities to banks to encourage export under various schemes such as the Bill Market Scheme (1958), Export Bills Credit Scheme(1963) shipment Credit Scheme (1969); Duty Drawback Credit Scheme (1976). (b) The Reserve bank has stipulating concessional interest rates on various types of export credit granted by the scheduled (c) Export has been recognised as priority sector and receive preferential treatment from the bank regard to the availability and cost of credit (d) In 1982, the Government of India set up the export-import Bank (EXIM) as the apex institution for financing foreign trade

7. Credit to Weaker Sections.

The Reserve Bank has taken the following measures to encourage adequate and cheaper credit to the weaker sections of society. (a) In 1971, the Credit Guarantee Corporation of was setup which was later merged into the Deposit Insurance Corporation in 1978. (b) In 1972, the different Rate of Interest Scheme was started.

8. Regulation of Credit.

The Reserve Bank has been extensively using various control weapons regulate (a) the cost of credit, (b) the amount of credit, and (e) the purpose of credit. For regulating and amount of credit, it has been using the quantitative weapons such as the bank rate, the open operations, etc., and for influencing the purpose and direction of credit, it has been using vat credit controls. By regulating credit, the Reserve Bank to certain extent has been able (a) to provide economic growth in the country; (b) to check inflationary trends in the country; (c) to prevent the financial resources from being used for speculative purpose; (d) to make financial resources available for products purposes keeping in view the priorities of the plans; and (c) to encourage savings in the country.

Other Achievements

Other achievements of the Reserve Bank are:

i. The Reserve Bank has been able to remove the variations in the interest rates in different season's different business centres which were the regular feature of the Indian money market before established of reserve bank.
ii. The Reserve Bank has been able to stabilise the bank rate in the country. There were 11 change the bank rate during 1955-81 in India as against 400 changes in the U.K. during 1844-1900,66 change during 1901-1914 an 7 changes during 1952-62.
iii. The Reserve Bank has been managing the public debt in the country with great success. During it converted sterling debt into rupee debt. It has floated loans for the central and state government at low rates, "Ways and Means' funds are also arranged for the government through the sales of treat bills.
iv. The Reserve Bank has been providing cheap remittance facilities to the government, the schedules banks and cooperative banks for the transfer of funds from one place to another.
v. The Reserve Bank has been able to maintain the stability of the exchange value of the rupee even under heavy strains and pressure. It has also managed the exchange controls successfully.
vi. The Reserve Bank has also successfully represented the country in international monetary conferences

vii. The Research and Statistical Department of Reserve Bank has been rendering a great service by conducting and encouraging research and by providing varied and useful statistical information regarding the economic conditions of the country.

viii. The Reserve Bank has been making clearing arrangements in different centres of the country and which has facilitated inter-bank transactions and popularised the use of cheques in the country.

ix. The Reserve Bank is also making valuable contribution to the development of banking system by

Failures

There are certain areas in which the performance of the reserve bank of india has not been up to the market. Major failures of the Reserve Bank are given below:

(i) Despite its best efforts, the Reserve Bank has not been able to integrate the indigenous bankers with the modern banking system. A large part of the Indian money market (ie., the indigenous bankers) still remains outside the control of the Reserve Bank..

(ii) The Reserve Bank has not succeeded in developing Indian exchange banks. As a consequence, the foreign exchange banks continue to enjoy monopoly position in the field of financing to foreign trade.

(iii) The Reserve Bank failed to protect the member-banks in times of crises. The banks like the Quilon Bank, The Pilai Bank, The Lakshmi Bank failed due to the absence of the timely assistance from the Reserve Bank.

(iv) The Reserve Bank has also not been able to successfully develop the bill market in the country. Inspite of its bill market scheme, good and discountable bills of exchange are still lacking apply.

(v) The Reserve Bank has failed to fully check inflationary pressures in India. In spite of the several credit control measures taken by the Reserve Bank, it has not been able to control effectively the rapidly increasing credit and money supply in the country.

(vi) The Reserve bank could not exercise its effective control over the expansion of black money and other unproductive activities in the economy.

(vii) In spite of many attempts made by the Reserve Bank to improve and expand agricultural finance in the country ,adequate and cheap credit is still not available to the indian farmers

Conclusion

Despite certain failures and short-comings of the Reserve Bank, and the limitations under which it has to function in a developing country like India, the overall performance of the Bank is quite satisfactory. It has efficiently operated the credit and currency system and achieved fair degree of monetary stability. It has been able to develop the financial structure of the country on sound footing consistent with the national socio-economic objectives and priorities.

NON-BANKING FINANCIAL COMPANIES

India has financial institutions, which are not banks but perform bank like functions, especially the financial intermediation of mobilisation of funds and extending credit. These are called Non-Banking Financial Companies (NBFCs) and they play a critical role in the financial system by providing last mile credit intermediation, while absorbing and diversifying risks by catering to segments not serviced by banks and pioneering innovative financial products. In regulating these entities, the challenge is to maintain a fine balance between maintaining the innovativeness and dynamism of the sector while also promoting its resilience. Their sheer number (over 9,000) and heterogeneity makes supervising them a daunting task with onsite supervision needing to be reinforced by offsite monitoring, market intelligence, statutory auditors reports and stakeholder interaction. This Chapter attempts to give an insight into the NBFC sector by delving into the definition of an NBFC, explicating the heterogeneity of the sector and giving an overview of the regulatory and supervisory framework.

Definition of NBFC

An NBFC is defined under section 45 I(f) of the Reserve Bank of India Act, 1934 ('RBI Act') as a:

i. a financial institution, which is a company;

ii. a non-banking institution which is a company, and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

iii. such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify

Thus, a 'financial institution' that is a company is an NBFC. The term 'financial institution', is defined under Section 45I(c) of the RBI Act. Briefly, a financial institution means any non-banking institution that carries on as its business (or part of its business) any of the following activities ('financial activities'):

i. Lending or financing for activities other than its own

ii. Acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority

iii. Leasing or hire-purchase

iv. Insurance business

v. Chit business

vi. Collection of monies

vii. Acceptance of deposits but does not include any institution, which carries on its principal business in

1. Agriculture operations
2. Industrial activity
3. Purchase or sale of any goods (other than securities)
4. Providing any services and
5. Sale/purchase/construction of immovable property

Sometimes, non-banking institutions that do not carry out the activities of a financial institution are still categorised as NBFCs. They are designated as NBFCs through a notification in the Gazette72 as in the case of Account Aggregators and Peer-to-Peer Lending Platforms, explained later. Another aspect is that a company need not be fully engaged in financial activities to be classified as an NBFC as long as it does not undertake as its principal business, non-financial activities such as agriculture, industrial activity, trading in goods, etc. The issue is how does one define principal business?

Principal Business Criteria (PBC):

As explained above only a company that carries on the business of a financial institution ('financial activity') as its principal business can be called an NBFC. On the other hand, if a company undertakes agriculture, manufacturing, trading in goods, etc. as its principal activity, it cannot be called an NBFC, even if carries out some financial activity. The term "principal business" is not defined in the RBI Act. Therefore, to give clarity and consistency to the interpretation of the term 'principal business', the Bank explained the term vide its press release dated April 8,1999. As per this press release, to identify a company as an NBFC, the Bank will consider both, the assets and the income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. A company is treated as an NBFC, if its financial assets are more than 50 per cent (excluding fixed deposits73) of its total assets (netted off by intangible assets) and income from financial assets should be more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company. If a company meets the PBC it is an NBFC and is required to be registered with the RBI unless specifically exempted from doing so.

Exemptions from RBI regulation

As may have been observed from the definition of NBFC in the RBI Act, even entities such as insurance companies and stock broking companies are NBFCs.

However, these entities are regulated by other regulators as part of their statutory function. Therefore, to avoid dual regulation, the RBI has exempted76 various categories of NBFCs which are regulated by other regulators/ government from registration and/or other requirements. The table below lists various exempted categories and their regulators. Until August 9, 2019, Housing Finance Companies (HFCs) were regulated by the National Housing Bank (NHB). However, the same has now been transferred to the RBI through an amendment to the National Housing Bank Act, 1987.

Types of NBFCs/Activities	Regulated by
Venture Capital Fund, Merchant Banking Companies, Stock Broking Companies, Mutual Funds, Collective Investment Schemes (CIS)	Securities and Exchange Board of India (SEBI)
Insurance Companies	Insurance Regulatory and Development Authority (IRDA)
Pension Funds	Pension Fund Regulatory and Development Authority (PFRDA)
Mutual Benefit Companies, Nidhi Companies	Ministry of Corporate Affairs (MCA)
Chit Funds	State Governments

Types of NBFCs

Broadly, NBFCs can be categorised in the following ways:

i. Based on acceptance of public funds and customer interface

ii. Based on deposit acceptance and size

iii. Based on activity its regulatory framework

1. **Based on acceptance of public funds and customer interface**

As mentioned previously, applications for registration of deposit accepting NBFCs (NBFC-D) are not considered since 1997. Further, in June 2016, the RBI issued a press release simplifying and rationalising the process for registration of new NBFCs. In respect of non-deposit accepting NBFCs (NBFC-NDs), there are two types of applications based on sources of funds and customer interface.

Type I - NBFC-NDs not accepting public funds / not intending to accept public funds in the future and not having customer interface / not intending to have customer interface in the future. The term "Public funds" shall include funds raised either directly or indirectly through public deposits, commercial paper, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years

from the date of issue. The processing of cases for Type I - NBFC-ND applicants are subjected to less intensive scrutiny and due-diligence. However, in case these companies intend to avail public funds or have customer interface in future, they are required to seek approval from the Department of Regulation (DoR).

Type II - NBFC-ND accepting public funds/intending to accept public funds in the future and/or having customer interface/intending to have customer interface in the future. Even the regulatory framework provides certain relaxations for companies that do not access public funds and/ or have customer interface.

2. Based on size

An NBFCs-ND is categorised as systemically important (i.e. NBFC-ND-SI) if its asset size is ₹ 500 crore or more. Given the sensitivity towards public deposits, deposit taking NBFCs (i.e. NBFC-Ds) are clubbed along with NBFC-ND-SIs irrespective of their size. Indeed, some regulations for NBFC-Ds are restrictive and stringent as compared to NBFC-ND-SIs.

3. Based on activity

NBFCs are heterogeneous in their activities. While some engage primarily in micro finance and dealing with the underserved sections of society, others specialise in long term project and infrastructure finance. Consequently, it is difficult to have a 'one size fits all' regulatory framework and NBFCs need to be categorised based on their principal activities. This does make the regulatory framework complex and attempts have been made to harmonise regulations and reduce the number of categories. Today almost 99 per cent of NBFCs by number fall under the Investment and Credit Category (ICC) explained below.

Sl. No.	Type of NBFC	Nature of activity / Principal Business	Key Qualifying Criteria
1.	Investment and Credit Company (ICC)	i. Lending (erstwhile Loan companies) ii. Financing of physical assets including automobiles, tractors and generators (erstwhile Asset Finance Companies) iii) Acquisition of securities (erstwhile Investment Companies) Includes Gold Loan companies which are NBFCs primarily engaged (i.e. 50 per cent or more of	Does not qualify (or has not registered) to be in any other category

		financial assets) in lending against gold jewellery.	
2.	Infrastructure Finance Company (IFC)	Providing long term loans for Infrastructure development	a. Infrastructure loans should be at least 75 per cent of total assets. b. Minimum NOF of ₹ 300 crore c. Minimum credit rating of 'A' d. CRAR of 15 per cent with min. Tier 1 of 10 per cent
3.	Core Investment Company (CIC)	Investing in / lending to group companies	a. 90 per cent of total assets to be investments in group companies and 60 per cent of investments in group companies to be in equity shares of group companies b. Does not trade in its investments in shares, bonds, debentures, debt/loans of group companies except through block sale for dilution/disinvestment. c. Does not carry out any other financial activity
4.	Infrastructure Debt Fund (IDF)	Refinancing existing debt of infrastructure companies	a. Minimum NOF of Rs.300 crore b. Invests only in Public Private Partnerships (PPP) and post commencement of operations date (COD) in infrastructure projects which have completed c. at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.
5.	Micro Finance Institutions (MFI)	Collateral free loans to small borrowers	a. Minimum NOF of Rs.5 crore (for North East: Rs. 2 crore) b. Invests only in Public 85 per cent of assets to be in qualifying assets criteria.
6.	NBFC – Factors	Factoring business i.e. financing of receivables. Registered under section 3 of the Factoring Act	(i) Minimum NOF of ₹5 crore (ii) Financial assets in factoring business at least 50 per cent of total assets and income derived there from not less than 50 per cent of total income.
7.	Mortgage Guarantee Companies (MGC)	Providing mortgage guarantees for loans	90 per cent of business turnover in principal business and 90 per cent of gross income from this business
	Non-Operative	For setting up new banks in	Should have first received an in-

8.	Financial Holding Company (NOFHC)	private sector through its promoter/promoter groups	principle approval for setting up a commercial bank from RBI.
9.	Account Aggregators (AA) [notified under section 45I(f)(iii)]	Providing under contract the service of retrieving, consolidating, organising and presenting financial information of its customer (with explicit consent).	Can only provide account aggregation services. Only those financial assets that are under the regulatory ambit of financial sector regulators can be aggregated. These aggregators cannot support the transactions of customers and cannot take services of third-party service providers.
10.	Peer-to-Peer (P2P) Lending Platforms [notified under section 45I(f)(iii)]	Carries on the business of a P2P lending platform i.e. providing loan facilitation services to participants on the platform.	Can only provide platform. No lending from its own books.
11.	Housing Finance Company (HFC)	Registered under section 29A the NHB Act to carry on the business of providing finance for housing and housing projects.	Minimum NOF is ₹ 10 crore.
12.	Standalone Primary Dealers (SPD)	Primary Dealers are expected to play an active role in the G-Sec market, both in its primary and secondary market segments through various obligations like participating in Primary auction, market making in G-Secs, predominance of investment in G-Secs, achieving minimum secondary market turnover ratio, etc.	Minimum NOF of ₹150 crore for undertaking core activities and ₹250 crore for undertaking diversified activities.

In addition to the above categories there is a class of NBFCs called Residuary Non-Banking Companies (RNBCs). The principal business of such companies is receiving deposits under any scheme or arrangement or in any other manner. However, no fresh registrations for this category are being issued. Miscellaneous Non-Banking

Companies (MNBCs) are NBFCs that manage chit fund79 business. Chit funds are primarily regulated by State Governments and NBFCs carrying on chit fund business are exempt from registration requirements. Further, MNBCs have been barred from accepting fresh public deposits since July 1, 1977 and the extant RBI regulatory framework deals with protecting the interest of depositors of the existing depositors of such companies.

Apart from the above, there are also Asset Reconstruction Companies (ARC) that are registered and regulated under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 for acquiring and dealing in financial assets sold by banks and financial institutions. ARCs play a crucial role in resolution of non-performing assets (NPAs). ARCs have been exempting by the RBI from registration under the RBI Act and are instead registered by RBI under section 3 of the SARFAESI Act. The minimum NOF stipulated for these companies was increased from ₹.2 crore to ₹.100 crore in April 2017. Prudential guidelines on maintenance of capital adequacy, deployment of funds, asset reconstruction, asset classification norms, disclosure norms, etc., have been stipulated for these companies also by RBI.

Another way to distinguish NBFCs is based on ownership i.e. Government owned and others. The regulatory framework has endeavoured to remove this distinction by making the prudential framework applicable to Government owned NBFCs in a phased manner. However, there is a distinction in the statutory framework with the RBI not having the powers to remove directors or supersede the Board of Directors of a Government owned Company.

Regulation of NBFCs - Genesis and Legal Framework

RBI acquired regulatory and supervisory powers over NBFCs with the insertion of Chapter III-B in the RBI Act in 1963. An extract of the Statement of Objects and Reasons to the Banking Laws (Miscellaneous Provisions) Bill, 1963 that inserted Chapter III B into the RBI Act is given below.

“The existing enactments relating to banks do not provide for any control over companies or institutions, which, although they are not treated as banks, accept deposits from the general public or carry on other business which is allied to banking. For ensuring more effective supervision and management of the monetary and credit system by the Reserve Bank, it is desirable that the Reserve Bank should be enabled to regulate the conditions on which deposits may be accepted by these non-banking companies or institutions. The Reserve Bank should also be empowered to give to any financial institution or institutions directions in respect of matters, in which the Reserve Bank, as the central banking institution of the country, may be interested from the point of view of the control of credit policy.”

While regulation of NBFCs by RBI started in 1963 with Parliament's recognition of the need to regulate the deposit taking activity of NBFCs, 1996 marked a watershed year for NBFCs with the failure of a large NBFC (CRB Capital). Based on the recommendations of the Shah Committee (1992), which had highlighted the need to expand the regulatory and supervisory focus of NBFCs, RBI's regulatory and supervisory powers were strengthened with amendments to Chapter III B of the RBI Act. Some of the important amendments carried out in 1997 included:

- Compulsory registration with RBI and maintenance of minimum Net Owned Fund (NOF) 80 for companies satisfying the 'principal business' criteria (Sec.45-IA)
- Maintenance of liquid assets by NBFCs accepting public deposits (Sec.45-IB)
- Creation of a Reserve Fund by all NBFCs by transfer of 20 per cent of their net profit every year (Sec.45-IC)
- Powers of RBI to determine Policy and issue directions to NBFCs (Sec.45JA)
- Conduct of Special Audit of the accounts of NBFCs, if necessary (Sec.45MA)
- Power of RBI to prohibit acceptance of deposits and alienation of assets (Sec.45MB)
- Power of RBI to file winding up petition under Companies Act, 1956 (Sec.45MC)
- Introduction of nomination facility for depositors of NBFCs (Sec.45QB)
- Prohibition of deposit acceptance by unincorporated bodies engaged in financial business (Sec.45S)
- Power of RBI to impose fine on NBFCs for violations / contraventions of guidelines (Sec.58G)

The Reserve Bank tightened the regulatory structure over the NBFCs, with rigorous registration requirements, enhanced reporting, and supervision. The Bank also took a policy stance to not register new public deposit accepting NBFCs and encourage the existing ones to convert to non-deposit taking NBFCs. Further, in 1999 capital requirement for fresh registration was enhanced from Rs..25 lakh to Rs.2 crore.

In view of the rapid strides made by NBFCs in terms of their size, nature of operations with entry into newer areas of financial services and products, adoption of newer technologies, etc., the regulatory framework for the sector was reviewed again in 2014. The review was also necessary as this sector was increasingly getting inter-connected with other segments of the financial sector with changes observed in both

sides of the balance sheet. The key changes in the revised regulatory framework were as follows:

a) Requirement of minimum NOF of Rs.2 crore for legacy NBFCs.

b) Harmonisation of deposit acceptance requirements across categories and introduction of minimum investment grade rating requirement for deposit acceptance.

c) Revision of the threshold of systemic significance from ₹100 crore to ₹ 500 crore and inclusion of multiple NBFCs within the same group for reckoning systemic significance threshold.

d) Differentiated regulatory approach based on customer interface and source of funds. At one end of the spectrum, entities with asset size less than ₹500 crore and not accessing public funds with no customer interface were exempted from prudential and business conduct regulations. At the other end, entities accessing public funds with customer interface were subjected to full slew of regulations.

e) Harmonisation of asset classification norms for NBFC-D and NBFC-ND-SIs with banks.

f) Review of corporate governance and disclosure norms leading to constitution of Board Committees (Audit Committee, Nomination Committee, and Risk Management Committee) and rotation of audit partners every three years applicable for NBFC-Ds and NBFC-ND-SIs.

In 2019, certain amendments enumerated below were again carried out to Chapter III-B of the RBI Act, which has inter-alia strengthened RBI's supervisory powers.

- Reserve Bank may notify different amount of NOF to different categories of NBFCs with minimum NOF between ₹.25 lakh and ₹.100 crore (Sec.45-IA)
- RBI can remove Directors of NBFC (other than Government owned NBFCs) – (Sec.45-ID)
- RBI can supersede the BOD of NBFC (other than Government owned NBFCs) – (Sec.45-IE)
- RBI can remove or debar an auditor of NBFC for a max. period of 3 years at a time (Sec.45MAA)
- Resolution of NBFCs through amalgamation, reconstruction, splitting into various activities, etc. (Sec.45MBA)

- Power to call for information of Group Companies and inspection of Group Companies (Sec.45NAA)

Further, the Finance (No.2) Act, 2019 (23 of 2019) has amended the National Housing Bank Act, 1987 transferring the registration and regulation of HFCs to RBI. With the notification of the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 by the Government of India, the Bank is also entrusted with insolvency resolution process of NBFCs (including HFCs) under the Insolvency and Bankruptcy Code (IBC) from November 2019 onwards.

Supervision of NBFCs

The RBI has instituted a strong and comprehensive supervisory mechanism for NBFCs. The focus of the RBI is on prudential supervision to ensure that NBFCs function on sound and healthy lines and avoid excessive risk taking. The RBI has put in place a five-pronged supervisory framework based on:

(I) On-site Inspections:

The system of on-site examination put in place during 1997 is structured on the basis of CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Systems and Controls) approach. The Reserve Bank derives its powers under Section 45N of the RBI Act, 1934 to cause an inspection of an NBFC for the purpose of verifying the correctness or completeness of any statement or information or for obtaining any information or particulars or if the Bank feels that such an inspection is warranted. Powers to inspect the books of an NBFC have also been vested with the Bank under Section 45-IA(4) of the RBI Act, 1934, primarily to verify as to whether the financial company complies with the conditions laid down for grant of Certificate of Registration (CoR). The overall objectives of on-site inspection of an NBFC are to:-

- Assess the adequacy of capital and earnings prospects and assign a supervisory rating on the basis of CAMELS.

- Evaluate the solvency of the financial company.

- Evaluate the position of compliance with provisions of the RBI Act and the directions/notifications issued from time to time, and any other guidelines/regulations which may be prescribed by the Bank under the extant Act.

- Identify the areas where corrective actions are needed to strengthen the company.

The supervisory framework takes into account the statutory prescriptions, directions and prudential regulations. Within this framework, companies are expected

to manage themselves prudently to meet the risks emanating from their business and ensure that they are in a position to meet their obligations, particularly (public) deposit liabilities and other creditors and also ensure that they do not function in a manner detrimental to the interests of their depositors or the overall financial system. The periodicity of such inspections will be based on the category and asset-size of NBFCs.

(II) Off-site monitoring:

In order to supplement information gathered from on-site inspections, several returns have been prescribed for NBFCs as part of the off-site surveillance system. The information provided is analysed to identify potential supervisory concerns and in certain cases serves as a trigger for on-site inspection. The returns being submitted by the NBFCs are reviewed and examined at intervals to widen the scope of information, so as to address the requirements either for supervisory objectives or for furnishing the same to various interest groups on the important aspects of the working of these companies.

(III) Market Intelligence:

Market Intelligence is an important component of monitoring financial sector. While off-site surveillance system and on-site inspections are effective tools in assessing the financial position and overall regulatory compliance of the registered companies, pro-active market intelligence can help pick up early warning signals about the health of a particular NBFC and trigger supervisory action to protect the interest of the depositors/avoid systemic risks. In the recent past, there has been a spurt in the activities of the entities which accept money under various garbs by violating the directions of the Regulators and structure their scheme in a manner which escapes the apparent meaning of 'Deposits' and the attention of the Regulators. With the objective to control the incidents of unauthorized acceptance of deposits by unscrupulous entities, State Level Coordination Committees (SLCC) are formed in all States to facilitate information sharing among the Regulators viz. RBI, SEBI, IRDA, NHB, PFRDA, Registrar of Companies (RoCs) etc., and Enforcement Agencies of the States viz., Home Department, Finance Department, Law Department, Economic Offences Wing (EOW) etc. SLCCs were reconstituted in May 2014 with renewed focus on the illegal activities of the unauthorised entities. In the last few years, the regular discussions among the Regulators and Enforcement Authorities has led to increased awareness & co-ordination and Standard Operating Procedures are being evolved for effective handling of such matter.

The Sachet Portal: The Reserve Bank launched a mobile friendly portal Sachet (sachet.rbi.org.in) on August 4, 2016 to help the public as well as regulators to ensure that only regulated entities accept deposits from the public. The portal can be used by the public to share information wherein they can also upload photographs of advertisements/publicity material, raise queries on any fund raising/investment schemes that they come across and lodge complaints. The portal has links to all the

regulators and the public can easily access information on lists of regulated entities. The portal has a section for a closed user group – the SLCC inter-regulatory forum for exchange of information and coordinated action on unauthorised deposit collection and financial activities. It helps in enhancing coordination among regulators and State Government agencies, which serves as a useful source of information for early detection and curbing of unauthorised acceptance of deposits. On October 24, 2019 Sachet portal was made available in 11 more prominent regional languages besides Hindi and English to further its penetration in general public.

(IV) Exception Reports of Statutory Auditors:

In addition to all the above types of supervision, the responsibility of ensuring compliance with the directions issued by the Reserve Bank, as well as adherence to the provisions of the RBI Act has also been entrusted to the Statutory Auditors of NBFCs. The Statutory Auditors are required to report to the Reserve Bank about any irregularity or violation of regulations concerning acceptance of public deposits, credit rating, prudential norms and exposure limits, capital adequacy, maintenance of liquid assets and regularisation of excess deposits held by the companies.

(V) Interaction with stakeholders:

In order to develop a closer understanding of the emerging risks and developments in the sector to facilitate prompt action Supervision department interacts with various stakeholders like Management of NBFCs, Statutory Auditors, Credit Rating Agencies, Credit Information Companies, Mutual funds etc. In addition to the above, the actions of the supervised entity in the market and the approach of the investors in the bonds/ CPs of NBFCs is discussed with market department to understand the position of the supervised entity from the perspective of investors.

Conclusion

Over the last decade, non-banking financial companies (NBFCs) have witnessed phenomenal growth. From being around 10 per cent of the balance sheet size of banks in 2009, they are now more than a quarter of the size of banks. While the development of a robust non-bank intermediation channel provides a good 'spare tyre' to the economy, unbridled growth fuelled by a lighter regulatory framework can also lead to systemic risks. Therefore, it is a constant endeavour of the Reserve Bank to enable prudential growth of the sector, keeping in view the multiple objectives of financial stability, consumer and depositor protection, the need for more players in the financial market and addressing regulatory arbitrage concerns while not forgetting the uniqueness of the NBFC sector.

CREDIT INSTRUMENTS OF A BANK

Definition

The law relating to negotiable instruments is contained in the Negotiable Instruments Act, 1881. It is an Act to define and amend the law relating to promissory notes, bills of exchange and cheques.

The Act does not affect the custom or local usage relating to an instrument in oriental language i.e., a Hundi.

The term *"negotiable instrument"* means a document transferable from one person to another. However the Act has not defined the term. It merely says that "A .negotiable instrument" means a promissory note, bill of exchange or cheque payab1e either to order or to bearer. [Section 13(1)]

A negotiable instrument may be defined as "an instrument, the. property in which is acquired byanyone who takes it bona fide, and for value, notwithstanding any defect of title in the person from whom he took it, from which it follows that an instrument cannot be negotiable unless it is such and in such astate that the true owner could transfer the contract or engagement contained therein by simple delivery of instrument"

The Act recognizes only three types of instruments viz., a Promissory Note, a Bill of. Exchange and a Cheque as negotiable instruments. However, it does not mean that other instruments are not negotiable instruments provided that they satisfy the following conditions of negotiability:

1. The instrument should be freely transferable by the custom of trade. Transferability may be by (i) delivery or (ii) endorsement and delivery.
2. The person who obtains it in good faith and for consideration gets it free from all defects and can sue upon it in his own name.
3. The holder has the right to transfer. The negotiability continues till thematurity.

Important Characteristics of Negotiable Instruments

Following are the important characteristics of negotiable instruments:

(1) The holder of the instrument is presumed to be the owner of the property contained in it.

(2) They are freely transferable.

(3) A holder in due course gets the instrument free from all defects of title of any previous holder.

(4) The holder in due course is entitled to sue on the instrument in his own name.

(5) The instrument is transferable till maturity and in case of cheques till it becomes stale (on theexpiry of 6 months from the date of issue).

(6) Certain equal presumptions are applicable to all negotiable instruments unless the contrary isproved.

Types of Credit Instruments of a Bank

There seven credit instruments of a bank. The instruments are: 1. Cheque 2. Hundi 3. Bank Draft 4. Bill of Exchange 5. Promissory Note 6. Trade Bills 7. Accommodation Bills.

A. CHEQUE:

According to Section 6 of the Negotiable Instrument Act, 1881, “A cheque is a bill of exchange drawn upon a specified banker and payable on demand.”

From this definition, it is clear that a cheque is a bill of exchange, but it has the following two additional qualifications:

(i) It is always drawn on a specified banker, and

(ii) It is always payable on demand.

In essence, a cheque may be defined as a written order, signed by a customer of a bank, directing the bank to pay on demand out of his (the customer’s) account a stated sum of money to or to the order of a specified person, or to bearer.

Essentials/Characteristics of a Cheque:

1. A cheque must be in writing.

2. Cheque is an order on a specified bank to pay the amount.

3. The order to pay the amount must be an unconditional order.

4. A cheque is always drawn on a banker.

5. It must be signed by the drawer.

6. The amount ordered to be paid by the bank must be certain.

7. It is always payable on demand without any days of grace.

8. A cheque requires no acceptance.

9. A cheque to be valid must be made payable to, or to the order of a certain person or to the bearer of the instrument.

10. A cheque may be crossed.

Parties to a Cheque:

There are three parties to every cheque: (i) drawer, (ii) drawee, and (iii) payee.

i. Drawer:

The drawer is the person who signs the cheque ordering the bank to pay the amount.

ii. Drawee:

The drawee is a bank on which cheque is drawn.

iii. Payee:

The payee is a person to whom the sum of money expressed in the order is payable. Sometimes drawer and payee are the same person.

Dishonour of a Cheque:

The banks may refuse payment or may dishonour a cheque in the following cases:

1. When there are insufficient funds to the credit of the drawer.

2. When the cheque is post-dated and is presented before the date it bears.

3. When a cheque is not duly presented, e.g. presented after banking hours.

4. When the signatures of the drawer do not tally with the specimen signatures.

5. When the cheque is presented at a branch where the customer has no account.

6. When the amount in figures and in words does not tally.

7. When the cheque is mutilated, ambiguous, irregular or otherwise materially altered.

8. When the cheque is not presented within 6 months of the issue of the cheque.

9. When some persons have joint account and the cheque is not signed by all jointly or by the survivors of them.

10. When a cheque is crossed and not presented through a bank.

Types of Cheque:

There are two types of cheques:

(i) Open cheque, and

(ii) Crossed cheque.

(i) Open Cheque:

A cheque, which is payable in cash across the counter of the bank, is called an open cheque. If its holder loses it, its finder may go to the bank and get the payment. In order to avoid the losses incurred by open cheques getting into the hands of wrong parties the custom of crossing was introduced.

(ii) Crossed Cheque:

A crossed cheque is one on which parallel transverse lines with or without the words '& Co.' are drawn. A crossing is a direction to the paying banker to pay the money generally to a banker or a particular banker, as the case may be, and not to pay to holder across the counter. The crossing provides a protection and safeguard to the owner of the cheque. Crossing does not affect the negotiability of a cheque, except where the words 'not negotiable' are added.

इण्डियन ओवरसीज़ बैंक
Indian Overseas Bank
32
दिनांक
Date________19__
या धारक को
PAY______________________________OR BEARER
रुपये
RUPEES__________________________ रु. Rs.________
______________________________अदा करें
सं.– No. US/MM 112700 Signature

Types of Crossing:

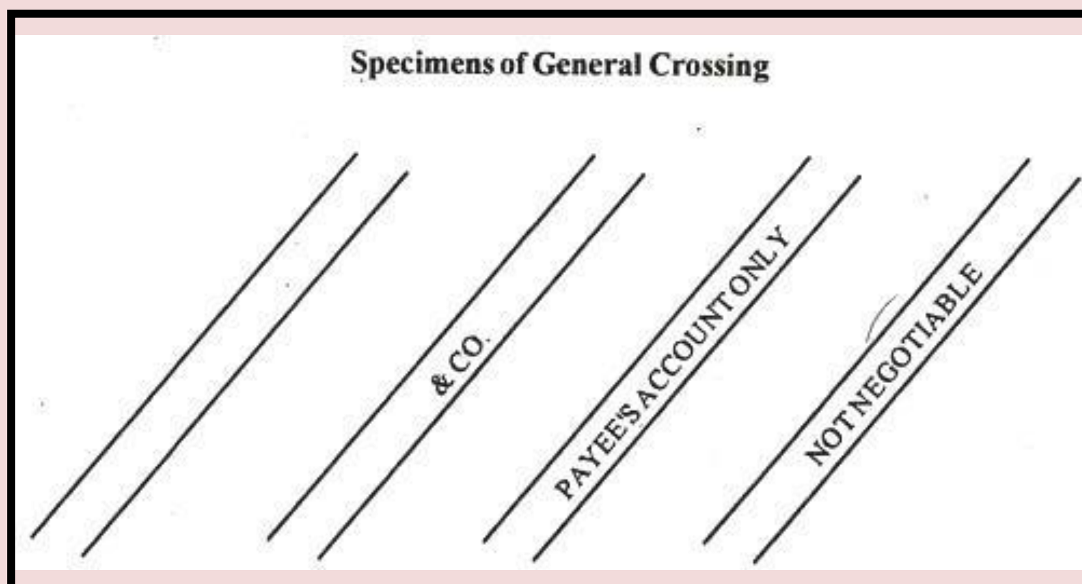
There are two types of crossing:

(a) General Crossing, and

(b) Special Crossing.

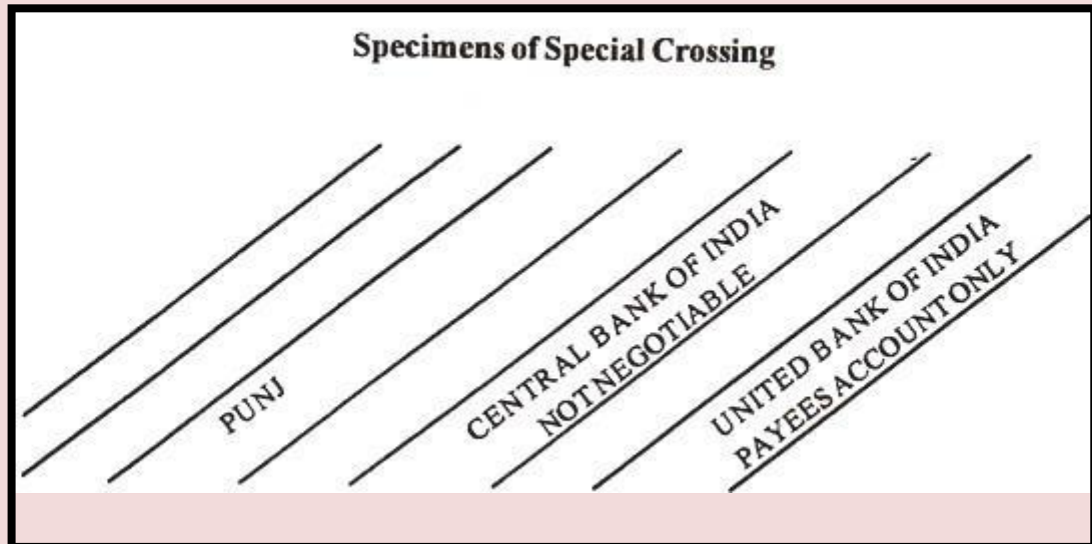
a. General Crossing:

General crossing implies simply putting two parallel transverse lines on the face of a cheque. Some words like '& Co.', 'Not Negotiable' may be inserted in these lines. If a cheque is crossed generally, the paying banker shall pay only to a banker.



b. Special Crossing:

Where a cheque bears across its face an addition of the name of a banker, either with or without the words 'Not Negotiable' the cheque is deemed to be crossed specially. The payment of a specially crossed cheque can be obtained only through the particular banker whose name appears between the lines. Transverse lines are not compulsory in case of a special crossing.



Endorsement of a Cheque:

Endorsement means signing at the back of instrument for the purpose of negotiation. The act of signing a cheque, for the purpose of transferring it to someone else, is called the endorsement of cheque. Under the Negotiable Instruments Act, the term endorsement means writing the name of a person on the back of the instrument with the intention of transferring the rights therein.

The person who endorses the cheque is called endorser. The person to whom the cheque is endorsed is called endorsee.

The endorsement is usually made on the back of the cheque. If no space is left on the cheque, the endorsement may be made on a separate slip to be attached with the cheque.

Kinds of Endorsement:

1. General or Blank Endorsement:

An endorsement is said to be general or blank if the endorser simply puts his signature on the instrument without specifying the endorsee. For example, if a cheque is payable to Ram Lai or order and Ram Lai endorses the cheque by simply putting his signature, it is a general or blank endorsement, as:

Ram Lal

2. Complete or Special Endorsement:

When the endorser adds a direction to pay the amount mentioned in the instrument to, or to the order of a specified person and signs it, the endorsement is said to be 'complete' or 'special'.

For example:

Pay to Shri Ram Kumar
V.K. Jain

3. Restrictive Endorsement:

A restrictive endorsement is one where the endorser restricts further negotiation of the instrument.

For example:

Pay to Shri Suresh Chand Gupta Only.
M. K. Gupta

4. Partial Endorsement:

A partial endorsement is one where the endorsement is made for a part of the amount of instrument.

For example:

Pay to Shri Ashok Kumar Jain
Rs. 500/- only
Shyam Lal

5. Sans Recourse Endorsement:

If the endorser wants to avoid his liability as endorser he can do so by adding appropriate words at the time of endorsement.

For example:

(i) 'Pay X or order sans recourse', or

(ii) 'Pay X or order without recourse to me', or

(iii) 'Pay X or order at his own risk'.

6. Conditional or Qualified Endorsement:

A conditional endorsement is one when the endorser inserts some condition in his endorsement.

For Example:

‘Pay A or order on his marriage’ is an example of conditional endorsement.

Bearer Cheque:

A ‘bearer cheque’ is one which is payable to its bearer or holder who presents it to the bank for the payment. In such cheques, the word ‘bearer’ is written after the name of the payee. A bearer cheque is transferable merely by delivery. The drawee bank need not take any pains to get the identification of person to whom the payment is being made. It need not be endorsed.

Order Cheque:

An ‘order cheque’ is one which is payable to the person named in the cheque or to his order. In such cheques, the word ‘order’ is written after the name of the payee. It is not transferable merely by delivery.

Difference between Bearer Cheque and Order Cheque:

S.No.	*Basis of Difference*	*Berer Cheque*	*Order Cheque*
1.	Word	On such cheques, the word **bearer** is written after the name of the payee.	In such cheques, the word **order** is written after the name of the payee.
2.	Payee	One who presents it at the counter of the bank can get the payment.	It is payable to the person named in the cheque or to his order.
3.	Transfer	It can be transferred by mere delivery.	It must be endorsed before it can be transferred.
4.	Safety	Bearer cheques are not safe.	Order cheques are comparatively more safe.
5.	Bank's Liability	Bank is not liable if the payment is made to any wrong person.	Bank is liable if the payment is made to any wrong person.

B. HUNDI:

A hundi is almost an Indian bill of exchange, which has been in use since time immemorial. It is the oldest surviving form of credit instrument in India.

A hundi may be defined as **"A written order, usually unconditional, drawn by one person on another for payment on demand or after a specified time of a certain sum of money, to a person named therein."**

A bill of exchange is always unconditional, but a hundi is sometimes conditional, e.g., Jokhami Hundi.

Types of Hundis:

Some of the important hundis used in India are discussed below:

1. Namjog Hundi:

A hundi payable to a specified person named in the hundi is known as Namjog Hundi. It can be negotiated by endorsement and delivery.

2. Shahjog Hundi:

A shahjog hundi is one which is payable to or through a Shah. Shah means a respectable person in the market. It is like a crossed cheque.

3. Dhanijog Hundi:

A dhanijog hundi is one which is payable to the person who holds or to the bearer thereof. The word 'Dhani' means owner.

4. Firmanjog Hundi:

A firmanjog hundi is one which is payable to order.

5. Darshanhar Hundi:

A darshanhar hundi is one which is payable to bearer.

6. Darshani Hundi:

A darshani hundi is one which is payable at sight or on demand. Darshani hundi is similar to a demand bill.

7. Muddati Hundi:

A muddati hundi is one payable after the expiry of a certain period. This is also called 'Miadi Hundi' or 'Thavani'.

8. Jawabi Hundi:

A jawabi hundi is used for remittance of money from one place to another. It is similar to a money order. The person receiving the money has to send a Jawab (answer) to the remitter showing that he has received the money.

9. Jokhami Hundi:

A jokhami hundi is one which is drawn against goods shipped on the vessel named in the hundi.

According to Justice Baley, “A Jokhami Hundi is in the nature of a policy of insurance, with the difference that the money is paid before hand to be recovered if the ship is not lost.”

It is payable only when the goods reach safely at the destination.

10. Nishanjog Hundi:

This type of hundi is payable only to the person who presents it.

Difference between Hundi and Bill of Exchange:

S.No.	Basis of Difference	Hundi	Bill of Exchange
1.	Language	It is a negotiable instrument written in an oriental language.	It is usually written in English.
2.	Conditional	Hundi may be both conditional and unconditional.	Bill of exchange is always unconditional.
3.	Amount	In hundi, the amount is written several times.	In bill of exchange the amount appears twice (words and figures).
4.	Use	Hundies are used within the country.	Bill of exchange are used both in inland and foreign trade.
5.	Name of Drawer	In hundi, the name of the drawer appears two times.	In bill of exchange, the name of the drawer appears only when he signs it.

C. BANK DRAFT:

It is usually drawn by one branch of a bank upon its another branch, instructing the latter to pay a specified amount to payee named therein or to his order. There cannot be any bearer draft. Bank drafts are always payable to a certain payee named in the draft or to his order. They may be crossed like a cheque. Bank drafts are called ‘Demand Drafts’ as they are payable on demand without any days of grace.

Bank draft is the most convenient and economical method for sending money from one place to another. A person who wants to send money, obtains the draft from the

bank by paying the necessary amount and the bank commission. He sends the draft to the payee by post. He (payee) presents the draft in the concerned branch and get the payment.

Specimen of a Bank Draft

No. 729995 DRAWEE BRANCH CODE NO........

VALID FOR SIX MONTHS ONLY

New Bank of India

(H.O. Tolstoy Marg, New Delhi)

Branch.. Date...........19.......

On Demand pay to the order of..

....

Rupees..

.... Rs..

New Bank of India *For value received.*

....*Manager*

....*Accountant*

D. BILL OF EXCHANGE:

It is an important part of negotiable instruments used both in inland and overseas trade. Its use has increased manifold due to expansion of trade and commerce.

According to Negotiable Instruments Act, 1981, **"A 'bill of exchange' is an instrument in writing and containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument."**

Characteristics/Essentials of a Bill of Exchange:

1. It should be in writing.

2. It should contain an order to pay

3. It should have unconditional order.

4. It must be signed by the drawer.

5. It must contain amount of money.

6. All the three parties-drawer, drawee and payee must be mentioned.

7. The bill may be made payable on demand or after specified period of time.

8. It must bear the required revenue stamp.-

Parties to a Bill of Exchange:

There are three parties to a bill of exchange:

1. Drawer:

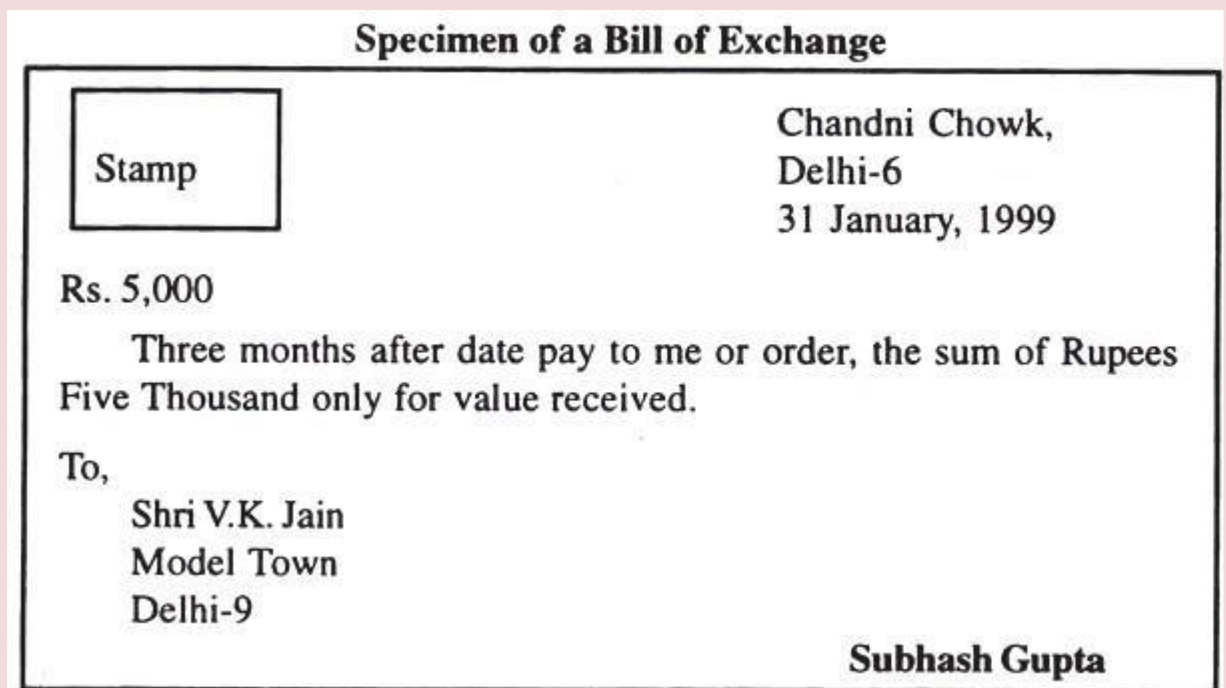
The maker/writer of the bill is called Drawer. He is generally the creditor.

2. Drawee:

The person on whom the bill is drawn is called Drawee. He is normally the debtor.

3. Payee:

The person who is entitled to receive the amount of bill on its maturity is called Payee. Writer of the bill can be drawer as well as payee of the bill.


Specimen of a Bill of Exchange

Stamp

Chandni Chowk,
Delhi-6
31 January, 1999

Rs. 5,000

Three months after date pay to me or order, the sum of Rupees Five Thousand only for value received.

To,
Shri V.K. Jain
Model Town
Delhi-9

Subhash Gupta

Advantages of a Bill of Exchange:

The main advantages of a bill of exchange are:

1. Helps in Enhancing Business:

Those persons who are not in a position to run their business due to scarcity of funds, can run their business by obtaining credit through bills or by discounting the bills from bank.

2. Legal Document:

It is a legal document under Negotiable Instrument Act. And if, after accepting the bill, the drawee fails to pay the amount, the dishonoured bill is sufficient proof for court to decide the liability of the drawee.

3. Negotiable Instrument:

A bill of exchange is a negotiable instrument. So, it can be transferred from one person to another in the settlement of debts.

4. Discounting:

If the holder of the bill needs funds before the due date, he can get money readily by discounting the bill with a bank.

5. Foreign Payments:

The difficulties in payment of foreign debts are also removed by bill of exchange and now trader of one country can very easily make payment to his foreign counterpart.

6. Credit Facility:

A bill of exchange enables a person to buy goods on credit.

7. Easy Transfer of Money:

A bill of exchange provides an easy way of sending money from one place to another.

8. Exact Date of Payment:

By drawing a bill on drawee, the drawer knows that when he is going to receive certain payment. The drawee is also certain about the time of making the payment.

E. PROMISSORY NOTE:

According to Negotiable Instrument Act, 1881, **"A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument."**

Essential Characteristics of a Promissory Note:

1. It should always be in writing.

2. It is always unconditional.

3. It is a promise by debtor to pay.

4. The promise is always for payment of money.

5. It must be signed by the maker.

6. The maker must be a certain person.

7. The payee must be a certain person.

8. The amount of payment under promissory note must be certain.

9. A promissory note must be stamped as prescribed by the Indian Stamp Act.

10. The place, time and date of payment are not essentials of a promissory note.

But usually these are also given in a promissory note.

Parties to a Promissory Note:

1. Drawer/Maker: Drawer is a person who promises to pay the amount stated in the promissory note. He is the debtor.

2. Payee is the person to whom the promise is made for the payment. He is the creditor.

Kinds of Promissory Note:

A promissory note may be made or drawn by one or more than one person and thus it is classified as given below:

1. Simple or Single Promissory Note:

When a promissory note is made or drawn by one person, it is called a simple/single promissory note. The maker of this promissory note is individually liable for the amount.

2. Joint Promissory Note:

When a promissory note is made or drawn by two or more persons, it is called a joint promissory note. The makers of this promissory note are jointly liable for the payment.

3. Joint and Several Promissory Note:

When a promissory note is made by two or more persons and the makers of the promissory note are liable jointly and severally, it is called a joint and several promissory note.

Specimen of Promissory Note

(i) **Payable on Demand :**

Rs. 3,000 — Delhi. 31 October, 1999

Stamp

On demand, I promise to pay Shri Anil or order, the sum of Rupees Three Thousand only, for value received.

Vinod Jain

(ii) **Payable at a Future Date :**

Rs. 3,000 — Delhi. 31 January, 1999

Stamp

Three months after date, I promise to pay Shri Anil or order, the sum of Rupees Three Thousand only, for value received.

Vinod Jain

F. TRADE BILLS:

Ordinarily bills are drawn and accepted for the purpose of receiving or making payments of goods sold or purchased on credit. Such bills, which are drawn for consideration, are known as Trade Bills.

1. Purpose:

It is drawn and accepted for any business transaction.

2. Proof:

It is a proof of debt.

3. Consideration:

Trade bill is drawn and accepted for some consideration.

4. Dishonour:

If this bill is dishonoured, payment can be taken with the help of court.

5. Discounting of the Bill:

If such a bill is discounted with the bank, the whole amount of bill remains the drawer.

G. ACCOMMODATION BILLS:

Sometimes a bill is drawn and accepted without any consideration. It is drawn and accepted just to help the drawer or both the drawer and the acceptor or raise funds temporarily by getting the bill discounted. A bill drawn without any consideration is known as Accommodation Bill. It is also termed as 'Kite Bill' or 'Fictitious Bill'.

1. Purpose:

It is drawn and accepted to raise funds temporarily.

2. Proof:

It is drawn and accepted for financial help.

3. Consideration:

Accommodation Bill is drawn and accepted without any consideration.

4. Dishonour:

If this bill is dishonoured, payment cannot be taken with the help of court.

5. Discounting of the Bill:

If such a bill is discounted with the bank and the money received is distributed between the drawer and drawee.

MONETARY POLICY

Introduction

Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

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

Meaning

Monetary policy refers to the policy of the central bank – ie Reserve Bank of India – in matters of interest rates, money supply and availability of credit. It is through the monetary policy, RBI controls inflation in the country. RBI uses various monetary instruments like Repo rate, Reverse Repo rate, SLR, CRR etc to achieve its purpose. In short, Monetary policy refers to the useof monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.

Definition

According to **Prof. Harry Johnson**, "A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."

According to **A.G. Hart**, "A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

From both these definitions, it is clear that a monetary policy is related to the availabilityand cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

OBJECTIVES OF THE MONETARY POLICY

The objectives of a monetary policy in India are similar to the objectives of its five year plans. In a nutshell planning in India aims at growth, stability and social justice. The objectives of the monetary policy of India, as stated by RBI, is:

1. **Price Stability :**

It implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favorable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability. All the economics suffer from inflation and deflation. It can also be called as Price Instability. Both are harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.

2. **Rapid Economic Growth** :

It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.

3. **Controlled Expansion of Bank Credit**

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

4. **Exchange Rate Stability :**

Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.

5. **Balance of Payments (BOP) Equilibrium :**

Many developing countries like India suffer from the Disequilibrium in the BOP. The Reserve Bank of India through its monetary policy tries to maintain equilibrium in the balance of payments. The BOP has two aspects i.e. the 'BOP Surplus' and the 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOPequilibrium can be achieved.

6. Equal Income Distribution :

Many economists used to justify the role of the fiscal policy in maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attaining an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

7. Neutrality of Money :

Economist such as **Wicksteed**, **Robertson** has always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion. However this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.

8. Full Employment :

The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is Zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy.

9. Promotion of Fixed Investment:

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

10. Promotion of Exports and Food Procurement Operations

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

11. Desired Distribution of Credit

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

12. Equitable Distribution of Credit

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

13. To Promote Efficiency

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

14. Reducing the Rigidity

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

INSTRUMENTS OF MONETARY POLICY:

Instruments of Monetary operations involve monetary techniques which operate on monetary magnitudes such as money supply, interest rates and availability of credit aimed to maintain Price Stability, Stable exchange rate, Healthy Balance of Payment, Financial stability, Economic growth etc. RBI, the apex institute of India which monitors and regulates the monetary policy of the country stabilizes the price by controlling Inflation.RBI takes into account the following monetary policies:

The instruments of monetary policy and control can be classified into two:-

I. **Quantitative weapons (Indirect Instruments)**

II. **Qualitative weapons (Direct Instruments):**

I. Quantitative weapons (Indirect Instruments):

Quantitative methods or weapons are those which control total volume or size of credit in the country without any reference to the purpose for which it is used. They affect indiscriminately all sections of the economy. Important quantitative weapons are:

1. Bank rate policy
2. Open market operations
3. Variable Cash Reserve Ratio (CRR)
4. Variable Statutory Liquidity Ratio (SLR)
5. Liquidity Adjustment Facility (LAF) includes Repo rate and Reverse Repo rate
6. Marginal Standing Facility (MSF)

The details review of the quantitative methods of monetary policy are discussed here under.

1. **Bank rate policy:** Section 49 of RBI Act, 1934 defines the bank rate as "the standard rate at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the Act". Thus bank rate is the minimum rate at which the RBI is ready to rediscount eligible bills of exchange or other commercial papers presented to it by the commercial banks or grant loans to the commercial banks against approved securities. By manipulating the bank rate the RBI can control the bank credit and the general price level of the country.

By raising the bank rate, it can make the bank credit costlier and thereby cause contraction of bank credit. By lowering the bank rate, on the other hand, it can make the bank credit cheaper and therebycause contraction of bank credit.

Though the bank rate policy of RBI has had some effects on some occasions, on a whole, it has not been very effective. The ineffectiveness of bank rate in controlling credit is due to the following factors.

- A major portion of credit requirements is met by indigenous bankers, who are not under thecontrol of RBI.
- Lack of co-ordination between various sectors of money market: There is a wide disparity ofinterest rates in Indian money market.
- Market rate of interest does not change in same proportion of bank rate.
- There is scarcity of eligible bills in Indian money market and rediscounting is not so popular inIndia.
- Banks are left with large deposits even after meeting the minimum statutory reserves. So they didnot feel the necessity of seeking financial assistance from RBI.

2. **Open Market Operations (OMO):** - An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stabilityin government securities market.

Apart from outright purchase and sales of securities, RBI also involves in the Switch operations i.e., purchase of one type of securities against the sales of another type of securities. The main objectives of open market operations are:

Objectives of OMO

- To facilitate borrowing of funds by the govt. from the public.
- To maintain the prices of Government Securities stable. When

there is a fall, RBI purchases them to raise their prices.

- To offset the seasonal changes in the supply of money in money market.
- To support the bank rate policy.
- To control credit.

3. Variable Cash Reserve Ratio (CRR): - Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances .Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa.RBI is empowered to vary CRR between 15 percent and 3 percent. But as per the suggestion by the Narshimham committee Report the CRR was reduced from 15% in the 1990 to 5 percent in 2002. As of October 2013, the CRR is 4.00 percent.

Though the RBI was empowered to make use of the weapon of variable cash reserve ratio as early as 1951, the RBI made use of this weapon only since March,1960.

4. Variable Statutory Liquidity ratio (SLR): - The current SLR is 23%. According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (as on jan'2014)

5. Liquidity Adjustment Facility (LAF) includes Repo rate and Reverse Repo: - LAF consists of daily infusion or absorption of liquidity on a repurchase basis, through repo (liquidity injection) and reverse repo (liquidity absorption) auction operations through government securities as collateral securities.

- Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaperrate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.

- Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation

This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75 % and reverse repo rate is 6.75%. On January 28, 2014, RBI raised repo rate by 25 basis points to 8.00 %.

6. Marginal Standing Facility: - This was instituted under which the scheduled commercial banks can borrow over night at their discretion upto one percent of their respective NDTL at 100 basis points above the repo rate to provide a safety valve against unanticipated liquidity shocks.

II. Qualitative weapons (Direct Instruments):

Qualitative weapons are those which regulate the quality of credit i.e., uses to which credit is put. They are concerned with the encouragement of credit to productive uses, and discouragement of credit to non essential activities. The main qualitative credit control weapons are:

1. Regulation of margin requirements
2. Regulation of consumer credit
3. Issuing of Directives
4. Rationing of credit
5. Credit authorization scheme
6. Moral suasion
7. Direct action

The detailed explanations of the major qualitative methods are given here under.

1. Regulation of margin requirement: - Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For e.g. if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

2. Issuing of Directives: - Under section 21,of the BRA of 1949, RBI is empowered to issue directives to any particular bank or to the entire banking system and the banks are bound to comply with the directives issued to them. RBI directives can be in regard to:

- Purpose for which advance may or may not be made
- Margins requirement
- Maximum amount of loan that can be sanctioned to any company, firm or person.
- Rate of interest and other terms and conditions on which loans may be given.

3. Credit Ceiling: - In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.

4. **Credit Authorization Scheme:** - Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI's prior authorization for sanctioning any fresh credit beyond the authorized limits.

5. **Moral Suasion:** - Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

6. **Direct Action** : - This method is rarely used by RBI. But it is adopted when all other measures fail. It implies refusal of RBI to extend rediscounting facilities to banks which follows unsound banking practices and such other measures.

TYPES OF MONETARY POLICY

There are three common types of monetary policy. These are,

1. Expansionary Monetary Policy
2. Contractionary Monetary Policy
3. Unconventional Monetary Policy

1) Expansionary Monetary Policy

Expansionary monetary policy is the monetary policy which seeks to increase aggregate demand and economic growth in the economy. It involves increasing the money supply and lowering the interest rates. The lower interest rate encourages the borrowers to buy more which increases the economic activity. The increased economic activity leads to more employment opportunities thus decreasing unemployment. It also increases the inflation as more money is available to buy goods and services. It is also known as **Easy Money Policy or Loose Money Policy** as central banks seeks to increase the money supply by lowering the interest rates.

2) Contractionary Monetary Policy

Contraction monetary policy is the monetary policy which is used to fight the inflation in economy. It involves decreasing the money supply and increasing the interest rates. As reduction in money supply increases the interest rates, the borrowers will be reluctant to borrow the money due to higher borrowing cost which ultimately reduces the economic activity. It leads to decrease in inflation, increase in unemployment and slowdown in economy. It is also known as tight money policy as central banks seeks to reduce the money supply by restricting credit by increasing interest rates.

3) Unconventional Monetary Policy

Unconventional monetary policy is pursued by central banks when their traditional instruments of monetary policy cease to achieve their goals. The one such

unconventional monetary policy was employed us United States after the financial crisis of 2007 in the form Quantitative Easing (QE).

MONETARY POLICY OF THE R.B.I.

INTRODUCTION

Monetary policy refers to the policy of a Central Bank to systematically regulate the supply of money in the economy with a definite purpose. It comprises of those measures which aim at regulating the supply of credit in quantity and prices consistent with specific national objectives.

The monetary policy of the R.B.I. has been guided by three objectives right from its nationalisation in1949, viz., stability, growth and social justice. The emphasis on one or more of these objectives was changing from time to time. But the sole guiding principle has been all along the price stability. So the main focus of the R.B.I's monetary policy has been one of controlled expansion of money supply in 1952-72.to reduce the volume of excess capacity created by an enormous inflow of funds into India. It sold Government securities in the open market and reduced the ability of the commercial banks to lend.

MONETARY POLICY IN 1952-72

The monetary policy since 1957 emphasised the twin aims of the economic policy of the Government –

1. to speed up economic development in the country to raise national income and standard of living in India and
2. to reduce and control inflationary pressures in the economy. Hence this policy is called as the controlled expansion policy. Accordingly, the RB.I expanded the volume of money and credit and at the same time, attempted to check rise in prices by the use of qualitative methods of credit control.

MONETARY POLICY SINCE 1972

The Indian economy has been working with considerable inflationary potential right from 1972. This in due to rapid increase in the money supply with the public and the banking institutions. There was a serious inflationary situation in the country. The faulty government's policy, global oil price hike, Gulf war, fluctuations in agricultural production, etc. added fuel to the fire. Therefore, the Government was forced to abandon the controlled expansion policy and introduce an anti-inflationary policy: The R.B.I. has been following an anti-inflationary policy with varying degrees of success.

The R.B.I. has been using both quantitative credit controls and qualitative credit controls. Quantitative credit controls are also known as general credit controls. They include bank rate policy, open market operations and cash reserve ratios. Qualitative credit controls include minimum margins for lending against specific

securities, ceiling on the amounts of credit for certain purposes and discriminatory rate of interest charged on certain types of advances, etc. Let us discuss how these various methods were used in recent years in India.

1. **Bank Rate Policy (BRP)**

The RBI followed a cheap money policy as a general tradition since 1930's. The bank rate was fixed at 3% for a quite a long time. It was in November 1953 that the bank rate was raised from 3% to 3.5%. The bank rate gradually rose to 10% in July 1981, to 11% in July 1991 and further to 12% in October 1991. The RBI reduced the bank rate from 12% to 11% in April 1997, to 10% in June 1997 and further to 9% in October, 1997.

2. **Cash Reserve Requirements (CRR)**

Under the RBI Act, 1934, every commercial bank was required to maintain a minimum cash reserve with the RBI. Initially it was 5% against demand deposits and 2% against time deposits. Since 1962, the RBI was empowered to vary the cash reserve requirements between 3% and 15% of the total of demand and time deposits. During 1973, the RBI followed a credit squeeze policy and raised the cash reserve requirements from 3% to 5% in June, 1973 and from 5% to 7% in September, 1973. Since 1973, the RBI either increased or decreased the CRR a number of times. It raised the CRR to a maximum of 15% of net demand and time deposits. However, the CRR was reduced to 14% in 1995-96 and further to 8% in October 1997.

3. **Statutory Liquidity Requirements (CRR)**

Apart from the CRR, the commercial banks were required under Section 24 of the Banking Regulation Act, 1949 to keep liquid assets in the form of cash, gold and unencumbered approved securities equal to 25% of their total demand and time deposits. This is known as statutory liquidity requirement. The RBI also has the power to vary this SLR in accordance with the economic conditions prevailing in the country. Accordingly, the SLR was revised from 25% gradually and finally to 38.5%. However, the Narasimham Committee, 1991 recommended reduction of the SLR and the RBI, therefore, reduced it to 25% in October1997 in successive stages.

4. **Open Market Operations (OMO)**

The RBI did not make use of this weapon for a long time. It was forced to use this weapon since 1991 to reduce the volume of excess capacity created by an enormous inflow of funds into India. It sold Government securitiesin the open market and reduced the ability of the commercial banks to lend.

5. Margin requirements

In 1964-65, the RBI fixed the minimum margins in respect of advances against all food grains, oilseeds vegetable oils, etc.

6. Credit Authorisation Scheme (CAS)

The Credit Authorisation Scheme is a selective credit control device. It was introduced in November 1965.The commercial banks had to obtain prior permission from the RBI before sanctioning any fresh loan of Rs.1 crore or more to a single party. This was later on raised to Rs. 6 crores in April 1986. The scheme included the borrowers in both the private sector and public sector The CAS was liberalised in July 1987.Finally, the RBIgranted certain exemptions in getting permission from it

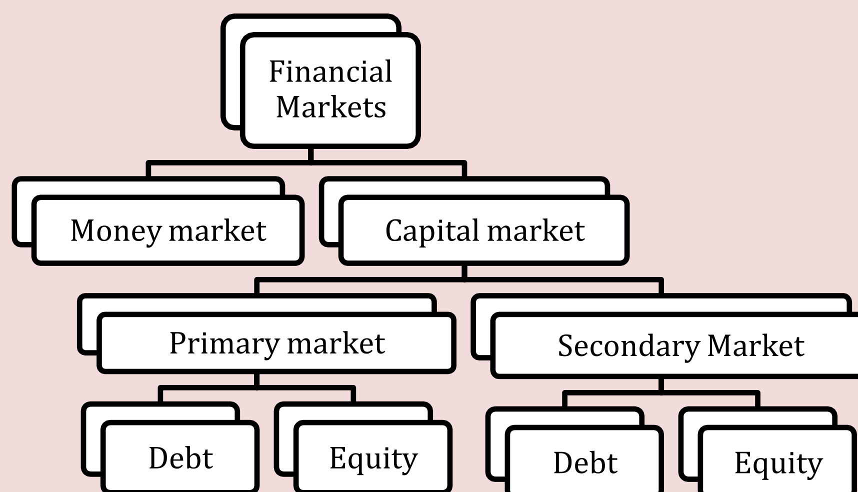
7. Credit Monitoring Arrangements (CMA)

The Credit Authorisation Scheme was abolished in October 1988. Instead, the RBI introduced a scheme called Credit Monitoring Arrangements. According to this scheme, the RBI would monitor and scrutinize all sanctions of bank loans exceeding (a) Rs. 5 crores to a single party for working capital requirements and b(b) Rs.2 cores in the case of term loans. This post - sanction scheme is designated as Credit Monitoring Arrangement (CMA).

MONEY MARKET

The money market is a market for short term funds which deals in monetary assets whose period of maturity is up to one year. These assets are close substitutes for money. It is a market where low risk, unsecured and short term debt instruments that are highly liquid are issued and actively traded everyday. It has no physical location, but is an activity conducted over the telephone and through the internet. It enables the raising of short-term funds for meeting the temporary shortages of cash and obligations and the temporary deployment of excess funds for earning returns. The major participants in the market are the Reserve Bank of India (RBI), Commercial Banks, Non- Banking Finance Companies, State Governments, Large Corporate Houses and Mutual Funds.

Classification of Financial Markets



MEANING OF MONEY MARKET

Market is a place where goods are bought and sold. It is aggregate of buyers and sellers of a certain good or service and the transactions between them. Financial market is a type of market that deals in financial assets and credit instruments such as currency, cheques, bank deposits, shares, debentures, govt. securities, treasury bills, bill of exchange etc.

On the basis of maturity of assets that is dealt with, financial market is divided into two categories *viz.*, money market & capital market. **Money market** deals in highly liquid short term financial assets (maturity ranging between several days to one year) whereas **capital market** deals in long term financial instruments (say, with a maturity of more than one year) like equity shares.

But money market does not refer to a particular place where money is borrowed

and lent by the parties concerned. Mostly, transactions between takes place over phone or mail or through agents. No personal contact or presence of the two parties is essential.

Thus money market refers to the institutional arrangements facilitating borrowing andlending of short term funds. According to Crowther "Money Market is the collective name given to the various firms and institutions that deal in various grades of near money".

RBI defined money market as "a market for short term financial assets that are close substitute for money, facilitate the exchange of money, in primary and secondary markets"

INSTRUMENTS OF MONEY MARKET

1. Treasury Bill:

A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than one year. They are also known as Zero Coupon Bonds issued by the Reserve Bank of India on behalf of the Central government to meet its short-term requirement of funds. Treasury bills are issued in the form of a promissory note. They are highly liquid and have assured yield and negligible risk of default. They are issued at a price which is lower than their face value and repaid at par. The difference between the price at which the treasury bills are issued and their redemption value is the interest receivable on them and is called discount. Treasury bills are available for a minimum amount of Rs 25,000 and in multiples thereof.

Example: Suppose an investor purchases a 91 days Treasury bill with a face value of Rs. 1,00,000 for Rs. 96,000. By holding the bill until the maturity date, the investor receives Rs. 1,00,000. The difference of Rs. 4,000 between the proceeds received at maturity and the amount paid to purchase the bill represents the interest received by him.

2. Commercial Paper:

Commercial paper is a short-term unsecured promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is issued by large and creditworthy companies to raise short-term funds at lower rates of interest than market rates.

It usually has a maturity period of 15 days to one year. The issuance of commercial paper is an alternative to bank borrowing for large companies that are generally considered to be financially strong. It is sold at a discount and redeemed at par. The original purpose of commercial paper was to provide short-terms funds for seasonal and working capital needs. For example companies use this instrument for purposes such as bridge financing.

Example: Suppose a company needs long-term finance to buy some machinery. In order to raise the long term funds in the capital market the company will have to incur floatation costs (costs associated with floating of an issue are brokerage, commission, printing of applications and advertising etc.). Funds raised through commercial paper are used to meet the floatation costs. This is known as Bridge Financing.

3. Call Money:

Call money is short term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions. Commercial banks have to maintain a minimum cash balance known as cash reserve ratio. The Reserve Bank of India changes the cash reserve ratio from time to time which in turn affects the amount of funds available to be given as loans by commercial banks. Call money is a method by which banks borrow from each other to be able to maintain the cash reserve ratio. The interest rate paid on call money loans is known as the call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour. There is an inverse relationship between call rates and other short-term money market instruments such as certificates of deposit and commercial paper. A rise in call money rates makes other sources of finance such as commercial paper and certificates of deposit cheaper in comparison for banks raise funds from these sources.

4. Certificate of Deposit:

Certificates of deposit (CD) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. They can be issued to individuals, corporations and companies during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high. They help to mobilise a large amount of money for short periods.

5. Commercial Bill:

A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term, negotiable, self-liquidating instrument which is used to finance the credit sales of firms. When goods are sold on credit, the buyer becomes liable to make payment on a specific date in future. The seller could wait till the specified date or make use of a bill of exchange.

The seller (drawer) of the goods draws the bill and the buyer (drawee) accepts it. On being accepted, the bill becomes a marketable instrument and is called a trade bill. These bills can be discounted with a bank if the seller needs funds before the bill matures. When a trade bill is accepted by a commercial bank it is known as a commercial bill.

CONSTITUENTS OF INDIAN MONEY MARKET

Main constituents of money market are the lenders who supply funds and borrowers who demand short term credit. Suppliers of funds may belong to either

1. Unorganised sector whose activities are not controlled or coordinated by RBI (comprising ofindigenous bankers and village money lenders) or

2. Organised sector (comprising of RBI, commercial banks, Development Financial Institutions,co-operative banks and other financial institutions such as LIC)

The main borrowers of short term funds are central government, state governments, local authorities (such as municipal corporations), traders and industrialists, farmers, exporters, importersand general public.

Sub- markets of organised money market

1. Call/Notice/Term money market

Call/Notice money is an amount borrowed or lent on demand for a very short period says, a few hours to 14 days. If the period is less than 24 hours it is 'Call money'. They can be recalled on demand and that is why it is known as call money. If the period of loan is more than one day and up to 14 days it is called 'Notice money'. Term money refers to borrowing/lending of funds for aperiod exceeding 14 days. No collateral security is required to cover these transactions. Banks are the major borrower and lender of call money. Banks with temporary deficit of funds, to meet their CRR requirements, form the demand side and banks with temporary excess of funds from the supply side of call money market. In India major suppliers of call money are Non-Banking Financial Institutions like LIC, GIC etc. It is a completely inter-bank market hence non-bank entities are not allowed access to this market. Interest rates in the call and notice money market are 'market determined'. In view of the short tenure of such transactions, both the borrowers and the lenders are required to have current accounts with the RBI.

2. Commercial bill market:

A **bill of exchange** is a written, unconditional order by one party *(the seller of goods/the drawer)* to another *(the buyer/the drawee)* to pay a certain sum, either immediately (a sight bill) or on a fixed date (a term bill), for payment of goods and/or services received. These bills are called tradebills. These trade bills are called commercial bills when they are accepted by commercial banks. Maturity of the bill is generally three months.

If the bill is payable at a future date and the seller needs money during the currency of the bill then he may approach his bank for discounting the bill. The maturity proceeds (face value of discounted bill), from the drawee, will be received by the bank.

If the bank needs fund during the currency of the bill then it can rediscount

the bill already discounted by it in the commercial bill rediscount market at the market related discount rate.

The bill discounting market is not so popular in India. It barely constitute 10% of total bank credit. The establishment of Discount and Finance House of India (DFHI) in 1988 has been an important step towards the development of an active discount market in India. In India, the major reason cited for the non-development of bill financing is the hesitation of the industry and trade to subject themselves to the rigours of bill discipline.

3. Bankers acceptance

Bankers' acceptances date back to the 12th century when they emerged as a means tofinance uncertain trade, as banks bought bills of exchange at a discount. A short-term debt instrument issued by a firm that is guaranteed by a commercial bank. Banker's acceptances are issued by firms as part of a commercial transaction. It is a promised future payment which is accepted and guaranteed by a bank and drawn on a deposit at the bank. The banker's acceptance specifies the amount of money, the date, and the person to which the payment is due. After acceptance, the draft becomes an unconditional liability of the bank. The party that holds the banker's acceptance may keep the acceptance until it matures, and thereby allow the bank to make the promised payment, or it may sell the acceptance at a discount today to any party willing to wait for the face value payment of the deposit on the maturity date.

Banker's acceptances make a transaction between two parties who do not know each other safer because they allow the parties to substitute the bank's credit worthiness for that who owes the payment.

4. Treasury bill (T bill) market

Treasury Bill Market refers to the market where treasury bills are bought and sold. T Bill is a promissory note issued by RBI on behalf of central/state government. It is issued to meet short term requirements of the govt. TBs are highly secured and liquid as repayment is guaranteed by RBI. Treasury bills are available for a minimum amount of Rs.25000 and in multiples of Rs. 25000. Treasury bills are issued at a discount and are redeemed at par.

Types of T-bills

In India, there are 2 types of treasury bills viz

1. Ordinary or regular
2. 'Ad-hoc' known as 'ad hocs'.

Ordinary are issued to the public and other financial institutions for meeting the short-term financial requirements of the Central Government. These are freely marketable and they can be bought and sold at any time and they have a secondary market also.

On the other hand, **'ad-hocs'** are always issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI and the RBI is authorised to issue currency notes against them. They aren't marketable in India. Holders of these bills can always sell them back to the RBI.

On the basis of periodicity, Treasury bills may be classified into three

1. 91-day (3 months) T bill- maturity is in 91 days. Its auction is on every Wednesdays of every week.

2. 182-day (6 months)T bill- maturity is in 182 days. Its auction is on every alternate Wednesdays preceding non-reporting Fridays. (Banks are required to furnish various data to RBI on every alternate Friday, called reporting Fridays).

3. 364-Day (1 year) T bill- maturity is in 364 days. Its auction is on every alternate Wednesdays preceding reporting Fridays.

A considerable part of the government's borrowings happen through TBills of variousmaturities. Based on the bids received at the auctions, RBI decides the cut off yield and accepts all bids below this yield.

All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills

These T bills which are issued at a discount can be traded in the market. The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialised form.

Advantages of investment in TB

- No tax deducted at source
- Zero default risk being sovereign paper
- Highly liquid money market instrument
- Better returns especially in the short term

- Transparency
- Simplified settlement
- High degree of tradability and active secondary market facilitates meeting unplanned fundrequirements.

4. Certificates of Deposits

Certificate of Deposit (CD) is a negotiable money market instrument issued against funds deposited at a bank or other eligible financial institution for a specified time period. After treasury bills, this is the next lowest risk category investment option.

Allowed in 1989, CD is a negotiable promissory note, secure and short term in nature. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue. The maturity most quoted in the market is for 90 days. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue. A CD is issued at a discount to the face value, the discount rate being negotiated between the issuer and the investor.

CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred as per the procedure applicable to other demat securities. There is no lock- in period for the CDs. It can be issued to individuals, corporations, companies, trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs.

The minimum issue of CD to single investor is Rs.1 lakh and additional amount in multiplesof Rs.1 lakh each.

CDs are issued by banks and FIs mainly to augment funds by attracting deposits from corporates, high net worth individuals, trusts, etc. Those foreign and private banks which do not have large branch networks and hence lower deposit base, use this instrument to raise funds.

5. Commercial Paper Market

Introduced in 1990, CPs are negotiable, short-term, unsecured promissory notes with fixed maturities, issued by well rated companies. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Companies having a net worth of Rs.4 crores and whose shares are listed in a stock exchange can issue CPs either directly to the investors or through merchant banks. All eligible participants shall obtain the credit rating for issuance of Commercial Paper from a credit rating agency as notified by RBI such as CRISIL. These are

basically instruments evidencing the liability of the issuer to pay the holder in due course a fixed amount (face value of the instrument) on the specified due date. These are issued for a fixed period of time at a discountto the face value and mature at par.

CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. These instruments are normally issued in the multiples of five lakhs for 30/ 45/ 60/ 90/ 120/ 180/ 270/ 364 days. CP can be issued either in the form of a promissory note or in a dematerialised form through any of the depositories approved by and registered with SEBI. Banks, FIs and PDs can hold CP only in dematerialised form.

Funds raised through CPs do not represent fresh borrowings for the corporate issuer but merely substitute a part of the banking limits available to it. Hence a company issues CPs mostly to save on interest costs i.e. it will issue CPs only when the CP rate is lower than the bank's lending rate.

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

The maximum amount a company can raise through CP is up to 75 % of its total working capital limit. Fixed Income Money Market and Derivatives Association of India (FIMMDA), may prescribe, in consultation with the RBI, any standardised procedure and documentation for operational flexibility and smooth functioning of CP market.

On October 15 1997, total outstanding amount on Commercial paper transaction in Indian money market was Rs. 3377 crore. This outstanding amount increased substantially to Rs. 1,28,347 crore on July 15, 2011. This growth of Commercial paper market may be attributed to the rapid expansion of corporate manufacturing and financial companies in liberalized and Globalized Indianeconomy.

6. REPO Market

A **repurchase agreement**, also known as a **repo**, is the sale of securities together with an agreement for the seller to buy back the securities at a later date. Predominantly, repos areundertaken on overnight basis, i.e., for one day period. The repurchase price should be greater than the original sale price, the difference representing interest, sometimes called the *repo rate*. The party that originally buys the securities effectively acts as a lender and the original seller is acting as a borrower.

Different instruments can be considered as collateral security for undertaking the ready forward deals and they include Government dated securities, Treasury Bills, corporate bonds, money market securities and equity. Legal title to the collateral security which is used in repo transaction, passes to the buyer during the repo period. As a result in case the seller defaults the buyer does not require to establish right on the collateral security.

The Repo/Reverse Repo transaction can only be done at Mumbai between parties approved by RBI and in securities as approved by RBI.The repo rate is the rate at which the banks borrow from RBI, while the reverse repo rate is the rate offered by RBI for funds borrowed from banks.

A reverse repo is the mirror image of a repo. For, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence whether a transaction is a repo or a reverse repois determined only in terms of who initiated the first leg of the transaction.

As part of the measures to develop the corporate debt market, RBI has permitted select entities (scheduled commercial banks excluding RRBs and LABs, Primary Dealers, all-India FIs, NBFCs, mutual funds, housing finance companies, insurance companies) to undertake repo in corporate debt securities. This is similar to repo in Government securities except that corporate debt securities are used as collateral for borrowing funds. Only listed corporate debt securities that are rated 'AA' or above by the rating agencies are eligible to be used for repo. Commercial paper, certificate of deposit, non-convertible debentures of original maturity less than one year **are not eligible** for the purpose.

7. Collateralised Borrowing and Lending Obligation

CBLO is another money market instrument operated by the Clearing Corporation of India Ltd. (CCIL), for the benefit of the entities who have either no access to the interbank call money market or have restricted access in terms of ceiling on call borrowing and lending transactions. CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (up to one year as per RBI guidelines). In order to enable the market participants to borrow and lend funds, CCIL provides the Dealing System through Indian Financial Network (INFINET), a closed user group to the Members of the Negotiated Dealing

System (NDS) who maintain Current account with RBI and through Internet for other entities whodo not maintain Current account with RBI.[i]

Membership to the CBLO segment is extended to entities who are RBI- NDS members, viz., Nationalized Banks, Private Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers,

etc. Associate Membership to CBLO segment is extended to entities who are not members of RBI- NDS, viz., Co-operative Banks, Mutual Funds, Insurance companies, NBFCs, Corporates, Provident/ Pension Funds, etc. By participating in the CBLO market, CCIL members can borrow or lend funds against the collateral of eligible securities. Eligible securities are Central Government securities including Treasury Bills, and such other securities as specified by CCIL from time to time. Borrowers in CBLO have to deposit the required amount of eligible securities with the CCIL based on which CCIL fixes the borrowing limits.

Difference-Capital Market & Money Market

Money Market	Capital Market
Concerned with short term funds, for a period not exceeding one year	Concerned with long term funds for a periodexceeding one year.
Meets short term requirements of govt. &working capital requirement of business concerns	Meet long term requirements of govt and fixedcapital requirement of business concerns
Instruments are TBs, BoEs, CPs, CDs & govt. Bonds etc.	Instruments are shares, debentures govt. Bondsetc.
Central bank and other banks are working aspart of money market	Capital market is functioning through moneymarket and it has no direct contact with central bank.
Transactions are of larger amount	Transactions are of smaller amount.
Instruments do not have an active secondarymarket	Instruments have active secondary market.
Transactions normally takes place over phone and there is no formal place	Transactions take place at formal place.
Transactions have to be conducted withoutthe help of brokers	Transactions are conducted with the help of brokers.

DEFECTS /FEATURES OF INDIAN MONEY MARKET

A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. RBI controls and regulates the money supply in the country through the money market. However, unfortunately, the Indian money market is inadequately developed, loosely organised and suffers from many weaknesses. Major defects are discussed below

1. **Existence of unorganized money market:** unorganised money market comprises of indigenous bankers and money lenders. Substantially higher rate of interest prevails in unorganised sector. They follow their own rules of banking and finance. RBI's attempt to bring them under control has failed many times.

2. **Absence of integration:** Different sections of money market are loosely connected with one another. Organised and unorganised sector of money market do not have any contact between them. With the setting up of RBI and passing of BRA 1949, the conditions have improved.

3. **Multiplicity in rates of interest:** The immobility of funds from one section to another creates diversity in interest rates. Immobility arises due to difficulty of making cheap and quickremittance of funds from one centre to another. At present wide divergence does not exist.

4. **Seasonal stringency of funds:** The demand for money in Indian money market is seasonal in nature. During busy season from October to April money is needed for financing and marketing of agricultural products and seasonal industries such as sugar. RBI attempt to lessen the fluctuations in money rates by increasing money supply during busy season and withdrawingthe same in lean season.

5. **Absence of bill market:** a well organised bill market is essential for smooth functioning of a credit system. An important shortcoming of Indian Money Market is the absence of a well- developed bill market. Though both inland and foreign bills are traded in Indian Money Market yet its scope is very limited. In spite of the efforts of Reserve Bank in 1952 and in 1970, only a limited bill market exists in India. Thus, an organised bill market in the real sense of the term has not yet been fully developed in India. The establishment of DFHI has improved the situation now. The main obstacles in the development of bill market appear to be the following:

- ✓ The lack of uniformity in drawing bills in different parts of the country,
- ✓ The large use of cash credit as the main form of borrowing from commercial banks,
- ✓ Presence of Inter-call money market and
- ✓ The pressure of cash transactions. Thus, Bill Market is relatively underdeveloped.

6. **Absence of Acceptance and Discount Houses :** There is almost complete absence of acceptance and discount houses in the Indian money market. This is due to the underdeveloped bill market in India.

7. **No contact with foreign money market:** Indian money market is an insular one with little contact with money market in other countries. Indian money market does not attract any foreignfund as western money markets do.

8. **Limited instruments:** Supply of money market instruments like bills, TBs etc. is very limitedand inadequate in nature considering the varied requirements of short term funds.

9. Limited secondary market: Secondary market is very limited in the case of money market instruments. Practically it is restricted to rediscounting of commercial and treasury bills. In India banks have the tendency to hold these bills till maturity, thus preventing an active trade in these bills.

10. Limited participants: participants in Indian money market are also limited. Entry into the market is strictly regulated. In fact there are a large number of borrowers but a few lenders. Hence, the market is not very active.

11. Absence of specialized financial institutions: Specialised institutions are lacking to carry out specialised jobs in certain fields like bank for tourism, bank for financing SSIs. etc.

12. Underdeveloped Banking Habits: In spite of rapid branches expansion of banks and spread of banking to unbanked and rural centres, the banking habits in India are still underdeveloped. There are several reasons for it.

- ✓ Whereas in U.S.A. for every 1400 persons there is a branch of a commercial bank, inIndia there is a branch for every 13,000 people,
- ✓ The use of cheques is restricted,
- ✓ The majority of transactions are settled in cash,
- ✓ The hoarding habit is widespread.

IMPORTANCE OF MONEY MARKET

If the money market is well developed and broad based in a country, it greatly helps in the economic development. The central bank can use its monetary policy effectively and can bring desired changes in the economy for the industrial and commercial progress of the country. The importance of money market is given, in brief, below:

Financing Industry: A well-developed money market helps the industries to secure short term loans for meeting their working capital requirements. It thus saves a number of industrial units frombecoming sick.

Financing trade: An outward and a well-knit money market system play an important role in financing the domestic as well as international trade. The traders can get short term finance from banks by discounting bills of exchange. The acceptance houses and discount market help infinancing foreign trade.

Profitable investment: The money market helps the commercial banks to earn profit by investing their surplus funds in the purchase of Treasury bills and bills of exchange, these short term credit instruments are not only safe but also highly liquid. The banks can easily convert them into cash ata short notice.

Self sufficiency of banks: The money market is useful for the commercial banks

themselves. If thecommercial banks are at any time in need of funds, they can meet their requirements by recalling their old short term loans from the money market.

Encourages economic growth: If the money market is well organized, it safeguards the liquidity and safety of financial asset. This encourages the twin functions of economic growth, savings and investments.

Effective implementation of monetary policy: The well-developed money market helps the central bank in shaping and controlling the flow of money in the country. The central bank mops up excess short term liquidity through the sale of treasury bills and injects liquidity by purchase of treasury bills.

Proper allocation of resources: In the money market, the demand for and supply of loan able funds are brought at equilibrium. The savings of the community are converted into investment which leads to pro allocation of resources in the country.

Help to government: The organized money market helps the government of a country to borrow funds through the sale of Treasury bills at low rate of interest The government thus would not gofor deficit financing through the printing of notes and issuing of more money which generally leads to rise in an increase in general prices.

CAPITAL MARKET

CAPITAL MARKET

The term capital market refers to facilities and institutional arrangements through which long-term funds, both debt and equity are raised and invested. It consists of a series of channels through which savings of the community are made available for industrial and commercial enterprises and for the public in general. It directs these savings into their most productive use leading to growth and development of the economy. The capital market consists of development banks, commercial banks and stock exchanges. An ideal capital market is one where finance is available at reasonable cost.

The process of economic development is facilitated by the existence of a well functioning capital market. In fact, development of the financial system is seen as a necessary condition for economic growth. It is essential that financial institutions are sufficiently developed and that market operations are free, fair, competitive and transparent. The capital market should also be efficient in respect of the information that it delivers, minimise transaction costs and allocate capital most productively.

The Capital Market can be divided into two parts:

a. Primary Market
b. Secondary Market

ROLE / FUNCTIONS OF CAPITAL MARKET

Capital market plays an important role in mobilising resources, and diverting them in productive channels. In this way, it facilitates and promotes the process of economic growth in the country. It ensures better coordination between the flow of savings and the flow of investment that leads to capital formation and directs the flow of savings into most profitable channels.

In addition to resource allocation, capital markets also provide a medium for risk management by allowing the diversification of risk in the economy. A well-functioning capital market tends to improve information quality as it plays a major role in encouraging the adoption of stronger corporate governance principles, thus supporting a trading environment, which is founded on integrity.

Following are the main role or functions of capital market.

1. **Link between Savers and Investors:**

The capital market acts as a link between savers and investors. It plays an important role in mobilising the idle savings of people and diverting them in productive and profitable investment. Inthis way, capital market plays a vital role in transferring the financial resources from surplus and wasteful areas to deficit and productive areas, thus increasing the productivity and prosperity of the country.

2. Encouragement to Saving:

With the development of capital market, the banking and non-banking institutions provide facilities to invest money in stock market, which encourage people to save more. In the less- developed countries, in the absence of a capital market, there are very little savings and those who save often invest their savings in unproductive and wasteful areas such as rela estate, gold etc.

3. Capital Formation:

The capital market facilitates lending to the businessmen and the government and thus encourages investment. It helps to mobilise the huge capital required for business. It is an important and efficient means to channel and mobilize funds to enterprises, and provide an effective source of investment in the economy.

4. Promotes Economic Growth:

The capital market not only reflects the general condition of the economy, but also smoothens and accelerates the process of economic growth. The proper allocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growth in the country. It plays a critical role in mobilizing savings for investment in productive assets, with a view to enhancing a country's long-term growth prospects, and thus acts as a major catalyst in transforming the economy into a more efficient, innovative and competitive marketplace within the global arena

5. Stability in Security Prices:

The capital market tends to stabilise the values of stocks and securities and reduce the fluctuations in the prices to the minimum. The process of stabilisation is facilitated by providing capital to the borrowers at a lower interest rate and reducing the speculative and unproductive activities.

6. Assists to Government :

Capital market assists the Government to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project based capital.

7. Benefits to Investors:

Capital market is beneficial to the investors in many ways:

a) **Liquidity of Investment:** Shares and bonds are easily transferable at low transaction cost as compared toother assets such as real estate. Therefore an investor can buy and sell at considerable convenience.

b) **Hedge against inflation:** Securities prices over the long term tend to outperform inflation, therefore investment in securities can be a reliable hedge against inflation in the long term.

c) **Higher Return:** Capital market provides comparatively higher return in the long run than other investavenues such as real estate, gold, and bank deposits.

d) **Collateral:** Securities represent stocks of wealth, and can be used as ollateral to secure financing such asloans from lending institutions.

e) **Flexibility:** Shares and bonds are traded in units and lots that are affordable by investors of different income levels. As such, investment in securities can be customized to the specific incomes of investors.

f) **Tax advantage:** The government offers many tax advantages to the long term investment in equitymarket.

COMPONENTS OF CAPITAL MARKET:

Capital market can be classified into two;

1. Primary market
2. Secondary market.

Primary market is the market where the securities are issued for the first time. It is the primary market in which the companies issue their securities. Secondary market is the market for already issued (second hand) securities. Secondary market enables the further buying and selling ofissued securities.

PRIMARY MARKET

It is also called New Issue Market. It is the market where securities are issued for the first time. These securities are never traded before elsewhere. Both new companies and existing companies approach primary market for raising capital. The main function of primary market is to facilitate transfer of funds from willing investors to the entrepreneurs setting up new business or diversification, expansion or modernisation of existing business. The investors in this market are banks, financial institutions, insurance companies, mutual funds and individuals.

A company can raise capital through the primary market in the form of equity shares, preference shares, debentures, loans and deposits. Funds raised may be for setting up new projects, expansion, diversification, modernisation of existing projects, mergers and takeovers etc.

A new issue market is of paramount importance for economic growth and industrial development as it supplies necessary long term capital. Though the functions of primary market are so different from that of secondary market, the sentiments in the secondary market do affect the primary market activities.

METHODS OF FLOATATION

There are various methods of floating new issues in the primary market :

1. Offer through Prospectus: Offer through prospectus is the most popular method of raising funds by public companies in the primary market. This involves inviting subscription from the public through issue of prospectus. A prospectus makes a direct appeal to investors to raise capital, through an advertisement in newspapers and magazines. The issues may be underwritten and also are required to be listed on at least one stock exchange. The contents of the prospectus have to be in accordance with the provisions of the Companies Act and SEBI disclosure and investor protection guidelines.

2. Offer for Sale: Under this method securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses or stock brokers. In this case, a company sells securities enbloc at an agreed price to brokers who, in turn, resell them to the investing public.

3. Private Placement: Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It helps to raise capital more quickly than a public issue. Access to the primary market can be expensive on account of various mandatory and non-mandatory expenses. Some companies, therefore, cannot afford a public issue and choose to use private placement.

4. Rights Issue: This is a privilege given to existing shareholders to subscribe to a new issue of shares according to the terms and conditions of the company. The shareholders are offered the 'right' to buy new shares in proportion to the number of shares they already possess.

5. e-IPOs: A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an Initial Public Offer (IPO). SEBI registered brokers have to be appointed for the purpose of accepting applications and placing orders with the company. The issuer company should also appoint a registrar to the issue having electronic connectivity with the exchange. The issuer company can apply for listing of its securities on any exchange other than the exchange through which it has offered its securities. The lead manager coordinates all the activities amongst intermediaries connected with the issue.

PRIMARY MARKET INTERMEDIARIES

A number of intermediaries play a critical role in the process of issue of new securities. They are

1. **Merchant bankers/lead managers:** it is an institution that extends a number of services in connection with issue of capital. Their services include management of security issues, portfoliomanagement services, underwriting of capital issues, credit syndication, financial advice and project counselling etc. It has now made mandatory that all public issues should be made by merchant bankers acting as lead managers.

2. **Underwriters:** underwriter guarantee that the securities offered for the public will be subscribed if it is not subscribed by the public. It is an insurance to the issuing company againstthe failure of issue. In case, the public fails to subscribe, the underwriter will have to take themup and pay for them. They charge a commission called underwriting commission for their service. It should not exceed 5 percent in case of shares and 2.5 percent for debentures.

3. **Bankers to an issue:** Banker to an issue accepts applications and application money, refund application money after allotment and participate in the payment of dividend by companies. No banker can act as a banker to an issue unless it possesses a registration with SEBI. SEBI grants registration only when it is satisfied that the bank has enough infrastructure, communication and data processing facilities and requisite man power to discharge such duties. The banker is required to maintain documents and records relating to the issue for a period of 3 years. It is also required to furnish information to the SEBI regarding the number of applications received, number of issues for which it has acted as a banker to an issue, date on which applications from investors were forwarded to registrar of issue, date and amount of refund to investors etc

4. **Registrar to an issue:** It is an intermediary who performs the function of collecting application from investors (through bankers), keeping record of applications, keeping record of money received from investors, assisting companies in allotment and helping despatch of allotment letters, refund orders etc.

5. **Share transfer agents:** They maintain the record of holders of securities on behalf of companies and deals with all activities connected with transfer or redemption of securities.

6. **Debenture trustees:** A debenture is an instrument of debt issued by the company acknowledging its obligation to repay the sum along with an interest. In the case of public issueof debentures, there would be a large number of debenture holders on the register of the company. As such it shall not be feasible to create charge in favour of each of the debenture holder. A common methodology generally adopted is to create Trust Deed conveying the property of the company. A Trust deed is an arrangement enabling the property to be held by a person or persons for the benefit of some other person known as beneficiary. It has been made mandatory for any company making a public/rights issue of debentures to appoint one or more debenture trustees before issuing the prospectus or letter of offer and to obtain their consent which shall be mentioned in the offer document.

7. **Brokers to an issue:** Brokers are the persons who procure subscriptions to issue from prospective investors spread over a larger area. A company can appoint as much number of brokers as it wants.

8. **Portfolio managers:** Portfolio construction, formulation of investment

strategy, evaluation and regular monitoring of portfolio is an art that requires skill and high degree of expertise. Any person who pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of theclient [whether as a discretionary portfolio manager or otherwise(adviser)] the management or administration of a portfolio of securities or the funds of the client, as the case may be is a portfolio manager.

SECONDARY MARKET/STOCK MARKET

Secondary Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. It is the organized mechanism for purchase and sale of existing securities. Investors in new issue market who do not want to hold the securities up to maturity can approach stock market to sell theirsecurities. Similarly those who want to become an investor in an existing company which do not offer new issue of securities at present, approach stock market for purchasing securities.

The secondary market is also known as the stock market or stock exchange. It is a market for the purchase and sale of existing securities. It helps existing investors to disinvest and fresh investors to enter the market. It also provides liquidity and marketability to existing securities. It also contributes to economic growth by channelizing funds towards the most productive investments through the process of disinvestment and reinvestment. Securities are traded, cleared and settled within the regulatory framework prescribed by SEBI. Advances in information technology have made trading through stock exchanges accessible from anywhere in the country through trading terminals.

Along with the growth of the primary market in the country, the secondary market has also grown significantly during the last ten years.

STOCK EXCHANGE

A stock exchange is an institution which provides a platform for buying and selling of existing securities. As a market, the stock exchange facilitates the exchange of a security (share, debenture etc.) into money and vice versa. Stock exchanges help companies raise finance, provide liquidity and safety of investment to the investors and enhance the credit worthiness of individual companies.

According to Securities Contracts (Regulation) Act 1956, stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying and selling or dealing in securities.

Functions of a Stock Exchange

The efficient functioning of a stock exchange creates a conducive climate for an active and growing primary market for new issues. An active and healthy secondary market in existing securities leads to positive environment among

investors. The following are some of the important functions of a stock exchange.

1. Providing Liquidity and Marketability to Existing Securities:

The basic function of a stock exchange is the creation of a continuous market where securities are bought and sold. It gives investors the chance to disinvest and reinvest. This provides both liquidity and easy marketability to already existing securities in the market.

2. Pricing of Securities:

Share prices on a stock exchange are determined by the forces of demand and supply. A stock exchange is a mechanism of constant valuation through which the prices of securities are determined. Such a valuation provides important instant information to both buyers and sellers in the market.

3. Safety of Transaction:

The membership of a stock exchange is well regulated and its dealings are well defined according to the existing legal framework. This ensures that the investing public gets a safe and fair deal on the market.

4. Contributes to Economic Growth:

A stock exchange is a market in which existing securities are resold or traded. Through this process of disinvestment and reinvestment savings get channelised into their most productive investment avenues. This leads to capital formation and economic growth.

5. Spreading of Equity Cult:

The stock exchange can play a vital role in ensuring wider share ownership by regulating new issues, better trading practices and taking effective steps in educating the public about investments.

6. Providing Scope for Speculation:

The stock exchange provides sufficient scope within the provisions of law for speculative activity in a restricted and controlled manner. It is generally accepted that a certain degree of healthy speculation is necessary to ensure liquidity and price continuity in the stock market.

DIFFERENCE BETWEEN PRIMARY MARKET AND SECONDARY MARKET

The major points of distinction between the two markets are as follows:

(i) ***Participants****:* The participants in the capital market are financial institutions, banks, corporate entities, foreign investors and ordinary retail investors from members of the public. Participation in the money market is by and large undertaken by institutional participants such as the RBI, banks, financial institutions and finance companies. Individual investors although permitted to transact in the secondary money market, do not normally do so.

(ii) ***Instruments****:* The main instruments traded in the capital market are – equity shares, debentures, bonds, preference shares etc. The main instruments traded in the money market are short term debt instruments such as T-bills, trade bills reports, commercial paper and certificates of deposit.

(iii) ***Investment Outlay:*** Investment in the capital market i.e. securities does not necessarily require a huge financial outlay. The value of units of securities is generally low i.e. Rs 10, Rs 100 and so is the case with minimum trading lot of shares which is kept small i.e. 5, 50, 100 or so. This helps individuals with small savings to subscribe to these securities. In the market deals in medium and long term securities such as equity shares and debentures. Money market instruments have a maximum tenure of one year, and may even be issued for a single day.
(v) ***Liquidity:*** Capital market securities are considered liquid investments because they are marketable on the stock exchanges. However, a share may not be actively traded, i.e. it may not easily find a buyer. Money market instruments on the other hand, enjoy a higher degree of liquidity as there is formal arrangement for this. The Discount Finance House of India (DFHI) has been established for the specific objective of providing a ready market for money market instruments.

(vi) ***Safety:*** Capital market instruments are riskier both with respect to returns and principal repayment. Issuing companies may fail to perform as per projections and promoters may defraud investors. But the money market is generally much safer with a minimum risk of default. This is due to the shorter duration of investing and also to financial soundness of the issuers, which primarily are the government, banks and highly rated companies.
(vii) ***Expected return:*** The investment in capital markets generally yield a higher return for investors than the money markets. The possibility of earnings is higher if the securities are held for a longer duration.
First, there is the scope of earning capital gains in equity share.
Second, in the long run, the prosperity of a company is shared by shareholders by way of high dividends and bonus issues.

Distinction between Capital Market and Money Market.

Primary Market	Secondary Market
1. It is the market where securities areissued for the first time	1. It is the market for already issued(Second hand) securities
2. It deals with issuing of securities	2. It deals with buying and selling of securities.
3. Primary market for a security opens for alimited period	3. Secondary market for a security is alwaysopen
4. Company is directly involved intransaction	4. Company is not directly involved. Transactions occur between investors through Stock exchange
5. Primary market is a source of fund to thecompany	5. It is not a direct source of fund to thecompany